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Danube and the Human Face of Development

Introduction

It is difficult to explain persistent differences in development. Especially if these differences are between states or regions that are close to each other or share a common border (Hirschamn 1958, Acemoglu and Johnson 2012). Even more so if geography is such that there is no impediment to trade and communication, and even more difficult if there exists a natural infrastructure that facilitates them. These considerations make it particularly hard to understand the persistent lack of success in developing the large parts of the Danube region. In this essay, some of the possible advantages of the existence of a big river like Danube will be discussed. Then, some differences in the processes of development in the region around that river will be described. Next, some of the problems with the transition and development will be suggested. Finally, some tentative policy conclusions will be drawn.

Natural Infrastructure

In development economics, investments in infrastructure often play the crucial role. Indeed, in many theories of underdevelopment, poor physical or institutional infrastructure is considered as main reason for the persistence of low production and welfare. There are many reasons why the greater distance to markets, to centres of education, and to finance tends to retard growth and maintain one or the other type of development trap (Hoff 2000). In that, geography provides important barriers to development, if a country is landlocked or lacks other cheap infrastructure for transportation (Gallup, Sachs, and Mellinger 1999).

As a consequence, one way to assess the potential for development is to perform a thought experiment: if there were a road to be built that connects a less developed with the more developed region, how much would be the economic growth spurred? As such a road would have to cross borders that would imply that these regions that the road was going to connect would have to integrate their markets and perhaps coordinate their policies (Rosenstein-Rodan 1943, Murphy, Shleifer and Vishny 1989, DeLong and Summers 1991). So, in many cases, the lack of infrastructure investments has been explained by one type or another of erected barriers or,

alternatively, the failure of an existing infrastructure to spur development has been explained by the political, security, or institutional barriers that authorities put up in order not to liberalize trade and finance (Gerschenkron 1977).

Now, in the case of a region around a big river this question of the persistence of differences in development is particularly puzzling. It is as if the nature has invested in this huge infrastructure project, but it has not succeeded in pushing intraregional convergence in development. The river plays similar role to that of a long distance railway or an interregional highway. It presents a huge investment in fixed cost that has been undertaken by nature so that doing business, communication or traveling along the river should be quite cheap as it requires covering the variable costs only. The expectation would be that development will travel fast up or downstream as the case may be.

The river, being a large infrastructure investment by nature, spills around a lot of externalities. It makes quite a number of activities profitable – in agriculture, fishery, energy production, services, manufacturing and all kinds of other activities. Also, it supports social and institutional arrangements that enable increasing returns to be captured. Not accidentally, towns are situated along a river and in the case of Danube, several state and provincial capitals are located along that river. Clearly, towns, especially large ones are centres of trade, finance, and social and political institutions. And are the centres of education, learning, and innovation. So, it would be not unexpected if those urban and centres of economic activities were to spur and sustain development and its diffusion.

Natural infrastructure presents problems also. Given that it is in a way a public good and also the source of significant externalities, good and bad, there is implicitly a tragedy of commons problem. There are clearly ways to deal with those in a communal way, rather than politically (Ostrom 1990). However, there are also advantages to political enclosures, i.e. in setting up borders and centralised taxation systems in order to make use of this natural resource. These borders may prove to be just the type of barriers that stop the diffusion of development. Indeed, once political geography of the Danube region is charted, it becomes clear that the river tends to coordinate activities as well as to provide for political enclosures that break up the flow of trade, finance, innovation, and economic and social development. It also magnifies security problems due to inter-state problems of distribution of power and resources. So, it is a mixed blessing, at least in the political sense: it can carry goods as well as armies. It can also provide

not only for cheap way to travel, but can also magnify the security risks. So, in the same way that a river can spur economic development it can support military operations and thus have significant consequences for the level of inter-state security.

Investments and Borders

The difference between a river and a road, for example, for thinking about development can be seen by considering what could be called an Austrian theory of development. The issue raised by Rosenstein-Rodan in 1943 and then taken up by Hirschman, Gerschenkron and development economics in general (Hoff 2000) is that development requires investments that private interest may fail to support. In a way, all market failures may be present in for instance the decision to invest in development projects – be it infrastructure, education, institutions, or security. One is that if a long distance infrastructure is built, there will be external effects that cannot be captured by the private investors, though it could be by the political authority. There may not be possible to price the external effects and thus recoup the ensuing profits, but there is a possibility to tax these rents away.

So, there is a developmental argument for public investments due to the fact that those substitute for the failure of private interests to support them.

These problems do not arise in the case of natural infrastructure like that of a river. Rather than building a road to connect various settlements, the river provides an incentive to build those along it. Thus, it presents a natural way to make use of positive externalities of cheap means of communication. It also provides for advantages of agglomeration, such as organizing markets and building settlements. There is something of a spontaneous order that can be built up around a favourable geographical infrastructure.

Additional issue is the diffusion of development via the hospitable geography. In particular, there is an important role that cheap transportation plays in the transmission of knowledge and technology. That supports *inter alia* industrialization and urbanization and what used to be called modernization. Low communication and transportation costs open up markets and indeed not only connect them but enlarge the region of their reach. Thus, to the extent that growth and development depend on the extent of the market, as Adam Smith argued, favourable natural infrastructure is a costless vehicle of its expansion. In economic terms, the whole region that gravitates to a big river is potentially one market. That has additional advantages that go

with specialization and decrease of the barriers to enterprise and cooperation. Given that nature has taken care of one big fixed cost, there are reduced barriers to setting up small and medium size enterprises as well as clustering them and making use of advantages of agglomeration, economic and political.

Thus, externalities that better infrastructure creates provide incentives for specialization, clustering, agglomeration, and growth of small and medium size enterprises. This is especially true once industrialization takes hold and urbanization creates the environment for the growth of services.

There are, however, public goods to be supplied – e.g. rule of law, security, and various types of welfare insurance institutions. Those require political institutions and those are in turn territorial, i.e. they are defined by borders. A river can play a role of a natural border, which is often the case. It can also create opportunities for creating political budget centres that can rely on taxes put on the trade and other businesses that a river will support. So, for security and reasons of taxation, rivers can be made to pass through different states and other political budget centres. A large river will tend to support both political integration and disintegration. The political geography can thus be quite different from the economic one, i.e. market and political institutions may have rather uneasy relationship.

The political economy of these relationships between the market and the security role of geography leads to both incentives to integrate economies along a natural infrastructure and also to disintegrate politically in order to take advantage of that very infrastructure. Naturally, this is hardly the only or the most important reason why political communities integrate or disintegrate. Historically and theoretically the primary reasons have had to do with the distribution of power and the incentive to maintain it by amassing resources through taxation. In that sense, however, control of infrastructure and taxation of activities that it supports does have political and economic significance.

Thus, the combination of incentives for investments and for putting up borders that natural infrastructure raises define the political economy of geography as it were.

Persistent Divergence

The presumption would be that if there are natural advantages to trade, to invest, and to innovate, there will be convergence in levels of development and in the long term of the growth

rates. Even if the starting point were one of significant divergence, easy access to markets and cheap diffusion of knowledge should lead to convergent growth within the same natural economic region. It is thus rather surprising when there is not only temporary, but also persistent divergence as is to be found in the Danube region. There is a persistent lower level of development downstream than upstream. Indeed, the region south of Danube and Sava tends to be resistant to development and has rather unstable growth record. Why is it that development does not flow with the river?

The divergence is mostly the reflection of the slow diffusion of industrialization from the west to the east and south (Berend and Ranki 1982). Indeed, increased difference between the more and the less developed countries in the Danube region has created a threshold problem, a kind of a development trap – it is hard for less developed countries and regions to master the necessary resources to invest in development in order to engineer a take-off and a sustained catch-up growth. Indeed, in a number of cases, there is an emergence of an underdevelopment trap, where a bad equilibrium of underdevelopment has set in.

This uneven development was aggravated by the political divisions, which have been a constant characteristic in the last two centuries or so (Berend and Ranki 1974). Nationalism did not really help and socialism was not a very effective strategy for development, even though it was designed to a very large extent precisely for that. In any case, institutional and technological progress tended not to diffuse all that smoothly throughout Europe. In particular, it mostly aggravated the divergence between the more developed and less developed countries across Europe. This is clearly a complex story and need not be summarised here. There is however no doubt that institutional and political differences and conflicts played a significant role and the connecting and welcoming geography was of no help in this process of development.

Thus, a persistent divergence can be observed and indeed an increasing one at that with the last stretch of socialist protectionism being especially damaging.

Development and Transition

With transition, the prospects for development were certainly improved. The political barriers were lowered or even disappeared and institutional differentiation started to decrease - with the exception of the Balkans. There, for the most part, transition started around the year 2000. In any case, liberalisation proceeded after favourable political changes, trade increased

significantly, and investment flows have been substantial. For the most part, since 1995 or 2000, there was some catch-up growth at least until the beginning of the crisis in 2008. This catch-op process was significantly unbalanced in Southeast Europe in particular. This has led to the crisis have rather severe consequences for the development in the countries on the downstream of Danube river.

The main imbalance that developed during the transition had been on the trade and current accounts of the transition economies. Those were most prominent in countries that had failed to build up capacities for exports, i.e. have been producing small share of tradable goods. This certainly applies to most countries in the Balkans, which means those that are to the south of rivers Danube and Sava. Countries like Hungary, the Czech Republic and Slovakia have had to deal with significant negative effects due to the crisis, but only the former was more severely hit than typical Central or Western European countries; and not for the reason of external imbalances. Still, it can be argued that the Danube transition countries have suffered more from the crisis than most any other region in the world. In fact, as to underline the divergence, the upstream Danube countries, e.g. Austria and Germany, have done better than most other developed countries in Europe. So, the widening divergence has been a feature of this crisis episode also.

In Table 1, the development of the GDP per capita since 1991 can be found. These are comparisons of values at purchasing power parities (PPP), which means that they compare the actual difference in what income can buy. It is clear that there have been significant advances in most transition countries in the last twenty or so years. These improvements are expected to continue in the next few years and hopefully will lead to the close of the income gap that now exists. However, the improvement is much less present in the southern countries of the Danube region. They are still as a rule at around or below 50 per cent of the European Union average. Also, the expected improvements in the near future tend to be rather smaller than in most other Danube countries. So, the long term divergence between more developed and less developed countries in the Danube basis is expected to persist.

Table 1

GDP per capita at current PPPs (EUR), from 2011 at constant PPPs and population

	1991	1995	2000	2005	2007	2008	2009	2010	2011	2012	2013	2014
Bulgaria	4400	4600	5400	8200	10000	10900	10300	10700	11300	11300	11400	11700
Cyprus	10600	12800	16700	20300	23100	24700	23500	24200	24600	24400	24500	25500
Czech Republic	8800	11200	13500	17800	20600	20200	19300	19400	20100	20200	20700	21400
Estonia	5500	5300	8600	13900	17500	17300	14900	15700	17700	18000	18700	19600
Hungary	6800	7500	10300	14200	15400	16000	15200	15800	16300	16100	16400	16900
Latvia	6500	4600	6900	10800	13900	14100	12000	12500	14500	14800	15300	15800
Lithuania	7100	5200	7500	11900	14800	15400	12800	14000	16200	16500	17100	17800
Malta	9500	12700	16200	17600	19000	19700	19300	20100	20700	20900	21300	22200
Poland	4500	6200	9100	11500	13600	14100	14300	15300	16200	16700	17400	18100
Romania	4000	4800	5000	7900	10400	11700	11000	11400	13300	13400	13800	14200
Slovakia	5800	7000	9600	13500	16900	18100	17000	17900	18900	19200	19800	20600
Slovenia	8500	10900	15300	19700	22100	22700	20500	20700	21000	20800	21100	21400
NMS-12	5400	6500	8600	11800	14100	14700	14200	14900	16000	16200	16700	17300
Croatia	7000	6700	9500	12800	15200	15800	14600	14500	14800	14600	14700	15000
Macedonia	4300	4000	5100	6600	7700	8400	8500	8900	9500	9700	10000	10400
Montenegro	.	.	5600	6900	10000	10700	9700	10100	10500	10600	10800	11100
Turkey	3800	4400	8000	9500	11300	11700	10900	11900	13000	13400	14100	14800
Albania	1400	2000	3500	5000	5800	6400	6500	6600	6800	6900	7100	7300
Bosnia & Herzeg.	.	.	3900	5200	6300	6700	6400	6600	6800	6800	6900	7000
Serbia	.	.	5000	7100	8200	9000	8400	8400	8700	8700	8800	9000
Kazakhstan	.	3100	4200	7300	8800	8900	8500	9300	10000	10600	11100	11700
Russia	7600	5300	6600	10000	12500	13100	11900	12600	13400	14000	14600	15200
Ukraine	4700	2600	2800	4700	5800	6000	5100	5400	5800	6000	6300	6600
Austria	18700	19700	25100	28200	30900	31100	29300	30800	32100	32400	33000	33700
Germany	18200	18900	22400	26000	28900	29000	27200	28800	30100	30300	30800	31400
Greece	12200	12300	16000	20400	22500	23100	22100	21900	20700	19700	19700	20100
Ireland	12400	15200	25100	32600	36900	33300	30000	31100	31700	31900	32500	33200
Italy	16800	17800	22400	23700	26000	26100	24300	24600	24900	24600	24700	25200
Portugal	10600	11300	15500	17900	19600	19500	18800	19600	19500	18900	19000	19400
Spain	12800	13400	18500	22900	26200	25900	24200	24500	25000	24600	24500	25000
USA	21400	23300	30600	35700	37700	36700	34200	36100	37000	37700	38500	39300
EU-27 average	13700	14700	19000	22500	25000	25000	23500	24400	25200	25200	25500	26100

European Union (27) average = 100

	1991	1995	2000	2005	2007	2008	2009	2010	2011	2012	2013	2014
Bulgaria	32	31	28	36	40	44	44	44	45	45	45	45
Cyprus	77	87	88	90	92	99	100	99	98	97	96	98
Czech Republic	64	76	71	79	82	81	82	80	80	80	81	82
Estonia	40	36	45	62	70	69	63	64	70	71	73	75
Hungary	50	51	54	63	62	64	65	65	65	64	64	65
Latvia	47	31	36	48	56	56	51	51	58	59	60	61
Lithuania	52	35	39	53	59	62	54	57	64	65	67	68
Malta	69	86	85	78	76	79	82	82	82	83	84	85
Poland	33	42	48	51	54	56	61	63	64	66	68	69
Romania	29	33	26	35	42	47	47	47	53	53	54	54
Slovakia	42	48	51	60	68	72	72	73	75	76	78	79
Slovenia	62	74	81	88	88	91	87	85	83	83	83	82
NMS-12	39	44	45	52	56	59	60	61	63	64	65	66
Croatia	51	46	50	57	61	63	62	59	59	58	58	57

Macedonia	31	27	27	29	31	34	36	36	38	38	39	40
Montenegro	.	.	29	31	40	43	41	41	42	42	42	43
Turkey	28	30	42	42	45	47	46	49	52	53	55	57
Albania	10	14	18	22	23	26	28	27	27	27	28	28
Bosnia & Herzeg.	.	.	21	23	25	27	27	27	27	27	27	27
Serbia	.	.	26	32	33	36	36	34	35	35	35	34
Kazakhstan	.	21	22	32	35	36	36	38	40	42	44	45
Russia	55	36	35	44	50	52	51	52	53	56	57	58
Ukraine	34	18	15	21	23	24	22	22	23	24	25	25
Austria	136	134	132	125	124	124	125	126	127	129	129	129
Germany	133	129	118	116	116	116	116	118	119	120	121	120
Greece	89	84	84	91	90	92	94	90	82	78	77	77
Ireland	91	103	132	145	148	133	128	127	126	127	127	127
Italy	123	121	118	105	104	104	103	101	99	98	97	97
Portugal	77	77	82	80	78	78	80	80	77	75	75	74
Spain	93	91	97	102	105	104	103	100	99	98	96	96
USA	156	159	161	159	151	147	146	148	147	150	151	151
EU-27 average	100	100	100	100	100	100	100	100	100	100	100	100

Note: From 2011 data may be affected by new population census data.

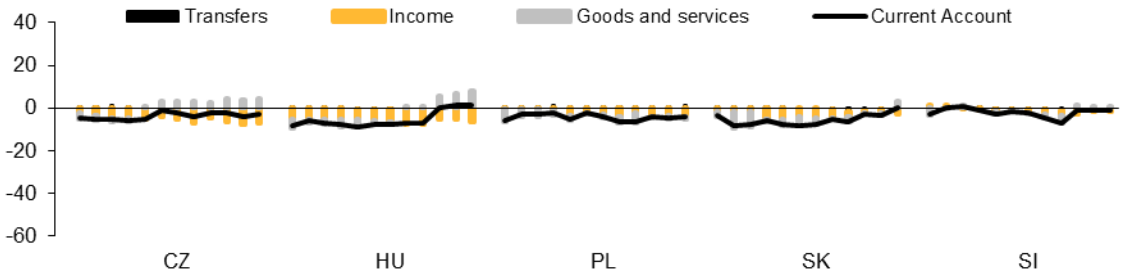
Sources: wiiw Database incorporating national and Eurostat statistics, wiiw estimates.

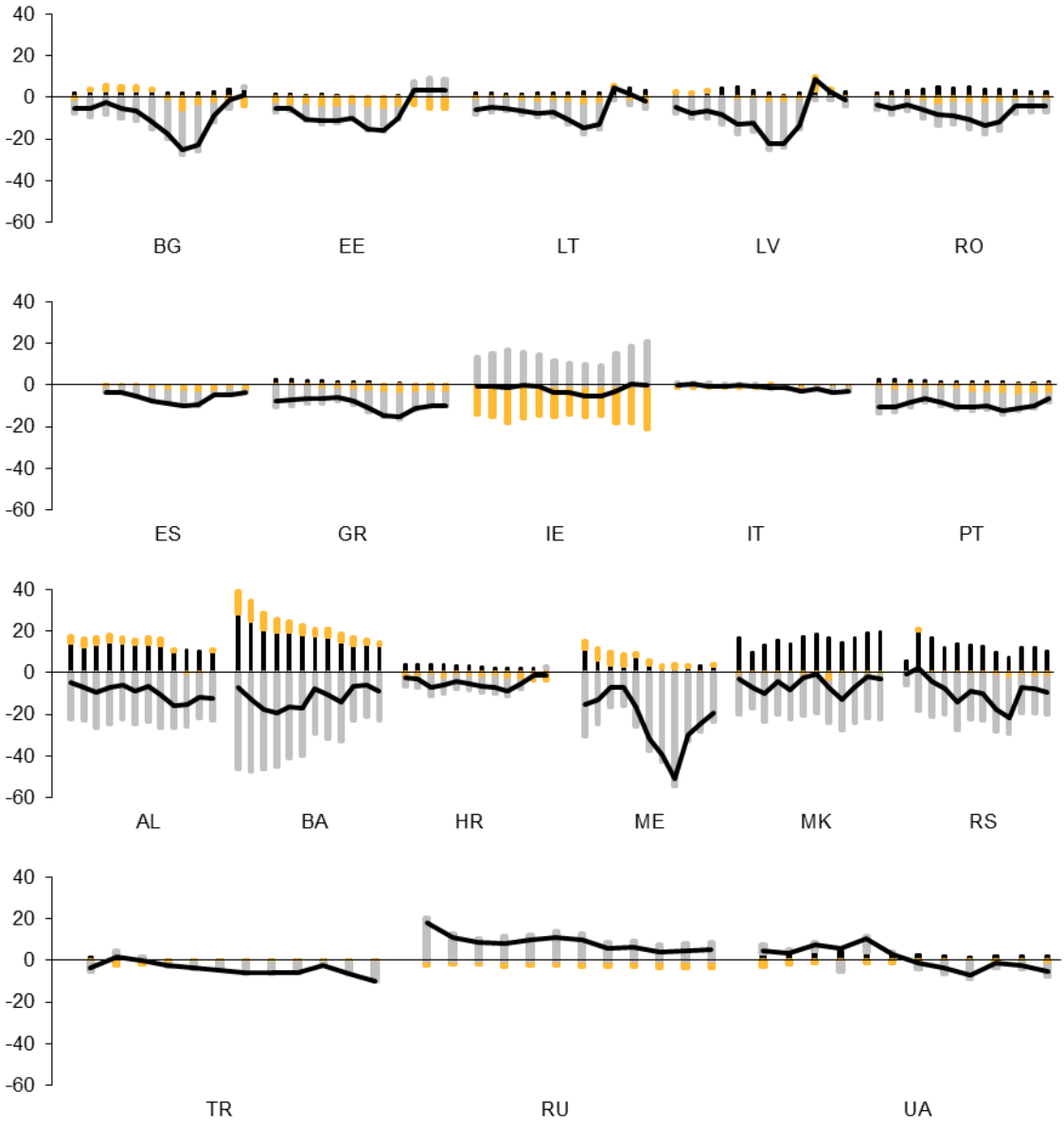
Figure 1 shows the already mentioned external imbalances. As can be seen, there is a significant difference between the same groups of countries. On one side are the more industrialized countries, among which are also countries in transition that have seen significant increases in industrial production after the collapse of communism, while on the other side are countries that have experienced persistent trade deficits and often accompanied deficits in their current accounts. Some compensate large trade deficits with surpluses in the trade of services, e.g. tourism, while the others rely on large inflows of remittances, which are the income transfers from people living abroad.

Figure 1

Composition of the current account of the balance of payments, 2000-2011

in % of GDP





Source: wiiw Database incorporating national and Eurostat statistics.

So, what can be read out of these data on external balances is that goods and investments are flowing from more developed Danube countries to those less developed, while people and services are flowing from less developed to more developed Danube regions. As a consequence, there is a stock of debt that is piling up in the less developed regions while a stock of immigrants keeps increasing in the more developed regions. These intra-regional imbalances in trade, finance and migration are also characteristic within particular countries. It is probably true along the whole length of the Danube River that urban and rural settlements along the river are doing

better than the more distant regions. Thus, there is regional divergence that the natural infrastructure supports and perhaps accentuates. This is of course especially true for the capital cities, of which quite a number are located on the Danube. Generally, the process of development, transitional or the more usual one enhances the role of the capital cities, for fiscal and financial reasons. But also there are advantages that ports provide for transportation and for clustering and agglomeration of business activities.

The key policy decision that a transition country needs to make is whether it will put in place invectives for industrialisation or for the inflow of investments that mainly develops services and domestic consumption. In the latter case, the development process will be unbalanced, with significantly faster increase of imports than exports, and will prove unstable and can potentially lead to return to one or other type of backwardness.

Gerschenkron used to argue (in 1977) that backward countries need to rely more on the state as an agency of development than on entrepreneurs or banks and other financial institutions. Given that infrastructure investments are the key to development, it may be difficult to interest private agents to invest in those while the state may have the interest and the resources to do that. In the case of the economic activities along a large and long stretching river, that may not be necessary. Private interest to invest in activities that make use of cheap transportation and easy access to the markets may be enough. Of course, the argument still applies to infrastructure investments that complement or substitute that of the river and certainly those that connect far away regions with the main centres of industry and commerce.

The process of transition, however, in many countries led to macroeconomic weaknesses and also to policies that did not support the development of modern, industrial private sector. Indeed, transition stimulated deindustrialisation and speedy build-up of both private and in the crisis of public debts. This process was much faster than the one of the development of capacity to produce goods and services that would justify these fast rising debts. As a consequence, the financial crisis hit the less developed Danube countries especially hard.

This is nowhere more visible than in the labour market. Figure 2 gives the levels of employment and their development in the last five or so years. It is obvious that the levels are low and decreasing in quite a number of countries. In addition, unemployment rates are high especially among the young. This is only aggravated during the crisis, but is a long lasting

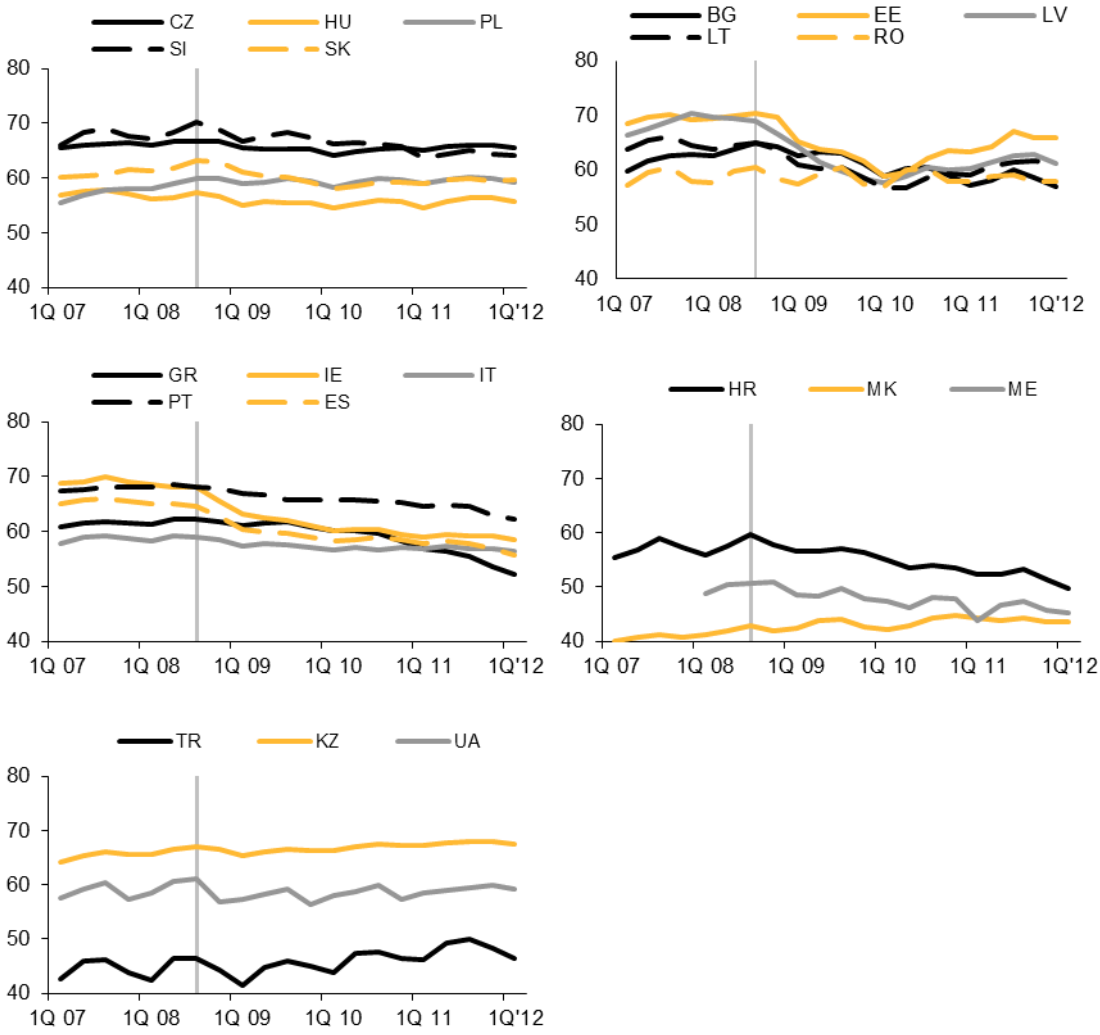
phenomenon even though most of the countries were under communist rule and nominally had full or very high level of employment.

So, he key cost of transition and of the chosen strategy of development is the permanently depressed labour market. Indeed, the effects of the crisis, which are not yet exhausted, have sever when it comes to employment and unemployment.

Figure 2

Employment rates total

employed in % of working age population (15-64)



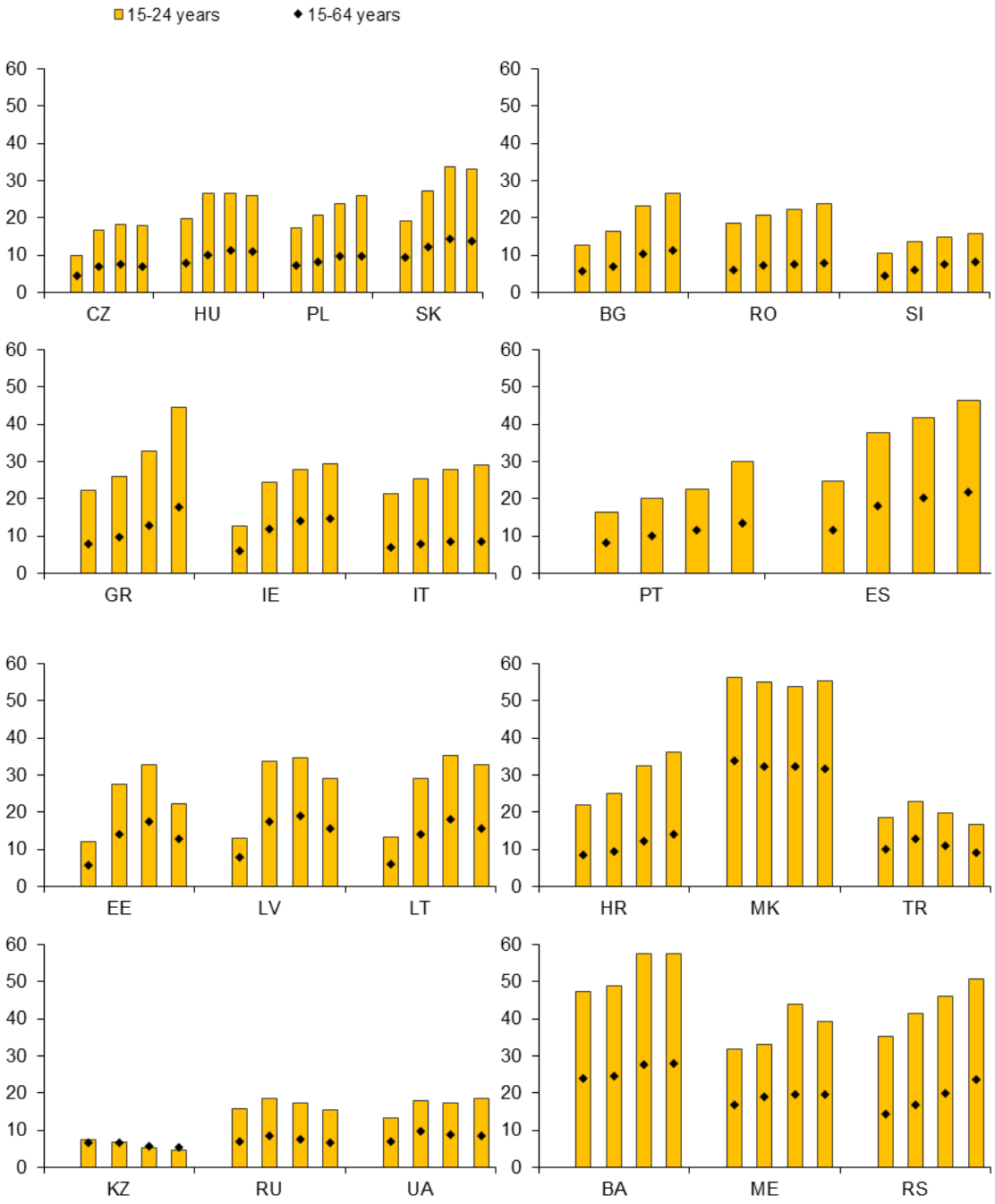
Working age population in Kazakhstan 15+, in Ukraine 15-70.

Source: Eurostat, national statistics.

Figure 3

Total and youth unemployment rates

2008, 2009, 2010, 2011



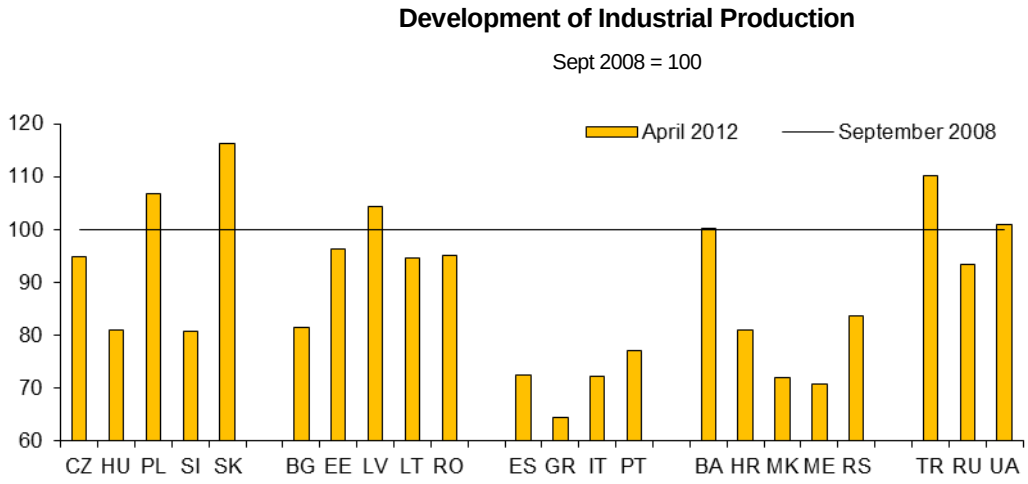
Remark: Unemployment rate in KZ refers to 15+, in Russia 15-72.

Source: Eurostat, national statistics.

Finally, there has been a strong effect on industrial production in this crisis. As already mentioned, the process of transition has led to deindustrialisation, in some cases quite a strong

one. However, the countries that have had particular weakness in industrial production have also suffered significant additional decline in manufacturing production in particular. This can be read out from Figure 4. Again, there is an obvious divergence between the more developed and less developed Danube countries. Of course, the phenomenon is characteristic of Europe as a whole as the Figure 4 illustrates.

Figure 4



Source: wiiw Database incorporating national and Eurostat statistics.

Looking longer term, there is clear difference in the process of industrialisation and the recovery from periods of deindustrialisation across different countries in the Danube region. This is especially clear when it comes to the successor states of Yugoslavia. Most of them, with the exception of Slovenia, have still to make up for the loss suffered after the breakup of the common state. And as can be seen in Figure 4, the crisis has been an additional set back. Overall, costs to GDP in comparison to the hypothetical one if the regional differences had not increased can be found in Figure 5.

The divergence between the late 1980s and 2010 in terms of actual production is quite large. This obviously has had significant consequences for welfare and also for all the other indicators of social and human development. This divergence is not unlike some others that have happened in previous unsuccessful attempts at faster development in especially Balkan economies in the Danube region. Though Central European developments were not necessarily different in further away history, it has proved to do better this time around, in large part due to

speed up in industrialisation support with the market and political integration within the European Union.

Figure 5

Per capita GDP, 2010, actual and hypothetical

		GDP p. c. (Slovenia = 100)		GDP p.c. (Euro)		GDP p.c. 2010 (Euro)	Average GDP	GDP pc PPP
	1987	2010	2010	2010	2010		1990-2010	
		actual	hypothetical	Actual	hypothetical	actual - hypothetical	growth rate	
Slovenia	100	100	100	17860	17860	0	2.3	100
Bosnia and Herzegovina	34	18.4	30.3	3283	6126	-2843	-1	30,3
Croatia	64	57.5	70.6	10275	11430	-1155	0.5	70,6
Macedonia	33	18.5	39.8	3314	5947	-2633	0.7	39,8
Montenegro	37	26.6	46	4747	6590	-1843	-0.8	46
Serbia	54	22.4	42.2	3994	9734	-5740	-1	42,2

Note: PPP is purchasing power parity; p.c. per capita.
Source: Own calculations.

Knowledge and institutions

Difference in development is reflected in the difference in technology, which is usually and indicator of the accumulation of knowledge in different countries or regions. In other words, the quality of the human capital is the key to development and should explain much of the divergence in levels of development. In the case of the less developed countries in the Danube region that is not all that straightforward. The reason is that the spread of knowledge is much easier now than it used to be in the past. However, the decline in industrial production and in the higher level services have led to the overall endowment of knowledge and human capital being in many cases above the amount and composition of GDP produced.

This is not difficult to see. If industrial production declines by 50 percent, it stands to reason that the number of industrial workers and high skill employees will that a country has will be higher than the one needed at the available productivity to produce the lower supply of industrial goods. Also, it is to be expected that there will be overcapacity at the universities and that there will be significant outward migration of skilled people. This is clearly the case in most less developed countries in the Balkans and in the Danube region.

For instance, one finds that most of these countries export goods of lower technological content and produced mostly with high low skilled labour. If one were to determine the level of

human capital development in the region by looking at the structure of their exports, one would have to conclude that these countries lack in high skilled people. However, if one were to check the actual number of people with high and secondary level education, one would find that they are endowed with higher human capital than the amount of GDP that the country produces would require.

This suggests significant misallocation of human resources. Even if the effect of outward migration is taken into account and even though demand for skills tends to be much larger than for unskilled labour, it still is the case that the productivity is too low and in that sense the use made of available skills inefficient. Of course, over time, there is gradual loss of skill and capacity, that is deskilling is going on. In general, it can be argued that in the last couple of decades, and possibly earlier, the level of human capital has been adjusting to the dismal economic performance, rather than the other way around.

This fact points to another source of slow development or even regression – which is the institutions: economic, political, and social. They exhibit lack of entrepreneurship, legitimacy, and responsiveness.

In the case of economic institutions, one indicator of how efficient and supportive are those is evolution of the firms. If it is the case that the majority of the firms are very small and do not tend to increase, there is some deficiency in the entrepreneurial ability or in the circumstances in which it can be developed. In developing countries, small firm size is in part the effect of the lack of access to credit or to public services and in part a device that protects the owner from adverse competition. If firms are small, there is no advantage to their agglomeration because they mostly operate with constant return to scale technologies. Also, if growth of the firm increases the costs of administration and of tax burden, there is a disincentive to invest in agglomeration. Similarly, lack of access to finance leads to the use of alternative sources for investment, which tend to be rather expensive and thus limit the ability of the firm to grow. The latter problem also stands in the way of clustering because of institutional and financial resources that it needs. So, there is a overabundance of small or micro firms, in some cases much of the economy consists of firms with one person employed.

When it comes to political institutions, their lack of responsiveness can be illustrated in a number of ways. The indicators of corruption and regulatory capture are quite sobering. In a country in which corruption is widespread and in fact accepted as a way of doing thing by the

population, it is quite difficult to have political decision-making process that delivers responsive governments. Thus, most governments are susceptible to rent-seeking and political discretion. In general, these governments dispose of significant amounts of resources, with public expenditure being above 40 percent of GDP as a rule. However, the efficiency of the spending as well as that of taxation is highly questionable. So, these are weak state not because they do not collect taxes and do not spend them, but because of the prevalent biases in their fiscal policies.

The most striking social fact is that the level of employment tends to be rather low, and the rate of unemployment tends to be quite high – and persistently. It is a special characteristic of these societies that they show low level of social pressure and social cohesion. Though indicators on the micro level – families and local communities – give an impression of tight social structure and thus high social capital, in fact societies are rather disorganised and there is no effective way to put social and especially employment concerns to the consideration of the public. In general, people are used to looking at the world market when considering employment rather than trying to develop capacities to influence the employment and investment policies of their respective governments.

These institutional deficiencies tend to explain the misallocation of knowledge, entrepreneurship, and perpetuate sluggish and volatile development.

Polity issues

Openness is one factor that contributes to development (Sachs and Warner 1995). This claim has been challenged in the context of the criticism of globalisation and the policies of free trade and investments. However, in Europe, it seems to be the case that catch-up growth is positively associated with openness. In that, countries in the Danube region differ significantly, with those less developed being as a rule less open. In terms of their exports to GDP ratios, and in particular if exports of goods are looked at only, these are rather closed economies. They tend to import a lot, but those imports have not led to increased export capacities, at least not all that quickly.

One reason is in slow process of integration in world and European trade. A number of countries are not members of the World Trade Organisation and still though shrinking part of the Balkans is not integrated with the EU. As argued here, the advantages of natural infrastructure for trade and investment are going to be impeded if there are political barriers to free flow of

goods, services, people, and capital. With that in mind, integration is certainly the key policy instrument of development of the Danube region.

Another issue is the institutional development. If institutions are not inclusive (to borrow the Acemoglu and Johnson 2012 term), the advantages of external effects that are connected with natural infrastructure, will not be there to be made use of. This suggests the need for institutional modernisation, which is also connected with European integration.

When it comes to investments, industrial development is the key. As argued by Radrik (2012), industrial development is the one source of persistent convergence, which means of development that closes the gap between the les and more developed countries.

Finally, the existence of externalities suggests that clusters and other activities with increasing returns of scale could be supported. That of course means that significant investments in human capital are needed as those are specifically characterised with higher returns. When it comes to the Danube region, urbanisation is clearly supportive of these developments as is the large gains that could be made in the areas of energy and agriculture and agro industries.

Given that the region consists of highly developed upstream and less developed downstream, with human capital flowing upstream and consumer goods downstream, the aim would be to reverse these streams.

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