

SCENARIOS OF LOCAL GOVERNMENT INTERVENTION IN CASE OF MARKET FAILURE. THE CASE OF LATVIA

Cite as:

1. Valtenbergs, V., Brīgsa, S., Līviņa, A., Vilka, I. (2017) Scenarios of Local Government Intervention in Case of Market Failure: The Case of Latvia. New Challenges of Economic and Business Development – 2017: Digital Economy,” Rīga, 18-20 May, 2017. Faculty of Business, Management and Economics, University of Latvia, pp. 655-666. ISBN 978-9934-18-242-6. DOI: to be assigned. Available: http://www.bvef.lu.lv/fileadmin/user_upload/lu_portal/projekti/evf_conf2017/Proceedings_of_Reports.pdf.

Abstract

Local and regional governments have always been important players in economic development. They create jobs as employers and as purchasers of inputs from the private sector. Local governments are often responsible for regulating local economic activities and providing the social and physical infrastructure which complements private economic activities. In liberal market regimes the opinion is generally divided on whether municipalities who intervene in market in developing their own government enterprises, promote local economic development or, in contrary, create an additional competition in private sector. The aim of the article is to outline possible scenarios for local government intervention in order to correct market failures at the local level. The methodology is based on the literature review about local economic development, and the concept of market failure. This allows to distinguish between a variety of approaches to local economic development policies, such as the business-oriented approach, or the poverty reduction-oriented approach, such as the reduction of unemployment. Additionally, an e-mail survey of Latvian local governments conducted in May of 2016 about their views on local economic intervention provided an additional insight in describing the scenario.

The assessment of economic role of local and regional governments shows that in nearly all EU countries local and regional authorities are allowed to engage in economic activity. In some cases, there are restrictions or safeguards such as prohibitions on exercising a monopoly, ceilings (whether absolute or percentage) on equity participation, or a requirement that activities be reconcilable with the local authority's interests. Theoretical investigation of the concept of market failure as well as the results of the survey show that local government's interpretation of the market failure in practice largely depends on its strategic orientation and economic capabilities. Before the implementation of the particular method of correcting the market failure, the local government need to be aware of whether the free market mechanism can solve the specific problems. In cases where the provision of services for the private market players is a high risk, risk mitigation strategies or alternative economic development models have to be considered.

Key words: economic intervention, local governments, market failure, scenarios

JEL code: H70 - State and Local Government

Introduction

The discussion about economic intervention by local governments has gained a momentum in response to post-austerity measures which have significantly limited the financing available for local investments, and motivated local

governments to explore other streams of revenue. The decisions about the nature and the extent of economic intervention can take place in complex environment involving different legal, value based and strategic considerations, and therefore can be rather contentious. In *market-oriented approach* the priority for performing economic activities is assigned to private companies. It is assumed that the benefits of private incentive driven economic growth would “trickle down” and benefit the population, while the economic role of the local and regional authorities is seen as secondary (Richardson, 1973). In the *interventionist approach* it is expected that market outcomes will produce many adverse effects and therefore some sort of government intervention (Lamothe & Lamothe, 2016). These interventions can take shape in many forms and lead to diverse actions. Defensive actions can be aimed at preventing local business closures. They can also be aimed at promoting *promoting structural changes* and key sectors towards which investment, training and other measures will be directed. Finally, some *specialty targeted measures* can be undertaken, such as training and employment initiatives in favour of economically disadvantaged groups (Council of Europe CoRe, 2015).

Local and regional governments have always played an important role in local economic development. Local governments are responsible for managing day to day activities in Europe’s fast growing cities, which provide more jobs and services, more high-growth firms, higher employment rates, better accessibility and connectivity that are all factors for boosting the overall productivity of national economy. For EU as a whole, local governments manage about 43% of total public investment. Local governments manage more than a half of total public investment Bulgaria, Italy, Romania Finland, France, The Netherlands and Sweden. In Malta, Cyprus and Greece local government’s share is the lowest accounting for 20% and lower (EC, UN Habitat, 2016: 195).

After the financial and economic recession of 2008-09 local governments were the first to encounter the social costs of economic problems. Although local governments are often positioned on the frontline of combating economic and social problems, and are directly involved in distributing public aid, central government transfers to local governments in EU countries have declined since 2010 (EC, UN Habitat, 2016: 194). This has strongly affected the local authorities especially those which are more dependent on central government transfers – e.g. Hungary, the Netherlands and the UK. From 1995-2015 local government expenditures relative to total government expenditure in the EU decreased from 24,5% in 2008 to 23,5% in 2015. So did local government expenditures relative to the GDP from 13% (2010) to 11% (2015) reaching the level of 1995 (EC, UN Habitat, 2016: 191). Local investment in EU countries also fell from it’s peak in 2009 when it was 1,6% of GDP to just 1,3% in 2014. These reductions are explained by growing expenditure for social benefits which left less space for investments. According to OECD-CoR survey 39% of local authorities reported a reduction or stagnation in borrowing for investments since 2010 and only 12% stated a increase (OECD-CoR, 2015). In order to increase the efficiency of administration, many countries began or continued to merge the municipalities. In the early 1990s, Europe had a total of 97,500 municipalities, but by 2014 only about 92,000 (EC, UN Habitat, 2016: 191-3).

The need for economic intervention by local governments is facilitated by several factors, like the need for *inward investment*, as well as *social* factors, such as unemployment, crime and unequal distribution of resources. In addition, many municipalities are looking for the opportunities to *create technological and scientific momentum* necessary for economic development by creating enterprises (Putnins, 2015). Intervention can also be driven by simple motivation of *profit seeking*, thus earning more with services that are profitable and can be provided effectively by local government enterprises. These services include public transport, energy, water supply, sewage treatment, household refuse collection and treatment, site development for economic and business enterprises.

Much has been written about government actions to support business and entrepreneurship, however the literature on the role of local governments has been more limited (OECD, 2004). In many countries market regulation guidelines suggest that before intervening public authority should make a thorough economic appraisal of the intervention backed up by a technical feasibility study covering all aspects of the operation, and the economic appraisal which then can be

weighted against the social appraisal (Council of Europe CoRe, 2015). Based on the study of Latvian local governments, this paper seeks to provide more insight into local government market interventions. This is done by developing a scenario of appraisal for local government economic interventions. The scenario is intended to provide the guidance of arriving at transparent and effective decisions for local governments.

Local Government Decisions Over Market Intervention

In countries of the European Union (EU) local and regional governments are allowed to engage in economic activity. In some cases, there are restrictions regarding monopoly or equity participation, or a requirement that activities to be reconcilable with local authority's interests. Generally, local authorities are required by national laws to stay within their field of responsibility and their economic activities must be compatible with their basic function (Council of Europe CoRe, 2015).

Decisions over desired forms of intervention are typically affected by:

1. *legal constitutional and institutional framework*, placing limits on the extent and nature of economic activities undertaken by local and regional governments in particular country;
2. *various stakeholder groups* and their specific interest that are usually motivated by some form of profit seeking and are looking to change the rules of the market;
3. *strategic outlook and orientation of local government* which can be:
 - a. *business-oriented*, focusing more on business infrastructure development (pro-business)
 - b. *poverty reduction-oriented* focusing on as the reduction of unemployment (pro-poor) (Hague et. al, 2011)

For many local and regional governments development approaches have become much more comprehensive and diversified. Many local governments no longer limit their support to large scale manufacturing industries and agriculture. Instead they take comprehensive approach and direct their support to business related areas, such as education, housing, personal social services. To address this growing array of approaches we refer to Hague et. al (2011) who distinguishes between the situations in which free market solutions provide optimal outcomes in value and equity, and the situation where free market cannot provide optimal solutions (see, Fig 2). Market solutions fail to provide optimal results because of the lack of resources (e.g. limited human resources) or incentives (e.g. no private incentive to invest). In addition to market performance we also emphasize the dimension of economic competitiveness vs. sustainability. Some local governments choose not to opt for creation of jobs at any price. Instead they aim to attract high quality jobs, or direct their investments towards preserving the environment (e.g. limiting traffic congestions, and pollution), maintaining historical heritage, and increasing the quality of life. ("Smart planning" approach).

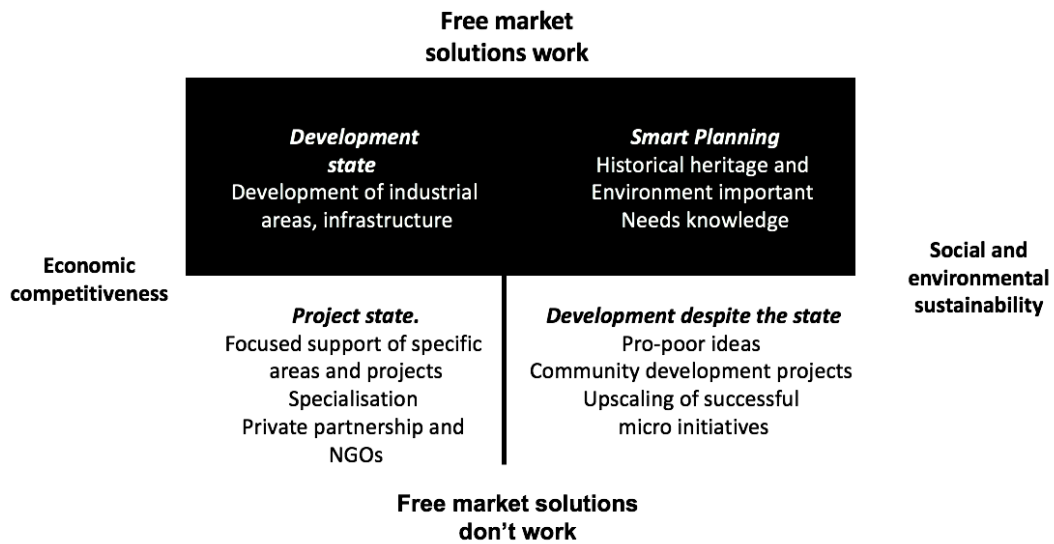


Fig. 1. Local Development Strategies of Local and Regional Governments
Source: adapted from: Hague et.al. (2011)

In the “Development State” approach, the market, in general, is capable of providing the benefits for the population. In the “Smart planning” approach rapid economic development is not necessarily sustainable, therefore local government purposefully tries to restructure its economy by strategically attracting the needed investment, knowledge and human resources. Similar approach is taken in the “Project state” approach where local government decides to focus it’s efforts on developing specific area, location, project or sector. Since “Project state” have the tendency to suffer from market failures, local governments have incentive to adopt so called “contract culture” which aims at combining external financial resources (private sector or development funds) and local financing which is provided directly or by in kind contributions. “Development despite the state” approach is taken by local governments who see themselves deprived of opportunities of market-lead development and are therefore more concerned with nurturing social and environmental capital. By adopting this approach, local government can decide to play pro-active role in seizing the opportunity of small scale community development. This can also be attributed to alternative development approaches (Buch-Hansen, Lauridsen, 2012). In order to ensure the critical mass needed for territorial development, local governments can directly participate in projects that replicate and/or upscale successful micro-level initiatives.

Economic instruments available to local and regional governments have been widely discussed (OECD, 2004; OECD, 2003; OECD). Generally, these instruments fall into three groups – direct aid, indirect aid and general aid. Similar structure of economic instruments in case of Latvian local governments has been recently discussed by Grizāns (2015). Table 1 outlines each group of instruments.

Table 1

Economic Instruments Available to Local and Regional Governments in Europe

<p><i>Direct aid</i></p> <ul style="list-style-type: none"> • Subsidies and other payments • Loans and reduced interest rates • Sale or let of land on advantageous terms • Leases with purchase option • Minority share ownership in private business <p><i>Indirect aid</i></p> <ul style="list-style-type: none"> • Provision and equipment of industrial estates and trading estates
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- Surveys, consultancy services, management advice and advice on legal and tax matters
- Training/retraining facilities
- Help with provision of worker amenities (worker transport, canteen facilities)
- Aid to maintenance of public services necessary to local community
- Temporary provision of premises or common facilities as start-up aid to the young entrepreneur
- Aid to partnerships between schools and industry

General aid

- Trade fairs/exhibitions
- Development of high-technology centres
- Local research centres, network cooperation with other centres
- Aid to ownership transfer/purchase of an enterprise
- Quality of life services (public services adapted to firms' needs, improvement of the natural environment s
- The local authority's image

Source: based on: Council of Europe CoRe, 2015

Before taking an action of economic intervention local government need to establish whether the free market mechanism can be applied to solve the specific problems (Rapaczynski, 1996). In cases where the provision of services by the private market players is putting the population at high risk, a variety of risk mitigation strategies or alternative development models can be considered (Buch-Hansen, Lauridsen, 2012).

There is no universal understanding about what constitutes a market failure in local economic development. Few recent studies have addressed related areas. Hefetz and Warner (2007) have looked at the privatisation in the cities of United States. Putnins (2015) has looked on the role of state and local government owned enterprises. The study by Deloitte (2013) has examined the impact of Latvian local government enterprises in providing services.

The market failure definition used by OECD is widely used in academic literature. According to this definition market failure is a general term to describe situations in which market outcomes are not Pareto efficient. In these situations, government interventions usually occur (Khemani, Shapiro, 1993).

The literature distinguishes between three main causes of market failure:

1. *Inefficient pricing mechanism* caused the market failure, as there may be cases where a particular product or service on the market is either produced in insufficiently or too large quantities.
2. *Incomplete information* may lead to a situation where small businesses are unable to take full advantage of the work, as well as the opportunities offered by the financial markets, or health care. In this case service recipient is discriminated against for a given amount of service received.
3. *Equivocal ownership*. In this case market participants do not take care of the reduction of transaction costs (does not internalize costs). Therefore, the market is being distorted and created by external effects (e.g, inefficient heating systems or sewer) (Boettke & Coyne, 2011; FSA, 2006; Horvath, 2004).

These causes of market failure may lead to one or the combination of several market failure situations, such as:

1. *Market with no or limited competition* with dominance of monopolies or lack of certain incentives, such as high interest credit resources
2. *Unfavorable externalities*. Such externalities are typically caused by external factors outside the municipality, for example the neighboring effect of urban areas in causing the rapid outflow of labor. However, externalities can also be internally caused. In this instance, for example, *intensive competition* between public passenger

service providers can actually decrease the quality and availability of transportation service due to conflicting schedules.

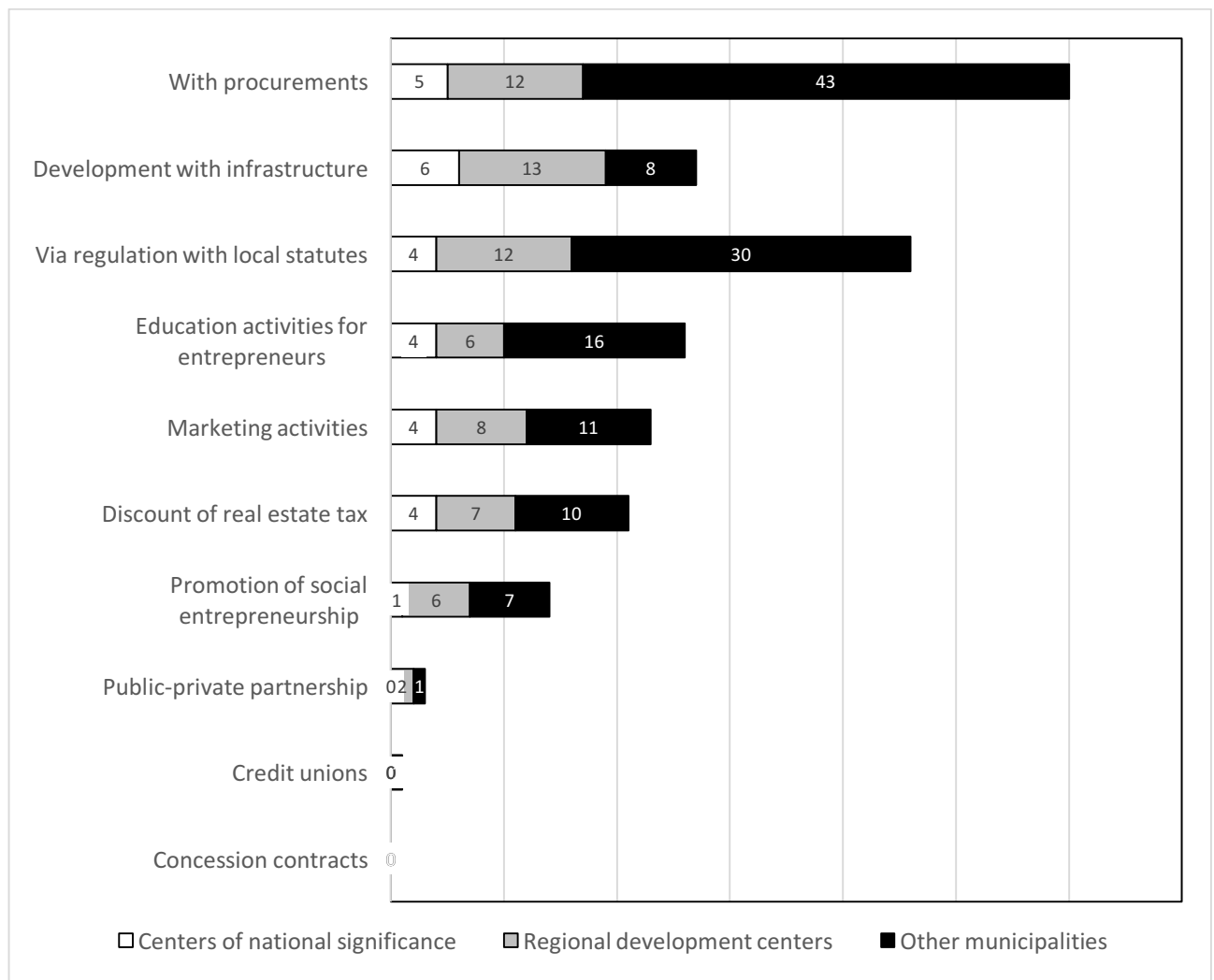
3. *Absence of certain public goods*, such as labor, infrastructure (Head, 1972).
4. *Informational asymmetry* – absence of information about market opportunities, services, costs, one-sided information about the local government etc. (Pūķis, Jaunsleinis, 2014).

Methodology

The study was designed to assist to the elaboration of scenario which involves several steps in diagnosing the market failure. To accomplish this, in addition to theoretical literature review, an e-mail survey of local governments was performed. The survey consisted of questions aimed at identifying existing forms of entrepreneurial support as well as testing the views of some central assumptions related to market operations. In total 119 e-mails were sent. From those 76 valid answers were received. The surveys were addressed to Development departments of Municipal administrations, since these departments are usually responsible for serving the local business community. The results of this survey are fully described in the study “Opportunities of local governments to support the development of local economy” commissioned in 2016 by the Association of Municipalities of Latvia (HESPI, 2016).

Research results and discussion

According to e-mail survey undertaken in 2016 the municipalities in Latvia are more frequently using indirect forms of aid. Among 75 municipalities that responded to the questionnaire, most had aided business development with their procurements (60), and with local regulation (46). Some forms of general support, such as education and marketing activities for entrepreneurs were also used but not to such great extent. Very few municipalities were involved into public-private partnership or concession contracts since there are some legal complexities associated with these forms of support.



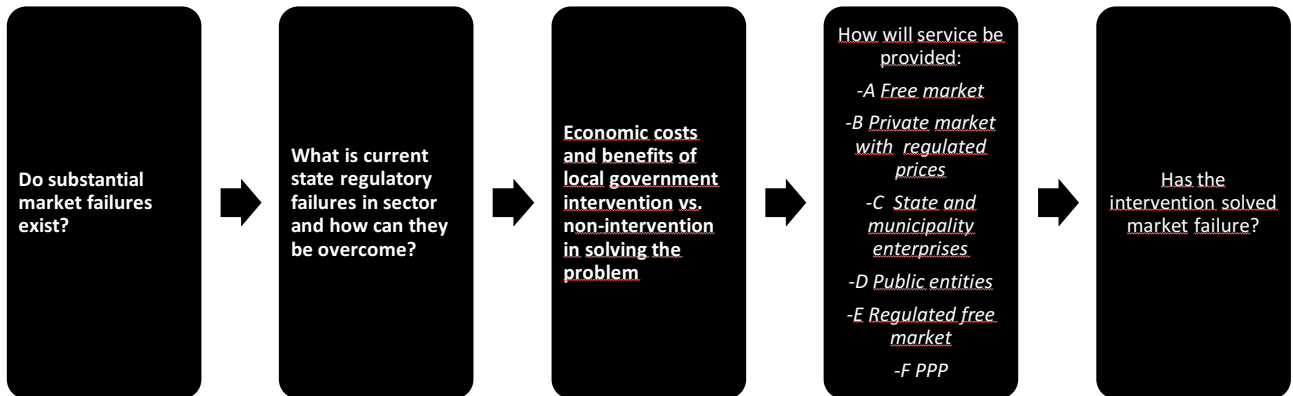
Source: based on: survey performed by authors, 2016

Fig. 2. Basic Forms of Entrepreneurship Support Regularly Used by Latvian municipalities (%)

When asked if local municipalities should in principle give preference to the local entrepreneur even it is more expensive, the answers were ambiguous 67% of the responding local governments answered affirmatively, among them most centers of national significance. The rest disagreed. 50% of respondents indicated that parallel operation of local governments and the market in providing identical products reduced the motivation of innovative and capable entrepreneurs to build their business.

43% of surveyed respondents agreed that municipalities may offer products and services on the market at a cheaper price than existing private suppliers, and about a half of respondents (51%) indicated that the municipality offered a service or a product that was already available on the market but took on some of the risks in order to ensure the stability and sustainability of the service. There were no significant differences in responses of national development centers and other municipalities, although the representatives from national development centers tended to agree more with this statement. A half (50%) of respondents agreed to the statement that parallel provision of the identical product by the municipality and the market decreases the motivation of entrepreneurs to establish their business. Another ambiguity among municipalities was revealed in their answers to the statement about whether local governments should provide preferences to local entrepreneurs even if they offered service which was more expensive. Here again about a half agreed and the other half disagreed. To summarize, the results of the survey show that there is no consensus among the

municipalities about their role in economic interventions, therefore some sort of formalized scenario to aid economic decisions is needed.



Source: author's construction based on HESPI (2016).

Fig. 3. Basic Steps in Diagnosing and Acting Upon the Market Failure

Proposed scenario for diagnosing the market failures in local governments consists of five steps:

1. The first step is the determination whether the particular market has *significant market failures*.
2. In the second step *market failures are examined deeper* by clarifying what are the *current market and regulatory gaps* within the sector and how local governments can prevent them.
3. The third step is the *evaluation of costs and benefits* for chosen local government activities.
4. The fourth step is the selection of *intervention alternatives*. In case of no intervention the solution will be left to free market (a) The service and can also be left to free market while setting regulated prices (b). Furthermore, the service provision can also be taken up by state or municipality enterprises (c) or public entities (d) In addition, there is an options for regulating the market (e) and the use of public-private partnership mechanisms (PPP) (f).
5. In last step the *effects of the intervention* are assessed. Figure 1 and Table 2 outlines and details each step by presenting the key questions for analysis as well as methodologies.

Questions and Methodology in Diagnosing and Acting Upon Market Failure

	Step	Key question	Suggested Methodology
1.	Diagnosing market failure	<i>Do substantial market failures exist?</i>	Assessment market sector competitiveness <ul style="list-style-type: none"> • Analysis of financial reports Assessment of the properties of product or service Assessment of positive and negative impacts on society
2.	Clarification of the market failure	<i>What current market and/or regulatory failures in particular sector and how can these be overcome?</i>	Assessment of the possibilities of regulation via subsidies and taxes <ul style="list-style-type: none"> • Assessment of legal basis (mixed goods or external effects) Choosing appropriate form of product/service delivery <ul style="list-style-type: none"> • Comparison of product/service production and delivery costs
3.	Weighting the costs and benefits of local government's intervention	<i>What are economic costs and benefits of selected kind of intervention vs. the costs of not intervening?</i>	Cost/benefit analysis
4.	Assessment of local government's intervention	<i>Has local government's intervention improved the situation?</i>	Control questions involving the analysis of market players, service price, customer complaints

Source: author's construction based on HESPI (2016).

During the initiation and evaluative stages of the intervention scenario there is a need to perform business and population surveys, as well as to analyse the local political and economic environment because the data obtained enables to perform comprehensive market analysis and provides the justification for the local governments to take an active participation in local economic development (FSA, 2006: 11).

Proposed scenario is generic and does not provide specific actions if particular local government development specifics is not considered. Therefore, we propose several control questions for frequent intervention areas. These areas are labour market, housing, and utility provision market. It is beyond the scope of this article to outline control questions for all of these areas. Therefore, a short-list of questions for the utility provision market are provided in Table 3.

Table 3

Control Questions for Assessing the Local Government's Intervention Utility Provision

1. Does the service provider's contracts are clearly stipulated in the dealings of the parties' rights and obligations?
2. Have local service providers in the market have increased the price of the services provided?
3. Has local debt for utilities substantially increased?
4. Have residents have complained about the lack of quality of service?
5. Do people have the opportunity to choose the service provider?
6. Do people have sufficient information on available local utility services in the municipality?

Source: author's construction based on HESPI (2016).

Each of local development approaches outlined before includes specific instruments that can help to correct the market failure. Labour market failures can be addressed by introducing full or partial subsidies, and by different forms of support for young entrepreneurs. Local governments can also support the purchase of assets or subsidized social entrepreneurship. Public-private partnerships are typical for the "Project state" whereas "Smart planning" government mainly use regulations, and "Development despite the state" opt for establishing the local government enterprise (see, Table 4).

Table 4

Local Government Actions Taken in Case of Market Failure

Economic development approach	Local government actions taken in case of ...		
	labour market failure	housing market failure	service market failure
Smart Planning	Regulation Promotion activities Social entrepreneurship	Regulation Promotion activities	Regulation
Development State	No specific intervention	Supervision and administration Promotion activities	Supervision and administration Promotion activities
Development Despite the State	Supervision and administration Promotion activities Social entrepreneurship	Formation of local government enterprise Social entrepreneurship	Full or partial subsidies Formation of local government enterprise
Project State	Promotion activities External tenders Social entrepreneurship	External tenders Public-Private partnerships Promotion activities	Supervision and administration External tenders Social entrepreneurship Public-Private partnerships

Source: author's construction based on HESPI (2016).

Conclusions, proposals, recommendations

1. Market failure detection is inherently microeconomic analysis, which means proper identification of market economic principles and the understanding of the special characteristics of the local and regional market. In the same time, it is also a qualitative exercise about assessing local government's role and strategic orientation.
2. The detection of market failure should take into account different types of markets in which local governments operate (labour market, housing market and quasi markets - services and utilities).
3. There are also several challenges to identifying the market failures. First, state and market failures are in practice often mixed and therefore it can be difficult to distinguish between the roles that should be taken by national and local government in order to correct the market failure. Secondly, the detection of the market failure can also be relative to the spatial scale of analysis. Local market analysis can show that there are no alternative service providers in a single municipality, but regional market analysis undertaken on larger scale can uncover opportunities to attracting service providers from neighbouring municipalities, thus eliminating the need for market intervention.
4. Future analysis of local government market intervention should therefore take into account uncertain distinction between the state and market failures. It should also take into the account the dimension of the scale of the market analysis. It is important to emphasize, that strategic economic development orientation of the local government does matter in predicting local government approaches and instruments that are used in local economic development.
5. Ambiguous responses of local governments to statements about market intervention suggest that there is no consensus on what role should local governments play in providing goods and services that can in principle be provided by the private sector. Therefore, the methodology for determining market intervention is needed. This study takes the first step in designing such a methodology, but more research in empirical aspects of local market operations is needed.
6. Before intervening local government should make a thorough economic appraisal of the intervention backed up by a technical feasibility study covering all aspects of the operation, and the economic appraisal which then can be weighted against the social appraisal. The application of such methodology would make market interventions more transparent and contribute to solid reputation of local business environment.

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