

REGIONAL DEVELOPMENT IN DEVELOPING COUNTRIES: A SURVEY

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New economic geography has come of age' (Neary, 2001).

'... one of the best ways to understand how the international economy works is to start by looking at what happens inside nations. If we want to understand differences in national growth rates, a good place to start is by examining differences in regional growth; if we want to understand international specialization, a good place to start is with local specialization.' (Krugman, 1991, p. 3)

'[L]arge regional disparities are a symptom of deep-seated disorders and structural defects in the national economy; and there is no case on record of such problems being remedied by measures to accelerate growth, taken at the national level alone.' (Higgins, 1989, p. 120)

'Regional development policies have failed in all countries – federal and unitary alike – to reduce regional inequalities.' (Shankar and Shah, 2003, p. 1437)

'[Decentralization is neither] a plague or a panacea' (Bird and Villancourt, 1998, p.1).

'What is happening now to the Philippines is one of the best arguments why countries which face chronic fiscal deficits should go slow in the decentralization process.' (Diokno, 2003, p. 11)

1. INTRODUCTION

For several reasons – analytics, policy, transitions from economic crises or command economies, and the uneven impacts of rapid global integration – spatial disparities and centre-region relations are the focus of much attention in the developing world.

Why do some regions grow faster than others?

Why is the spatial location of economic activity so uneven in many countries?

Is regional inequality a cause for concern?

Why does regional inequality vary so greatly, within countries and over time?

What is 'regional policy', and what is the optimal mix of revenue, expenditure and administrative responsibilities between the central and regional governments?

Concern motivated by high and apparently entrenched levels of regional inequality. (eg, Mexico). Jakarta/NTT, 10:1.
Intra-country socio-economic disparities can be just as large and intractable a inter-country differences. Yet literature much more focused on the latter.

Economic and political crises may trigger major (and sometimes hasty) decentralization programs, especially when authoritarian, centralized regimes crumble. Eg, Indonesia, the Philippines and Russia.

Fear of national disintegration sometimes a motive.

In transition economies, part of shift from plan to market. Eg, China, Vietnam.

Political imperative to focus on lagging regions, especially if populous (eg, Thailand), occupy vast maritime resources (eg, Indonesia), or incubators of terrorism (eg, Philippines).

Even an issue in small & compact states (eg, Korea, East Timor).

Paradoxically, as international barriers to commerce decline, in some cases sub-national barriers are high or rising (eg, Indonesia, India). And coastal areas often better integrated with international economy than with hinterland (eg, various transport cost estimates).

Moving to an 'EU-type world', of weak centres and strong regions?

In absence of corrective policy, globalization likely to increase regional disparities? The capacity to connect to the global economy is a key determinant of regional growth.

Can one draw on the literature attempting to explain international differences in growth rates to help explain inter-regional differences? If assume perfect (intra-country) factor mobility and homogeneous nation wide institutions, presumably no. ie, all regions of a country have the same macroeconomic and trade regime, same institutions, etc.

Conversely, perhaps 'openness' can be redefined to mean 'connected' (to the global economy); institutions do differ among regions; and factor and product markets may be poorly integrated.

No consensus in the literature on how far and how quickly decentralization ought to proceed. Though general presumption (eg, in fiscal federalism literature) that, with mobile factors, policy competition between regions is desirable and that decision-making should be as close as possible to stake holders. Mobile factors will exit jurisdictions which fail to deliver, etc.

However, the empirics seem to conclude that there is no discernible correlation between the degree of decentralization and economic growth.

Also evidence on long-term trends in inter-regional inequality is mixed. No clear evidence of a 'Williamson-Kuznets' curve.

Some caveats:

- Concerned mainly with socio-economic aspects.
- Definitions of 'regions' often arbitrary; official boundaries frequently change; 'natural economic zones' often extend beyond national boundaries.
- Regional data bases in developing countries typically much weaker than national data. Eg, time periods, trade, changing definitions, cross-country limitations.

2. ANALYTICS

(a) Spatial structures and the determinants of regional growth

Key patterns and trends

At least five stand out:

- Very large regional differences in per capita income; 5:1 or more.
- On rankings over time, evidence of both continuity and change. More fluidity in high-growth economies
- Huge differences in economic size and in relative factor endowments across jurisdictions; eg, 50:1 or more.
- Economic structure varies significantly. Hence notions of 'regional comparative advantage'.
- Social indicators display substantial differences, and usually – but not always – correlate closely with economic indicators.

Market integration

- Economic development and improved infrastructure and communications systems usually result in more integrated national economies over time. Though limited empirical research.
- Price disparities should converge. Not so clear in case of wages.
- Regulations often inhibit capacity of poor regions to build on comparative advantage. Though changing; eg, in the Philippines.
- The decentralization of education appears to lead to increased regional inequality in human capital.

Determinants of regional growth

Why do some regions perform better than others? Limited empirical research.

Need to modify the growth theory framework. Eg, drop the macro variable. Redefine 'openness'.

Human capital relevant only if there is less than perfect labour mobility. Institutions? Inequality?

Conversely, inter-regional fiscal transfers generally much greater than international aid flows.

In the regional development literature, at least four sets of factors appear to be relevant.

Geography and openness: Location; some geographic attribute (natural harbour, mouth of major river system, strategically location, etc).

Locational advantage a necessary but not sufficient condition for rapid growth. Eg, Singapore and HK – infrastructure, openness, institutions, etc.

How define location and openness? 'Connectivity', regional trade shares, etc.

Clustering and scale: Increasing returns to scale, backward and forward linkages, spill-overs, 'reputation effects'. Outward orientation and infrastructure critical (eg, Singapore). Converse is rising congestion costs and urban disamenity.

Increasingly, these clusters straddle national boundaries. Eg, SIJORI.

Are these global impacts symmetrical? Mixed evidence. Internationally connected regions generally grow more quickly than the rest of the economy in times of growth, but impacts of domestic crises and/or global recessions uneven. Eg, 1997-98 Asian crisis.

Governance and institutions:

Capital cities - High human capital; control of rents. Important in both open and inward-looking economies.

Centre-region fiscal arrangements a key factor.

Very difficult to measure regional institutional quality, especially over time. Eg, level or rate of increase in government expenditure, public sector human capital quality, business rankings, legal quality, etc.

Often local case studies illuminating.

Resource endowments: As with countries, the impact of natural resource endowments on levels and rates of growth in regional incomes appears to be mixed.

Summing up, in an open economy environment, successful regions are likely to be those which

- have some sort of locational advantage;
- have good quality, competitively priced physical infrastructure;
- have a commercial policy regime – nationally and locally – which ensures minimum regulatory barriers and maximum policy predictability;
- have supplies of competitively priced labour, utilities, and other key inputs; and receive at least equal fiscal treatment from the central government.

(b) Inter-regional inequality

What determines levels of and trends in inter-regional inequality in developing countries? Two interrelated approaches, one static, the other dynamic.

Traditionally, coefficient of variation, or some other static measure (gini, Thiel, etc), first popularized by Williamson (1965). Economic and social variables. Following Kuznets, and on the basis of some OECD country data, Williamson conjectured an inverted-U shaped relationship.

A more recent literature employs the dynamic framework of Barro and Sala-i Martin (1995), to determine whether there has been convergence across regions. Convergence assumed under the strong assumptions of perfect competition, constant returns to scale (and no externalities), and free and costless movement of factors across regions.

Two measures adopted. ' α convergence' (essentially the Williamson approach). And ' β convergence', ie, whether poor regions are catching up to richer ones. β convergence is a necessary but not sufficient condition for α convergence.

An additional classification introduces the notion of 'absolute' and 'conditional' convergence. Latter refers to variables which are presumed to influence inter-regional differences in economic performance (eg, natural resource endowments, human capital, locational advantages, etc).

Political systems: Sometimes argued that federal political systems and open, participatory regimes are more likely to produce equitable spatial outcomes. Mixed evidence.

Trade regimes and openness: No clear impacts on inequality, a priori or empirically. Openness can cut both ways. The key seems to be the availability of internationally connected infrastructure, especially for footloose manufacturing activities.

FDI: These flows generally reinforce trade effects. MNEs are likely to exhibit greater spatial concentration than their domestic counterparts – more trade intensive; they operate in more skill and capital-intensive activities; and they are less 'historically attached' to particular regions.

Country patterns

China: Some regional convergence 1952-65, mixed trends 1965-90, and then sharply rising inequality from 1990. Major trend is the widening gap between the southern coastal zones – formerly quite poor regions – and the rest of the country. Much of the widening gap associated with increasing rural-urban disparities. Note impact of past restrictions on labour mobility. Within-province inequality seems to be more important than between-regions inequality.

Indonesia: Estimates are highly sensitive to the selection of variables (oil, etc). But no discernible long-term trend evident. Unusual. Social disparities lower than economic ones. Some, albeit very slow, alpha and beta convergence. Within-province differences the largest source of inequality, cf. Between province and between-region.

India: Appear to have been rising regional disparities since 1980, and especially following the early 1990s liberalization. Though not a 'China' story. Appears to be some evidence of conditional convergence (factoring in regional infrastructure and human capital), but no unconditional convergence.

The Philippines: Moderately high inequality but no clear overall trend. Alpha convergence in some periods, beta convergence more frequently. Sectoral growth rates affect the story.

Thailand: Rising regional inequality through to about 1990. Negative beta coefficients, ie, poorer provinces not catching up. Geography – ie, one major connection to the global economy – seems to be a key factor.

Malaysia: Moderately low spatial inequality, no clear long-term trend apparent (slight beta convergence). Like Indonesia, depends on the selection of economic indicators. The NEP has operated de facto as a powerful regional policy tool.

Vietnam: Sharp rise in regional inequality during the 1990s. Especially associated with opening up and industrialization around HCM City.

More coming on these:

Russia: Very sharp rise in inequality 1994-97.

Mexico & Brazil: Both federal, both very high inequality. Brazil – inequality rising slightly since 1980. Mexico – no clear trends; capital city and US border effects.

To sum up:

- Globalization has mixed effects.
- Inter-regional inequality is generally less than either intra-regional or inter-personal inequality.
- The policy framework varies considerably, from consistently strong fiscal equalization strategies to weak, anti-poor measures.
- The type of growth matters for regions just as it does for countries. Eg, 'inclusive growth' v/s natural resource enclaves.
- Finally, the estimates of regional inequality are rarely comparable across countries; but regional inequality is generally higher in developing countries.

3. POLICY

Four inter-related sets of policy issues – what is regional policy and is there a case for it; the analytics of regional competition; decentralization; and intended versus unintended regional policies.

(a) What is regional policy and is there a case for it?

Regional policy refers to any government intervention which seeks to influence the regional patterns of economic activity and living standards. Eg, includes:

- market-based policies, designed to correct market failures;
- interventionist approaches, including development programs for depressed, or by-passed, regions;
- formula-driven fiscal transfers, designed to achieve certain objectives;
- programs which focus on nationally defined minimum standards (eg, for education), and which by implication have particular regional impacts.

Should governments have explicit regional equality objectives?

'No'. Standard neoclassical view of convergence. Factors migrate to the highest return location; migration is the most effective anti-poverty strategy. The principal objective of governments should be to facilitate this factor mobility.

Moreover, government intervention is frequently perverse in its regional impacts.

'Yes'. Spatial inequalities are socially and politically unacceptable. Poverty traps and lagging regions do require special assistance. Migration may not always work. Regional inequality may have adverse political repercussions.

Yet the policy record of dealing with depressed regions is everywhere mixed.

Investment in physical infrastructure is often a means of pursuing both efficiency and regional equity objectives, and may be the most effective instrument of regional policy (if only to facilitate migration out of poverty).

(b) 'Competitive regionalism'

General presumption is that, provided the rules of the game are clearly established, and credible, sub-national competition is conducive to improved economic policy. Better performing regions – low-corruption, predictable, and transparent business environment, secure property rights, flexible labour markets, a competitive tax regime, and efficiently supplied public goods – will be correspondingly rewarded.

Such an idealized political economy construct is predicated on strong assumptions.

The empirical evidence is ambivalent. Eg, risks of local capture and lack of accountability, etc. Danger of 'over-grazing' and rising corruption.

Hence, poorly defined policy frameworks, large vertical fiscal imbalances, weak central governments, soft budget constraints, and autocratic local authorities result in poor outcomes.

Little cross-country evidence in support of the notion that more decentralization automatically improves the quality of governance. Much depends on the nature of decentralization and how it is implemented. More assertive local governments may result in more, not less, barriers to factor mobility.

Local governments may borrow adventurously if they believe that central governments will bail them out. Local elites may capture power in their jurisdictions and be less subject to the usual checks and balances than central governments. Alternatively, their tenure may be insecure and short lived, maximizing the temptation to engage in corruption quickly.

Can central governments construct a regulatory environment which results in improved local government performance? Very few genuine attempts at enforce a system of 'performance grants'.

(c) Decentralization

Options are vast. Fiscal arrangements can be 'formula-driven', ad hoc, or involve a fixed proportion of central government resources.

Administrative options:

- 'deconcentration' (ie, shifting functions within the central government bureaucracy out of the headquarters),
- 'delegation' (eg, of specific tasks to another tier of government or agency), or
- 'devolution' (of responsibilities to sub-national governments).

Key parameters include revenue independence, expenditure autonomy, debt autonomy, fiscal equalization, and inter-governmental coordination. May be 'big bang' or gradual and incremental. May involve more than one sub national jurisdiction.

As noted, hard to find a clear cross-country relationship between economic growth and the extent of decentralization. Partly because of the difficulties associated with defining decentralization.

The circumstances in which decentralization is undertaken seem to matter. Big bang experiments often fail.

Country evidence

- China: Part of the shift from plan to market. The regional fiscal framework -expenditure responsibilities and revenue authority – remains poorly specified. Challenge of imposing a hard budget constraint.
- Vietnam: Similar (lagged) experience as China. SOE reform a major (unintended) impact on regional policy.
- Indonesia: 'Soeharto paradox' – authoritarian, centralized regime, but good regional outcomes. Creeping but limited decentralization in last decade of regime, but regional initiative stifled. Then sudden big bang, work in progress, much weakened centre.

- Philippines: Major decentralization introduced in 1992, circumstances similar to Indonesia, though more gradual, and with prior history of strong regions. Modest reforms. But see Diokno quote above: grant system has been 'substitutive rather than stimulative'. The IRA has also become a drag on the national budget: declining national revenues hence rising IRA share, contributing to sharply rising national fiscal deficits. Insurrection problems in Mindanao have complicated regional budgets and problems.
- Thailand: Embarked on a major decentralization program in the late 1990s, share of total government expenditures disbursed by local governments increasing quickly. Mostly to the (approx 7,000) villages. Work in progress.

Argentina: Centre-region fiscal relations contributed to that country's recent economic crisis. A highly decentralized state, but the central government collects most of the taxes – 17-18% of GDP, compared to around 3% by provinces. These huge vertical imbalances have facilitated provincial fiscal irresponsibility. Moreover, transfer system is complex, opaque, and unstable. Need to harden of provincial budget constraints.

Some general policy lessons:

- Decentralization should not proceed too quickly, until a clear policy framework is firmly in place. Local governments need to have the requisite technical and financial skills to manage their larger responsibilities.
- For a decentralization program to be successful, the macroeconomic fiscal parameters have to be tightly defined.
- Central government leadership is vital.
- There needs to be a framework for sub-national cooperation, eg, in infrastructure.
- Important to avoid large vertical fiscal imbalances.
- As a corollary, the allocation of expenditure responsibilities is crucial.
- The allocation formulae need to be transparent, apolitical and stable.
- Need to retain some mechanisms for fiscal equalization.
- Local governments' tax policies should be nationally consistent.

Intended versus 'unintended' regional policies

Many government policies have unintended regional effects; often more important than the formal 'regional policy' regime. Eg, trade protection with region-specific impacts. Infrastructure policies. The SOE sector. Rigid national product and factor pricing. Various production and trading regulations.

4. SUMMING UP: PROPOSITIONS AND OPEN QUESTIONS

Some propositions (some very obvious!):

- (1) The most important determinant of regional progress is invariably national economic progress.
- (2) It is no simple matter to define 'regions'.
- (3) Neither the analytics nor the empirics point convincingly to a well-defined relationship between growth and regional inequality.
- (4) Regional socio-economic rankings typically change over time. The faster the rate of national economic growth, the less stable the rankings.
- (5) International comparisons of the extent of regional autonomy and decentralization are almost always extremely approximate.

(6) Modelling the determinants of regional economic growth in developing countries is still in its infancy, but three explanatory factors seem to central: geography and infrastructure; the quality of local institutions; and the quality of local human capital.

(7) There is no clear relationship between the extent of decentralization and the (national) rate of economic growth.

(8) A minimal regional policy would at least entail free mobility of goods, services, and factors, the provision of some nationally specified social objectives (eg, in education and health), and the avoidance of large centre region fiscal imbalances.

(9) Intra-regional inequality (both between lower tier jurisdictions within a region and inter-personal inequality) is typically higher than that of inter-regional inequality.

(10) The totality of regional interventions is generally much greater than officially enunciated 'regional policies'. Quite often the latter are relatively unimportant.

(11) Perhaps paradoxically, a strong central government is required for effective decentralization.

(12) A major regional policy challenge for some countries is to facilitate cross-border economic cooperation.

Some questions and unresolved issues:

- (1) Is increased regional inequality inevitable as countries globalize? Probably yes.
- (2) Is the national commitment to egalitarian regional outcomes in developing countries waning pretty much everywhere? Probably yes.
- (3) Could we be moving to a world where sub-national barriers become more important than national ones, for example like the EU? Probably no.
- (4) Can central governments improve the performance of local governments and, if so, how? Mixed evidence.
- (5) Is there an 'optimal degree of decentralization'? Probably no; it seems to vary considerably across countries.