

# Regional Economic Development: A Review

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## **Abstract**

This review offers an analysis of the main concepts explored in the regional and local economic development literature. We start by explaining the rationale for a regional approach to development in a context of growing internationalisation of the world economy. Therefore, the relevance of local social and institutional characteristics is discussed by arguing that favourable conditions for development are the result of a highly context specific combination of rules, norms and social relations which encourage and facilitate knowledge diffusion and exploitation mostly on a localised basis. In this respect, some evidence is provided about the emergence of spatial inequalities connected to the localised nature of development processes and innovative activities. We then discuss the importance of a bottom-up approach to economic development emerging from the frequent ineffectiveness of top-down policies employed to spur regional development. Finally, we argue that the increasing demand for decentralisation of powers and resources from central governments to regional and local administrations in most parts of the world in the last decades can be interpreted as the acknowledgement that regional forces and characteristics are strongly relevant in shaping local development trajectories in a context of increasing globalisation. In this framework, therefore, decentralisation represents the capacity of heterogeneous regions and territories to tailor specific development strategies in order to address their particular needs and influence their own destinies.

**Keywords** Regional development, globalisation, system of innovation, bottom-up, decentralisation

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## 1. Introduction

Modern growth theory has devoted substantial attention to the search for the determinants of economic growth by means of aggregated models. In these approaches 'economic development' has been often conceptualised as an increase in 'equilibrium' per-capita income and the interest of researchers mainly has concerned the identification of the main economic factors influencing it. From the 'capital fundamentalism' vision of development à la Harrod-Domar to the neoclassical model of growth (Solow, 1956), which long dominated both theory and policies, economic development has been considered as a linear process which could be triggered just by moving the right economic pieces on the chessboard, while largely overlooking the process of qualitative change and improvement of the economy as a complex social, institutional and historical system. Later in the 1980s, endogenous growth theorists argued that technological change is at the core of economic growth processes and highlighted the importance of investment in human capital (Romer, 1986; Lucas, 1988; Grossman and Helpman, 1991). However, again the linearity of the process of technological change entailed in such theories fundamentally neglects the importance of non-market processes and socio-institutional characteristics that impact on economic performance and are also extremely significant for human well-being (Sen, 1994). Conversely, other streams of literature, such as the innovation system approach (Freeman, 1987; Lundvall, 1992; Nelson, 1993) and, more generally, the local and regional development literature (Pike et al., 2006) have brought the relevance of contextual socio-economic and institutional characteristics at the core of the analysis of economic growth and development as multidimensional processes. As will be argued in this review, these approaches are particularly informative for policy purposes in a context of increasing globalisation, due to the local embeddedness of the fundamental forces triggering growth and development.

This text offers an overview of the main concepts explored in the regional and local economic development literature. Firstly, we explain the rationale for a regional approach to development in a context of growing internationalisation of the world economy. Secondly, the relevance of regional and local social and institutional characteristics and processes is discussed by arguing that favourable conditions for development are the result of a highly context specific combination of rules, norms and social relations which encourage and facilitate knowledge diffusion and exploitation. Thirdly, we argue that the localised nature of development processes and innovative activities is linked to the emergence of spatial inequalities in development levels. Such disparities at the geographical level

appear to be even more relevant in the case of developing and emerging countries, where only a limited set of locations shows the capability to spur economic growth, while the rest seems to stagnate or decline. In the fourth section, we discuss the importance of a bottom-up approach to economic development given the localised nature of this process and the frequent ineffectiveness of top-down policies. Subsequently, we argue that the increasing demand for decentralisation of powers and resources from central governments to regional and local administrations in most parts of the world in the last decades can be interpreted as the acknowledgement that regional forces and characteristics are strongly relevant in shaping local development trajectories in a context of increasing globalisation. In this framework, therefore, decentralisation represents the capacity of heterogeneous regions and territories to tailor specific development strategies in order to address their particular needs and influence their own destinies. Hence, the relevance of the processes of decentralisation is also connected to the shift from traditional top-down development strategies to bottom-up approaches by means of the increasing level of decision-making power that decentralisation attaches to local authorities and institutions. In other words, decentralised governments are most likely to adopt regional development strategies where the evaluation of territorial strengths and weaknesses as well as the inclusiveness of local agents are at the core of policies. Thus, when discussing the process of decentralisation we also explore its drawbacks and benefits in terms of economic equity and efficiency.

## **2. Regional perspectives on economic development in a global world**

Over the past three decades the process of globalisation has brought forward major changes in the economic landscape. Since the 1980s, the unprecedented expansion in volumes of international trade and capital mobility across countries has dramatically altered pre-existing equilibria based on the strong role of nation states in regulating, orienting and/or restricting such flows. Therefore, globalisation has gradually frayed nation-state level economic institutions as they were known in the post-WWII period. At the same time, globalisation has contributed to the progressive evolution of the industrial organisation paradigm of mass production towards more flexible and successful production systems as a way to respond to the increasing competitive pressure of international markets. As a result, 'standardized' production became progressively obsolete in favour of a specialised and more flexible-to-demand-changes system, which allowed firms to survive to the uncertainty of global challenges. Along with these changes, the importance of Multinational Enterprises (MNEs) has risen and contributed further in the weakening of national borders and economic institutions in managing

international flows of goods and capital. The increased importance of MNEs appears to be a response to the changes determined by the process of globalisation as a way for firms to adapt their industrial governance and competitiveness to the new economic environment. The magnitude of this processes has encouraged some commentators to conceive the globalised world as a 'flat world' (Friedman, 2005) as well as to evoke notions such the 'end of geography' (O'Brien, 1992) and the 'death of distance' (Cairncross, 1997). In this perspective globalisation has basically eroded differences between places through the international reach of its technological and socio-economic forces. As such, locations seem to be emptied of their particular characteristics and local actors fundamentally lose the capacity to shape regional destinies. Improvements in communication technologies and the fall in transportation costs reduce the importance of physical distance in the location of productive activities. Consequently, economic development may virtually occur everywhere without any role being played by local/spatial factors. Convergence in incomes across regions and countries would thus be the ultimate result of globalisation.

This conceptualisation of both the nature and trajectory of the process of globalisation is in sharp contrast with the theoretical insights and empirical evidence produced by a large (and growing) body of literature in the fields of institutional and evolutionary economics, internal business studies and economic geography. In all these disciplines there is increasing awareness that the process of globalisation is progressively increasing the importance of regional processes and the role of local actors in shaping development trajectories. Since the 1980s it is apparent that some regions (and not others) have followed successful post-Fordist development paths. In this respect, Bagnasco (1977) and Piore and Sabel (1984) are among the first scholars to highlight the experience of flexible specialisation, trust and face-to-face social relations in the industry of 'Third Italy' as a case of regional economic success in an era of global economic expansion. In general, the importance of local specificities has increased rather than being marginalised in a context of increasing globalisation and functional economic integration (Storper, 1995): development processes unfold at the local level and globalisation reinforces such patterns. In other words, the emergence of a 'regional world' (Storper, 1997) is essentially underpinned by the spatially-bounded localised forces that trigger economic development and push welfare to agglomerate in specific locations within countries. Hence, economic development stemming from industrial renovation after mass production also seems to coincide with territorial development (Amin and Thirft, 1992). As such, in spite of some evidence in favour of convergence between countries in the last decades (Crafts, 2004; Sala-i-Martin, 2006), disparities within countries have increased in a number of cases (Rodriguez-Pose and Gill, 2006; Brakman and

van Marrevijk, 2008), suggesting that economic development patterns are characterised by strong spatial concentration at the regional level and that distance and geography do matter in a global world. In addition, and perhaps more importantly, such insights also suggest that national economic growth tends to be driven by the performance of a limited number of local economies within nation-states. Particularly, urban areas appear to be the physical *loci* where economic growth most likely concentrates. Indeed, most industrial production, skilled labour and higher wages tend to agglomerate in cities where geographical proximity between economic agents facilitates communication and creates an environment which favours frequent interactions and flows of ideas. This basically consists of the Marshallian idea of agglomeration economies related to knowledge diffusion. The importance of such interactions that give rise to positive externalities in the form of technological or knowledge spillovers is particularly crucial for economic development, as pointed out by various scholars (Romer, 1986, 1990; Grossman and Helpman, 1991; Coe and Helpman, 1995). Moreover, empirical evidence suggests that knowledge externalities provide relevant explanation for spatially uneven economic and innovative performance (Jaffe, 1989; Jaffe et al., 1993; Audretsch and Feldman, 1996). Following this line of reasoning, knowledge-intensive activities become fundamental for economic performance, following distinctive patterns of geographical distribution and contributing to generate localised sources of competitive advantage (Rodríguez-Pose and Crescenzi, 2008a).

As such, cumulative and path-dependent processes of accumulation of knowledge shape the distribution of welfare across space, suggesting the existence of a more complex economic geography than that of a flat world. In other words, economic development is ultimately spurred at the local level where knowledge externalities are generated. As a matter of fact, while codified knowledge becomes largely available and accessible as a result of improvements in communication technologies, tacit knowledge remains spatially bounded and its economic value has even increased as a consequence of its relative scarcity in respect to codified knowledge (Sonn and Storper, 2008). Similarly, while globalisation has determined a net fall of the transmission costs of codified knowledge, economically valuable knowledge which is tacit and complex by nature increasingly requires spatial proximity to be transmitted, absorbed and successfully re-used (Storper and Venables, 2004; McCann, 2008).

Moreover, fast-growing locations are not closed and independent economies, but rather they are most likely those areas hosting MNEs and their international investment which crucially connect the region with foreign markets and resources (McCann and Acs, 2009). As a matter of fact, international capital mobility has increased notably in the past decades: on the one hand, the dispersion of international

investments across different countries has increased; on the other hand, it tends to concentrate in a few regions within these. Locations where MNEs invest thus become part of global production networks (GPN) at different stages of the production process (Ernst and Kim, 2002) or, as it has been suggested, ‘neo-Marshallian nodes in global networks’ (Amin and Thrift, 1992). In addition, regions involved in such GPN may also benefit of channels for both international knowledge diffusion and local capability building. The creation and maintaining of external linkages, such as hosting international investment, in order to access external knowledge and innovation, is acknowledged to be fundamental for local economies as a way to complement and enrich locally produced knowledge (Bathelt et al., 2004). This is particularly the case of developing countries where the bulk of available information is not locally produced rather than imported from exogenous sources and, thus, such an external knowledge tends to play a primary role (Pietrobelli and Rabellotti, 2009). However, the success of host regions in capturing the advantages of knowledge diffusion through global networks crucially relies on fundamental and structural characteristics ranging from local knowledge-base and absorptive capacity to social and institutional infrastructure. In this respect, the existence of a system of innovation at the local level represents a crucial element for the attraction and exploitation of external knowledge. The system of innovation approach applied to developed countries implies that the existence of linkages between actors and organisations within a framework of a favourable social and institutional context gives rise to positive dynamics of learning, new knowledge creation and exploitation. The nature of these dynamics is systemic in the sense that the innovation process is far from a linear phenomenon, but, contrarily, it is the result of complex patterns of interactions between a number of components acting together according to common norms, practices and historical inheritance. Such a characterisation entails the fact that the concept of system of innovation is not easily applicable to the context of developing countries mainly due to institutional weakness and fragmentation of linkages between relevant actors (Intarakumnerd et al., 2002; Padilla-Perez et al., 2009). As a consequence, the scope of systems of innovation is limited these countries, thus sharpening the localised nature of knowledge-related activities and, eventually, that of economic development.

As mentioned, in combination with highly localised drivers of economic performance, the process of globalisation has also emphasized the developmental impact of the international reach of firms which determine the degree of global connectivity and international competitiveness of their host regions (McCann and Acs, 2009). What emerges from this picture is basically that increasing international trade and capital mobility crucially sharpen the regional character of development processes,

emphasizing the role of geographical proximity in shaping successful economic performance. Of course, it is not geographical proximity *per se* that causes growth, but it is an important factor shaping the location behaviour of economic agents as well as the intensity of linkages between them. In other words, geographical proximity often represents the necessary setting for other positive forces to occur (Rodríguez-Pose and Crescenzi, 2008a) or, similarly, it provides the context favouring development through the occurrence of intangible and complex ‘untraded interdependencies’ among economic actors (Storper, 1995).

### **3. Regional development beyond geographical proximity**

Even if economic development processes are highly localised not all 'locations' are equally able to succeed in the global competitive environment. In fact, knowledge and innovation activities require a favourable environment to make positive feedback and interactions possible. Therefore, differences in local social, political and institutional settings determine different interactions between local economic agents, knowledge and innovation activities (Rodríguez-Pose, 1999). This translates into different capacities to trigger economic development processes across space. In other words, physical proximity and co-location between economic agents is not a sufficient condition for knowledge spillovers to be effectively exploited and innovation to occur. For instance, Boschma (2005) argues that other 'proximities' between economic actors are also crucial for innovation to take place. Cognitive proximity provides firms with the necessary absorptive capacity to exchange knowledge and make it economically useful (Cohen and Levinthal, 1990). This dimension of proximity appears to be extremely important since it underpins the concrete and productive exchange of tacit knowledge between agents, making knowledge externalities and diffusion ultimately effective. Organisational proximity also favours innovation and interactive learning, providing agents with common mechanisms and arrangements to tackle uncertainty and opportunistic behaviours. Social proximity reflects the embeddedness of firms and workers in informal social relations and networks which are fundamentally based on interpersonal trust. This favours knowledge diffusion and learning through a more communicative context than that of impersonal transactions, eliminating frictions and difficulties related to pure market exchanges (Granovetter, 1985; Knack and Keefer, 1997; Zack and Knack, 2001) or permitting to attain objectives that would not be otherwise realised in absence of social relationships and trust (Trigilia, 2001). Finally, institutional proximity refers to the mechanisms of coordination of the economy, ranging from the legal and regulatory system to informal cultural norms and habits. In this respect, successful innovation and economic performance is facilitated by



solid institutional arrangements and common cultural norms which crucially lubricate market mechanisms. Non-geographical proximities shed light on a number of relevant drivers for the process of economic development. Furthermore, these elements tend to be combined together at the local level in highly context-specific ways shaping the processes of new knowledge generation, collective learning and, eventually, economic performance. In other words, successful innovation and related economic development mostly occur regionally (Amin and Thrift, 1994; Scott, 1996; Storper, 1997; Cooke et al., 1997; Rigby, 2000) where systematic and repeated interactions between relevant local actors encouraged by a favourable institutional framework both shape the innovative capacity of specific regional contexts and allow absorbing and employing exogenously produced knowledge in an economically productive way (Iammarino, 2005, p.499), as highlighted by the (regional) system of innovation literature (Lundvall, 1992; Cooke et al. 1997). As such, local economic development may be encouraged by the realisation of a regional competitive advantage based on location-specific and specialised capabilities and competencies nurtured by socio-institutional and cultural structures. Since such conditions are context-specific, they are extremely difficult to replicate in different settings and each location has to shape its own competitive advantage on the basis of functional and effective interactions between local economic agents and socio-institutional forces. It is exactly the existence of adequate formal (societal) and informal (communitarian) institutions promoting collective action and favouring coordination among local actors that provides the appropriate environment for regional economic development to be spurred (Rodríguez-Pose and Storper, 2006). This conceptualisation of the institutions supporting the process of economic development is not dissimilar from the institutional and social 'proximities' necessary for the diffusion of innovation and knowledge: they provide economic agents with context-specific arrangements of collective organisation, problem-solving, improved predictability about market behaviour and, especially, learning and absorptive competencies. Notwithstanding the polarisation in the debate about the role of informal versus formal institutions, with some pointing out the prominence of formal institutions (North, 1990; Durlauf and Fafchamps, 2004) while other highlighting the relevance of informal ones (Granovetter, 1985; Coleman, 1990; Putnam et al., 1993), the interaction and balance between *society* and *community* appear to be a key element in shaping the development potential of regions (Rodríguez-Pose and Storper, 2006) as learning actors (Morgan, 1997). As such, formal and informal institutions complement each other, offsetting reciprocally the potential negative externalities of the other, which may occur for instance in terms of lack of confidence, more costly conflict resolution, inability to act collectively, low scope of networks, etc. (Storper, 2005; Rodríguez-Pose and Storper, 2006; Rodríguez-Pose, 2010).

In light of the literature reviewed in this section, it is apparent that regional economic development processes are supported by context-specific social and institutional factors. These factors are crucial since they shape local capability to translate knowledge into economic wealth through a complex set of interactions and shared codes and practices. Clearly, spatial variations in the quality of such elements may determine a geographically uneven potential for economic development across regions leading to growing divergence among different locations. Therefore, regional development policies should include measures to address institutional weaknesses. This is certainly not an easy task for policy-makers for a number of reasons ranging from the lack of consensus on 'optimal' institutional arrangements to the fact that institutions are strongly embedded into specific as well as highly path-dependent and particularly resilient to change contexts (Rodríguez-Pose, 2010). This for instance makes it difficult to replicate successful institutional forms of one region in different contexts as well as to intervene on institutional malfunctions in the short period. Nevertheless, acknowledging that innovation and economic development are mostly regional phenomena and that localised social and institutional factors are crucial for them leads to considering the meso-level perspective in both theory and policy as the relevant target for investigation.

#### **4. Local economic development, global economic integration and spatial inequalities: empirical evidence**

As discussed above, economic development tends to occur at the local level where interactions between economic agents are particularly dense. At the same time, socio-institutional factors appear crucial for the creation of a local competitive advantage and make interactions work in a systemic way. However, not all locations are characterised by such favourable conditions and we suggested that national growth is often led by few fast-growing and innovative places within a country, mostly coinciding with large metropolitan areas. As a consequence, when looking at the performance of sub-national entities it is not surprising that welfare concentrates in these same few places giving potentially rise to spatial inequalities at the national level. In the case of EU and US, it is well documented that innovation is highly geographically concentrated in a limited number of locations (Carlino et al., 2001; Crescenzi et al., 2007) suggesting that also underlying characteristics for innovation to succeed are highly unevenly distributed. Similarly, it has been suggested that the capacity of European regions to translate knowledge into valuable economic activity differs across space according to qualitatively different local social structures (Rodríguez-Pose, 1999) and regional systems of innovation (Crescenzi and Rodríguez-Pose, 2008b). Studies on convergence across regions

usually offer mixed results in the case of developed world (Magrini, 2004; Rey and Janikas, 2005), but, in the case of the EU, an increasing number of contributions agree to suggest that poor regions tend to lag behind while most prosperous areas exhibit sustained growth (Marcet and Canova, 1995; Magrini, 1999; Cheshire and Magrini, 2000; Magrini, 2004). This leads to substantial public resources being devoted to the alleviation of 'regional divergence' patterns, as in the case of the EU regional policy (Rodríguez-Pose and Fratesi, 2004).

As far as developing countries are concerned, the localised nature of economic development and the importance of socio-institutional factors appear even more crucial since favourable locations and contexts become less likely. This is witnessed by the strong patterns of spatial inequalities experienced by most developing countries in the last few decades, witnessed by the extraordinary fast growth rates of few locations (i.e. metropolitan regions) as compared to the remaining areas within the same country. Furthermore, globalisation crucially contributes to reinforce these trends by attaching strong relevance to localised processes of agglomeration, innovation and growth (Scott and Storper, 2003). For instance, it is widely acknowledged that the participation of China in world trade and international capital flows has strongly contributed to rising internal disparities in welfare levels between mainly agricultural inland areas and strongly urbanised coastal provinces (Fleisher and Chen, 1997; Kanbur and Zhang, 1999; Zhang and Kanbur, 2001; Zhang and Zhang, 2003). Divergence in regional income is suggested also in the case of India, with richer states registering rapid growth rates and driving national economic performance (Milanovic, 2005). Increasing regional disparities connected with agglomerated growth enhancing activities are further confirmed in the case of Indonesia and China (Akita and Kawamura, 2002). Similar evidence is provided in the case of Brazil, where the speed of national growth rate appears positively associated with the evolution of between-regions disparities (Azzoni, 2001). As far as transition economies are concerned, strong polarisation of income at the regional level is also experienced in Central and Eastern European Countries (CEECs) following their integration with the EU (Monastiriotis, 2011). In this case, main metropolitan areas and those bordering old EU members have gained the most from liberalisation while residual regions have in great majority of cases declined (Petraikos, 1996; 2000; Traistaru et al. 2003; Bradley et al., 2005).

Hence, what this reported evidence seems to confirm, especially with respect to developing countries (including transition countries), is that economic development processes are strongly embedded in particular densely developed areas which drive national growth by competing in international markets

whereas the rest stagnates or declines with limited benefits from globalisation and integration processes. This pattern eventually produces and reinforces spatially uneven economic development.

## **5. Bottom-up approach to regional economic development**

Once the genesis of economic development is acknowledged as a localised process, the existing policy tools for its support and promotion should be re-considered. Traditional growth policies which have paid little or no attention to forces and features such as agglomeration, physical distance, learning, innovation and institutions appear no longer adequate to respond to economic development needs of regions in an era of increasing globalisation (Barca et al., 2011). Moreover, the growing awareness of the importance of local features in shaping development trajectories crucially undermines one of the main characteristics of top-down policies: the transferability of 'universal' strategies to every region, regardless of local weaknesses and strengths. Such a 'one-size-fits-all' character of top-down policies has frequently led to the promotion of infrastructural investment as a way to improve market access of remote regions or endow poor areas with physical capital in the belief that returns from such a kind of investment are exceptionally high (Aschauer, 1989). The popularity of these policies is still widespread: the Italian Mezzogiorno is often considered as the most typical example of this approach with more than four decades of investment in infrastructures and no real benefits on local economies (Trigilia, 1992). Similar considerations can be made with respect to the development strategy of the city of Seville in the late 1980s, where a strong emphasis has been put on the development of infrastructure in order to promote regional growth (Pike et al., 2006). More recently, in the EU regional policy, almost 50% of the total budget devoted to Objective 1 regions (Convergence regions in the 2007-2013 period terminology) is spent for infrastructures while only the remaining is distributed between other axes such as business, human capital and rural development (Rodríguez-Pose and Fratesi, 2004). To confirm the popularity of top-down policies, the World Bank has also recently suggested that connective infrastructures are a priority for economic development in poor countries (World Bank, 2008). The attraction of large firms to locations with weak levels of industrialisation has been another kind of frequent top-down policy. Italian Mezzogiorno is again a good example of failure of this policy approach (Trigilia, 1992; Viesti, 2000), which has in most cases led to the localisation of firms within contexts which could not support the presence of industry mainly due to the lack of adequate skills and capabilities as well as institutional weaknesses. The generalised failure of most top-down development policies, coupled with the resurgence of regional economies as determined by global forces, has thus encouraged to consider alternative policy options

in the form of bottom-up regional development policies (Pike et al., 2006), despite the lack of a clear theoretical foundation of such an approach (Crescenzi and Rodríguez-Pose, 2011). Pike et al. (2006) explain bottom-up development policies as those strategies that fundamentally aim at unleashing indigenous economic potential by favouring local competitive advantage, and where the involvement of local actors in designing, implementing and managing development strategies is crucial. In so doing, bottom-up development initiatives are built on an in-depth analysis of local characteristics in terms of economic and socio-institutional conditions, in order to embed economic activity in the territory. This appears to be extremely relevant in a period of increasing globalisation, as discussed above. In fact, it is argued that regional institutions are those especially well placed for mitigating and exploiting potentially disruptive global forces (Pike et al., 2010). As compared to top-down development policies, bottom-up initiatives pay thus much more attention to context-related elements. For instance, the role attributed to regional social and institutional forces by bottom-up policies is very close to the importance that the system of innovation approach gives to the same elements as catalysts of the regional capacity to learn, absorb and create knowledge as well as to translate such an economic valuable knowledge into economic growth. The acknowledgement of the relevance of such factors for regional development strategies has also favoured the so-called ‘place-based’ approach to economic development, which takes into consideration the effects of the local context on economic performance, rather than ignoring regional specificities when designing policies. In this framework, policy interventions should be aware of context diversity and be contingent on the specific characteristics of the target regions (Barca et al., 2011).

Therefore, generally speaking, such local characteristics intimately affect the development trajectory of places, embedding each region’s development process in a pattern of path-dependency (Sunley, 2000). Hence, pure traditional top-down interventions may have detrimental or no impact on regional economies since they mostly overlook context-related elements. Contrarily, bottom-up development strategies are based on the claim that context diversity across space fundamentally requests a geographical variation of objectives to be targeted by policy, and that these objectives have to be selected according to local specificities and past trajectories.

## 6. Decentralisation and regional economic development

The central role played by local forces and spatial proximity in shaping regional economic development has increasingly led to the decentralisation<sup>1</sup> of decision-making in most parts of the world in the last decades. As a matter of fact, some countries have recently opted for federalist state structures according to different degrees of decentralization, such as Italy and Spain, while in others the process of devolution has emerged after a long-standing tradition of centralised government, as in France, UK and some developing countries. Moreover, federalist countries such as the US, Australia and India have experienced a revival of devolution, whereas on-the-paper decentralized states have been characterized by a more concrete push towards devolution, such as Mexico and Brazil (Rodríguez-Pose and Gill, 2003). As mentioned, such global trend of authority transfer from central to sub-national governments (SNG) is intimately connected with economic development since policies are increasingly designed and adopted at regional level, due to the acknowledgement that geography and the local context matter for development strategies to be effective and sustainable. Hence, decentralised administrations are empowered with the capacity to design and implement strategies that recognize the local cultural and socio-institutional underpinnings of regional economic interactions and behaviour. As such, they are in the position to favour "bottom-up, region-specific, longer-term, and plural-actor based policy action" (Amin, 1999, p. 366) which crucially differs from traditional top-down development strategies managed at the central level. In the relevant literature studying the linkages between decentralisation and economic performance, the analysis is carried out from the points of view of equity and efficiency. We will follow the same scheme to review the implications of decentralisation on regional economic development.

### 6.1 Decentralisation and equity

Economic theory suggests that decentralisation may have – at the same time - both beneficial and detrimental effects on equity. As far as beneficial effects are concerned, it is argued that fiscal decentralization contributes to reduce income inequalities between regions. In fact, poorer regions attempt to fill the gap with richer ones and to attract resources by offering favourable conditions and incentives (Ezcurra and Pascual, 2008). Hence, territorial competition represents an opportunity for

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<sup>1</sup> Following the conceptualization of three types of administrative decentralization (Rondinelli, 1981; 1989; Prud'homme, 1994), we use exclusively the concept of devolution meaning the transfer of power to lower tiers of autonomous government, ignoring the notions of redistribution of decision-making to SNG (deconcentration) or the involvement of semi-autonomous organizations (delegation). Thus, we assume that the concepts of devolution and decentralization are interchangeable (Rodríguez-Pose and Gill, 2003).

poorer regions to manage local economic development since devolution allows them to play an active role in designing their own strategies. This is particularly evident if compared with situations where the central government promotes traditional sectoral development policies. Indeed, since such policies address the most dynamic sectors of the economy that are more likely located in rich areas, poor regions are often excluded from national strategies. Furthermore, decentralization implies the downsizing of central government. This leads to less concentration of economic activity around capital regions and the dispersion of such activity on the whole national territory (Gil Canaleta et al., 2004).

However, the processes of devolution may have negative effects on equity. In this context, Rodríguez-Pose and Gill (2005) identify two key processes increasing spatial inequalities. Firstly, rich regions have stronger bargaining power than poor regions in influencing the decision of the central government. Indeed, not only the economic interest of rich regions may be closer to that of the centre, but also national governments may favour rich regions in order to gain legitimacy in terms of electorate, mass-media influence, etc. Secondly, the competitiveness of rich regions may overwhelm those of poor ones. Indeed, scarce endowment of physical and human capital and other structural gaps make territorial competition too hard for poor regions to gain from devolution. Moreover, the small tax base of poor regions reduces their spending capacity reducing the possibility of implementing development policies.

## **6.2 Decentralisation and efficiency**

The relationship between devolution and efficiency is twofold as well. Arguments in favour of the process of devolution tend to highlight three key points. Firstly, assuming that regional needs may differ from national ones and since SNG are supposed to be better informed about regional demands, local provision of goods and services as well as policies tailored by SNG better fulfil regional needs, determining a greater *allocative efficiency* in the economy (Oates, 1999; Azfar et al., 1999). Secondly, devolution enhances *production efficiency* because it leads SNG to be more efficient and creative in terms of development policies as a result of territorial competition. Indeed, not only SNG have more opportunities to innovate than the centre due to less risks resulting from smaller responsibilities, but also they directly aim at improving their resources and developing their economy through new policy solutions and better local coordination. Furthermore, regional decision-making is more accountable and transparent (Azfar et al., 1999; Ebel and Yilmaz, 2002). This implies the reduction of corruption

because of the proximity of voters to SNG, the larger participation of local stakeholders and the possibility to create significant institutions such as trust.

However, devolution may also cause inefficiency. First, a mismatch between resources and authorities combined with a culture of soft budget constraint may be extremely inefficient. That is, in countries where devolved powers are larger than devolved resources, regions are increasingly dependent on external financing such as national transfers or bank loans. Moreover, as a result of soft budget constraint, information asymmetry in the form of moral-hazard may emerge. Consequently, regions may over-spend and accumulate huge debts, being certain that the national government will bail them out. Hence, regional overspending may negatively affect the macroeconomic stability of the whole country potentially undermining macro-economic stability. Second, central governments may be more efficient in the provision of goods and services because of economies of scale and scope. Indeed, the regional scale may be too small to be efficient and save costs. As Prud'homme (1995) suggests, a minimum critical mass is required to use powers effectively. Hence, devolution increases efficiency only in cases where SNG have a sufficient size in terms of economy, demography, geography, etc. to provide goods and services at smaller cost. Third, territorial competition may reduce efficiency because it leads regions to incur in costs related to making a location more attractive for external resources. Cheshire and Gordon (1998) highlight that the national benefit of attracting foreign resources could be the same regardless of the specific regions receiving the investment, suggesting that territorial competition is a zero-sum game. Furthermore, territorial competition may also lead to a negative-sum game when an industry attracted in a region is less productive than it would be by locating elsewhere without regional competition (World Bank, 2008). Moreover, devolution may affect efficiency because of the possibility of overlapping competencies between different tiers of government that tend to replicate the same services. Finally, efficiency is also reduced by the risk of corruption that is greater at local level where the interaction between economic and political agents is more frequent.

In light of the literature reviewed above, the relationship between devolution and both economic equity and efficiency is ambiguous. Therefore, we suggest that the impact of transferring powers to lower tiers of government on regional economic development most likely depends on the initial level of disparities and inefficiency in a country, on the structural characteristics of countries and regions implementing decentralisation, and on the modalities of transfer of power to SNG. These elements are of utmost importance when designing decentralisation. We will briefly explain this by recalling the Mexican experience of decentralisation. The choice of Mexico is justified in this context by several



facts. First, risks (and also benefits) of decentralisation design are strongly evident in this case due to the deep level of decentralisation in this country. Moreover, the Mexican case could also be informative in the perspective of the European Neighbouring Policy (ENP). In fact, Mexico is a developing country (as well as European neighbours) that integrated its economy with the US as a result of NAFTA.

### **6.3 An example of decentralisation: the experience of Mexico**

Mexico has long been a “on-the paper” federalist country, that is, although the Mexican Constitution implied a decentralized state, the central government has always been the core of decision-making (Shirk, 1999; Rodríguez-Pose and Gill, 2004). However, a concrete shift towards decentralization begins in the 1980s to maintain political stability after the debt crisis of 1982 and to respond to regional demands of larger autonomy, such as in the case of the Chiapas revolt (Rodríguez-Pose and Gill, 2003). Therefore, from the presidency of de la Madrid (1982-1988) to that of Salinas (1988-1994) the level decentralization increases gradually. Then, under the presidency of Zedillo (1994-2000), decentralization plays a major role with the “New Federalism” agenda, aiming at increasing the transfer of resources and authority at sub-national level.

With respect to equity, Rodríguez-Pose and Gill (2004) suggest that the gap in regional GDP widens along with the increase of decentralization from the period of president de la Madrid to the “New Federalism” of Zedillo. Therefore, a temporal (not causal) correlation exists between greater decentralization and rising inequalities. However, they also argue that other significant factors unrelated with devolution may affect equity. For instance, the relatively fast trade liberalization of Mexico from an import-substitution strategy to the GATT regime and then to a free-trade area (NAFTA) contributes to widen disparities among Mexican states, benefitting regions at the border with the US and Mexico City (Krugman and Livas Elizondo, 1996; Sanchez-Reaza and Rodríguez-Pose, 2003). Decentralization may amplify such disparities. Indeed, the existing gap between rich and poor states is perpetuated by decentralization through the particular design of Mexican earmarked grants (*aportaciones federales*) (Joumard, 2005). Such federal transfers to SNG have to be spent for programs regulated at central level (mainly education and health), so that local actors have no autonomy on how to use such resources. Following Joumard (2005, p.13), the rationale for earmarked grants relies “on the existence of regional spillovers in sub-national spending programmes” so that such grants are needed “to avoid sub-optimal spending at a local level”. Moreover, when there are “similar spillover effects across states, then states should receive the same level of earmarked grants

per head”. However, in Mexico the amount of grants transferred depends on the costs faced by the central government to provide such services prior to decentralization. Given that transfers were biased towards richer states, earmarked grants not only still largely reflect old disparities but also tend to exacerbate them.

With respect to efficiency, the existing literature seems to suggest that decentralization in Mexico promotes managerial and political innovation. However, the institutional and legal framework associated with fiscal discipline represents a problematic issue for efficiency.

Joumard (2005) has analysed some efficient and creative solutions that SNG have designed to address local problems. For instance, regions such as Chiapas and Jalisco have adopted “a modern budgetary and payment information system which simplifies the registration and control of financial operations, thus reducing the scope for corruption” (Joumard, 2005, p.10). Chiapas and Sonora have created a mechanism of selection of teachers that is more transparent and meritorious than it was under the control of trade unions. Other states have made more accountable and effective their administrative system. In addition, Jalisco has adopted innovative solutions such as support centres for small and medium enterprises and incentives for niche productions as part of a comprehensive strategy of local sustainable development. Most important, successful innovations in one state are being gradually adopted by other states through channels organized by the central government, such as co-operation and technical meetings. Moreover, service provision in rural and remote areas is increasingly being based on consultations between different tiers of government and civil society rather than being adopted with a top-down approach (OECD, 2005), suggesting that decentralization may also facilitate political innovation.

However, efficiency is seriously threatened by the rising debt of most Mexican states, due to a deep imbalance between revenues and expenditures. This may be interpreted as the joint result of two different elements: the extraordinary 1995 federal bailout to Mexican states after the peso crisis of 1994 (IMF, 2004) and a weak general fiscal discipline. Indeed, such a bailout created a moral-hazard problem leading SNG to overborrow from banks given the certainty to be supported by federal transfers (Hernández Trillo et al., 2002), with the risk to harm federal public finance. This situation is negative also in terms of equity since moral-hazard is particularly strong in the case of richer states due to the too-big-to-fail argument. Thus, federal transfers for the support of indebted states are biased towards richer ones.

With respect to weak fiscal discipline, it is reflected in both the soft budget constraint allowing states to borrow without particular restrictions and the Mexican fiscal system that relies mostly on federal transfers rather than regional taxation revenues. In fact, the regulation of sub-national borrowing is soft and banks have no incentive to assess the risk of regional projects (Hernández Trillo et al., 2002). Moreover, the combination of SNG reliance on federal resources and the limited capacity of raising local taxes (Joumard, 2005) further reduces the spending responsibility of states, exacerbating the accumulation of debt and negatively affecting efficiency.

What can be learnt from the Mexican example is that the overall impact of devolution largely depends on the modalities of the transfer of authority and resources to SNG as well as the specific characteristics of the country. In fact, the unequal system of Mexican earmarked grants as well as weak fiscal instruments and the legal and institutional framework that facilitates the culture of soft budget constraint are issues directly connected with the design and implementation of devolution and local conditions rather than with the notion of devolution itself. Therefore, we argue that good design and correct implementation according to the local context are fundamental elements in order to gain from devolution both at national and sub-national level. As highlighted, national and regional structural characteristics may mediate the relationship between devolution and development. In Mexico, the opportunities of trade liberalization have mainly been caught by the capital-city and the states at the border with the US for geographical reasons linked to the advantage of easier market access to North America (Krugman and Livas Elizondo, 1996; Sanchez-Reaza and Rodríguez-Pose, 2003). Hence, devolution may also exacerbate pre-existing large disparities due to peculiar characteristics of a country, such as economic geography. This remark suggests that, although a well-designed devolution may contribute to regional economic development, some countries and regions may present a number of obstacles implying that not always devolution is desirable or it should be implemented to a lesser degree.

## **7. Concluding remarks**

In this paper we have explored the main concepts and ideas arising from the literature on regional economic development. We argued that geography matters for economic development in the sense that forces that lead to innovation and growth are rooted in specific places or regions (rather than countries) and they cannot be easily moved elsewhere or replicated in different contexts. Therefore, regional economic development literature focuses on the processes that favour learning and new

knowledge creation at the local level. A particular relevant role is played by the cultural and socio-institutional characteristics of regions, which basically drive the economic behaviour and attitudes of local actors by providing the appropriate structural relational assets to the regional economy (Storper, 1997; Scott and Storper, 2003). This makes innovation and development no longer a linear but a multidimensional process by affecting local relations, rules, absorptive capacity and the capability to re-use knowledge. Globalisation sharpens the localised nature of innovation and development rather than alleviating it, since successful regions become able to exploit external knowledge as well as to serve international markets. Acknowledging that development is a localised process dependent on spatially-bounded elements as well as past trajectories (i.e. path dependency) provides an explanation for inequalities between regions within countries. We also argued that the pattern of regional disparities is more evident in developing countries due to the scarcity of locations that are able to absorb external knowledge in these areas. Bottom-up policies are precisely designed to take into consideration forces that influence innovation and development in specific locations. Such policies are in contrast with traditional top-down strategies that basically offer the same general measures of economic policy regardless of local conditions and characteristics. Crescenzi and Rodríguez-Pose (2011) argues for a reconciliation of top-down and bottom-up policies in order to approach regional development issues from a meso-level perspective. This 'integrated framework' makes it possible to analyse with the same conceptual tool different regions and to identify, on the one hand, regularities across space in the development trajectories of different locations and, on the other hand, specificities in the functioning of the economic system related to particular places. The growing awareness about the relevance of local forces in shaping regional economic development path is reinforced by the increasing demand for power decentralisation from national to regional governments in the last decades. Decision-making at the local level could be extremely positive for regional development by encouraging collective action and tailoring strategies to local needs, although some drawbacks also exist in terms of equity and efficiency. In general, regional economic development theories highlight that development potential and competitive advantage are strongly localised elements. Therefore, what development strategies should aim at is basically to adopt balanced policies which build upon local strengths and try to alleviate local weaknesses as the only way to root economic activity in territories in a sustainable manner (Pike et al., 2006).

## 8. References

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