



**The Spotty Record
of Regional Development Programs:
Can Governments Do Better?**

By

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I am most grateful to the Alberta Economic Development for giving me an opportunity to address this conference on how we can make regional development programs work better. Every country that I know of throughout this world — whether developed or developing — faces a common dilemma: What can a government do to get poorer regions to grow faster so that regional disparity can be lessened?

The record of regional development programs has been spotty. One recent World Bank report came to the conclusion that “regional development policies have failed in almost all countries – federal and unitary alike”. Where there has been some reduction in regional inequality, such as in the United States, the convergence in regional income seems to be an outcome of policies that have eliminated barriers to the movement of people and capital rather than the success of any specialized regional development policy.

This conclusion – regional development policies do not work – is a rather depressing one for governments that face considerable political pressure to help poorer regions in a country. In Canada, the federal government spends almost three-quarters of a billion annually on regional development programs. Most provinces have their own regional development programs, as well. Moreover, many public programs, such as Employment Insurance and provincial revenue equalization, have regionally based benefits associated with them. Even some tax provisions like the federal Atlantic Investment Tax Credit or the Northern Ontario tax holiday are regionally based. With all the policies pursued here in Canada and elsewhere, surely some succeed in lessening regional disparity. Otherwise, we are wasting taxpayer dollars.

I will cover three issues:

First, why does regional inequality arise and what does that imply for policy? We might think that the answer to this question is obvious but I hope to show that it is not.

Second, what public policies, if any, can best be used to address regional inequality issues? In other words, what fails and what works?

And finally, what would I prescribe to governments today as best practice for regional development policies?

Why Does Regional Inequality Exist?

To understand what policies might work, we need to understand why regional inequality arises in the first place. I will segregate my discussion to consider two polar cases entitled “integrated economies” and “agglomeration”. As I hope to make clear, each case has some important implications for policy.

“Integrated” Economies. To begin, let me start with what I call the “integrated” economies to analyze regional disparity. Without any special regional attributes, a mobile population will spread out evenly among regions. Regional inequality would not arise at all if people were freely mobile, moving to where they earn more income or enjoy

a better lifestyle. As long as no jurisdiction has something intrinsically better to offer than another (such as living near the mountains or harbours), incomes adjust to same levels across all regions.

Of course, some places might have some significant economic advantages, such as the oil-sands areas of Northern Alberta. Businesses will flock to Fort McMurray because they can earn profits by exploiting the oil resource. They will have to hire more workers creating more demand for labour in the region. Wages go up — recently almost \$70,000 per employee — causing people to migrate into the region. Housing and land prices rise, eventually cutting off migration as the region becomes too expensive to attract new people. In other words, personal incomes primarily derived from employment and adjusted for prices including the cost of housing, eventually fall to levels found elsewhere. Differences in income observed regionally therefore only depend on the ownership of property that becomes more valuable in the face of new development. Residents near the oil sands enjoy higher incomes if they own the real estate prior to development. Of course, non-residents might derive income by owning Northern Alberta property too.

The implication for national government policies in the presence of “integrated” economies is to reduce barriers to mobility of people and businesses. By opening up trade and factor flows, people and businesses will pursue their best economic opportunities without being restricted by regulations and other barriers to mobility. The best regional policy is therefore to make sure that the economic environment promotes mobility.

Agglomeration Economies. So far, I have suggested one theory, which predicts that employment incomes equalize across regions in the absence of barriers to mobility. Another view is that people and businesses derive benefits by locating in clusters because they can more efficiently trade goods and services at lower per-unit transport and communication costs. Therefore, agglomeration explains differences in incomes among regions.

In larger centres, businesses find they have a bigger, more heterogeneous, pool of workers, so that they can find more easily the most suitable employee. Managers can meet more often face-to-face with their bankers to work out lending deals. Employees, such as those in the hi-tech industry, can more easily talk to each other when they meet in bars and coffee shops. Further, some activities that help attract large populations are cheaper to provide because of greater consumer demand — opera houses, sports teams and museums are some clear examples.

In the presence of agglomeration, businesses and workers enjoy productivity gains that enable them to earn higher incomes. Businesses won't shift production to low-cost regions because it is important to remain close to their product, capital or labour markets. It is even possible for the poor region to empty out entirely with the whole population eventually residing in the large urban centre.

So why does one place of residence end up being the richer centre? In part it depends on historical advantages. Usually, a region takes off by having some locational advantage: a harbour (New York and Sydney, Australia), tourism (Florida or Hawaii) or a mineral resource (Houston or Calgary). Some regions have taken off simply because certain institutions, such as research universities, are present — San Francisco and Boston quickly come to mind.

The key difference between “integrated” and “agglomeration” economies is that agglomeration results in differential regional incomes — some regions will have richer, larger populations than others, even after correcting for differences in price levels.

Most importantly, unlike “integrated” economies where the population is optimally distributed, agglomeration could lead to a non-optimal distribution of the population. The non-optimality results from migrants not taking into account the economic impact of their moves on the community. Too little migration will result when migrants to a new community do not take into account the economic benefits conferred on existing residents by creating larger networks. In contrast, too much migration takes place when migrants impose economic costs in those communities which they left.

On balance, I come to a conclusion typical for two-handed economists — theoretically, migration may be too little or too large. A weak case might be made for either too little or too much migration but it is difficult to measure it empirically.

Some recent work suggests that productivity gains to an economy are associated with greater urbanization. As a consequence, agglomeration should be encouraged, not discouraged, by public policies, and regional-development policies should be aimed at helping high growth areas instead of low growth regions. The case for policies aimed at supporting low growth regions is as “shaky as a fiddler on the roof”.

However, one should not jump to the conclusion that migration to urban centres should be promoted by governments. Policies that pursue agglomeration aggressively not only reduce productivity in regions that are being abandoned but also increase congestion costs in urban centres. The case for active promotion of agglomeration is also on shaky grounds.

Let me provide an example. In the late 18th century, Great Britain, followed by the rest of Europe, underwent a major transformation with the adoption of the steam engine — railway lines connected major urban centres and ships were able to travel quickly among distant trading centres. Rural populations moved to urban centres leading to the growth of large cities like London and Manchester. Remaining rural communities were critical of the flight of people to large urban centres because it became more difficult to hire agricultural workers.

Using today’s lens, would we say that Europe had too little or too much migration from rural to urban populations? If too little, then the role of government would be to remove barriers to mobility and provide infrastructure like roads and water treatment centres for

the expanding urban populations. If migration was extreme, governments should then support the rural populations. Politicians during the 18th and 19th centuries debated these issues fiercely, just as much as we do today. Yet, they, like us, had little basis for their arguments outside of a gut feel as to whether populations were optimally distributed.

Regional development policies have been justified to help a region “get over the hump” by growing faster and attracting new people and businesses to a cluster. In recognizing this point, however, we must separate the role of a community trying to get over the hump, compared to a federal government trying to achieve the same thing.

From a region’s perspective, growth is a good thing — a community, competing for people and businesses, creates a better economy by finding new and innovative ways to develop. The World Bank study, which I referred to earlier, suggests that it is more likely for regional disparity to remain stable or lessen with decentralized governments, as in federal states, while regional incomes diverge more in unitary states. Competition among communities can be healthy because local governments are better able to judge what it takes to develop and, more importantly, they are accountable to their voters if things go wrong.

On the other hand, the policy justification for nationally provided regional development policy is far from clear. Federal regional policies can interfere with mobility, resulting in an inappropriate distribution of population from the national perspective. If we take a view that too much migration has taken place from poorer to richer communities, we can then justify some intervening role for federal government policy to support a poorer population. However, as I said, it is hard, very hard, to provide empirical support that too much migration has taken place.

Let me illustrate this point using a clear policy issue in Canada today. The oil-sands development in Northern Alberta, to which I have already referred, has attracted a significant new population to the area, including almost a fifth of its work force from Newfoundland. What should be the role of the federal government? Should it, along with Alberta, help cover the cost of infrastructure — transportation, hospitals, schools and water and sewage treatment — as the population grows in the Fort McMurray region? Or should it instead provide more regional development funds to Newfoundland to help keep the population at home? For “integrated” economies, the answer is pretty simple. The federal government should support infrastructure expenditure in Northern Alberta. For “agglomeration” economies, no simple answer to this question can be provided.

What Works?

If we accept that regional policies should be adopted to help poorer regions grow, what can we say works and does not work? Governments have good intentions to help poor regions to grow but sometimes the best policy advice is to avoid making costly mistakes. To make some points transparent, I begin with some reasons to explain why so often regional development policies fail so that we can understand better what might work.

What Does Not Work. Typically, regional development policies fail for three reasons. First, the mandate is wrong. Second, the design is poor. Third, political forces result in the wrong policies being adopted.

Mandate. Let me first begin with the mandate. The usual mandate is for the regional development program to create a “cluster”, whereby economic growth results from some perceived industrial advantage that might be exploited by private and public sectors. Support might be given for some specific business sector, small- and medium-size businesses, community-based non-profit activity, research and development, or venture capital. Public interventions in the form of business financial support (grants or loans), tax relief and other public spending programs are targeted to specific activities to help spur growth.

The record of governments in identifying the “right” clusters is pretty poor, whether it is the plastics industry in New Brunswick or forestry and toxic waste management in Alberta. Governments have been notoriously inept in identifying winning industries while losers are often first at the Minister’s doorstep to seek handouts.

The difficulty of trying to identify the “winning cluster” is not surprising since businesses enter and exit markets at rapid rates, especially in an era of rapid technological change. Arnold Harberger of the University of Chicago addressed this issue head on with an analysis of “star” and “dog” industries and businesses in the United States and Chile over several decades. In every decade, there is a new star industry whether transportation in the post-war period, or hi-tech in the 1990s. More importantly, within each industry, business success varies widely. Even in a “star” industry, most businesses are more likely to be “dogs”, although the “stars” do fantastically well.

Harberger’s conclusion is that governments have a very difficult time in identifying winning industries and have an even more difficult time identifying winning businesses. In his view, the best mandate for development policy is to create a good environment to nurture new businesses rather than trying to target assistance.

Even if a government succeeds in encouraging new firms to locate in a region, the policy may not achieve the aim of expanding the economy as a whole. Targeted policies often create more problems than successes:

- **Unneeded Assistance.** Subsidies or targeted tax relief might encourage new business to a region but the investment might have been planned anyway. Thus, the cost per job created could be substantial. For example, the per-job cost of the Cape Breton investment tax credit was estimated to be significantly higher than average earnings of workers.
- **Unfair Competition:** Government policies that try to attract targeted businesses to the economy could drive out competing businesses, creating little or no net gain in employment. In developing countries, tax holidays and special assistance for new companies have been perceived as leading to “unfair” competition for older

businesses, putting pressure on governments to provide additional assistance to established companies.

- **Undermining Incentives for Growth:** Businesses receiving handouts from governments have less incentive to grow since they become protected from facing bankruptcy or competition from other domestic and international markets. Instead of generating growth, business subsidies reduce it because companies have little incentive to innovate or improve business practices. A Swedish study showed that subsidized businesses qualifying for regional development grants had lower productivity than non-subsidized businesses. Further, as shown in several Canadian studies, small business subsidies and tax incentives have done much to create new small businesses (in part by breaking up larger companies) but little to encourage the growth of small businesses into larger companies. Targeted support for small companies has generally failed in achieving a solid basis for economic growth.
- **Someone has to Pay for The Assistance:** Government assistance in the form of spending or tax relief costs the treasury money. Even if the tax base expands to help compensate for subsidies or tax relief, the increased demand for public services like roads and hospitals will put pressure on public spending. With substantial spending and loss in revenues, governments lose the fiscal means to fund other public programs such as education and infrastructure that could be just as important in development. Further, if governments have to raise taxes to pay for targeted assistance, the economic cost of taxation would hinder economic growth as well.
- **Price Effects:** Instead of creating new growth, the effects of targeted subsidies might simply result in higher rents for landlords, higher salaries for employees in the subsidized business or higher capital good prices for industry-specific inputs. The Quebec tax-holiday for hi-tech businesses leasing space in the downtown Montreal Internet Towers drove up rents for Tower owners and hurt other landlords who lost tenants. Little economic growth resulted from the incentive.

Design. Even if the mandate for a regional development program is fine, the design of the program might be flawed, resulting in failure. Programs might be well intentioned, but their design can create incentives that undermine their effectiveness.

For example, some experts have suggested that tax cuts might work better than spending programs. But not all tax cuts are equal.

Corporate tax holidays, as used in Newfoundland, Northern Ontario and many developing economies, are the worst form of tax cut to spur economic growth. While some new activity might be generated, the economic and revenue costs are especially high. Tax holidays result in large tax leakages as businesses shift income into holiday firms from associated non-holiday companies. Further, churning occurs — many businesses, such as found in a Puerto Rican study of tax holidays, close down after the

holiday and restart as a new one to qualify for new holiday. Governments also lose substantial amounts of funds after a holiday is completed since the carry-forward of holiday losses and unclaimed capital cost deductions, as permitted in Canada, shelter post-holiday income from taxation.

If a tax cut is used to spur on activity in a specific region, a more efficient policy to adopt is an investment tax credit or allowance to minimize revenue losses. The tax assistance is provided upfront and directed at investment to take place rather than providing relief to investments already in place. Tax credits can also be provided to companies not paying taxes if they are made at least partially refundable. Further, the tax credit is only given if the activity is located in the region — other incentives like rate cuts might move profits but not activities to the jurisdiction. The investment tax credit can be broadly made available to all business activities, avoiding the necessity of governments to pick “winning” industries.

Politics and Accountability. Even if regional development policies have the right mandate and good design, politics could play an important role in their delivery. Political issues can significantly influence the choice between grant programs and tax relief measures.

Grant programs are more easily influenced by politics and therefore could be undermined in their effectiveness. Members of Parliament or a provincial legislature love cutting ribbons to win votes, so grant programs with a heavy dose of political intervention might be geared to less economically, but politically important, programs. Public spending will be timed to improve the chances of winning especially marginal seats.

Public spending on regional development programs to support communities is not only subject to political intervention, but could undermine accountability. If a community is responsible for covering the costs of its own development program, the government of the day is accountable to its electorate. However, if an upper level government pays for the cost of economic development in a community, the community leadership is less accountable to its own taxpayers because another level of government is “greasing the wheel”.

However, public spending is at least scrutinized in Parliament and legislatures making federal and provincial governments somewhat accountable for their decisions. Still, it is rare for opposition parties to have sufficient information to challenge details of a long list of different programs falling under different ministries. Accountability is better left at the local level of government.

What Works?

While much can be said about what does not work, can we say anything about regional development policies that do work? Some things have worked well and I will review the policies that seem to work best.

Efficient and Competitive Economic Policies: Sometimes just good old economic policies that are not micro-managed can do the trick in achieving a take-off for a region. No targeted subsidies, loan or tax relief is required since the private sector will create the clusters needed for economic growth.

Responsible fiscal policies create a stable economic climate for businesses to look favourably at a jurisdiction. Governments focussing on their traditional responsibilities such as education, infrastructure and law and order provide meaningful assistance to people and businesses to conduct their affairs. Competitive and neutral tax policies that keep rates low and bases broad engender an environment in which businesses pursue opportunities for economic gains rather than minimize taxes. An environment aimed at opening up markets for trade in goods, services, capital and people connect the regional economy to worldwide technologies, innovations and ideas.

It is not hard to find some good examples in which sound economic and fiscal policies have led to a take-off for poorer regions and a convergence of regional incomes. Three cases that come to mind include Chile, the United States and the European Union.

- With Chile, regional inequality declined from 1987 to 1994 in part because of market liberalization, which led to the growth of mining in the north and salmon breeding, tourism and methanol production in the far south. These two poorer regions have been catching up to the rich central part of Chile.
- Regional inequality in the United States has also declined in the past several decades. Much of this can be attributed to the dynamic nature of labour and capital markets – the U.S. population is highly mobile across states, and capital markets have become more integrated with financial reforms.
- The most dramatic change has occurred in the European Union. Among countries in the EU, regional incomes have been converging over time, similar to developments in the United States and Canada. The best-known case contributing to a convergence of regional incomes in Europe has been Ireland.

Ireland represents the poster child of successful economic development as it moved from being one of the poorest to one of the richest countries in the relatively short period of two decades. For centuries, Ireland's per capita income was one of the lowest in Europe. Since 1980, when unemployment was still close to 20 percent of the population and per capita income was less than 70 percent of the European average, Ireland enacted several important economic reforms that increased Irish GDP per capita by more than 7 percent annually, twice the typical rate of industrialized economies. Today, Irish per capita income is more than 20 percent higher than the average income of industrialized countries. As a result of these income gains, the historical brain drain to the United Kingdom and North America has been reversed to a brain *gain* for Ireland.

The Irish miracle is quite a complicated story, but analysts agree on several factors that have been important to its development. The first is that Ireland, being a member of the

European Union, had access to a large market into which it could sell goods and services. The second was that Ireland undertook a strategy, agreed among business, labour and government, to increase both the demand for and the supply of skilled workers. With some help provided by European regional subsidies, the Irish invested heavily in education to upgrade worker skills because so many individuals had only primary education, never mind secondary or post-secondary schooling. The Irish also substantially cut their high business taxes, initially on manufacturing and financial incomes, while eliminating several ineffective targeted investment incentives to attract multinationals to hire newly trained workers. The outcome of all these policies is success – Ireland is the development story of the late 20th century.

The examples I have given serve to illustrate that economic development can be generated by uncomplicated policies that remove barriers to the free flow of goods, services, capital and labour, promote investment in basic economic infrastructure, such as education, and foster competitive and neutral business taxes.

We have some Canadian examples, too. Regional incomes in Canada have been converging since 1980 in part as the result of better economic performance in the Atlantic (due to the discovery of non-renewable resources) and slower economic growth in British Columbia. New Brunswick, without the resource advantages of some other Atlantic provinces, has been catching up to the national average in past two decades. During the McKenna years, several policy reforms were adopted that moved towards a more efficient and better-operated public services and regulations. For example, New Brunswick adopted experience rating for workers' compensation that led to a better matching of contributions with benefits paid for injured workers across business activities. Payroll taxes fell sharply for service businesses, resulting in the well-known growth of call centres in New Brunswick during the 1990s.

Improving Access to Transportation and Communication Networks. While sound economic policies can generate growth for a region, some communities, especially in rural areas, may simply be too isolated due to high transportation and communication costs. Therefore, some governments have pursued public policies aimed at building better transportation and communication networks to connect less-populated regions with urban centres.

The European Union has turned to the Trans-European Transport Network program as a new form of regional development policy. Canada is connecting rural communities with urban centres by investing in broadband Internet services. Glasgow City Council has developed 70 percent of its land for enterprises in close proximity to the city's strategic network.

Such policies can improve incomes in both urban and rural areas. Lower transportation and communication costs permit greater access for isolated regions to larger markets but also make it cheaper for the urban centres to service rural communities. As a consequence of better access, the forces of agglomeration could generate greater migration from poor-populated to dense-populated regions. Nonetheless, incomes should

rise overall as economies become more productive in the face of lower transportation and communication costs.

Co-ordinating Efforts of Administrative Units. Countries with federal systems of government and independent jurisdictions tend to experience greater convergence of regional outcomes. Although central government action might be viewed as necessary to fund regional development programs, local communities often proceed best with development plans since they know better their advantages and resources, including entrepreneurs. Federal policies could, however, help improve the environment for business competitiveness and fund basic public services. Local communities are in a better position to undertake development plans.

Nonetheless, some co-ordination is often appropriate across local boundaries, especially for small jurisdictions that need to better leverage their resources. Provincial or state level governments could create a forum for private and public interests at the community level to co-ordinate efforts when linkages among the communities would be fruitful. France and Hungary have promoted co-operation agreements and voluntary associations among sub-national governments. The Alberta government is recently working with local communities in rural areas to help them pursue common interests in development. Municipalities, as in the Czech Republic, have created municipal associations with the goal of building better and cheaper administrative capacity. Partnerships among businesses, voluntary organizations and governments have been created in the United Kingdom to redevelop distressed urban areas.

Conclusions: What Should Canada Do

Current Canadian regional development policy is directed at an old model based on the assumption that targeted financial assistance for certain business activities spur economic growth in poor regions. However, this approach has demonstrably failed and should be scrapped. Targeted subsidies and tax relief measures fail to generate growth since some businesses might have undertaken the activity without the support, drive out competitors from a region and impose economic costs if the program is ill-designed or subject to political manipulation.

Instead, a far better plan for federal and provincial regional development would be based on the assumption that growth is best supported by open and competitive markets and fewer regulatory, tax and other barriers to mobility. Specifically, governments could promote regional development with a three-point plan:

- Create conditions for a dynamic, competitive business sector with the provision of basic public services such as education and infrastructure as well as a competitive and neutral tax system with low rates and broad bases.
- Invest in transportation and communication networks that better link densely and less-populated regions.

- Improve co-ordination of local governments to leverage their resources better, without limiting independent, innovative policies that accountable local communities are in the best position to promote.

With this three-point plan — based on the notion that the most successful economies with converging regional incomes are those with competitive communities — regional development policies might be in better position to actually work. Let's hope governments might be able to succeed where they so far have failed.

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