

## **Government and Sub-national Growth**

### ***Uneven growth within low income countries: Does it matter, and can governments do anything effective?***

A framework paper prepared for DFID Rural-Urban Change Team

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## **Government and Sub-national Growth**

### ***Uneven growth within low income countries: Does it matter, and can governments do anything effective?***

#### **Executive Summary**

This paper discusses how governments in low income countries should respond to uneven patterns of growth and poverty reduction between different regions within the country. Evidence reviewed in this paper indicates that the spatial concentration of economic activity in and around cities is a major driver of growth and poverty reduction. However, this may often result in widening disparities between sub-national regions. The fundamental issue addressed by this paper is whether these disparities matter, and whether governments can do anything effective to address them.

The debate centres on a number of questions:

- Will policies to reduce inequalities between regions depress overall growth and hence undermine poverty reduction?
- Should governments focus on promoting growth in favoured locations where it is most likely to take off, or would this generate unacceptable inequalities between regions that would threaten peace and political stability?
- Are there realistic ways to minimise these trade-offs and to enable pro-poor growth in poorer regions without undermining overall growth and poverty reduction?
- What are the political and institutional impediments to achieving more evenly distributed growth and poverty reduction?
- How can donors intervene effectively in this area?

The paper is structured in four parts:

#### **Part A – Why do sub-national growth issues matter for development?**

Although sub-national growth issues feature prominently in policy making processes in developing countries, these issues have not figured strongly in donor analysis, policies and programmes. This paper argues that there are four main reasons why sub-national growth issues matter for development:

- The ability of governments to manage the spatial dimensions of growth will affect progress towards the MDGs and conflict reduction. The marked concentration of poor people in specific regions points to the importance of the sub-national pattern of growth for overall poverty reduction. Inequality between sub-national regions can also be a driver of conflict (section 2).
- Evidence presented in this paper indicates that disparities in income levels between sub-national regions have tended to widen in most low income countries over the past two decades. In particular, economic activity has become increasingly concentrated spatially in and around expanding urban centres (section 3).
- It is particularly important to consider sub-national growth issues in low income countries, which are often characterised by large primate cities that dominate the national economy.

Evidence suggests that the proportion of the population living in the largest city (primate city) is greatest in low income countries (section 4).

- New theories of growth and economic geography have drawn attention to the spatial dimensions of the growth process. In particular, they highlight the externalities (both positive and negative) that arise when firms cluster together. They suggest that the spatial concentration of economic activity, often associated with urbanisation, is an important driver of growth. They also predict that market forces will commonly cause the economic performance of different regions to diverge (section 5).

## **Part B – What can governments do to address uneven sub-national growth?**

Governments intervene in numerous ways to influence sub-national patterns of growth. One of the main emphases of this paper is that the objectives of policy may differ. In some cases governments seek to maximise economic efficiency and overall growth by correcting market failures. In other cases, governments may be primarily concerned with equity and reducing inequalities between regions. Finally, governments may intervene in order to ease regionally-based political tensions that arise from uneven sub-national growth. While some of these objectives are complementary, there are also important trade-offs between them (section 6).

It is difficult to generalise about the objectives and content of policies because these vary in different country contexts (section 7). There are a number of key geographical, historical and political variables that influence sub-national growth processes and the appropriate policy response. The paper emphasises the importance of political economy factors in explaining why sub-optimal policies are often adopted.

The paper discusses four broad policy approaches to address sub-national growth issues:

- (i) **Sub-national fiscal transfers** (section 8.1). There are significant drawbacks to sub-national transfers as a means of promoting growth. However, most countries have developed a system of transfers for a variety of well-founded reasons, including concerns with equity and political stability, as well as the pressures arising from the structure of tax and expenditure assignment between different levels of government. Greater understanding is required on how to minimise growth-equity trade-offs in the design of transfers.
- (ii) **Strengthening the enabling environment for growth within sub-national regions** (section 8.2). A major priority should be to remove obstacles to doing business. Investment and tax incentives can also play a positive role in promoting development in lagging regions. However, rules need to be put in place to avoid zero-sum competition between regions. Investment climate reforms are likely to generate significant growth benefits within well-located regions, but remoter areas are unlikely to experience much benefit.
- (iii) **Facilitating labour mobility** (Section 8.3). The contribution of labour migration to growth, poverty reduction and inter-regional equity has often been overlooked. There is a wide-ranging policy agenda that needs to be addressed covering: labour market policies, infrastructure policies, social policies and financial sector policies; and the management of internal migration in conditions where this may generate social tensions.

- (iv) **Spatial planning and transport infrastructure** (Section 8.4). Infrastructure investment can stimulate sub-national growth. There are difficult choices between competing priorities including the need for improvements in urban infrastructure, infrastructure linking urban areas to peri-urban and rural hinterlands, infrastructure in remote rural areas, inter-regional infrastructure and cross-border infrastructure. In order to make these choices there is a need to strengthen planning capacities and institutions. Donors should provide greater support for these processes, as well as providing the necessary finance for infrastructure investment.

Finally it is important to consider the sub-national effects of macroeconomic and sectoral policies (section 8.5). Although these policies are rarely considered in spatial terms, their effect may differ from one region to another. This paper calls for a more spatially sensitive macro approach.

### **Part C – How should governments implement policies for sub-national growth?**

The third part of the paper considers the institutional and governance arrangements that need to be in place to implement the above policies and approaches. The paper argues that decentralisation presents particular opportunities to improve policy making, but that it is difficult to generalise about its effect on overall rates of growth, the efficiency of service provision and the quality of governance. There is some evidence that decentralisation is associated with the widening of inter-regional inequalities. This risk needs to be countered by promoting well-designed sub-national fiscal transfer systems (section 9).

Another concern addressed by this paper is the need for coordinated action between different levels of government and between local governments in different geographical areas. The governance of large cities presents special problems due to their size, complexity, functional linkages to surrounding areas, their political sensitivity and the fractured nature of their administration. There is a need to strengthen the quality of urban governance, in particular to promote more integrated planning of metropolitan regions. City-regions are drivers of growth, yet their development is often constrained by the fractured nature of their administration. Donor support for institutional development and capacity building can help to promote more “joined up” planning and management (section 10).

Problems of weak governance and accountability are often most acute at sub-national levels of government. A key challenge for improving policy making at sub-national level will be to strengthen local democracy, and the role of civil society and business organisations in pressing for greater accountability and improved government performance (section 11).

### **Part D – Conclusions and implications for donors**

Donors affect spatial patterns of development, sometimes inadvertently, through their decisions on where to invest, their sectoral priorities, the policies that they advocate, and the broader impact of their funding on patterns of public expenditure. Donors’ strategies, policies and programmes therefore need to be based on more spatially-sensitive analysis, and to be better designed to support growth processes at the sub-national level. However, at present the impact of development aid is often insufficiently analysed in spatial terms. Such spatial blindness carries the risk of investing in the wrong places, missing opportunities to support growth and poverty reduction, and exacerbating conflict.

Recipient governments tend to be more sensitive to the political and sub-national implications of policies and investments than donors, who are usually most concerned with development indicators

at the national level. In order to support their partners more effectively donors' perspectives will need to change in order to treat the spatial dimensions of development with more system and seriousness.

The most important messages are presented below, and are discussed more fully in section 12:

- **Focus resources on regions where there is the greatest potential to raise rates of pro-poor growth in the long term.** Greater impact will be achieved by supporting regions with better growth prospects rather than directing resources at the poorest regions. Urban development should figure more highly in donor priorities because of the role of cities in generating growth, their potential to absorb migrants originating from lagging regions, and their linkages to the surrounding rural economy (e.g. through labour and product markets). There is great potential in many countries to enhance the contribution of cities to growth and poverty reduction by addressing problems of weak urban governance and inadequate service and infrastructure provision. Donors have tended to steer clear of urban projects on the false assumption that efficient city management is not an important component of a national pro-poor development strategy.
- **But, also pursue a balanced strategy that addresses concerns with equity and conflict prevention in addition to growth objectives.** The main risk of the above strategy is that widening inter-regional disparities may threaten social and political stability and thereby undermine growth. It is important to build conflict awareness into development planning and implementation, and to be sensitive to the fact that spatial disparities often exacerbate other fault lines, ethnic, religious or otherwise. In addition, it is important to recognise that there are large concentrations of poor people in lagging regions, for which labour migration offers only a partial solution. These concerns dictate that donor resources should not solely be directed at regions with the strongest potential for growth and poverty reduction, but should also be used to address the problems of lagging regions. Unambiguous guidelines for the appropriate balance cannot be given; but the question needs explicit recognition and analysis in any given case.
- **An understanding of political economy should underlie donor strategies to support sub-national growth.** Political processes and competing vested interests mean that political elites often fail to adopt policies that maximise growth or optimise spatial patterns of development. There are important implications for donors. There are clear risks when donors become engaged in highly politicised processes, for example the reform of sub-national fiscal transfers. However, there are also opportunities for influencing change, most importantly by supporting accountability mechanisms to enhance the role of civil society and private sector organisations to press for reform. These processes are particularly relevant at sub-national level, where accountability tends to be weakest. Effective intervention depends on a thorough understanding of the political processes at work in each specific country situation, something donors tend to overlook.
- **Mainstream spatial thinking into the design of development policies and programmes.** For all development policies and programmes proposed by donors it is important to consider carefully their spatial implications, and to recognise the trade-offs between growth, equity and political dimensions. Spatial analysis should be applied across a range of donor instruments, including public expenditure reviews, budget support, sector programmes and large infrastructure development programmes. It should also be extended to policies that are not normally considered in spatial terms, for instance the sub-national effects of macroeconomic policies.

- ***Donor strategies to address sub-national growth issues must be adapted according to the country context.*** This paper discusses the issues in general terms, but interventions must be designed on the basis of careful country analysis. When assessing the country context there are several considerations: First, the reasons for donors to engage with sub-national growth issues will vary between countries. Inter-regional inequalities are present in all countries, but the problems are likely to be more severe in large, geographically diverse, ethnically divided and conflict-prone countries. Second, the design of strategies will depend on the available entry points for donor support. Within decentralised political systems (in particular federal states) sub-national growth issues tend to be more prominent in political debate and policy making, and there is greater scope for donor engagement. Third, the content of strategies should be adapted according to the geographical, historical and political context. A certain mix of policies may be appropriate in one setting, but not in another.
- ***Address gaps in knowledge that limit the ability of government and donors to formulate an effective policy response.*** A final recommendation for donors is to strengthen information and analysis on sub-national growth processes. Better spatial information will be essential to improve understanding of how growth occurs, and to formulate an effective policy response. It is also important to understand the spatial dimensions of growth and the associated trade-offs between growth, equity and political stability. The main knowledge gaps that are highlighted by the paper include: (i) understanding growth processes, (ii) the problem of supporting lagging regions, (iii) identifying best practice in the design of sub-national fiscal transfers, (iv) designing supportive policies for internal labour migration, (v) determining infrastructure priorities, (vi) understanding the spatial effects of macroeconomic and sectoral policies, (vii) learning how best to strengthen city-region management, and (viii) improving institutional arrangements for sub-national government. The numerous unanswered questions point to a broad research agenda bridging issues of theory, policy and practice, and highlight the need for further analysis at the country level.

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#### **1. Introduction**

*The spatial unevenness of growth is a key problem in development*

1. Faster economic growth tends to be associated with rising income disparities both among and within regions. Recent advances in empirical analysis and growth theory provide ample evidence that sub-national disparities matter for development and poverty reduction. Governments in low income countries have long recognised this, and have intervened in numerous ways to influence the pattern of growth at sub-national level. However, there is insufficient understanding about the effectiveness of such policies. In spite of their relevance to development, sub-national growth issues have also been neglected in donor analysis, policies and programmes.

*Purpose of the paper*

2. The aim of this paper is to discuss how governments in low income countries should respond to uneven patterns of pro-poor growth between sub-national regions in order to reduce poverty. The focus of the paper is on public policies and institutions that address two related sets of problems: (i) enabling and accelerating pro-poor growth within particular regions, and (ii) managing and possibly reducing over time, spatial disparities in growth between regions. The term sub-national growth is used to refer to these two objectives and is defined below.

#### **Sub-national growth: definition**

The term sub-national growth is used to refer to the patterns of growth within and among different regions within a given country. The paper considers variations in growth among sub-national regions in two dimensions: rates of growth in per capita incomes; and the extent to which growth benefits the poor.

*Users of the paper*

3. This paper has been prepared for DFID staff in order to examine the relevance of sub-national growth issues to development, to bring together a body of theoretical ideas and research evidence, and to discuss the implications for government and donor policy. The paper is particularly intended for use within country offices, in order to provide a framework for further analysis of issues and policies at the country level.

*Scope and limitations of the paper*

4. The questions addressed by the paper cover a wide range of development processes and policies. In the space available it will only be possible to provide an overview of the key issues rather than a comprehensive assessment of the evidence and review of the literature. Generalisations are difficult because patterns of sub-national growth are often country-specific. Consequently, the approach taken here will be to demonstrate how sub-national growth issues vary in different country contexts, in particular in relation to political economy, geographical and historical factors. The focus of the analysis will be on low income countries, but relevant examples will also be drawn from the experience of more developed countries.

*Key questions to be addressed*

5. An important message emerging from the paper is that the spatial concentration of economic activity in and around cities is a major driver of growth *and* poverty reduction, even though this may often result in widening income disparities between sub-national regions. The fundamental issue is whether these disparities matter, and whether governments can do anything effective to address them. There are a number of difficult questions that underlie the policy debate:

- Will policies to reduce inequalities between regions depress overall growth and hence undermine poverty reduction?
- Should governments focus on promoting growth in favoured locations where it is most likely to take off, or would this generate unacceptable inequalities between regions that would threaten peace and political stability?
- Are there realistic ways to minimise these trade-offs and to enable pro-poor growth in poorer regions without undermining overall growth and poverty reduction?
- What are the political and institutional impediments to achieving more evenly-distributed growth and poverty reduction?
- How can donors intervene effectively in this area?

This paper begins to address these questions, and explores the wide range of geographical, historical and political factors that explain why the answers differ according to the country context.

*Structure of the paper*

6. This paper is structured in four parts. Part A considers why sub-national growth issues matter for development, and attempts to describe and explain key trends using empirical evidence and theoretical propositions. Part B discusses what governments should do to respond to uneven patterns of growth, and presents a number of alternative approaches and policies. Part C considers how governments might implement these approaches, and the institutions and governance arrangements that may be required. Part D discusses implications for donors.

## **Part A – Why do sub-national growth issues matter for development?**

7. Sub-national growth issues matter for development for several reasons. First, the ability of governments to manage the spatial dimensions of growth will affect progress towards the MDGs and conflict reduction. Second, sub-national growth is becoming a more important policy issue because there appears to be a trend in many low income countries towards the widening of regional inequalities and for economic activity to become more concentrated in space. Third, growth may be more concentrated spatially in low income countries than in more developed countries. Finally, new theories of growth and economic geography are providing new insights into underlying factors that may be leading to the widening of regional disparities and the concentration of economic activity. All of these points suggest that greater attention needs to be given to the spatial dimensions of growth.

The following sections discuss each of these arguments in turn.

## 2. Relevance to the Millennium Development Goals (MDGs)

*Progress in poverty reduction depends on the sub-national pattern of growth*

8. Sub-national growth issues are relevant to all of the MDGs. They are particularly crucial for the attainment of the income poverty target (MDG 1), which is the focus of this paper. In low income countries it is common to observe substantial differences in poverty headcount rates between different sub-national regions, and between rural and urban areas. The marked concentration of poor people in specific regions points to the importance of the sub-national pattern of growth for overall poverty reduction. Progress in poverty reduction will depend on the regional variations in GDP growth and variations in the extent to which this growth is pro-poor. The case of Ghana provides a typical illustration of the unevenness of pro-poor growth at sub-national level, and the extent to which these differences determine how poverty is distributed spatially (see box). Policies that influence the pattern of growth and poverty reduction between sub-national regions will have a major impact on overall progress in poverty reduction.

### **Sub-national variations in pro-poor growth. The case of Ghana**

Average annual regional growth rates in Ghana during the 1990s varied from -5.3% in Upper East Region to +6.5% in Western Region. In addition, there are significant variations in the growth elasticity of poverty, ranging from -1.0 (least poverty reducing growth) in Western Region to -5.7 (most poverty reducing growth) in Northern Region. Such trends have generated considerable inter-regional divergence in average per capita income and the incomes of the poor. Poverty headcount ratios (1998/99 figures) vary from 5.2% in Greater Accra to 88.1% in Upper East Region.

Source: McKay and Shepherd (2005)

*Links to health and education MDGs ...*

9. Sub-national growth issues are relevant also to the other MDGs. Progress in achieving the health and education targets (MDGs 2-6) will depend on the ability of governments to reduce the substantial variations in access to social services that often exist at sub-national level. Addressing these disparities will depend on the regional allocation of public spending, and on the pattern of sub-national growth, which will be critical to generating the required public and private resources.

*and the environment*

10. There are links between the environmental sustainability targets (MDG 7) and the sub-national growth agenda. Problems of environmental degradation and water and sanitation tend to vary greatly across space and are influenced by growth processes. The problems of slum settlements are clearly related to spatial processes of urbanisation and rural-urban migration that are rooted in uneven growth.

*Links to the security and development agenda*

11. Beyond the MDGs, sub-national growth issues are relevant to other concerns in development policy. There is a close connection between sub-national growth issues and the security and development agenda. There is a large literature on the ways in which failing or inequitable development contribute to conflict; of particular relevance is the relative growth after the Cold War of complex political emergencies or 'new wars.' These not only have their roots largely in domestic issues, many of them inequality-related,<sup>1</sup> but impact particularly severely on civilian populations, and intensify the

<sup>1</sup> See, for instance, Collier and Hoeffler (2000)

causes of underdevelopment and low growth. Luckham *et al.* (2001) suggest that the majority of recent African conflicts fall into this category, and are associated with fractured states and the emergence of warfare as a widely used means of accumulating power and wealth.

12. Stewart (2000) argues that 'horizontal inequalities' are a major driver of conflict. Since these are normally based on differences in religion, culture, class or geographical location, insecurity and conflict often arise where spatial disparities in economic performance coincide with ethnic divisions. Insecurity and conflict often arise where spatial disparities in economic performance coincide with ethnic divisions. For example, recent econometric analysis by Murshed and Gates (2005) on the ongoing conflict in Nepal establishes a link between local conflict intensity and geographical variations in socioeconomic indicators.<sup>2</sup> The conflict appears to be centred on disadvantaged regions in the mid and far west of the country. There are many other countries where regional disparities, sometimes associated with disputes over the distribution of the benefits of natural resources, have generated significant tensions or outright conflict, for example Indonesia (Aceh), Ghana (insecurity in the north), Nigeria (insecurity in the oil producing Niger Delta) and Bolivia (highland vs lowland tensions).

*The importance of political economy*

13. These examples serve to illustrate the importance of sub-national growth issues in national political processes. Even within peaceful countries sub-national disparities have an important bearing on the political economy, and thereby influence wider prospects for development. The political dimensions of sub-national growth issues are emphasised throughout this paper and are discussed specifically in section 7.5.

### **3. The changing context: Widening disparities and increasing spatial concentration**

*Two trends are evident: regional divergence and spatial concentration*

14. The past few decades have been marked by two trends that point to the increasing importance of sub-national growth issues in low income countries. First, there is evidence that inter-regional disparities in income levels have tended to widen. Secondly, associated with rapid urbanisation, economic activities have become increasingly concentrated in space.

*Regional divergence*

15. The trend towards regional divergence in income levels has been documented by numerous studies. For example, Rodríguez-Pose and Gill (2004) quantify widening variations in regional GDP over the 1990s in China, India, Mexico and Brazil. Similar results have been reported for China by Kanbur and Zhang (2001) and Lin (2005), Russia by Yemtsov (2005) and India by Datt and Ravallion (2002).

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<sup>2</sup> The regression analysis demonstrated a link between conflict intensity as measured by the number of conflict-related deaths at district level and local measures of human development and landlessness.

**Table 1 – Evidence from Operationalising Pro-poor Growth country case studies on widening regional disparities over the 1990s**

Country	Trend in regional income levels	Commentary
Ghana McKay and Shepherd (2005)	Divergence	<ul style="list-style-type: none"> <li>• Faster growth in initially more prosperous regions including Greater Accra and the cocoa growing Western Region.</li> <li>• Slow growth in northern regions which had a much higher initial incidence of poverty.</li> </ul>
Uganda Okidi <i>et al.</i> , (2004)	Divergence	<ul style="list-style-type: none"> <li>• Average household income in the Northern region (the poorest part of Uganda that has been affected by persistent insecurity) fell from 76% to 58% of the national average over the 1990s.</li> <li>• Average household incomes in the Central region (in and around Kampala) rose from 130% to 150% of the national average over the same period.</li> <li>• The relative position of the Eastern region has also declined.</li> </ul>
Zambia Thurlow and Wobst (2004)	Convergence	<ul style="list-style-type: none"> <li>• Economic and population decline in previously prosperous Copperbelt provinces and Lusaka.</li> <li>• Slow growth in other rural provinces partly as a result of correction of urban bias in food pricing policies.</li> </ul>
Bangladesh Sen <i>et al.</i> (2004)	Lack of evidence	<ul style="list-style-type: none"> <li>• Study reports faster poverty reduction in urban areas than rural areas.</li> <li>• Regionally disaggregated data not available.</li> </ul>
India Besley and Burgess (2004)	Divergence	<ul style="list-style-type: none"> <li>• Faster growth in more prosperous states in south and west of India.</li> <li>• Slow growth or recession in more populous and poorer states in north and east of the country.</li> <li>• The effect on poverty reduction has been particularly pronounced because the poverty elasticity of growth has tended to be greater in faster growing states.</li> <li>• Rural-urban inequalities have widened across India.</li> </ul>
Vietnam Klump and Bonschab (2004)	Divergence	<ul style="list-style-type: none"> <li>• Faster growth and poverty reduction in initially more wealthy and populous regions in the southeast (in and around Ho Chi Minh City) and Red River Delta (in and around Hanoi).</li> <li>• Slow growth and persistent higher levels of poverty in areas inhabited by ethnic minorities, particularly the northwest highlands.</li> </ul>
Brazil Menezes Filho and Vasconcellos (2004)	Limited divergence	<ul style="list-style-type: none"> <li>• Slower growth in northeast Brazil, which has the highest rate of poverty.</li> <li>• Little evidence of divergence between other regions.</li> <li>• Rodríguez-Pose and Gill (2004) suggest that regional convergence occurred during the 1980s, but that this trend reversed during the 1990s.</li> <li>• Rural-urban differences in poverty rates have tended to diminish as the population has become predominantly urbanised.</li> </ul>
Bolivia Klasen <i>et al.</i> (2004)	Divergence	<ul style="list-style-type: none"> <li>• Low growth in poorest provinces in highland areas characterised by land fragmentation and declining yields.</li> <li>• Recent economic decline of large cities associated with civil unrest.</li> <li>• Faster growth in lowland areas. But the dominance of capital intensive farming and natural resource extraction provides few links to poverty reduction.</li> </ul>

- Case study evidence* 16. Another source of evidence on inter-regional growth trends is the Operationalising Pro-Poor Growth (OPPG) country case studies (see above). Eight of the fourteen case studies were examined in order to establish whether regional income levels tended to diverge or converge over the 1990s.<sup>3</sup> There is evidence of regional divergence in six out of the eight cases (Ghana, Uganda, India, Vietnam, Brazil, Bolivia) and convergence in only one case (Zambia). In one case there was insufficient evidence to determine the direction of change (Bangladesh).
- Spatial concentration* 17. The second trend that is evident in most low income countries is the increasing spatial concentration of economic activities, usually within or close to expanding urban centres. This is reflected in the findings of the OPPG country case studies, most of which report that gaps in income levels between rural and urban areas, and between farm and non-farm activities have widened over the 1990s.
- The concept of the city-region* 18. Some commentators have suggested that these trends reflect a fundamental change in the spatial organisation of economic activity. The concept of city-regions describes how the world economy is increasingly focused on globally connected cities and their surrounding regions (see box).

### City-regions

The city-regions literature covers a rather disparate set of ideas, but essentially describes three commonly observed phenomena: (i) the concentration of economic activity within cities and their surrounding regions, (ii) the increasing integration of city-regions in the world economy and the growing competition between these centres, and (iii) the strengthening of links between urban economies, and their peri-urban and rural hinterlands (Rodríguez-Pose, 2005). All of these processes tend to generate divergence in economic performance, on the one hand between competing city-regions, and on the other hand between locations within and outside city-regions.

The concept of city-regions draws attention to the need for policy to focus on raising the competitiveness of cities, and to strengthen functional links between cities and their hinterlands. It has been suggested that city-regions provide the ideal scale for the organisation of public administration and the design of public policy. However, there are few examples of where such models have been applied in practice. Most city-regions are split between several administrative areas, which makes integrated planning difficult.

The city-regions literature mainly refers to developed countries and a degree of caution needs to be exercised when applying the concept to low income countries. While many cities in low income countries in Asia fit this model, it is debateable whether city-regions are emerging in Sub-Saharan Africa. Rakodi (2005) argues that African cities (with the exception of Johannesburg) have been unable to compete globally, and are largely excluded from global trade and investment flows. There is also a debate about the extent to which the growth of African cities in terms of population has been a driver of growth or merely an indicator of the urbanisation of poverty (Rakodi, 2005).

<sup>3</sup> This sub-set of 8 countries was selected to ensure wide geographical spread and to cover most of the low income and lower middle income countries included in the study. The results presented here are based on a rapid assessment of the case study reports rather than a detailed analysis of the data. The quality and coverage of data varied greatly between countries.

*The problem of lagging regions* 19. The observed trends of spatial concentration and regional divergence create difficult challenges for policy makers. On the one hand they are associated with the rapid growth of certain dynamic regions. On the other hand lagging regions may experience relative or absolute decline. The resulting concentration of poverty in lagging regions is a matter of concern, but it is very difficult to generate growth in these regions and to turn around regionally diverging trends.

#### **4. Sub-national growth in low income countries**

*Spatial concentration may be particularly marked in low income countries* 20. There is some evidence to suggest that the spatial concentration of economic activities and sub-national disparities in growth are most significant in low income countries. Williamson (1965) hypothesised that regional disparities at first widen and then narrow with increasing levels of income. According to this view, growth is initially focussed in a few core regions, but as development proceeds more peripheral regions tend to catch up. Davis and Henderson (2003) suggest that at low levels of development there are particular advantages to spatial concentration because this helps to conserve scarce infrastructure, human resources and institutional capacity. As development proceeds there are greater resources available for investment in peripheral regions, and the increasing congestion of the core region encourages dispersion of economic activity.

*This can be observed in patterns of urban primacy* 21. Williamson's hypothesis has proven difficult to verify empirically. Evidence on regional divergence and convergence trends at different income levels is rather inconclusive. However, a similar effect has been measured in relation to urban primacy.<sup>4</sup> Several researchers have demonstrated that the concentration of population within the largest city rises with income in the poorest countries, peaks at around 25% at per capita incomes in the range of \$2,000-4,000 (1985 PPP), and then declines at higher levels of income (Davis and Henderson, 2003). This evidence suggests that the spatial concentration of economic activity, often within a single urban centre, is a particularly important phenomenon in low income countries.

#### **5. New theories of growth and spatial development**

*Neo-classical growth models predict convergence between regions and the dispersion of economic activity,* 22. The tendency for economic activity to concentrate spatially has only recently been addressed by economic theory. Until the early 1990s neo-classical economic theories dominated development thinking. Neo-classical growth models attribute little importance to space, and tend to predict the convergence of per capita incomes in different regions as diminishing returns to capital set in under conditions where technology is determined exogenously. Neo-classical models have generally assumed the mobility of production factors within countries. Under this assumption differences in income levels between regions would diminish with time as labour moves in search of higher wage locations and capital moves in the opposite

<sup>4</sup> Primacy is commonly measured by the ratio of the population in the largest city to the total urban population (Henderson, 2004)

direction in search of lower-cost locations.

*Endogenous growth theories suggest that growth may arise through spatial concentration*

23. Recent theoretical advances, in particular the development of endogenous growth theory and the New Economic Geography, have provided more realistic explanations of how and where growth occurs. The essential contribution of endogenous growth theory has been to suggest that growth is generated within a particular economy through home-grown and self-reinforcing processes of human capital formation and technological innovation. These processes tend to be more active where economic activity is concentrated spatially. This is because a number of positive externalities arise where firms cluster together. Some of the most important effects described in the literature (see Henderson *et al.*, 2000; and Burgess and Venables, 2004) include:

*Positive externalities occur where firms cluster*

- Proximity to suppliers and customers lowers transport and search costs, facilitates supply chain management, and allows more frequent and face-to-face contacts that help to build trust and reduce transactions costs.
- Knowledge spillovers from one firm to another occur more frequently where firms are located close together. The spread of knowledge raises overall productivity, facilitates the adoption of new technology, and increases levels of human capital, thereby promoting technological innovation.
- The existence of thick labour markets makes it easier to match workers to jobs, reducing both the recruitment cost for employers and the search costs for job-seekers. The presence of employment opportunities provides strong incentives for workers to raise their skills.
- The concentration of economic activity enhances market linkages, lowering infrastructure and service provision costs, and improving access to capital.

*Agglomeration economies allow increasing returns to scale*

24. Collectively these effects, referred to as agglomeration economies, raise the productivity of firms that are located close to one another. Agglomeration economies tend to become stronger as clustering increases. Hence, there are increasing returns to scale that further strengthen the benefits of spatial concentration.

*Small initial differences generate divergence in economic performance*

25. An important insight of endogenous growth theory is that small initial differences in the quality of different locations will tend to generate divergence in growth performance. A location that is slightly more favourable than others will generate higher levels of investment. Once the process of clustering is underway, increasing returns to scale will tend to raise the competitiveness of the favoured location to the detriment of others. In this sense sub-national growth processes tend to be *path dependent* because present growth depends greatly on previous patterns of development.

*There has been limited empirical testing of key assumptions of endogenous growth theory,*

26. The general predictions of new theories of growth appear to fit with recent spatial and economic trends in low income countries. However, a degree of caution is required in using these theories because there has been relatively little empirical testing of their assumptions, and research evidence is almost exclusively related to middle income and industrialised countries. There is an unresolved debate about the extent to which agglomeration economies are restricted to a particular sub-sector

*particularly in low income countries* or confer wider benefits in urban areas.<sup>5</sup> Some of the effects described above may be less relevant in low income countries. For example, in very poor countries imported technology and the growth of mature, low-tech industries is likely to be more relevant than endogenous processes of innovation. On the other hand the benefits of proximity to suppliers and customers may be more important in low income countries where transport costs are often high.

*Agglomeration and dispersion forces operate together* 27. Theories of endogenous growth add a new level of understanding about how sub-national growth occurs, but they do not necessarily contradict previous theories. Models of city size typically include both agglomeration and dispersion forces. As city size increases there are increasing returns to agglomeration. However, beyond a certain point these benefits are outweighed by the effects of rising land prices (and wages if labour is relatively immobile), and the negative externalities associated with urban pollution and congestion. At this point it would be expected that labour and capital would move to lower-cost locations. The presence of a well-developed road network linking cities to their hinterlands would tend to promote dispersion and reduce the need for spatial proximity.

*As a result of market failures cities often grow beyond their theoretical optimum size* 28. Several analysts have developed models of optimum city size that consider both of these forces (Henderson *et al.*, 2000; Overman and Venables, 2005). It has frequently been argued that cities tend to grow beyond this optimum because the positive externalities of agglomeration lock firms into a particular location. There are weak incentives for an individual firm to move to a new location because the firm would lose all of the productivity benefits of clustering and would not internalise the positive externalities that it created by relocating. Such market failures may cause cities to become excessively large. However, there is evidence that in very large urban centres dispersal of economic activity does take place. Satterthwaite (2005) reports that the world's largest cities are undergoing slow or negative growth, and that the most rapid growth is occurring in small- and medium-sized urban centres.

*Not all growth is generated endogenously* 29. While endogenous growth ideas have proven to be very fruitful in explaining sub-national growth patterns, it must be recognised that not all growth is generated endogenously. Sub-national growth patterns are strongly influenced by exogenous processes, such as natural disasters (e.g. droughts), the adoption of imported technology (e.g. areas benefiting from Green Revolution technologies in South Asia), changes in capital flows, or rising global demand for scarce raw materials. Exogenous changes in prices resulting from market trends in the world economy are a particularly important determinant of growth in regions engaged in export production.

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<sup>5</sup> There is an important distinction between agglomeration economies that are specific to a particular sub-sector (referred to as "localisation economies") and agglomeration economies that confer wider benefits across the urban economy (referred to as "urbanisation economies"). This distinction has important implications for spatial organisation and policy. Where localisation economies are dominant, the most efficient form of spatial organisation would be the tight clustering of related firms in industrial districts (not necessarily located in urban centres). Where urbanisation economies are dominant there is a strong rationale for the concentration of a diverse range of economic activities in urban centres.

## PART B – What can governments do to address uneven sub-national growth?

30. This paper has so far explained sub-national growth in terms of market processes influenced by geographical and historical factors. However, government policies also influence sub-national growth in profound ways, and are the main focus of this paper. This part of the paper will attempt to provide a framework to understand the effects of policy. It will begin with a discussion of the general principles that underline policy choices: first the rationale for government intervention, and secondly the importance of considering the nature of the country context. The paper will then discuss the broad approaches and policy choices available to governments.

### 6. Rationale for government intervention

*Three justifications for policy:*

31. There are essentially three justifications for governments to intervene in sub-national growth processes: (i) efficiency arguments, (ii) equity considerations, and (iii) concerns about political stability.

*1) Efficiency arguments*

32. As explained in section 5, market forces do not necessarily lead to an efficient spatial pattern of growth. There are several types of market failure that cause sub-national growth processes to be sub-optimal. Government intervention may be justified in a number of areas:

- *Provision of public goods.* The most important example from the perspective of sub-national growth is transport infrastructure, which is vital for growth and exhibits a largely public goods character.<sup>6</sup> While a degree of private financing is sometimes appropriate, public funds are usually required to finance the bulk of transport infrastructure investment.
- *Internalising externalities.* Section 5 discussed the positive and negative externalities of agglomeration. Without government intervention there may be a tendency for cities to become excessively large and for small centres to grow too slowly. Such arguments have been used to justify government intervention to stimulate the formation of new industrial clusters and settlements, and to limit the growth of large cities (discussed more fully in section 8.4).
- *Factor immobility.* Constraints to the mobility of labour and capital prevent them from being deployed where they could earn the greatest return. Factor mobility is impeded by numerous market failures and regulatory constraints, for example the limited transferability of skills between places and sectors, failures in housing markets, incomplete information on job opportunities, and weaknesses in financial systems handling worker remittances. This points to a broad policy agenda that is discussed more fully in section 8.3

<sup>6</sup> Public goods have the twin characteristics of being non-excludable (making it difficult to restrict access) and non-rivalrous (one person's use does not affect another's). These features reduce the scope for producing public goods for private profit. There are few purely public goods. More commonly there are mixed goods with varying degrees of publicness. Transport infrastructure has a largely public character. Hence, the dominance of public financing of infrastructure. However, there are some exceptions. Toll roads are excludable and can be privately financed. Traffic congestion creates scarcity of road space, which may require pricing.

33. While market failure provides a justification for government intervention, the proposed remedies often make the problem worse. Policies are often misconceived because of the difficulty of identifying the exact nature of the market failure and designing an appropriate policy response that does not introduce new distortions. In addition, governments are often captured by special interests. It is therefore important to view the effects of market failure in perspective. Their influence on spatial patterns of growth is often less significant than the negative effects of inappropriate government policies.

*2) Equity considerations*

34. Wide disparities in income levels between sub-national regions usually lead to calls for government intervention on equity grounds. There are several different types of policy response. One of the most important of these is sub-national fiscal transfers, which can be designed to ensure a progressive redistribution of resources between regions. Policies to facilitate migration may also contribute to equity by reducing inter-regional wage disparities.

*3) Political stability*

35. As will be argued throughout this paper political objectives are often the overriding concern in determining sub-national growth policies. These objectives vary greatly between countries. In some cases there is a widely shared concern with maintaining peace and stability. This may require political compromises to be made that depart from principles of equity and efficiency. In many countries, however, policy is mainly driven by the narrow and personal interests of politicians seeking to entrench their power and gain access to resources.

*Trade-offs*

36. The key point emerging from the above is that governments engage with sub-national growth issues for different reasons. The policies government pursue will vary greatly depending on the priority given to the above objectives. While some policies may be consistent with several objectives at the same time, trade-offs between objectives are frequently encountered. There are potential conflicts between objectives that need to be made more explicit in considering government policy and donor responses. Two of these trade-offs are discussed below:

*Growth vs equity*

37. There is a fundamental tension between efficiency and equity objectives. New theories of growth tell us that the agglomeration of economic activities is vital for growth. However, such processes tend to generate substantial inequalities between sub-national regions. Redistribution of income between regions on equity grounds may help to reduce inequalities, but is likely to impose an efficiency and growth cost by transferring resources away from regions where they can be used most productively. This is especially evident when the time dimension is considered. Over time growth-maximising policies will generate the resources needed to reduce poverty, which would perhaps not be available if more redistributive and less efficient policies were chosen. It is very difficult to offer guidance on how to manage this trade-off. To begin with there is limited understanding of the strength of the trade-off and the extent to which the pursuit of greater sub-national equity will impose an efficiency cost. More fundamentally the balance between sub-national growth and equity is a social choice that can only be determined through national political processes rather than by reference to basic principles alone.

*Maintaining peace and stability*

38. In some cases governments will need to pursue redistributive policies that are sub-optimal from the point of view of economic efficiency, but are necessary to address regionally-based political tensions and sources of instability. The opportunity costs may be very significant, but may still be justified as the price to be paid for peace. Governments operate in an environment of “constrained optimisation”, where policy choices are constrained by broader considerations of maintaining social cohesion and political stability.

## **7. Country contexts**

*Policies need to be carefully tailored according to different country contexts*

39. The variability of country contexts makes it very difficult to generalise about sub-national growth processes and policies. There are significant differences between countries in terms of their geography, history and politics. These variations explain much of the difference in sub-national growth between countries, and influence the objectives and content of policies. The purpose of this section is to introduce briefly some of the key variables, and to discuss their influences on policy in general terms. More specific examples of the importance of country contexts will be given throughout the remainder of the paper.

### **7.1 Geographical factors**

*Effect of country size*

40. There are numerous geographical variables that influence sub-national growth processes and policy responses. One of the most obvious of these is country size. In large countries spatial disparities are likely to be more significant than in small countries. Due their size, greater complexity and regional variations, large countries are more commonly governed through federal structures than as a unitary state.

*The influence of physical geography: important but not deterministic*

41. The influence of physical geography is also very significant. Growth is usually concentrated close to coastlines or rivers, but development of the interior may occur where there has been substantial investment in connecting infrastructure. In landlocked states it is particularly difficult to establish dynamic centres of growth. Mountain ranges create formidable physical barriers that increase remoteness and reduce prospects for growth. However, this may not always be the case because in tropical regions higher elevations may confer climatic and health advantages (e.g. Kenyan highlands). The frequency of natural disasters and incidence of disease (e.g. in malarial areas) may also hold back the growth of certain regions. The presence of mineral and other natural resources can often stimulate growth in particular regions. However, oil and gas extraction tend to generate rather limited growth benefits in the vicinity of the resource, due to the capital-intensive nature of the industry and the transfer of profits and tax revenues out of the resource producing region.

42. All of these examples show that physical geography has a strong influence on development, but the relationship is not deterministic. New theories of growth suggest that initial locational advantages play an important role in determining where growth can start, but subsequent processes of agglomeration are more important in explaining which centres grow and which do not. Policy-influenced variables, most importantly the density of transport networks, also have important effects.

- Population density and remoteness* 43. Sub-national growth processes and policy choices are also influenced by human geography. In areas of low population density and in remote regions there are much higher costs of providing of social services and infrastructure. Market access tends to be limited, and there is little potential for agglomeration economies to develop. These factors also determine the political importance of different regions. Government policy is usually oriented towards the needs of centrally located regions with high population densities.
- Political geography* 44. Political geography is also an important explanation of sub-national growth patterns. For example, wealth is often highly concentrated around national and regional capital cities because of the greater access to resources and rents that these locations provide. In weakly governed states, development may be restricted to the capital city region because political and military authority may extend over a limited portion of territory (Herbst, 2000).<sup>7</sup>
- Capital cities*
- The role of border regions* 45. A particularly important aspect of political geography is the emergence of cross-border economic regions whose growth depends on trade and in some cases access to low cost labour markets. A classic example is the Mexican-US border, but there are also important cross-border regions in Southern and Western Africa (e.g. Maputo corridor, Lagos-Abidjan corridor) and in South East Asia (Mekong Basin).

## 7.2 Historical factors

- Previous patterns of development and inherited institutions influence the spatial configuration of growth* 46. New theories of growth emphasise path dependence and the enduring influence of historical factors. Previous patterns of investment in infrastructure and human capital affect the current growth performance of different regions, and may generate enduring growth disparities in regions. Long-term historical processes also explain the emergence of economic and political institutions that often play a crucial role in sub-national growth (North, 1990). For example, in India differences in land tenure have been shown to influence growth performance between different states (Besley and Burgess, 2004). While many states have undertaken land reform over the past few decades, the form of land tenure that existed in colonial and pre-colonial times appears to have had a long-lasting effect on growth. States that inherited non-landlord tenure systems at the time of independence appear to have grown faster than states that inherited landlord tenure systems (mainly in the north and east). Furthermore, the growth elasticity of poverty has been higher in the non-landlord tenure states.

## 7.3 Political structure: Centralised and decentralised states

- Centralised and decentralised states* 47. There are major differences between centralised and decentralised states in terms of their sub-national governance and policies. Generalisation is difficult because the term ‘decentralisation’ embraces a range of forms and dimensions of sub-national government. Different countries have devolved resources, responsibilities, political power and democratic structures in different ways, as

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<sup>7</sup> Jeffrey Herbst argues that in the context of low population densities and the absence of external threats, many African governments have focussed their attention on the region around the capital city and have been unable to extend political and military control to hinterland regions. According to Herbst’s thesis such political geographies explain the weakness of African states. Without the necessity of defending well-defined territories, states did not have to engage in building institutional, fiscal and military capacity (Herbst, 2000).

explained in the box below.

***What is decentralisation? Sorting out the terminology***

The term 'decentralisation' embraces a range of forms and dimensions of sub-national government. It is, therefore, useful to clarify the three main forms, following Rondonelli's widely accepted definitions. '*Deconcentration*' is the term used when central government departments give executive responsibility for various public functions to their regional or district offices, but retain control of policy making and oversight. '*Delegation*' is the term used when the powers and necessary resources for the performance of specified functions are handed over fully to a sub-national level of government. Accountability largely rests at that level, though the centre will typically retain responsibility for setting objectives and monitoring performance. '*Devolution*' is the term used when full authority and accountability for a function is transferred to a sub-national unit of government. Its authority covers decision-making, finance and execution.

A cross cutting set of terms relate to the way the political, financial, economic, and administrative dimensions of government are arranged. Thus, creating elected councils is a form of *political decentralisation*, empowering provincial administrations to levy their own taxes is termed *fiscal decentralisation*, while permitting district councils to run primary schools is *administrative decentralisation*.

Source: Rondonelli (1981)

48. Decentralisation is most evident in federal states where the devolution of power to sub-national tiers of government is constitutionally guaranteed.<sup>8</sup> Unitary states are characterised by greater centralisation of political power but, especially in larger countries, many functions are commonly undertaken at by sub-national levels of government, and there is often a significant level of political and fiscal decentralisation.<sup>9</sup>

*Sub-national growth issues are a particularly prominent political issue in federal states,*

49. While it is impossible to make rigid distinctions, sub-national growth issues tend to assume greater political importance in federal states than in unitary states. In federal states sub-national tiers of government have much more power to implement pro-growth policies. Growth and income disparities tend to be more visible and are more contested in the political arena. There is usually more data available on sub-national disparities, which feeds into the demands articulated by sub-national tiers of government towards the federal authorities. Consequently federal states tend to have more developed policy frameworks to address sub-national growth issues, usually including a formalised system of sub-national fiscal transfers.

<sup>8</sup> It is worth noting that in some federal countries decentralisation below the state level may be quite limited. For example, in India local government below state level tends to be very weak, and states are usually bigger than most unitary nations. Arguably India is therefore a relatively centralised state.

<sup>9</sup> The functional, as opposed to legal, distinction between unitary and federal states is not at all sharp. In practice one finds a spectrum of institutional arrangements ranging from highly centralised to highly decentralised political and administrative systems, some unitary and some federal.

*but they are also important in unitary states, especially where decentralisation has taken place.*

50. Over the past few decades there has been a trend towards greater decentralisation in many developing countries. The trend is evident in countries with existing federal structures, where the powers of lower levels of government have been strengthened (e.g. India, Brazil, Mexico). Decentralisation has also occurred in many unitary states where sub-national tiers of government have been newly created or substantially strengthened (e.g. Cambodia, Uganda). The general impact of these trends has been to increase the visibility of sub-national growth disparities, and to force these issues onto the national policy agenda. The devolution of power to sub-national levels of government has created new opportunities to address sub-national growth disparities, but has also created new tensions and additional complexity as will be discussed in section 9.

#### **7.4 Political economy**

51. There is increasing recognition of the importance of political economy factors in explaining pro-poor growth performance. The analysis of political economy is particularly relevant to understanding policy processes concerned with sub-national growth. The relationship between political economy and sub-national growth is complex and two-way, and varies greatly between countries. In the first place, sub-national variations influence the political economy of society as a whole, and affect broad patterns of social, political and economic change. At the same time political factors have a determining influence on the prospects for addressing sub-national growth issues, through, for instance, their influence on government's responses, or patterns of private investment.

*Drivers of Change*

52. In considering these two questions in any given case, the framework developed by DFID for the Drivers of Change initiative usefully distinguishes between: (i) underlying structures and processes, (ii) institutional factors, and (iii) actors, and analyses the interactions between them as a means of explaining observed patterns of change.<sup>10</sup>

##### **7.4.1 How do sub-national differences influence the wider political economy?**

53. Sub-national disparities and the underlying structures and trends can influence the development of political, social and economic institutions, and, through these, affect the patterns of behaviour of key actors. A few examples from among a very large number of potential influences may be identified for illustrative purposes. Some of these will lead to sub-national areas being marginalised in the political process; others may intensify pressures to address their concerns.

*Spatial disparities can cause political tensions and conflict.*

- Large regional income disparities (sometimes combined with uneven natural resource endowments) can cause tensions that may threaten political stability, especially if these coincide with ethnic or other socio-economic differences. Hence, containing sources of instability is often a preoccupation of political elites and the primary objective of regional policy.

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<sup>10</sup> Note for DFID Staff: Understanding the drivers of change: Concepts, Questions and Methods. Drivers of Change Team, DFID Policy Division. April 2004.

- Especially where combined with uneven natural resource endowments*
  - Sub-national differences in resource endowments generate particular problems in relation to the distribution of revenues, in particular in the case of point natural resources (e.g. oil and gas). There is a large literature on the ‘natural resource curse’, and its influence, often adverse in poor countries, on economic growth (see Auty, 2001).
- Ethnic/regional based political parties*
  - Regional inequalities manifest themselves in competitive politics. Political parties are often ethnic- or regional-based, leading sometimes to political leaderships answering to narrowly defined geographical constituencies.
- Migration and urbanisation*
  - Migration and urbanisation can influence politics and voting behaviour, which in turn will affect the preoccupations of political elites. For instance, urban populations with voice are likely to exert pressure for lower food prices, sometimes at the expense of the farming sector and rural incomes.

#### **7.4.2 How does the political economy influence sub-national differences?**

54. The wider configuration of political interests has an important influence on sub-national patterns of growth. Among the many dimensions, some may be highlighted, but analysis will need to be country-specific:

- The quality sub-national governance affects growth*
  - In general terms political systems based on patronage do not provide conducive conditions for growth at national and sub-national level, especially where the behaviour of political elites is primarily motivated by capturing resources and rents, and where restraints are weak. Such weaknesses in governance are often most apparent at sub-national levels of government in low income countries. However, this is not universally true, and there are examples of better governed regions, where elites take an interest in generating growth. Such variations in the quality of governance at sub-national level can make all the difference in explaining why some regions grow and others do not. There is an extensive literature that provides cross-country evidence of the relationship between institutional quality and growth (see IMF, 2003). However, evidence at the sub-national level is rather more limited. Some examples can be drawn from India. For example, the state of Bihar, ranked by Transparency International India 2005 survey as the most corrupt state, has long been one of India’s worst growth performers (Transparency International, 2005).<sup>11</sup> Similar observations can be made in the comparison of cities. For example, the difference in the economic growth of Bangalore and Calcutta is in part attributable to the quality of municipal governance.
- Regional patronage*
  - Systems of patronage can generate sharp spatial inequalities. Certain regions and ethnic groups receive favourable treatment by virtue of the political support they provide to the government in power. For example, in Kenya successive political leaders have directed investment and political towards their home regions that provided their main political power base. During the Moi era there was clear evidence of favouritism towards the area

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<sup>11</sup> For all Indian states there is a weak negative correlation between the level of corruption as measured by the TI survey and economic growth over the 1990s. However, the relationship is not statistically significant.

inhabited by the Kalenjin people around the Rift Valley (Ng'ethe *et al.*, 2004). The nature of political competition in many low income countries tends to reinforce such patterns. Political parties are often organised along regional or ethnic lines, and can become vehicles for regional elites to compete for a greater share of national resources rather than to pursue a developmental policy agenda.

*Lack of political voice explains why some regions lose out*

- Where marginalised ethnic or other socio-economic groups coincide with geography, lack of political voice may result in under-investment or poor service provision in the areas concerned. This may lead to conflict (as in southern Mexico or other parts of Latin America), or to long-term invisibility of poverty (as in South Africa during the apartheid period).

*Rent seeking behaviour fuels the growth of capital cities*

- The prevalence of rent-seeking behaviour may also have spatial consequences. Growth is likely to be focused on national and regional capital cities where the opportunities for rent seeking are greatest. Davis and Henderson (2003) find that primate cities that are also the national capital city are 20% larger than non-capital primate cities.<sup>12</sup> Ades and Glaeser (1995) find that in non-democratic countries the primate city is 40-45% larger, and suggest that under more democratic systems there is a more equitable spread of resources and economic opportunities between regions.

*Public accountability depends on sources of revenue*

- The sources of revenue for the state, if highly concentrated (for instance from 'point' natural resources, or in aid-dependent poor countries from aid), may weaken broad accountability, and pressures for improving growth performance. The weakness of public accountability is often particularly apparent at sub-national levels of government, which rely heavily for their revenues on transfers from the centre.

*Weak states may not fully control their territories*

- The weakness of the state may limit its ability to control all of its territory, and to provide crucial public goods required for markets to function and for investment to take place. The implications for growth and development in regions that lie outside the control of the centre are usually negative. However, the situation varies greatly in different countries. Certain regions may effectively be beyond the military control of central government (e.g. eastern DRC) or subject to prolonged and intense insecurity and lawlessness (e.g. northern Uganda). In other cases central government may reach an accommodation with local warlords, who may use local bases of power to influence national politics (e.g. northern Yemen). Where central government is stronger it may attempt to subdue unstable regions by military means or otherwise, often with the effect of further raising tensions. Official resettlement policies have been a common instrument to consolidate power in peripheral regions, for example the Han Chinese settlement of Tibet, and transmigration schemes between Java and outlying islands in the Indonesian archipelago.

55. All of these examples serve to illustrate the close links between sub-national growth and political processes at various spatial scales. These links often explain

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<sup>12</sup> Primate cities are the dominant city in the urban hierarchy, and most definitions require that they must have at least twice the population of the second largest city. Most low income countries have primate cities, although this is not always the case (e.g. India).

why political elites and their constituencies behave in certain ways, and the policy choices that result from political processes. The next section of the paper examines in greater detail the various policies that are used by governments to address sub-national growth issues, and shows how these vary in different geographical and political contexts.

## 8. Broad approaches and policy choices

*All policies have a spatial impact*

56. All government policies have spatial impacts, both intended and unintended, and it is impossible to review all of their effects. The approach taken here will be to group policies into four broad approaches that are regularly used by government to address sub-national growth issues. These include: (i) sub-national fiscal transfers, (ii) strengthening the enabling environment for growth at sub-national level, (iii) facilitating mobility, and (iv) spatial planning. It is important to bear in mind that the four approaches are not mutually exclusive, and that most countries employ a mix of policies that may cut across several of these approaches. For each of these approaches the paper will discuss spatial and distributional outcomes, will review the main issues, problems and trade-offs, and will illustrate how these vary in different country contexts.

### 8.1 Sub-national fiscal transfers

*Systems of sub-national fiscal transfers are common to all types of state*

57. Sub-national fiscal transfers have traditionally been the main instrument used by governments to address sub-national growth issues. They are a feature of nearly all states, both federal and unitary. In federal states there are usually well established mechanisms to share centrally and locally collected revenues between different sub-national governments. These are usually subject to established rules and constitutionally defined principles. Most unitary states have also introduced fiscal decentralisation and systems of sub-national transfers, leading to redistribution of resources between regions. In addition to formal systems of sub-national transfers, all states transfer money from central to regional and local levels through the sectoral budgets of central ministries (deconcentrated flows) or grants to community level organisations (for example Social Action Funds).

*Fiscal transfers are commonly designed to ensure greater inter-regional equity ...*

58. The objectives and design of sub-national transfers vary between countries. In most countries the emphasis has been on promoting inter-regional equity and to ensure a minimum level of service provision in disadvantaged regions. Many countries have introduced systems of equalisation payments to compensate for sub-national variations in fiscal capacity and expenditure needs. Poorer regions are usually the main beneficiaries because their fiscal capacity is lower and expenditure requirements are often greater.<sup>13</sup> However, it must be recognised that developing countries rarely have the resources to come close to equalising fiscal capacities between regions.

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<sup>13</sup> Fiscal capacity refers to potential ability of governments to raise taxes, and depends on the nature of the tax base. In poorer regions fiscal capacity will be lower because there are fewer taxpayers and average income is lower. Expenditure requirements per capita are often greater in poorer regions because: (i) in remote regions per capita costs of service delivery are higher, and (ii) anti-poverty and safety net expenditures may be higher, and (iii) private sector service providers may be absent.

59. In a few countries, China being the most notable example, systems of sub-national transfers have been designed to provide incentives for sub-national governments to promote growth. The fiscal reforms in 1994 allowed provinces to retain incremental tax revenues resulting from growth (Peterson, 2005).

*but, they also reflect political processes.*

60. Political considerations also influence the pattern of sub-national transfers. There is usually intense lobbying by sub-national governments to obtain larger transfers or to retain a greater proportion of their tax revenues. Such lobbying may be directed at revising the rules for the allocation of transfers to sub-national governments or obtaining discretionary grants from central government. Central governments have also sought to influence the sub-national allocation of resources for a variety of political reasons, in some cases to strengthen their regional support bases, and in other cases to as a tool to weaken political opposition or to assuage the demands of separatist regions.

*The extent of redistribution between regions varies greatly between countries,*

61. In many cases sub-national transfers result in a progressive redistribution of resources towards poorer regions. However, the extent of this redistribution varies greatly between countries. In South Africa, for example, the use of equalisation payments and conditional grants appears to have resulted in a moderately progressive redistribution of resources (van Ryneveld, 2005). However, in China fiscal reforms in 1994 allowed provinces to retain a substantial share of tax revenues, which has limited the ability of the sub-national fiscal system to redistribute resources. Consequently, the large disparities in provincial revenues have widened since 1994 (Peterson, 2005). In India the combined effect of statutory and discretionary transfers, as well as federal-state tax sharing mechanisms, also appears to have had a rather limited redistributive impact (Rao and Singh, 2001).

*and the political influence on resource allocation is often evident.*

62. Political influence is often apparent in the pattern of sub-national transfers. Its effect is generally to reduce the progressiveness of redistribution. Wealthier states in Brazil, for example, appear to have been more successful in extracting greater shares of transfers from central government (Rodríguez-Pose and Gill, 2004). In India, due to their high discretionary component, fiscal transfers appear to be heavily influenced by politics. Rao and Singh (2001) demonstrate that the allocation of transfers can be explained using three variables: (i) State Domestic Product, (ii) the proportion of the ruling party's MPs coming from the state, and (iii) whether or not the same political party is in power at state and federal level. In general terms political considerations will impose a limit on the extent to which sub-national transfers can be used to redistribute income. Richer areas will usually try to resist increases in transfers while poorer regions will lobby to retain access to transfers.

*Fiscal transfers may impose an efficiency cost,*

63. For the purposes of this paper the most important question is the extent to which sub-national fiscal transfers influence growth processes at the sub-national level. Unfortunately, there is very little research evidence on this question, and the debate is largely based on theoretical or ideological principles. In practice it is very difficult to distinguish between the effects of sub-national transfers, other regional policies and the broader influences of the market and geography. Progressive sub-national fiscal transfers have often been criticised on efficiency grounds. By their nature they tend to divert resources away from more productive regions towards poorer, slower growing regions where returns to investment are generally lower. They may also act to cushion the effect of market forces and weaken the incentives for people to migrate between regions, thereby counteracting an important mechanism for adjusting

- but there is a lack of evidence* regional imbalances. Sub-national transfers may also be inefficient from a fiscal point of view because they reduce the incentive on lower levels of government to raise taxes, and thereby weaken the tax effort overall. In view of these effects it might be expected that progressive sub-national fiscal transfers would impose a significant growth cost. While this prediction is theoretically-based and appears intuitively correct, there is a lack of empirical cross-country evidence to confirm or refute it.
- Can transfers reduce inter-regional inequalities?* 64. There is also rather limited evidence to support the opposing claim that progressive sub-national fiscal transfers can help to narrow inter-regional disparities. Country case study material tends to indicate that in the absence of redistributive fiscal policies sub-national disparities are likely to widen (e.g. China, India, Brazil). However, there are cases where large sub-national disparities have remained in spite of very active policies of redistribution (e.g. Vietnam, see Klump and Bonschab, 2004). On balance it appears that sub-national transfers have not been a sufficiently powerful instrument to reverse tendencies towards agglomeration and divergence. However, they may have had some impact in slowing these trends.
- Sub-national transfers are unavoidable* 65. The debate about whether or not to redistribute resources spatially is somewhat artificial because in practice the structure of tax and expenditure assignment between different levels of government usually makes sub-national transfers unavoidable. In most countries the expenditure responsibilities of sub-national governments far exceed their tax raising powers.<sup>14</sup> There are efficiency arguments against introducing greater fiscal decentralisation because this can cause factor mobility and the displacement of commercial activities from one sub-national region to another in search of the lowest tax rate.<sup>15</sup> In most countries there are therefore substantial transfers from central to sub-national tiers of government. There is a strong tendency for these flows to result in a progressive redistribution between regions because wealthier regions generate more taxes, whereas government expenditures are usually more evenly spread across the national population.
- How to design better transfers?* 66. The question of whether or not to redistribute income between regions is therefore of little practical relevance to policy. The real issue is how to design a system of sub-national transfers that minimises efficiency/equity trade-offs and opportunities for political interference. The design of the transfer system is critical in this regard, as illustrated in the box below. The use of transferred resources is also crucial. For example, in declining regions experiencing rapid out-migration it may be more worthwhile to invest in human capital rather than infrastructure. People can move elsewhere, whereas rural infrastructure cannot.

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<sup>14</sup> In theory sub-national tiers of government can only efficiently tax immobile factors (i.e. land/property taxes) and fixed activities (i.e. service charges). Attempts to tax mobile factors of production (i.e. labour and capital) or commerce (i.e. sales taxes) are likely to result in the displacement of factors and economic activities from one sub-national region to another in search of the lowest tax rate. Taxes on mobile factors or commercial activities can only efficiently be raised by central government. The problem is that the latter group of taxes tend to generate far greater revenues than the former. Hence, in most countries sub-national governments rely on transfers from central government for the majority of their revenues.

<sup>15</sup> Excessive fiscal decentralisation can result in national distortions and the widening of inter-regional disparities. If all taxes were raised at local level regions with higher per capita incomes would be able to impose lower tax rates in order to deliver a given level of services. Wealthy individuals would tend to migrate to these regions in search of lower taxes thereby accentuating the initial disparity.

### The design of efficient sub-national transfer systems

There is great diversity in the type of instrument used for sub-national fiscal transfer. In practice, it is desirable to combine several different types of instrument. Matching grants can prove to be an effective means to strengthen incentives for local revenue raising.<sup>16</sup> While matching grants can prove to be more beneficial to wealthier sub-national regions, it is possible to adjust the matching formula to compensate for regional income differences. Most countries also provide *non-matching* grants in order to provide a predictable level of funding to sub-national government. These are best allocated according to well established formula that minimise the possibility of political interference. There is a case to provide both unconditional and conditional non-matching grants. The former provides a guaranteed minimum level of income, while the latter can be a useful tool for central government to induce sub-national governments to spend resources according to national priorities.

There are also positive examples of the use of revenue sharing incentives to reward sub-national governments that achieve a strong growth performance. Since the 1994 reforms in China provincial governments been permitted to retain incremental tax earnings that arise from economic growth (Peterson, 2005).

*The need for transfers is greater in large, diverse states with greater labour mobility*

67. **Country contexts.** The objectives and design of sub-national fiscal transfers will vary greatly between countries. Geographical factors are particularly important. The need for transfers tends to be greatest in larger and more diverse states, in particular where there are large pre-existing disparities in income and growth between regions. The extent of labour mobility between sub-national regions will also impose limits on fiscal decentralisation. Where there is significant mobility between sub-national regions there will be a greater need for sub-national fiscal transfers. In such cases the absence of transfers would lead to widening differences in the fiscal capacity of different regions.

*Political factors explain why transfers are not equitable or efficient*

68. The ability of governments to introduce efficient and equitable sub-national transfer programmes is usually constrained by political factors. In highly fractured countries with a high potential for conflict, transfers may be used as a means to hold together different regions and promote stability, but these same tensions may also impose a limit on the size of transfers. In many states political stability is founded on relations of patronage. In these settings discretionary sub-national transfers tend to be more important than rule-based allocations.

*Transfers are a source of political tension between regions*

69. The existence of transfers also influences the political economy, and may be a source of tension between regions. Wealthier regions that act as net contributors usually seek to retain a greater share of revenues, and poorer regions that act as net beneficiaries usually seek to obtain larger transfers. Particular tensions may arise over the distribution of natural resource revenues. For example, in both Nigeria and Bolivia there are intense disputes over the allocation of oil and gas revenues, that have generated violence in the producing regions (Nigeria) and

<sup>16</sup> A matching grant is a grant that is made on the condition that the amount provided by central government must be supplemented by the local government according to an agreed formula. Non-matching grants do not require a local contribution. These may be provided unconditionally, or may be conditional upon the local government undertaking certain specified actions.

demands for greater regional autonomy (Bolivia). Central governments face a difficult balancing act managing these tensions. The resulting system of sub-national transfers is often based more on the need to accommodate political tensions rather than on principles of efficiency or equity.

## 8.2 Strengthening the enabling environment for growth within sub-national regions

70. There is increasing recognition of the limitations of sub-national fiscal transfers as an instrument to direct regional policy. There is an emerging consensus in both developed and developing countries that the main emphasis of regional policy should be to enable and accelerate growth within each region. This recognition has focussed attention on policies that aim to lower the costs and risks of doing business in particular locations. The World Development Report 2005 has emphasised the importance of the investment climate for generating growth. Its agenda covers a wide range of issues including property rights and security, business taxation, regulatory and legal reform, access to finance and infrastructure and well-functioning labour markets (World Bank, 2005a).

*The quality of the business environment often varies at sub-national level*

71. The quality of the business environment often varies at sub-national level. For example, the World Bank's Doing Business survey has measured large variations between Brazilian cities in the time and costs of starting a business and registering property (World Bank, 2005b). In India surveys have indicated wide variations in labour regulations between different states (Besley and Burgess, 2004). There is evidence that Indian states that have introduced more pro-worker regulations tend to have lower growth rates and higher rates of urban poverty than states with more pro-employer regulations. In addition to regulatory variations, in many countries there are often wide sub-national variations in local taxation rates, security conditions and the quality of infrastructure.

*Growing competition between regions to attract investment*

72. The globalisation of investment flows has intensified the competition between regions to attract and retain businesses. Consequently, investment climate issues have become an increasingly important policy issue at sub-national level. Policies can be grouped into two broad approaches: (i) removing disincentives to investment, and (ii) providing positive incentives to attract investment. The first group of policies is concerned with reforms aimed at removing or easing regulatory and administrative obstacles to doing business. The second group is concerned with offering tax incentives, subsidies and special preferences to attract investment, for example the creation of Export Processing Zones (EPZs) that are subject to tax exemptions or looser labour regulations. In addition to these policies, sub-national governments can improve the investment climate by investing in public goods (especially infrastructure, but also security and human capital formation). Such policies will be discussed further in section 8.4 on spatial planning.

*Removing obstacles to investment*

73. **Removing obstacles to doing business.** Regulatory, legal and administrative reforms can generate a significant growth dividend (see World Development Report 2005). Excessive regulation stifles the growth of formal enterprises, and also discourages informal sector businesses (where the poor are particularly concentrated) from expanding and becoming formal enterprises. Most of the evidence of the growth impact of regulatory reform relates to national level

investment climate surveys, and there have only been a few studies at sub-national level. One example is the aforementioned study on the effect of state-level labour regulations on growth in India (Besley and Burgess, 2004). In China Démurger *et al.* (2002) find a significant positive correlation between the easing of regulatory requirements for FDI (as measured by the number of Special Economic Zones in a province) and provincial growth rates. Further research is required on the effects of investment climate reform at the sub-national level. There are good reasons to expect a strong impact on growth, and for reform to spread between sub-national regions as a result of demonstration effects and competition for investment.

*Offering inducements for investment*

74. **Positive incentives for investment.** The second approach can also have a powerful stimulatory effect on development. For example, the success of the Special Economic Zones in China in generating growth is explained in part by the granting of tax concessions and other privileges in addition to the regulatory reforms mentioned above (Démurger *et al.*, 2002). However, there are several problems with offering inducements for investment. There is often a tendency for sub-national governments to offer financial sweeteners to businesses without addressing the more fundamental problems in the business environment. In many cases the benefits are short lived. For example, regional policies in the UK in the 1960s and 1970s were initially successful in relocating businesses to deprived areas, but when recession came many of these closed. The indiscriminate use of incentives by sub-national governments can also result in beggar-thy-neighbour practices and zero-sum competition between regions. Rodríguez-Pose (2005) describes the experience of Brazil where cities and states attempted to lure FDI with increasingly generous inducements that resulted in public funds being used to provide massive subsidies for multinational car manufacturers. The process has proven very costly for the nation as a whole, and has been particularly disadvantageous to poorer states, which lacked the funds to compete. This example illustrates the need for clear rules and limitations regarding the use of public resources by sub-national governments to attract investment.

*Federal states offer more opportunities to pursue sub-national investment climate reforms*

75. **Country contexts.** The relevance and effectiveness of investment climate reforms to stimulating growth at the sub-national level will vary in different country contexts. The approach is more applicable to federal states where relevant policy responsibilities have been devolved to a greater extent to sub-national tiers of government. In more centralised states local authorities have less leeway to introduce region-specific policies to attract business, but central government may be able to offer region specific tax incentives and other inducements.

*Well located regions will derive greater benefit than remote regions*

76. The extent of pre-existing regional disparities must also be considered. Investment climate reforms are likely to be of greatest benefit to sub-national regions that already enjoy certain locational advantages. In remote regions even the most business-friendly investment climate would be unlikely to offset locational disadvantages. Furthermore, wealthier regions will be in a stronger position to undertake investment climate reforms and to offer investment incentives than poorer regions that lack resources and capacity to reform. In view of these effects it would be expected that the promotion of investment climate reforms at sub-national level could act to widen inter-regional disparities.

*Political factors limit the prospects for reform*

77. In many low income country contexts political economy factors limit the prospects for investment climate reform. These reforms threaten to eliminate important sources of rent seeking for local officials, and may thereby undermine the basis of patronage politics. The reluctance to undertake reforms is likely to be greatest at lowest levels of government, where rent seeking and predatory behaviour by officials towards businesses is often particularly severe. In Nigeria for example, businesses report that the greatest problems of taxation, licensing and official harassment and corruption emanate from local government (PriceWaterhouseCoopers, 2001). Research into the imposition of local taxation in Uganda drew similar conclusions (Bahiigwa *et al.*, 2004). The key to change will be to convince local elites that there is to more to be gained from fostering growth than in stifling it through rent seeking. This transition is difficult to achieve, but will be more likely where there is pressure from civil society below, stronger oversight from central government above, a degree of competition between regions, and positive examples of change that can be emulated.

### **8.3 Facilitating labour and capital mobility**

*Labour migration offers a route out of poverty for people living in lagging regions*

78. In theory, the mobility of capital and labour between sub-national regions will tend to have an equalising effect on incomes, and will stimulate growth by raising allocative efficiency. Labour migration appears to offer a particularly important route out of poverty for people living in lagging regions, and generates economic benefits both in sending and receiving regions. However, governments have often sought to discourage and restrict internal migration by imposing numerous controls. In addition, donors have paid little attention to labour mobility as a means to address poverty. The dominant tendency of both government and donor policy has been to direct resources at poorer regions rather than to encourage mobility (Ellis and Harris, 2004).

*There are positive and negative effects of migration in sending and receiving regions*

79. There is a rich literature on the patterns and effects of internal labour migration (see recent review by Deshingkar, 2005). Many studies have analysed the impacts in sending regions, and identify both negative and positive effects. The most important cost is the depletion of labour in sending regions. Because migrants tend to be young and male there is often a noticeable effect on labour productivity, dependency ratios and gender balance in sending regions. However, this effect varies between regions, and some areas are known for female outmigration (e.g. NE Thailand, Yunnan, The Philippines). There is some evidence that outmigration may widen income inequalities in sending regions because the poorest individuals are less likely to migrate due to the significant up-front costs of relocation. Against these costs, however, migration often generates significant economic benefits in sending regions mainly as a result of the return flow of remittances. Research in Sub-Saharan Africa indicates that remittances contribute an average of 15% of rural incomes (Reardon, 1997). In China official surveys indicate that remittance incomes are about to overtake incomes from agriculture in rural areas (quoted in Ellis and Harris, 2004). There is evidence that remittances tend to be used mainly for consumption rather than investment, but even where this is the case there are strong multiplier effects that stimulate the rural economy (Deshingkar, 2005). In addition to the benefits of remittances, there are also positive effects arising from circular patterns of migration, where returning migrants bring back capital, new knowledge and ideas.

<p><i>Evidence on the effects of migration on growth is lacking</i></p>	<p>80. Although there have been numerous studies of different types of migration flows and their localised impacts, there is little knowledge about the overall impact of internal migration on growth at national and sub-national scales. Internal migration has usually been the main driver of urbanisation in low income countries, and has made a substantial contribution to growth by allowing agglomeration economies to occur. However, the strength of these effects have rarely been researched, and have tended to be ignored by government policy. Instead, governments have tended to emphasise negative effects in receiving regions, for example the expansion of slum settlements, the growth of the informal sector, underemployment and increasing congestion. Such arguments are frequently used to justify curbs on migration.</p>
<p><i>There is also a lack of evidence on the effect on inter-regional income disparities</i></p>	<p>81. The effect of migration on sub-national income disparities has also been subject to very little analysis. Predictions that migration would have an equalising effect on regional incomes appear to conflict with the reality in many countries where regional income inequalities have widened in spite of very active internal migration (e.g. China, India, Ghana). A possible interpretation is that the equalising tendency of migration is not sufficiently powerful to offset the effects of agglomeration economies that generate divergence in regional incomes.</p>
<p><i>Improvements in financial systems can facilitate remittance flows to less developed regions</i></p>	<p>82. Neo-classical economic models predict that capital will flow in the opposite direction to labour, and will result in the equalisation of regional incomes. In part this prediction is born out in the observation of large-scale remittance flows. However, the dominant tendency appears to be for capital to concentrate in urban centres. Again the strength of agglomeration economies appears to override tendencies for the dispersion of capital. In spite of this there is scope to facilitate the flow of capital to less developed regions by developing improved systems for the handling of remittances.</p>
<p><i>Government policies need to be more supportive towards labour mobility</i></p>	<p>83. Although there are still many unanswered questions about the effects of labour and capital mobility on sub-national growth, the overall effect appears to be beneficial. Government policies to promote mobility are therefore likely to be growth enhancing, and may in many cases offer part of the solution to the problems of lagging regions. A wide range of policies are relevant to supporting labour and capital mobility:</p>
<p><i>There is a broad policy agenda</i></p>	<ul style="list-style-type: none"><li>• Labour market: removal of migration and residence controls; easing of employment regulations (hiring and firing); information, training and recruitment programmes for potential migrants in sending regions.</li><li>• Infrastructure: improved housing policies to enable the provision of low cost housing; slum upgrading programmes; reforms to the transport sector to lower transport costs for migrants and commuters; facilitating commuting patterns by improving infrastructure in and around cities;</li><li>• Social policies: to affirm the rights of migrants and to reduce official harassment; to reduce the risks faced by migrants, including insurance schemes and safety nets.</li><li>• Financial sector: changes to financial regulations to encourage expansion of rural banks; improvements to systems handling remittances.</li></ul>

*There are some positive examples of change*

84. In general governments have given little attention to these policy areas, but there are some positive examples of change. For example, in China controls on residence and migration (Hukou) have been largely removed, and in some regions training has been provided for migrants to equip them with skills needed in urban areas. Provincial governments in both sending and receiving regions now actively promote migration through the use of training and recruitment programmes for prospective migrants, and the signing of inter-governmental migration contracts. In India there have recently been some private sector led innovations in the handling of remittances in the banking sector. There are some positive examples of NGO and donor funded migrant support programmes that have sought to provide information and to defend the rights of migrants (Deshingkar, 2005).

*The pattern and impacts of internal migration vary greatly among countries and regions*

85. **Country Contexts.** The pattern and impacts of internal migration vary greatly among countries and regions. Migration flows typically occur between well established sending and receiving regions. While some sending regions may account for the majority of migrants in a country (e.g. NE Thailand), other regions may contribute very few (e.g. hill tribe areas in Vietnam). Cross border migration may also have an important effect on regional economic development (e.g. Burmese migrant labour in border zones in western Thailand). There is often significant segmentation of migration flows by ethnicity and gender and the sector of the economy that different groups of migrants enter. The variability of migration flows and timescales adds a further level of complexity. There is usually a complex mix of rural-urban, urban-rural, rural-rural and urban-urban flows that may be permanent or circular, and take place on life cycle, seasonal or daily timescales. This complexity points to the importance of designing policy on the basis of country analysis.

*There are political obstacles to introducing more supportive migration policies*

86. Political economy factors largely explain the apparent reluctance of governments to introduce more liberal and supportive migration policies. The main reason why governments are typically wary of internal migration is its potential to upset the political balance. Governments are keenly aware that political opposition often emerges in urban centres with large migrant populations. Large numbers of new arrivals in urban settings can break down ethnically and regionally based political loyalties thereby challenging the basis of patronage politics.

*Migration needs to be well managed where there are risks of inflaming social and ethnic tensions*

87. In many countries there is a concern that internal migration and rapid urbanisation can generate social friction and ethnic based conflict. For example, in Nigeria and Kenya inter-ethnic riots have been a frequent occurrence in large, rapidly growing, and ethnically mixed cities. Such examples illustrate the need for the better management of internal migration in conditions where this may generate social tensions. The focus should be on policies to ease the integration of migrants, and to address sources of grievance in receiving areas, in particular tensions arising from the scarcity of housing and employment.

## 8.4 Spatial planning and transport infrastructure

88. The final policy approach considered by this paper, spatial planning, draws together a wide range of planning instruments used by governments to control how development occurs spatially. Examples include infrastructure development at different spatial scales, planning controls and zoning, creation of industrial estates and the promotion of clusters, the establishment of new cities and growth poles, and location decisions for public agencies and universities. All of these policies are aimed at restricting development in certain areas and/or stimulating it in others.

*The need for planning arises from market failures, and a concern with equity and political stability,*

89. The main justification for government's role in spatial planning is to address the market failures and coordination problems discussed in section 6. Arguably government intervention is required to guide the development of cities towards their optimum size and to provide public goods, in particular infrastructure. In addition, planning decisions are also motivated by concerns about equity and political stability. It is often assumed, for example, that the problems of lagging regions can be addressed through major infrastructure investments.

*but governments often get planning decisions wrong*

90. Spatial planning instruments are potentially a powerful instrument to stimulate growth at the sub-national level and to address inter-regional inequalities. However, these often fail. Planning decisions are commonly driven by political rather than economic considerations. Even where governments attempt to justify planning decisions on economic grounds, they usually have great difficulty assessing the nature of market failure and designing the appropriate response. In some places governments overprovide infrastructure, for example by constructing industrial estates where there is no demand, or constructing roads in the wrong places or to excessively high specifications. More often there is an underprovision of infrastructure, resulting in urban congestion and the growth of slum settlements. Misconceived planning policies can distort sub-national growth processes, reduce efficiency and waste resources. Another reason why spatial planning approaches have often failed is that governments are often unable to implement plans for technical and political reasons.

*Evidence of the positive effects of transport infrastructure on growth*

91. What does research evidence tell us about the type of spatial planning policies that are most likely to have a positive impact? The strongest evidence relates to the provision of transport infrastructure, where numerous studies have demonstrated the high returns to investment, and a positive association between infrastructure investment, growth and poverty reduction.<sup>17</sup>

92. Most of the research has focused on impacts of infrastructure investment at the national scale, but a few studies also find significant effects at the sub-national scale. In a study of 17 Indian states Nagaraj *et al.* (2000) find that a 10% increase in the road network raises average incomes at state level by 3.4%. Similar results have been reported from China, where Démurger (1999) finds that provincial disparities in incomes are strongly associated with differences in the density of road networks. There is also evidence that investment in transport infrastructure linking the main cities to hinterland regions can help to reduce the spatial concentration of economic activity. Davis and Henderson (2003) find that countries with higher road densities tend to have lower rates of urban primacy.

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<sup>17</sup> For a review of the evidence see Bricendo-Gormendia *et al.* (2004), Willoughby (2004), Fan and Chan-Kang (2005)

*Where should governments invest in infrastructure?*

93. While these studies point to the general importance of infrastructure for sub-national growth, they offer little guidance to governments on the critical questions of where and how to invest. Should governments focus on financing inter-regional infrastructure as a means to integrate the national economy and to connect lagging regions to centres of growth? Should they finance cross-border infrastructure to promote regional integration and to stimulate growth in border regions? Should they concentrate on rural feeder roads as a means to raise agricultural productivity? Or, should they give greatest attention to infrastructure needs in urban and peri-urban areas in order to reduce congestion, facilitate commuting and strengthen the integration and competitiveness of city-regions? Another major issue is whether governments should undertake new construction or focus on the often neglected maintenance of existing roads. Cost-benefit analysis can be used to guide such decisions, but is fraught with difficulty because immediate and broader economic impacts are very hard to predict.

94. A few studies have begun to analyse these issues. In China researchers have found that road investments yield their highest economic returns in eastern and central China, while their contributions to poverty reduction are greatest in western China (Fan and Chan-Kang, 2005). The same authors suggest that marginal returns to investment in large scale inter-city roads are beginning to decline, and improving low quality rural roads will now generate greater marginal returns and have a higher impact on poverty.

95. It is commonly believed that large scale investment in infrastructure can help to bring growth to lagging regions. The evidence on this point is rather limited, and there are cases of failure as well as success. Foster (2005) reviews various examples. In Thailand, investment in infrastructure surrounding planned growth poles in the impoverished northeast of the country had little impact on growth. However, in South Korea inter-regional infrastructure constructed in the 1980s appears to have played an important role in the dispersion of economic activity away from Seoul.

*Governments should avoid trying to regulate city size*

96. While there is ample evidence of the positive effects of transport infrastructure investment, the record for other spatial planning instruments is much more mixed. Many governments have sought to address supposed problems of over-urbanisation by introducing policies to control city size and to disperse population to new centres. This has often proven to be highly costly and usually ineffective. In many cases such policies have proven to be counterproductive because they have inhibited the realisation of agglomeration economies. In practice, it is very difficult to determine the optimum size of cities. Empirical evidence suggests that the costs of cities being oversized are much lower than the costs of being undersized (Overman and Venables, 2005). In addition, the optimum size of a city depends greatly on the quality of infrastructure, suggesting that infrastructure investment and good urban governance are far more important determinants of the efficiency of cities than the size of their population. All of these arguments suggest that governments should exercise great caution in introducing policies to regulate city size.

*Government attempts to promote industrial clusters have often been unsuccessful*

97. Public policies to promote industrial clusters could in theory help to correct market failures and generate productivity benefits. However, in practice the results have been disappointing. While there are some examples of success (for example in growth poles in Vietnam or Special Economic Zones in China), there are also numerous examples of underused industrial parks and misdirected subsidies that have been justified on the grounds of promoting clusters. Government attempts to pick winners amongst industrial sub-sectors and to intervene in firms' location decisions are often unsuccessful.<sup>18</sup> A more appropriate role for government is to strengthen the enabling conditions for the formation of clusters, and to provide public goods to facilitate the growth of clusters where they become established.

*Physical and economic geography determine the viability of infrastructure investment*

98. **Country contexts.** Geographical factors are a crucial determinant of the effectiveness of spatial planning policies. In relation to transport infrastructure the costs and benefits depend greatly on the distances to be covered, the nature of the terrain, the potential to increase internal trade and population density. Depending on these variables it may in some cases be worthwhile to invest in infrastructure linking remote regions to centres of growth, while in other cases there will be greater returns to concentrating investment in and around the primary city.

*Effective planning requires coordination between levels of government*

99. The political structure of a country also greatly influences the ability of government to carry out effective spatial planning policies. Strong local governments are required for effective planning of infrastructure at the local and city level. However, strong central government capacity is also required to undertake country-wide spatial analysis and planning, for example decisions relating to inter-regional infrastructure investment. There are important coordination issues between levels of government that are discussed more fully in section 10 below.

*Politics influence decisions on where to invest in infrastructure*

100. Political economy factors again emerge as an important constraint to introducing efficient and equitable policies. Patronage politics are likely to influence decisions on where to invest in infrastructure. The main beneficiaries tend to be capital cities where politicians live, and particular regions that provide electoral support to the party in power. Numerous rent-seeking opportunities arise because of the effects of planning on land values and land markets. Corruption may also influence infrastructure provision by inflating the costs of contracts and thereby lowering the overall level of infrastructure provision. It is possible that corrupt officials may distort planning decisions in favour of high cost/ high specification projects at the expense of basic infrastructure and maintenance.

## **8.5 Sub-national effects of macroeconomic and sectoral policies**

*Trade policies affect the sub-national pattern of growth*

101. The four policy approaches discussed above cover the main instruments that governments regularly use to enable and manage sub-national growth processes. It is also important to recognise that many apparently non-spatial policies that are introduced at the national level also result in uneven sub-national growth. One of the most important examples is trade liberalisation, which can have a dramatic impact on regional production patterns. Some regions may suffer where previously protected industries become unprofitable in open trading conditions. Other regions may prosper where their industries are internationally competitive. The impact of trade liberalisation will depend on the accessibility of sub-national regions, and the

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<sup>18</sup> There are some exceptions, for example, industrial policies in East Asian countries.

costs of domestic transport required to reach international borders. Hence, the greatest impact will be felt in regions close to land borders, sea ports and airports. There is some evidence that the trend towards widening regional disparities in the 1990s is in part explained by trade and investment liberalisation. For example, Kanbur and Zhang (2001) demonstrate that increasing trade openness in China has been associated with widening inter-regional disparities during the 1990s.

*Consider the spatial impact of a broad range on economic policies*

102. Monetary policy also affects sub-national regions in different ways. Interest rates are set on the basis of “one size fits all”, but may in practice be appropriate to certain sub-national regions, and not to others. Sectoral policies that influence the profitability of different sectors may have a profound impact on sub-national growth patterns. For example, in the past many low income countries have taxed agriculture disproportionately and subsidised food prices and import substituting industries. This stimulated urban development to the detriment of rural areas as described by Michael Lipton’s thesis of urban bias (Lipton, 1977). Structural adjustment reforms have removed many of these sources of bias (Corbridge and Jones, 2005), but have generally failed to generate a significant supply response in rural areas, except amongst certain export producers. There are numerous other examples of the sub-national effects of national policies that cannot be reviewed here due to space limitations. The general lesson is that all policies have consequences for sub-national growth, and that a spatially sensitive approach is required for their design.

## Part C – How should governments implement policies for sub-national growth? Institutional and governance questions.

103. Implementing the above policies and approaches for sub-national growth requires certain institutions and governance arrangements to be in place. The role of sub-national levels of government is particularly important in this regard. Decentralisation presents particular opportunities to improve policy making, and service delivery, but there are also difficult issues that must be addressed. Three issues that are particularly pertinent to the discussion are considered here. First, there is the question of how decentralisation influences growth and sub-national disparities. Second, there is the issue of how best to manage relations between the centre and sub-national government to support pro-poor growth. Third, there is the need to ensure greater accountability of sub-national government upwards towards central government and downwards towards civil society and the business sector. This part of the paper is organised around these three headings.

### 9. Decentralisation: Effects on sub-national growth

104. All of the four policy approaches discussed above imply an important role for sub-national government. It might therefore be expected that the current trends across the globe towards greater decentralisation would be helpful for introducing more effective policies for sub-national growth. What evidence is there on the effect of decentralisation on growth at national and sub-national level?

*Mixed evidence on the effect of decentralisation on sub-national growth*

105. It is widely assumed that decentralisation will generate faster growth by improving the effectiveness of policy making and the efficiency of public service delivery. The basic reasoning is that where government is decentralised, there will tend to be greater awareness of local conditions, a better understanding of local needs, more transparency and greater accountability. It has often been argued that decentralisation would lead to higher allocative efficiency and a greater willingness of the population to contribute to the cost of services (Briscoe and Garn 1995; Litvak and Seddon, 1999). In truth these arguments go back a long way (e.g. Hayek, 1945; Musgrave, 1959; and Oates 1999). Unfortunately, the empirical evidence remains at best weak. A 1998 review of the literature concluded that overall the performance of decentralised government depended on the individual circumstances and related institutional design; sometimes the outcomes were positive, but often they were not (Azfar *et al.*, 1999).

*Basic principles for effective decentralisation*

106. The evidence does not permit any simple generalisations about the overall benefits of decentralisation. Decentralisation may or may not improve governance and welfare; its effectiveness depends on its design, on the political context and on the specific circumstances. However, some basic principles emerge from the extensive literature on decentralisation (Litvak *et al.*, 1998; Azfar *et al.*, 1999):

1. *Roles and responsibilities* need to be clearly defined in law;
2. *Resources and capacities* at each level need to match the prescribed roles and responsibilities;

3. Effective *mechanisms of accountability* both upwards (legal regulation and financial oversight) and downwards (to the governed via elections and to civil society via channels for participation) need to be put in place; and
4. *Subsidiarity*, which means giving responsibility to the lowest level of sub-national government capable of exercising that responsibility effectively.

*Role of local democracy*

107. It is often argued that *elected* local governments would be more responsive to the needs of both local businesses and the poor owing to their closer proximity to their constituents or clients and their interest in being re-elected. There is very little evidence on the former and only limited evidence on the latter. Studies of the relationship between the number of tiers of elected government and UNDP's Human Development Index indicate that countries with more elected tiers do have higher HDIs (von Braun and Grote, 2000). Nonetheless, generalisations are hazardous; for example China, which has no genuinely competitive politics, has done markedly better in reducing poverty than India which has elections down to the village level. However, China, although formally highly centralised, has in practice ceded a large measure of autonomy to local government, while the elected village Panchayats in India are constrained by a rigid caste system that disadvantages the poor.

*Decentralisation may act to widen inter-regional inequalities*

108. There is a growing recognition that while decentralisation has clearly benefited some regions, the effects have been rather uneven. Some researchers have argued that decentralisation has been associated with widening sub-national growth and income disparities. Detailed analysis of trends since 1980 in six countries (Brazil, China, India, Mexico, Spain and the USA) revealed that in every case except Brazil devolution has been accompanied by widening inter-regional inequalities (Rodríguez-Pose and Gill, 2004). The authors put forward a number of explanations for the observed trends. First, decentralisation in the case study countries has been associated with the decline of sub-national transfers. Second, local governments have widely varying resources and capacities at their disposal to introduce growth enhancing policies and attract investment. Third, wealthier regions are usually more successful in lobbying central government for increased resources.

*But, the most important question is how it affects growth overall*

109. This study has raised some crucial issues, but leaves many questions unanswered. It is unclear whether the findings are more widely applicable beyond the six country case studies. From the perspective of this paper it is notable that there is only one low income country (India) in the sample. The paper does not address the most important question of whether decentralisation has led to more rapid growth and poverty reduction overall, and whether this has compensated for widening inequalities. Under conditions of rapid growth it is possible that incomes may increase and poverty may decline in the poorest regions even where inter-regional inequality increases. However, this is often not the case. Under conditions of slow growth widening inter-regional inequalities are likely to be associated with declining incomes and rising poverty in the poorest regions. More research is needed to measure these outcomes more accurately.

*Decentralisation must be coupled to effective systems for*

110. The widening of inter-regional inequalities is clearly an important risk inherent in decentralisation processes that needs to be more thoroughly researched and considered in policy design. Mitigating measures may be required to offset the tendency of decentralisation to generate divergence. Sub-national fiscal transfers

*sub-national transfers*

play an important role in this respect, and may be regarded as an essential complement to decentralisation policies. However, there are limits to the effectiveness and scope of transfers, as discussed in section 8.1. In devolved political systems richer regions are likely to resist calls for large scale subsidisation of poorer regions.

## 10. Managing inter-governmental relationships

*Coordination is required between different levels of government,*

111. Policies for sub-national growth require coordinated action between different levels of government and between public authorities in different places. This creates complex institutional problems, which are particularly challenging in many low income countries, where capacity for coordination is lacking. There are essentially two types of coordination problem. The first concerns the vertical links between different tiers of government. Effective coordination depends on adherence to the principles of good practice in decentralisation outlined above. However, this is often not the case in low income countries, where relationships between different levels of government are often characterised by a lack of clarity on roles and responsibilities, duplication, and inadequate resourcing. In such conditions lower tiers of government may lack the mandate, resources and capacity to implement key sub-national growth policies. Party political conflicts between central (or state) government and local government can also be a serious impediment.

*and between local governments in different geographical areas*

112. The second type of coordination problem concerns the horizontal links between local governments working in different geographical areas. Such coordination is difficult to achieve because reporting channels tend to function vertically between levels of governments rather than horizontally between adjacent administrative units. However, such coordination is essential in order to plan and manage spatial processes and public investment. For example, neighbouring authorities will need to coordinate the planning of joint infrastructure and transport services. Broader coordination within city-regions will be required for the effective planning and management of the movement of people and goods between the city and the hinterland. Cross-border regions create particular challenges in ensuring coordination between local and regional governments on either side of the international border.

113. All four policy approaches presented in this paper require effective coordination: vertical and/or horizontal. Sub-national fiscal transfers require complex financial systems linking different levels of government to be put in place. Measures to strengthen the enabling environment for business are also best carried out through coordinated action by central and sub-national governments, especially where incentives are provided to encourage investment in certain regions. The successful management of migration requires policy coordination between sending and receiving regions. Effective coordination is particularly important in the infrastructure sector, where different levels of government are responsible for different levels of the road network (feeder, secondary and trunk roads), and large projects may span several administrative units.

*Coordinated urban governance presents a particular challenge ...*

114. Large cities, especially the capital city, present special problems. Their administration is demanding and often politically sensitive. Defining their boundaries is often contentious, particularly where a city is growing rapidly and where there are strong functional linkages with surrounding areas (e.g. daily commuting patterns). Because cities play a crucial role in spearheading national growth, the efficiency of city management will be important in determining how successful a country is economically. All too often, the growth of the major cities has greatly outstripped the capacity of their administrations, leading to severe problems of congestion, pollution, insecurity, a shortage of serviced land and poorly managed basic services.

*because administration is often fractured between different authorities*

115. The governance problems of cities often arise from the fractured nature of their administration and the multiplicity of public authorities and agencies responsible for different geographical areas and services. This commonly results in duplication and gaps in service provision, costly disputes between government agencies, and blurred channels of accountability. All of these factors hinder efforts to tackle urban problems in an integrated way, to plan infrastructure in a rational sense and to improve competitiveness. The case of Hyderabad in Andhra Pradesh presents a typical example of dysfunctional city administration. A recent survey listed 161 public agencies and 8 parastatal bodies responsible for public administration within the Hyderabad Metropolitan Area (Mohanty *et al.*, 2005).

*More “joined up” government is essential for effective urban management*

116. The obvious solution is to establish a single greater metropolitan authority that can provide properly coordinated (“joined-up”) government. Steps have been taken in this direction with regard to cities such as Calcutta and Manila. Unfortunately central governments are often nervous about their major cities falling under the control of the political opposition, and hence they have a tendency to perpetuate weak city government.<sup>19</sup>

## **11. Strengthening accountability**

*The problems of weak governance are often most acute at sub-national level*

117. This paper has consistently emphasised the importance of political economy in explaining why government often fails to implement growth enhancing policies. Patronage, rent seeking, corruption and weak capacity characterise all levels of governments in most low income countries, but the problems are usually more acute at sub-national level. In seeking to overcome these problems reformers have sought to introduce more effective mechanisms of accountability. There has been an oscillation in the past between a tendency for governments to control more from the centre to limit local abuses (i.e. enhanced upward accountability), and a tendency to decentralise in the hope that there would be more effective downward accountability (via local elections, local councils, mandatory consultation and other forms of enhanced local participation in decision making).<sup>20</sup> The latter tendency is currently in the ascendant.

<sup>19</sup> London under the premiership of Margaret Thatcher is a prime example

<sup>20</sup> An example of this is Cambodia’s ‘Seila Programme’ where the local commune councils are elected, and grants provided for commune development are subject to an elaborate planning process aimed at ensuring the active involvement of all village families in local investment decisions.

*Local democracy does not necessarily result in better local governance*

118. There is increasing pressure to hold elections, sometimes emanating from Western donors. But, elections in themselves rarely result in administrations that are more pro-poor, since the local political elite will almost always emerge as winners. Political competition, to the extent it is genuinely allowed, will mostly be among factions within the elite, sometimes aligned on an ethnic or religious basis. However, some reforms may result in cases where the grievances or interests of the wider public are also a factor in the intra-elite struggle.

*The role of civil society is key in pressing for greater accountability*

119. Elections, although at the core of democratic government, are at the best of times a blunt instrument of accountability. Much depends on the density of social capital – in other words the number, size, diversity and effectiveness of civil society organisations (CSOs). CSOs play an important role in empowering otherwise disenfranchised poor people, providing a channel for their ‘voice’ in local councils. Because elections are infrequent, it is CSOs that provide a mechanism for day-to-day accountability and to monitor the performance of government officials in their communities.<sup>21</sup> In low income countries civil society tends to be relatively undeveloped, and there are great opportunities for strengthening their role in pressing for greater accountability.<sup>22</sup>

*Business associations can also press for better policies*

120. In addition to CSOs, private sector organisations, including business and professional associations, Chambers of Commerce and prominent business people can also generate pressure for the improved performance of government. Such organisations can be effective advocates for pro-growth policies. However, business lobbies can also be motivated by narrow firm- or sector-specific interests, and by a wish to gain access to rents.

*Civil society organisations and business associations tend to be more active in urban areas*

121. The nature and strength of civil society organisations and business associations varies greatly between countries and regions. The nature of the political climate and official tolerance of non-state voices has a particularly important influence. Almost universally, CSOs and business associations are more active in urban areas, in particularly within the capital city. This tends to reflect the distribution of well educated people, access to government, and business opportunities. There are limitations on the extent to which CSOs and business organisations can influence development in remote rural areas. Donor funding of NGOs can help to redress the balance, but this may come at the cost of transferring accountability away from citizens towards foreign funders.

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<sup>21</sup> This phenomenon is particularly present in Bangladesh and various Indian states where the indigenous NGO movement is unusually strong. In countries like Vietnam where the ruling political party is dominant in local affairs, civil society may be unable to achieve much influence in strengthening local accountability.

<sup>22</sup> See Goetz and Gaventa (2001) for a detailed discussion of opportunities and limitations for civil society to contribute to better governance and more client responsive public service delivery, taking account of the complex political dimensions of CSO activism.

## Part D – Conclusions and Implications for Donors

### 12. Lessons for donors

122. This paper has examined the various policy levers that can be applied to sub-national growth issues in different country contexts. The focus has been on the role of government, but there are also lessons for donors. The two most important are: (i) that sub-national growth issues matter for development, achieving the MDGs, and conflict reduction; and (ii) that donors affect spatial patterns of development, sometimes inadvertently, through their decisions on where to invest, their sectoral priorities, the policies that they advocate, and the broader impact of their funding on patterns of public expenditure.

123. Donors' strategies, policies and programmes therefore need to be based on more spatially-sensitive analysis, and to be better designed to support growth processes at the sub-national level. However, at present the impact of development aid is often insufficiently analysed in spatial terms. Such spatial blindness carries the risk of investing in the wrong places, missing opportunities to support growth and poverty reduction, and exacerbating conflict. Recipient governments tend to be more sensitive to the political and sub-national implications of policies and investments than donors, who are usually most concerned with development indicators at the national level. In order to support their partners more effectively donors' perspectives will need to change in order to treat the spatial dimensions of development with more system and seriousness.

124. A complete discussion of the implications for donors will require additional research and discussion beyond the scope of this paper. However, a number of lessons relevant to donor policy can be highlighted. The most important messages are presented below:

- 1) **Focus resources on regions where there is the greatest potential to raise rates of pro-poor growth in the long term.** Greater impact will be achieved by supporting regions with better growth prospects rather than directing resources at the poorest regions. Urban development should figure more highly in donor priorities because of the role of cities in generating growth, their potential to absorb migrants originating from lagging regions, and their linkages to the surrounding rural economy (e.g. through labour and product markets). There is great potential in many countries to enhance the contribution of cities to growth and poverty reduction by addressing problems of weak urban governance and inadequate service and infrastructure provision. Donors have tended to steer clear of urban projects on the false assumption that efficient city management is not an important component of a national pro-poor development strategy.
- 2) **But, also pursue a balanced strategy that addresses concerns with equity and conflict prevention in addition to growth objectives.** The main risk of the above strategy is that widening inter-regional disparities may threaten social and political stability and thereby undermine growth over the long term. It is important to build conflict awareness into development planning and implementation, and to be sensitive to the fact that spatial disparities often exacerbate other fault lines, ethnic, religious or otherwise. In addition, it is important to recognise that there are large concentrations of poor people in lagging regions, for which labour migration offers only a partial solution. These concerns dictate that donor resources should not solely be directed at regions with the strongest potential for growth and poverty reduction, but should also be used to address the problems of lagging regions. In making judgements on the appropriate balance, much depends on the specific conditions encountered at country level. It is important to take a long-term view of the growth potential of regions, the risk of conflict and instability, the overall pattern of poverty between regions, and

the role of internal migration in redressing these imbalances. It is also essential to take account of the functional linkages between regions at the level of markets (labour, products etc.) and at the household level (multiple livelihoods spanning urban and rural occupations).

- 3) An understanding of political economy should underlie donor strategies to support sub-national growth.** Policies are determined by political processes and competing vested interests. Consequently, political elites often fail to adopt policies that maximise growth or optimise spatial patterns of development. There are important implications for donors. There are clear risks when donors become engaged in highly politicised processes, for example the reform of sub-national fiscal transfers. However, there are also opportunities for influencing change, most importantly by supporting accountability mechanisms to enhance the role of civil society and private sector organisations to press for reform. These processes are particularly relevant at sub-national level, where accountability tends to be weakest. Effective intervention depends on a thorough understanding of the political processes at work in each specific country situation, something donors tend to overlook.
- 4) Mainstream spatial thinking into the design of development policies and programmes.** For all development policies and programmes proposed by donors it is important to consider carefully their spatial implications, and to recognise the trade-offs between growth, equity and political dimensions. Spatial analysis should be applied across a range of donor instruments, including public expenditure reviews, budget support, sector programmes and large infrastructure development programmes. It should also be extended to policies that are not normally considered in spatial terms, for instance the sub-national effects of macroeconomic policies.
- 5) Adopt better practice in the design of sub-national fiscal transfers.** There are significant drawbacks to sub-national transfers as a means of promoting growth. However, most countries have developed a system of transfers for a variety of well founded reasons, including concerns with equity and political stability, as well as the pressures arising from the structure of tax and expenditure assignment between different levels of government. Greater understanding is required on how to minimise growth-equity trade-offs in the design of transfers. While recognising the political sensitivity of transfers, donors should engage more actively with governments on these issues, in particular where donors provide budget support or fund sub-national levels of government.
- 6) Improvements to the enabling environment have potential to boost growth within sub-national regions.** In general the focus should be on measures to remove obstacles to doing business. Investment and tax incentives can play a positive role in promoting development in lagging regions. However, rules need to be put in place to avoid zero-sum competition between regions. Although significant growth benefits are likely within well-located regions, remoter areas are unlikely to experience much benefit. For good reasons economic activities will almost always tend to concentrate in dynamic growth areas and public policy should not seek to fight this process, but should seek other means to address the resultant inequalities.
- 7) More supportive policies are required to promote labour mobility.** The contribution of labour migration to growth, poverty reduction and inter-regional equity has often been overlooked. There is a wide-ranging policy agenda that needs to be addressed covering: labour market policies, infrastructure policies, social policies and financial sector policies; and the management of internal migration in conditions where this may generate social tensions.

- 8) Infrastructure investment can stimulate sub-national growth.** There are difficult choices between competing priorities including the need for improvements in urban infrastructure, infrastructure linking urban areas to peri-urban and rural hinterlands, infrastructure in remote rural areas, inter-regional infrastructure and cross-border infrastructure. In order to make these choices, there is a need to strengthen planning capacities and institutions. Donors should provide greater support for these processes, as well as providing the necessary finance for infrastructure investment.
- 9) Decentralisation offers new entry points for donors to support sub-national growth processes.** Donor engagement with sub-national governments should be encouraged as a means to support growth promoting policies at the local level. While decentralisation provides important opportunities there are also inherent risks. The potential for decentralisation to widen inter-regional inequalities needs to be countered by promoting well designed sub-national fiscal transfer systems. Local elite capture is a serious risk that requires a major effort to strengthen democratic processes, as well as civil society and business organisations that can press for greater accountability.
- 10) Decentralisation policy will be strongly influenced by the governance situation in a particular country.** Inevitably, a variety of political considerations will dominate government decision-making on decentralisation. Where political elites have little accountability at the centre, it may be possible to make public services more responsive to local needs if responsibility for their delivery is devolved to lower levels of government or, if this fails, for donors to work more with the non-governmental and private sector, if possible in partnership with local government. In these cases, ensuring effective accountability must remain a major concern of funding agencies.
- 11) There is a need to strengthen the quality of urban governance, in particular to promote more integrated planning of metropolitan regions.** City-regions are drivers of growth, yet their development is often constrained by the fractured nature of their administration. Donor support for institutional development and capacity building can help to promote more “joined up” planning and management.
- 12) The development of border regions should be given greater attention.** There are often great opportunities for boosting growth in border regions and enhancing cross-border trade and investment. This will require investment in cross-border infrastructure, trade policy reforms, investment promotion activities, and regional migration agreements. There are some examples of donor support to these processes, but there is potential to step up this engagement,
- 13) Donor strategies to address sub-national growth issues must be adapted according to the country context.** This paper discusses the issues in general terms, but interventions must be designed on the basis of careful country analysis. When assessing the country context there are three main considerations: First, the reasons for donors to engage with sub-national growth issues will vary between countries. Inter-regional inequalities are present in all countries, but the problems are likely to be more severe and urgent in large, geographically diverse, ethnically divided and conflict-prone countries. Second, the design of strategies will depend on the available entry points for donor support. Within decentralised political systems (in particular federal states) sub-national growth issues tend to be more prominent in political debate and policy making, and there is greater scope for donor engagement. Third, the content of strategies needs to be adapted according to the geographical, historical and

political context. A certain mix of policies may be appropriate in one setting, but not in another.

### 13. Knowledge gaps

125. A final recommendation for donors is to strengthen information and analysis on sub-national growth processes. Better spatial information will be essential to improve understanding of how growth occurs, and to formulate an effective policy response. It is also important to understand the spatial dimensions of growth and the associated trade-offs between growth, equity and political stability.

Some of the main unanswered questions are highlighted below, and point to a broad research agenda bridging issues of theory, policy and practice.

- **Understanding of growth processes.** Although the importance of agglomeration economies are understood at a general level, there is limited understanding of the actual processes that generate positive externalities and increasing returns to scale, particularly in the context of low income countries. The nature of market failures that result from the positive and negative externalities arising from spatial factors are not well understood, and this makes it difficult to devise effective policies. Also, there is a dearth of work connecting political and economic analysis of this issue in specific country situations.
- **Supporting lagging regions.** There is a need to gain experience in the context of low income countries on how to generate growth in lagging regions. This paper has pointed to the types of policies that may be effective, but more research will be needed to make more specific recommendations on what will work in different conditions. In lagging regions that possess reasonable prospects for long-term growth it may be appropriate to focus on improving the enabling environment, encouraging the productive investment of remittances and using fiscal transfers to invest in infrastructure and human capital. In regions locked into long-term economic decline a strategy of managed retreat may be the only viable option. This would focus on encouraging labour mobility, investing in human capital to improve the terms on which people can migrate, and providing safety nets for those remaining behind. Further research is required to understand these distinctions better, and to develop appropriate policy responses.
- **Best practice in managing sub-national fiscal transfers.** There is great diversity in the design of systems of sub-national fiscal transfers. On the basis of comparative cross-country studies, best practice needs to be made available on how to design more effective instruments. The relationship between local sources of revenue and sub-national fiscal transfers need to be better understood in terms of their impact on sub-national growth, as well the accountability and performance of sub-national governments. In general terms the trade-offs between growth and equity that follow from the redistribution of resources between regions need to be more fully researched.
- **Supportive policies for internal labour migration.** A few low income countries are beginning to develop more supportive policies towards internal migrants. However, there is rather little knowledge on good and bad practice, and the additional policy changes that are required to facilitate migration. There is also a need for more research in order to inform the debate about the social and political risks of migration and the design of strategies for managing these.
- **Infrastructure priorities.** There is a growing consensus surrounding the need to raise infrastructure investment in low income countries. However, there is surprising little knowledge on the types of infrastructure that will be most beneficial for growth and poverty

reduction at the sub-national level. Further research on these issues will be required to guide planning decisions on where to invest. A central issue here is the trade-off in terms of poverty reduction in the use of scarce infrastructure investment funds to support faster growth in the more dynamic areas as against assisting the lagging regions.

- **The spatial effects of macroeconomic and sectoral policies.** As discussed in section 8.5 macroeconomic policies have important spatial impacts. However, these have not been sufficiently researched, analysed or discussed. There is a need for a more spatially sensitive macro approach.
- **How best to strengthen city-region management.** In view of the low priority given by both governments and donors to the role of urbanisation and the interaction between the urban, peri-urban and rural areas, there is a need to devote more resources tackling the challenges of urban management. How may urban services and planning be better coordinated? How can greater resources be generated from within urban areas to fund the huge investments in urban infrastructure needed to support urban growth? What is the nature of the exchanges between the urban and rural areas and how may they best be nurtured to achieve the greatest possible impact on reducing poverty across a country? What priority should be given to secondary cities in relation to the capital city?
- **What are the best institutional arrangements for sub-national government?** The trend to greater decentralisation is largely driven by political considerations; but it is important also to understand better the economic and social implications of various institutional arrangements, especially for improved policy making, planning and service delivery. How can genuine participation in the design and delivery of services be best achieved in given socio-political contexts?

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