INTER-AMERICAN DEVELOPMENT BANK

ASYMMETRIES IN REGIONAL INTEGRATION AND LOCAL DEVELOPMENT

Paolo Giordano, Francesco Lanzafame and Jörg Meyer-Stamer
Editors

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Foreword

This book is based on the results of the seminar "Global and Local: Confronting the Challenges of Regional Development in Latin America and the Caribbean", held in Milan (Italy) during the 44th Annual Meeting of the Board of Governors of the Inter-American Development Bank. The seminar was jointly organized by the Social Programs Division of the Sustainable Development Department and the Integration and Regional Programs Department, with the support of the Bank's Italian Individual Consultant Trust Fund. The papers present insights on the distributive impact of globalization and policy options to address the challenge of reducing potentially asymmetric outcomes of this process. The seminar brought together European and Latin American researchers and practitioners to discuss experiences of regional policies during the 1990s.

As the chapters in this volume show, there is a consensus that Latin American development depends upon an efficient and equitable insertion into the international economy. Regional integration is taking place in the context of globalization and has an impact on local development. The insertion of national and subnational economic and social systems in the global economy is one of the most significant issues in the current academic, political and social debate.

Latin America has responded to the challenges of globalization with a renewed interest in regional integration and by transferring more responsibility and resources to local entities, which increasingly assume an active role in the promotion of socioeconomic development. Integration initiatives can be an important additional policy instrument that complements national and subnational policies. However, the distribution of costs and benefits of regional and global integration may be asymmetric. Certain territories or social groups may expand their opportunities, while those that are slower to adapt to the process may face divergent development paths. The absence of policy instruments to compensate asymmetries may hamper social cohesion and generate a backlash against integration and participation in the global economy.

An important conclusion of the seminar participants was that regional, national and subnational policy instruments should be conceived and implemented simultaneously. At the same time, it is important to fully exploit the potential of bottom-up approaches that build upon the efforts of civil society organizations and local governments to forge new international networks that facilitate regional and global integration. The response to this challenge requires stronger involvement of local actors in global networks and the active cooperation of stakeholders.

The Sustainable Development Department and the Integration and Regional Programs Department are pleased to present the results of this joint project. These studies contribute to an interesting and productive transfer of multidisciplinary knowledge between Europe and Latin America, and ultimately to the prospects of more efficient, equitable and sustainable integration into the global economy that should contribute to improve social cohesion in the region.

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Editors' Introduction

Paolo Giordano, Francesco Lanzafame, and Jörg Meyer-Stamer

In recent years, Latin America and the Caribbean (LAC) has promoted a new wave of regional integration agreements as a way to participate more efficiently in globalization. The relaunching of older integration agreements in Central America, the Andean region, and the Caribbean has been complemented by the creation of successful integration schemes, including the North American Free Trade Agreement (NAFTA) and the Southern Cone Common Market (Mercosur), and an emerging vintage of North-South agreements. In addition, the creation of a wide hemispheric free trade area has come onto the policy agenda.

At the same time, LAC countries have started a rapid decentralization process of political and fiscal decisions. In this context, subnational governments have assumed a growing role in promoting social and economic development in an increasingly global economy. Today the latest trend in the economic development debate is local economic development (LED). In their quest for accelerated socioeconomic development, LAC countries have paid greater attention to capturing the development opportunities of their subnational territories. They foresee dynamic local economies able to provide employment opportunities for subnational regions.

All of these issues are related to spatial aspects of development, but are addressed from a variety of angles and involve a range of players. Are the issues connected? The answer is a resounding "yes." The main message of this volume suggests the necessity to closely examine the interrelationship between regional integration and decentralized approaches to economic development. Bottom-up approaches often respond to immediate problem pressures, and are not necessarily based on deliberate policy designs. Yet, regional integration is one of the factors that creates the need for local approaches. In fact, regional integration is an effective additional policy tool to address issues related to globalization, this being a major explanation for the recent surge in local development approaches. Local economies and actors—businesses, governments, and supporting institutions—faced with intensifying international competition, suddenly realize that they are not fully prepared.

From a policy perspective, analysis of the links between regional integration and territorial development is a necessary condition for formulating sound and sustainable policy instruments aimed at correcting the spatial asymmetries that may arise in the process of economic development; policies usually labelled as regional. However, the term *regional* is intrinsically ambiguous. Particularly in LAC, it often connotes both supranational and subnational territorial entities. Therefore, the semantic complexity of the concept suggests the need to simultaneously address issues related to the global and local dimension of spatial development.

The contributions in this volume explore the links between these two dimensions of territorial development. They discuss the policy frameworks that could be adopted—at the supranational, national, and local level—to counterbalance the polarization effects that may arise from the process of integration into the global economy.

The book is organized into two parts: Asymmetries in Free Trade Agreements (chapters 1–4) and Territorial Development Policies (chapters 5–8).

In chapter 1, Giordano, Lanzafame, and Meyer-Stamer provide a conceptual framework appropriate to exploring the links between regional integration and territorial development. In chapter 2, Bustillo and Ocampo present a comprehensive view of the issues that must be considered to better distribute the gains from free trade agreements. In chapter 3, Hinojosa-Ojeda focuses on asymmetric integration between countries at various stages of economic development, using the case of NAFTA as a reference. In chapter 4, Bouzas systematizes, in the case of Mercosur, the analysis of the asymmetries relevant to the governance of regional integration, clearly distinguishing structural and policy-induced asymmetries.

In chapter 5, Markusen and Campolina Diniz present a sharp comparative balance of the national- and local-level forces that explain the growth of regional disparities and provide insights on policies that may be suited to contrast them. In chapter 6, Albistur Marin provides an interesting comparison of the experiences of Europe and LAC. Next, in chapter 7, Clark thoroughly explains the practical issues that must be addressed in implementing territorial development policies. Finally, in chapter 8, Meyer-Stamer offers a convincing conceptual framework within which to address these issues with effective and consistent policies.

It may be excessively optimistic to expect that public policies will soon reflect the diverse perspectives and solutions offered in these chapters. However, these contributions reveal a stark reality: exposure to globalization is a major force that governs the distributive effects of policy reforms. To counterbalance asymmetric outcomes and socially inefficient equilibria, policymakers will be pressed to implement national and regional policy instruments simultaneously. This book aims at contributing to this challenging task.

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Part I

Asymmetries in Free Trade Agreements

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CHAPTER 1

Regional Integration and Territorial Development in Latin America

*Paolo Giordano, Francesco Lanzafame, and Jörg Meyer-Stamer**

Over the past decade, Latin America and the Caribbean (LAC) has witnessed increasingly intensive regional integration, paralleling the process of globalization (IDB 2002). As indicated by a growing body of literature on economic geography, trade liberalization and regional integration have a notable effect on spatial development, and a compelling case can be made for public policy in this area (Baldwin et al. 2003). Left to the markets, the result is usually polarized and asymmetric development. This is illustrated in the case of Mexico, where booming export-assembly plants along the northern border contrast sharply with stagnation in southern states. Likewise, in Mercosur, the perception of an uneven distribution of the gains from trade integration has prompted lively debate on how to deal with the effects of asymmetries of regional integration. However, regional integration can also offer opportunities for adopting productive development policies to improve competitiveness in an increasingly globalized economy.

Thus, treatment of asymmetries and disparities in the regional integration agreements in force in LAC is emerging as a priority. In the regionalism of the 1960s, such objectives played a prominent role, but the instruments to foster them were intrinsically contradictory and resulted in limited effectiveness. By contrast, the new agreements of the 1990s, which were more effective in promoting regional integration, neglected the asym-

* The authors acknowledge Robert Devlin and Eduardo Rojas for their comments and suggestions.

metry issue (Devlin and Giordano 2004). Today, there is a growing consensus that regional integration can offer an effective strategic platform for formulating national policies aimed at maximizing the participation of local actors in the global economy. The ingredients of such a strategy include expanded market access, clear and predictable trade rules, strong collective regional institutions, special and differentiated treatment for smaller economies, and well-funded financial programs for the transition to free trade (Giordano, Mesquita, and Quevedo 2004).

This chapter explores the connection between regional integration and territorial development. It aims at providing a conceptual framework appropriate to simultaneously assessing the key global and local ingredients of policy instruments that may be suitable to compensate asymmetric economic and social outcomes resulting from increasing exposure to globalization.

Regional Integration: A Framework for Contrasting Local Asymmetries

In this light, one of the most relevant policy questions is how does one link global governance (trade and integration policies) with national governance (territorial policy) to reduce asymmetries and promote an equitable socioeconomic insertion into globalization? Table 1–1 provides a simple analytical way of looking at this issue. Nowadays, most LAC countries can be described as regimes of increasing asymmetries (Type 1), characterized by lack of territorial policies at the national level and lack of compensatory mechanisms at the regional level.

The contributions to this volume consistently support the conclusion that the LAC region should move toward a regime of decreasing asymmetries (Type 4), characterized by the simultaneous implementation of consistent policies at the national and regional levels. Therefore, the question is not *whether* but *how* to achieve the transition. In particular, which policy sequencing is appropriate to ensure the shift from Type 1 to 4? Certain pioneering experiences in the region suggest that governments have moved on the national front, prompting the evolution from Type 1 to 3. The

Table 1–1. Linking Regional Integration and National Policies

	Regional Integration Policy	
National Policy	*Increasing asymmetries: Free trade without compensation for disadvantaged regions*	*Decreasing asymmetries: Free trade with compensation for disadvantaged regions*
Increasing asymmetries: Macroeconomic stabilization without regional/territorial policy	**Type 1** Washington Consensus	**Type 2** Early EU model (especially in highly centralized countries)
Decreasing asymmetries: Macroeconomic stabilization with explicit regional/ territorial policy	**Type 3** Certain LAC countries (e.g., Bolivia, Brazil, Chile, and Mexico)	**Type 4** Current EU model

Source: Authors' assessment.

missing piece is, therefore, the adoption of an ambitious strategy on the regional front. One can, therefore, muse about the ingredients of such a strategy by highlighting key issues for the governance of LAC regional integration.

Trade and regional integration have emerged as an increasingly important strategic objective for LAC. The demand to intensify the insertion into the global economy has often advanced faster than the institutional capacity to formulate effective strategies, trade policies, and institutions (Devlin and Vodusek 2004). Under these circumstances, it is not surprising that trade-related capacity building has increasingly gained the attention of governments and donors alike. In order to link territorial development and regional integration, it is therefore crucial to include local actors in the delivery systems of trade-related capacity building. Hence, it is important to include a local dimension in the needs assessment exercises conducted throughout the region and raise donor awareness of the challenges local communities face in the process of implementing increasingly complex, demanding trade agreements.

Regional collective institutions can play a key role in the consolidation of regional markets, where local economic actors can successfully implement the first steps of their internationalization processes. They may also function as institutional "anchors"; that is, they restrain national policies that create asymmetries (e.g., government subsidies for private business—a long-time, key instrument of territorial development policy—which resulted in wars between territorial units of a country and neighboring countries). Finally, as the European Union (EU) example illustrates, regional collective institutions can pursue top-down approaches to stimulate bottom-up initiatives, promote horizontal learning and exchange between regions, and effectively pool resources to ensure greater efficiency in the delivery of technical and financial assistance. LAC policymakers can learn much from examining this evolution, thereby abbreviating their own learning curves.

In this context, LAC's biggest challenge is how to devise effective and ambitious policy instruments to promote the adjustments required to minimize the social cost of the transition to free trade. Iglesias (2004) clearly identified the key issues:

- macroeconomic stability,
- sectoral adjustments,
- investments in infrastructure and human capital,
- poverty reduction and equity, and
- good governance.

Trade agreements will determine how local economies are coordinated with the world economy in the decades to come. However sound, well financed, and far reaching, policies aimed at facilitating the transition to free trade must be explicitly consistent with territorial development policies. Such a holistic approach, based on a strong connection between regional integration and territorial development, would help the LAC region move from Type 1 regime to Type 4.

To sum up, when creating regional integration schemes, it is useful for national policymakers to delegate powers to supranational bodies, which ultimately must be accountable to elected national governments. However, it is crucial to establish a clear mandate for these bodies to counteract the natural tendency of free markets to create spatially asymmetric development. Moreover, regional policies should be supplemented by consistent, well-funded national policies that ensure a socially equitable and territorially balanced transition to free trade.

Understanding the Problem

The Washington Consensus aimed at creating a level playing field by eliminating market distortions, which create an array of obstacles to national-level growth. Current regional integration projects aim at removing obstacles to free trade at the regional, interregional, and hemispheric levels. This New Regionalism is part of a multipolar trade strategy aimed at supporting comprehensive processes of national structural reforms (Devlin and Estevadeordal 2001). In sharp contrast with past goals, these new initiatives aim at promoting growth by creating regionally integrated markets that permit the promotion of efficiency gains through trade and foreign direct investment (FDI) (Devlin and Giordano 2004). They also foster geopolitical objectives among like-minded countries and, more importantly, generate demands for additional regional cooperation to more fully exploit the advantages of a regional market.

To what extent will this approach promote spatially balanced growth in LAC countries? Economic geography has shown that, under free market conditions, economic development leads to spatially imbalanced growth (Arthur 1994; Fujita, Krugman, and Venables 1999). One can thus expect that national-level stabilization policies, decentralization processes, and regional integration will reinforce the current pattern of asymmetric growth within and among countries. Indeed, it is likely that regional integration has such an effect without accompanying development policies for disadvantaged locations.

Which options will balance this tendency? The traditional approach to regional policy—based on top-down policy, allocation of funds, and, in some cases, territorial privileges—has mostly failed (Hansen, Higgins, and Savoie 1990). It created market distortions that slowed growth and often led to massive misallocation of government funds, thus deepening the problems of public deficits. On the other hand, few regional policies are explicitly embedded in regional integration cooperation schemes. The most notable case is that of the EU, although recent evaluations have questioned their efficiency (Sapir 2003).

The past decade has witnessed the emergence of a new pattern of territory-based development policies, which, in LAC countries, like elsewhere in the world, emphasized endogenous potentials and bottom-up processes. As a result LED, cluster development, and similar approaches have mushroomed in many countries. Paradoxically, these issues did not play a prominent role in the regional integration agendas of the 1990s, even though many new integration agreements stemmed from sectoral and bottom-up approaches adopted in the late 1980s. Indeed, little evidence indicates that bottom-up approaches to territorial development have had a major effect to date. To understand why, it is useful to examine several factors, which are described below.

Policy framework

Is administrative decentralization giving sufficient incentives and latitude for policy formulation and implementation at the local level? Can local authorities raise their own taxes, and are the incentives development-oriented? Are any regional policy instruments suited to address the externalities that arise from the increasing interdependence of local economic and social systems with regional and global contexts? Or, at a minimum, are incentives sufficient to ensure that local and national policies are consistent with collective regional objectives?

Local authorities will pursue development efforts if they can expect a tangible benefit, such as employment creation, which usually creates legitimacy with the local electorate. Conversely, without local-level elections, local authorities will feel less pressure to act and will point to national governments to take responsibility for reducing unemployment. It is also possible to broaden the local tax base, but local taxes and more local business are needed to generate more local tax revenue.

Regional integration can play an important role in stabilizing the policy environment for national and local policies and signaling policy direction. In the old regionalism, contradictory policy signals may help to explain the region's failure to advance (Devlin and Giordano 2004). In the new regionalism, governments have been more successful in locking in reforms and consistent in signaling sound policymaking through regional commitments. A clear regional commitment to pursue territorial development policies may, therefore, help guarantee the sustainability of national and local policies.

Local governance

To what extent are local actors empowered to create solutions? Does the structure of policy and politics at the local level encourage problem solving? That local communities can form a consensus, even if national politics tends to be riddled with strife and dominated by zero-sum games, is a romantic notion. In the real world, local communities are often just as divided as the society at large, and conflict over issues is even more likely to be mixed with personal and family conflicts and rivalries.

Indeed, the most effective way to condemn a local development initiative to failure is to demand the formulation of a full consensus. Innovation and consensus are mutually exclusive. Innovation implies that only a few pioneers are prepared to accept the risks attached to it. Thus, one can either have an innovative territorial development initiative based on a limited alliance of particularly risk-friendly local actors or a consensus-based initiative shared by all relevant players.

Nevertheless, for collective action to have a sustained effect over time, the transparent involvement of State and non-State actors and well-functioning mechanisms of citizen representation and oversight are required for defining the policy priorities that define the framework of the insertion into globalization. Moreover, they are essential for holding elected subnational officials accountable and to ensure local management transparency. Attainment of these governance objectives, which are essential conditions for democratic oversight, is a necessary condition for good fiscal management and accountability at the subnational level. Strengthening the central functions related to setting performance standards, performing evaluations, and ensuring transparency of subnational government operations are also required to ensure good governance.

Outreach initiatives and an ordered dialogue that allows local actors to provide inputs into the formulation of trade and integration policies are key to promoting ownership and consistency of regional and territorial development policies. In the EU, for example, involvement of civil society in trade negotiations has proven to be an innovative feature of trade-related policymaking (Giordano 2002). Such initiatives probably responded to growing demonstrations of local groups, which increasingly organized events and actions related to globalization and trade integration. Participation in trade policymaking is only incipient in LAC, particularly at the local level. However, certain countries have witnessed a growing movement that will probably consolidate in the future (Ostry 2002). In any case, participation in an ordered, meaningful dialogue is often complex and involves technical issues. Thus, it presupposes the diffusion of sufficient trade-related capacity at the local level.

Local effects of globalization

To what extent is the local economy embedded in the global one? Is it connected to global corporate networks or value chains? What types of restrictions does this create for local policymaking? What is the specific policy space for local authorities? What should local policymaking's objectives and instruments be? Although globalization is pressuring localities to upgrade, it is by no means encouraging local initiatives. In the business sector, companies must develop a global perspective, which often erodes their local involvement. Moreover, the evolving global view of companies and the persistent local view of other organizations and politics create a mismatch, which makes public-private initiatives difficult.

Territorial economic policy aims to enhance local competitiveness and attract new investments of various sizes in order to exploit more fully locational comparative advantages and generate robust growth in local employment and income. Three basic factors must be considered:

- use of endogenous abilities and assets (e.g., local natural resources and productive and entrepreneurial skills),

- generation of external economies within the territory, and
- reduction of business transaction costs.

The sources of public funding for LED must be consistent with sound fiscal discipline. In fact, local governments should support the growth of dynamic, competitive, and self-sustained enterprises that become tax contributors rather than consumers of fiscal resources.

Subnational governments play a key role in complementing national policies to create competitive conditions to promote LED. They can reduce regulatory barriers to private investment and create a favorable environment. They can improve the capacity of territories to compete with others for new direct investment through (IDB 2004):

- providing good quality local infrastructure,
- implementing policies and regulations that promote firm efficiency (ranging from labor training to natural resource regulations, including the operation of real estate markets),
- promoting functioning markets for business development services in the local economy (e.g., accounting, maintenance, informatics, and advertisement), and
- promoting cooperation among enterprises to create economies of scale in providing certain goods and services.

If sufficiently connected with local subnational realities, regional integration can be a powerful policy tool. It can function as a dynamic catalytic interface that buffers local actors' exposure to global contexts. Competition with similar neighbors may be a useful training ground for preparing firms and institutions to face world-class competition. It can also provide a framework that helps to eliminate incentives for welfare-reducing fiscal wars among local districts that compete over foreign investment. As the EU case illustrates, development of trade and business contacts at the regional level may promote functional and institutional cooperation across a wide range of areas (Devlin and Estevadeordal 2004).

Box: Glocal Development: Opportunities and Challenges [1]

Recent years have witnessed much discussion about globalization; at the same time, localities have taken on an increasing relevance. The interrelationship between global flows and localities takes three forms: 1) exclusive predominance of global flows through localities, which frequently breaks down local structures, bending them to its interests and strategies; 2) defensive, self-centered localism—countries and regions that attempt to escape global flows by sealing themselves within their boundaries (they believe they could go it alone amid globalization's transformation of the entire planet); and 3) the glocal approach, whereby global and local actors meet, negotiate, and exchange ideas (dialogue also occurs between local actors, who aim to increase their combined negotiating strength).

The glocal approach is characterized by the convergence of local and global actors in areas of reciprocal advantage and common interest in an attempt to build common projects. Such a convergence is never natural—it is always sought and negotiated amid difficulties and tensions; however, two conditions make it possible:

- The local fabric, represented and constructed by local actors, must be sufficiently dense and complex to express its arguments and negotiate its interests. National authorities, local communities, locally-based institutions, associations of firms and professionals, universities and research and educational institutions, public or private service agencies, and chambers of commerce—all must have the capacity and will to network and negotiate. Since the 1980s, locally-based glocal actors have begun to emerge throughout the world. This has occurred in the so-called region-states with only a few million inhabitants (Singapore, Ireland, Finland) and in regions, city-regions, and industrial districts whose economies have been particularly dynamic in introducing innovation to their production sectors and linking to the neuralgic points of world markets; cases include Bavaria and Hamburg (Germany), Scotland (Great Britain), industrial districts of Lombardy, northeast Italy, Bangalore (India), Trinidad and Tobago (Caribbean region), and Orlando and Las Vegas (United States). These local systems have shown great dynamism and flexibility in their capacity to create a network of horizontal links within and among local systems and vertical, glocal links connected to the global dimension.
- Global actors must build a culture of complexity and a vision of their interests beyond the immediate situation. They must realize that the development and well-being of localities, in the medium and long term, are the conditions permitting their business development and profitability. In the aftermath of World War II, the United States realized this crucial lesson when it launched the Marshall Plan to reconstruct Europe.[2] Applied to the glocal approach, the Marshall Plan offers two important lessons: 1) the importance of the interdependence of well-being and development between continents and countries; and 2) continental integration, both economic and political, as a driving force for development.

[1] This box draws on Bressi (2003)

[2] The Marshall Plan was an act of great political intelligence, which enjoyed extraordinary success, partly thanks to the start-up (through the Organisation for Economic Co-operation and Development, promoted by the U.S. government) of early forms of economic and political collaboration among European countries; these were the germ of the subsequent integration process that culminated in the European Union.

Seeking a Solution

Bottom-up processes in countries affected by liberalized trade cannot be relied on to cope with the potentially negative outcomes of this process. At the same time, in LAC countries, active participation in international trade flows requires accelerating innovation, including technology transfer and development of new production sectors and learning processes. To this end, strategies must be devised to promote new firms and activities, restructure uncompetitive sectors, and support small- and medium-sized enterprises (SMEs) to strengthen ties between exports and productive sectors and thus participate competitively in new trade flows.

Notably, nowadays most analysts avoid such labels as "industrial policy." In fact, the 1990s witnessed the ending of industrial policy as defined over the previous three decades (i.e., a central government activity that aims to create entirely new industrial sectors). Dominance of the Washington Consensus was not the sole factor that led to the demise of industrial policy. Too many industrial policy initiatives simply failed; they often created serious problems, such as the financial drain frequently observed in State enterprises created with industrial policy instruments. The general consensus is that central governments are no longer positioned to plan multifaceted industrialization processes since the economy has become too complex and continues to change at a rate that far exceeds the planning capacities of government bodies.

The demise of industrial policy is one reason why LED, cluster initiatives, and other decentralized, territory-based development approaches became popular in the 1990s. The question is whether these approaches can fill the void created by the disappearance of the "development State" of earlier decades. Despite some policymakers' positive opinion, concern over this issue is growing in LAC. For example, competition with China—where public policies have played a critical role in promoting industrialization—is prompting a promising new debate that is rethinking the role of the State and competitiveness policies (IDB 2005).

Today's overriding issue, however, is not whether to conduct territorial development policies, but how to conduct them effectively and efficiently. From an operational standpoint, a well-designed structure of intergovernmental relationships should provide subnational governments with incentives for allocating resources efficiently to most socially profitable uses. Subnational governments must 1) assume clearly defined responsibilities; 2) have sufficient resources with which to discharge their assigned functions; and 3) face budget constraints and take full responsibility for the trade-offs involved in collecting, allocating, and managing a limited resource pool.

Examples from international experience

Taken alone, bottom-up approaches to territorial development are unlikely to compensate for the centripetal effects that free trade has on spatial development. Experiences from other countries and regions demonstrate that bottom-up approaches must be complemented by top-down approaches and that local approaches must be explicitly linked to regional initiatives.

United Kingdom. Traditionally a centralized country—the centralization process was reinforced in the Thatcher era of the 1980s—the United Kingdom has started to encourage decentralized approaches in development policy. National authorities in Scotland and Wales are investigating options, and England's Labor government has created nine Regional Development Agencies (RDAs), designed as part of a larger regionalization push (including the creation of regional assemblies). This effort, however, has not made the life of RDAs easier; local authorities tend to perceive them as intruders and competitors, and they tend to become entangled in party politics (Thanki 1999; Fuller, Bennett, and Ramsden 2002).

Germany. Since the creation of the Federal Republic in 1949, Germany has evolved its views on territorial development policy, involving a dynamic interplay of bottom-up and top-down approaches. The bottom-up approach rests on the autonomy of local municipalities, many of which have had LED units for decades. Their traditional task was to develop real estate. Since the 1980s, their profile has widened to include such approaches as technology incubators. The 1990s witnessed a further broadening of the scope of activities, often based on the creation of independent LED Agencies, which, in certain cases, became strategic development players, especially in declining regions that had to build a new economic base (Hollbach-Grömig 1996). Since the 1970s, the top-down approach to territorial development has been based on the Joint Task Promotion of Regional Economic Structure, known as the GA (*Gemeinschaftsaufgabe*), which the federal government funds and state governments implement. The GA's effectiveness has been questioned for some time, particularly after reunification. In certain states, the 1980s and 1990s saw a shift from top-down to combined approaches. For example, in 1989, North Rhine-Westphalia, the largest state government, encouraged the creation of Regional Conferences, whereby local players from neighboring municipalities and counties were to formulate a consensus view on development options and prioritize practical activities (Meyer-Stamer and Maggi 2004).

This activity coincided with a paradigm change in the conceptual discussion on regional policy, which now emphasized endogenous potential. In the mid-1990s, the national government, through the Federal Innovation Ministry, further developed this approach by launching contests to encourage innovative, bottom-up approaches to territorial development. Examples included the BioRegio Initiative to promote high-performance biotechnology clusters and the InnoRegio Initiative (which exclusively addressed the new eastern states) to promote innovative clusters in East Germany. The Federal Ministry for Urban Development pursued a similar approach with its Future Regions initiative. Certain states pursued similar performance-based approaches, which represented a new approach to regional policy that created more balanced incentives. As a result, the perverse incentives of traditional regional policy (e.g., rewarding backward regions' lack of performance) were eliminated, and innovation and bottom-up approaches were encouraged. The rationale was that, in a highly differentiated postindustrial economy, the central government was no longer positioned to coordinate local activities in a centralized, hierarchical way, but had to rely on the effectiveness and creativity of local-actor networks.

South Africa. One of the few countries where local governments have a legal mandate to pursue economic development activities is South Africa. The country's central and provincial governments play a guiding role in developing LED policies and identifying sound practices, while district and local municipalities execute LED interventions. The disappointing outcome of this approach to date involves conceptual and organizational problems (Tomlinson 2003).[3]

Until late 2003, central government ministries were unable to agree on LED objectives. The Department of Provincial and Local Government, which has coordinated the decentralization effort for several years, tends to define LED as a means of poverty alleviation, looking specifically at population groups with multiple disadvantages (e.g., poor, unskilled, residents in remote areas, women and youth, or persons infected with HIV/AIDS). The Department of Trade and Industry promotes a LED approach that addresses business upgrading and growth, as well as investment promotion. These conflicting policy objectives led to confusion on the ground.

Division between district- and local-level organizational functions is unclear in South Africa. In 2001, territorial reform created relatively large local municipalities, which often united several towns. Typically, four to six local municipalities formed one district municipality. The evidence to date indicates that local and district municipalities compete rather than cooperate, even though both are usually in the hands of the African National Congress (ANC), the dominant party. In cases where a different party governs one of the levels, any type of cooperation is more difficult.

European Union. On the regional front, the European Union (EU) has had a long-standing concern with the spatial polarization effects resulting from trade liberalization and regional integration. Therefore, collective policies directed toward disadvantaged localities have been the cornerstone of the regional integration policy mix, although operational instruments have

[3] Information based on Jörg Meyer-Stamer's extensive interviews and interaction with national, provincial, and local LED players in South Africa.

changed over time. Nowadays, the cohesion policy comprises 35 percent of total expenditure and is translated into financial disbursements via two main instruments: 1) Structural Fund; and 2) Cohesion Fund. The conspicuous financial support of the EU, which in poorer recipient countries can represent up to 4 percent of GDP, has played a key role in financing national projects at the local level and promoting convergence across European regions (Griffith-Jones et al. 2003).

However, a recent authoritative evaluation of this regional approach to LED suggests that the cohesion policy should focus on two main areas: 1) implementation with few instruments; and 2) financing on a national, rather than local, basis. According to Sapir (2003), on the one hand, a convergence policy should focus on investing in institution building and human and physical capital, rather than traditional regional development projects; moreover, national instruments should complement regional projects to foster political acceptability, long-term planning, and avoidance of crowding out national instruments. On the other hand, a restructuring policy that targets displaced workers should be set at the regional level to complement national policies. Such a policy should focus primarily on retraining and relocating the labor force or incentives to set up businesses.

From development fads to balanced territorial development processes

The international experiences outlined above show that policy networks have emerged as the most adequate response to fragmented governance structures (Messner and Meyer-Stamer 2000). Initially, they were a spontaneous response to the erosion of traditional hierarchical and government-driven governance. Nowadays, higher levels of government intentionally set the stage for the emergence of local and transnational policy networks.

Thus, if local actors can control their tendency to stir up political conflict, what exactly should they do? In this respect, policy guidelines are inconsistent. Currently, cluster development is fashionable. Other specialists would strongly recommend strategic planning. Still others would point at the crucial importance of creating LED agencies.

Some currently fashionable approaches to territorial development appear like a downsized version of traditional industrial policy with an enlightened, brilliantly informed, and strategically capable local government orchestrating the efforts of various players, pulling them out of their shortsightedness and narrow thinking. However, it is well recognized that government failures may induce even more distortions than market failures. Government intervention should therefore be limited to correcting market failures, which impede private actors from taking full advantage of business integration. They should provide national and regional public goods and leave market decisions to private actors.

Other approaches are borrowed from related fields, together with professionals who suddenly find themselves in charge of territorial development. For example, the strategic planning approach originated in urban planning; however, factors relevant to planning roads and buildings may not be applicable to planning a business.

Territorial development approaches must look beyond the current fads. LED is fundamentally a change, risk, asset, and relationship management activity implemented within a territorial framework. In other words, territorial development is basically about connecting people, not determining exactly what and when they do something. Moreover, one of local government's main tasks is to reduce the administrative burden it places on business and to make the services it provides more efficient.

Synthesizing, it is possible to argue that territorial development takes one of three forms: generic, reflexive, or strategic. Generic territorial development focuses on reducing government-created obstacles for companies, a measure that businesses usually appreciate and that can have a stronger growth effect than other proactive measures. Reflexive territorial development adds analytical activities to better understand the competitive environment of businesses so they can make better-informed decisions. The EU's current effort to promote regional foresight exercises is an example. Finally, strategic territorial development engages a variety of partners to agree on a shared vision and distribute responsibility for implementation.

In summary, territorial development must not be primarily about local government grappling with activities that are supposed to "help" business. Successful territorial government involves a partnership between government, private sector, and other players. It involves information sharing so that businesses know what the government is planning, and vice versa. It may involve joint activities to upgrade locational quality. It may even involve cluster initiatives, but only as the outcome of trust building between the public and private sectors and not as a starting point. In any event, territorial development should look beyond the local reality and facilitate local actors' connection with international contexts.

Local development and social cohesion

Public policies aimed at stimulating the emergence of a vibrant local economy should also be complemented by actions that favor social cohesion (Bouillon, Buvinic, and Jarque 2004; IDB 2004). One key responsibility of local governments is, therefore, the provision of social services, particularly in this new phase of globalization. In fact, increased external competition exposes local communities to structural change, which, in the absence of adequate safety nets, may result in job losses and social exclusion. Local governments should certainly promote economic development to stimulate the creation of new opportunities; however, it is also important to develop viable, efficient, and equitable initiatives to support those who, in the short or medium term, will not benefit from new economic opportunities during the transition to freer trade.

Specific actions for the poorest populations, excluded groups, and low-income geographic areas would promote social cohesion and help assuage resistance to globalization. They would allow for the mutual reinforcement of social and economic policies and would strengthen growth benefits for the poorest populations. In addition, more integrated efforts are needed in poor and excluded territories. Frequently, poverty is concentrated in spatially segregated territorial areas. A spatial focus facilitates diagnosing specific community needs, tailoring services, executing actions, and assessing impacts. Subnational governments can better deliver integrated services with a territorial focus, providing effective responses to the multiple disadvantages of the poor and marginalized.

Social progress depends on the institutional capacity of government and the performance of nongovernmental actors in the social sector. Local governments are the most appropriate entities for providing public services with localized benefits. They can potentially respond better to community preferences and needs, especially people-oriented social services that require good targeting. At the same time, it is important to link economic politics with cultural and social politics (Lanzafame 1996).

A local approach to social development makes early and coordinated interventions easier. Social policies and programs have focused insufficiently on preventing social ills and key transitions in the life cycle of individuals and families. Strategies capitalizing on powerful synergies that can be tapped by cross-sectoral interventions remain the exception, and programs fall short in combating exclusion. Yet, successes have been documented in all these areas, providing firm grounding for subnational government actions.

Effective reforms require effective, adaptive, and strategic management—features that have been largely lacking in social sector organizations. In fact, much can be gained from separating and then reconnecting economic and social development policies.

Past economic and social development approaches were often mixed and confused. Typical examples were support measures for microenterprises that followed social assistance, rather than competitive, logic. Local governments must pursue LED as a business using a competition-oriented approach, while social development should stimulate the self-help potential of marginalized groups rather than create welfare dependency.

Reconnecting economic and social development policy involves such features as better management of social interventions and projects, clear focus on efficiency and sustainability, and a targeted approach to establish marginalized parts of the population as market suppliers of labor and goods. It is important to invest in promoting human capital accumulation in poor territories and communities, and even more important to align this investment with clearly identified needs and market niches.

Moreover, as previous work with indigenous people demonstrates, projects fail when they do not recognize the cultural characteristics and values of excluded groups. Inclusion must respect diversity and build on cultural identity. Diversity is an asset that enriches the social fabric, and, if properly managed, project outcomes. Health, education, and housing-reform objectives, as well as services provision, must be tailored to incorporate the cultural richness of diverse ethnic and racial communities with a view to increasing these communities' access to and use of quality services.

At the global level, globalization and regional integration require a new set of policies to ensure the promotion of social cohesion. At the local level, cities must rapidly create new tools, implement new policies, and invent mechanisms of social inclusion. Urban rehabilitation, neighborhood upgrading, and integrated urban and rural community development projects take advantage of the synergies of combined interventions, amplifying their effect and reducing the fragmentation and duplication of policies common to many social assistance programs. International experience (e.g., European Social Fund) demonstrates the benefits of linking social development goals with a clear business orientation in practical interventions.

Top-down and Bottom-up Approaches: What Are the Lessons?

Six major lessons can be extracted from the conceptual framework and the international experiences outlined above:

- Irrespective of the level of development, central governments should delegate the implementation of certain aspects of the development policy mix to lower levels. They should also ensure the coherence of national strategies with subnational and supranational regional objectives and create policy instruments that are coordinated, effective, and well financed.
- When discussing intergovernmental relationships among various government tiers, it is necessary to clearly define the aspects related to: 1) expenditure assignment (who does what); 2) revenue assignment (who levies which taxes); 3) vertical imbalance (how is the resulting imbalance between revenue and expenditure of subnational governments to

be resolved); and 4) horizontal imbalance (to what extent should central fiscal institutions attempt to adjust for the differences in needs and capacities between local administrations) (IDB 2004).

- Top-down support for territorial development initiatives should not only address lagging regions but also accelerate good performers' growth by promoting institutional and infrastructure investments that allow all localities to link up in external regional and global contexts.
- Decentralization of territorial development policy easily clashes with administrative structures and political conflict lines. On the one hand, taking responsibility for territorial development can strain the resources and capacities of already overburdened local governments. On the other hand, successful territorial development buys political clout, which politicians are eager to exploit; however, this often impedes the sharing of responsibility with nongovernmental actors.
- A thorough regional integration scheme, characterized by a sufficient level of trade intensity and strong collective institutions, may play a crucial role for the sustainability of territorial development policies. Trade is a powerful anchor for a broad range of cooperation initiatives, including those at the local level. When regional collective bodies have adequate technical capacity, sufficient institutional independence, and relevant financial power, they can strengthen coherent policy frameworks for territorial initiatives.
- National politicians may find handing over responsibility to regional institutions attractive since it relieves them of having to make unpopular decisions. This delegation of power, in turn, can significantly reduce special interest groups' capture of local politics and foster rational policies directed at long-term development goals.

Based on these lessons, it is questionable whether the most organized approach—clearly defining responsibilities of local government bodies for territorial development—is in reality the most promising one. The international experiences tell a different story: they accept that political conflict and fragmentation exist at the local level, and offer an incentive that may or may not persuade local actors to forget animosities; the objective is to create local and regional policy networks that involve governmental and nongovernmental (including business) actors.

However before attempting to apply such international success stories to the LAC region, one must consider the great structural differences between LAC and other regions, particularly Europe. For example, it is crucial to consider differences in patterns of asymmetries among and within countries; civic culture; level and roots of political conflict; overall governance structure; level of regional interdependence; and, most importantly, availability of funds to finance public policies.

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Chapter 2

Free Trade Agreements and Asymmetries: Proposals to Foster Gains from Trade

*Inés Bustillo and José Antonio Ocampo**

Since the late 1980s, Latin America and Caribbean (LAC) countries have combined unilateral liberalization with bilateral, multilateral, and regional trade initiatives to integrate themselves into the global economy. Several of these initiatives involve links with developed countries. For example, the proposed Free Trade Area of the Americas (FTAA) between Latin America and the Caribbean (with the exception of Cuba), United States, and Canada—the world's largest free trade area—encompasses countries with wide disparities in size and development level. Free trade agreement negotiations between the Dominican Republic, Central America, and the United States were completed in 2004; while negotiations between Colombia, Ecuador, Peru, and the United States are expected to conclude in 2005. The North American Free Trade Agreement (NAFTA) has been in place for more than a decade, and new agreements between Mexico and the European Union (EU), as well as Chile, United States, EU, and Canada have entered into force.

The extent to which countries will benefit from freer trade in the Western Hemisphere depends on a confluence of factors (e.g., country-specific conditions, policies, and nature of the agreement). These authors argue that the capacity of LAC countries—particularly smaller, less-developed ones—to benefit from expanded trade opportunities also depends on how asymmetries in size and economic development are addressed. Key factors

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include preserving margins of flexibility in order to adopt active productive development policies to improve competitiveness and flexibility in managing the capital account as an instrument of macroeconomic regulation. In addition, trade liberalization may be insufficient to foster income convergence. This chapter maintains that, along with trade liberalization, mobilization of financial resources, particularly the design of cohesion and integration funds, and increased labor mobility may be needed.

Asymmetries and Trade-offs

Over the past several decades, LAC countries have sought ways to integrate into the global economy. Since the mid-1980s (earlier for certain countries), the region's governments introduced economic reforms aimed at greater openness and liberalization. During the late 1980s and early 1990s, elimination of tariff barriers and administrative and nontariff measures affecting imports was particularly intense. Along with unilateral liberalization, integration processes were encouraged, and a large set of free trade agreements was signed. The Economic Commission for Latin America and the Caribbean (ECLAC) characterized this trade policy mix—unilateral liberalization combined with the dynamism of free trade agreements—as "open regionalism" (ECLAC 1994).

The rebirth of regional integration, marked by the creation of the Southern Cone Common Market (Mercosur) in 1991, was accompanied by new impetus in older subregional agreements: Central American Common Market (CACM), Andean Community (CAN), and Caribbean Community (CARICOM). During the 1990s, bilateral free trade agreements proliferated, and countries sought close ties outside the region, mainly with the United States, Canada, and EU (table 2–1).

NAFTA was the first reciprocal agreement between developing and developed countries. Mexico, previously a Generalized System of Preferences (GSP) beneficiary of the United States and Canada, entered into an agreement characterized by similar obligations to that of developed countries. Many subsequent free trade agreements have followed a similar model (e.g., bilateral agreement between Chile and the United States and the agree-

Table 2–1. Free Trade Agreements in and outside the Western Hemisphere

Signatories	Year signed[c]	Year entered into force
In Western Hemisphere		
Colombia, Mexico, Venezuela (G3)[a]	1990	1995
NAFTA	1992	1994
Mexico, Nicaragua	1992	1998
Costa Rica, Mexico	1994	1995
Bolivia, Mexico	1994	1995
Canada, Chile	1996	1997
CACM, Dominican Republic	1998[d]	2001, 2002[h]
Chile, Mexico	1998[e]	1999
CARICOM, Dominican Republic	1998[f]	
CACM, Chile	1999[g]	2002[i]
Mexico, El Salvador, Guatemala, Honduras	2000	2001
Costa Rica, Canada	2001	2001
CACM, Panama	2002	2002
Chile, United States	2003	2004
Mexico, Uruguay	2003	
Costa Rica, CARICOM	2004	
Dominican Republic-Central America, United States	2004	
CA-4[b], Canada	IN	
Costa Rica, Trinidad and Tobago	IN	
Mercosur, CAN	IN	
Mexico, Ecuador	IN	
Mexico, Panama	IN	
Mexico, Peru	IN	
Mexico, Trinidad and Tobago	IN	
Outside Western Hemisphere		
Mexico, EU	1995	2000
Mexico, EFTA[j]	2000	2001
Mexico, Israel	2000	2000
Mexico, Japan	2004	2005
Chile, South Korea	2003	2004
Chile, EFTA[j]	2003	2004
Chile, EU	2002	2003
Panama, Taiwan	2003	2004
Mercosur, India[k]	2003	
Mercosur, EU	IN	
Mercosur, South Africa	IN	
Mexico, Singapore	IN	

[a] G3 = Group of Three.
[b] CA-4 = El Salvador, Guatemala, Honduras, and Nicaragua.
[c] IN = in negotiation.
[d] This agreement applies bilaterally between each country of the CACM and the Dominican Republic.
[e] In 1991, Chile and Mexico signed a free trade agreement within the Latin American Integration Association (LAIA).
[f] In 2000, a protocol was signed to implement the agreement.
[g] This agreement applies bilaterally between each Central American country and Chile.
[h] Costa Rica was the only country to enter into the agreement in 2002.
[i] Only in Costa Rica, Chile, and El Salvador has this agreement been entered into force.
[j] EFTA includes Iceland, Liechtenstein, Norway, and Switzerland.
[k] Framework agreement.

Source: ECLAC, based on information from SICE, OAS Trade Unit.

ment between Dominican Republic, Central America, and the United States).

The broad scope of trade agreements seeks to expand and deepen reciprocal commitments into new areas beyond the reduction of tariff and other border barriers. Following NAFTA, the agreements include the traditional market-access disciplines for trade in goods, as well as new issues (e.g., services and intellectual property), including such areas as competition policy and investment, which have not been the subject of multilateral negotiations in the World Trade Organization (WTO). They also seek to improve WTO rules and disciplines wherever appropriate. The FTAA was originally expected to follow this pattern; however, its scope is still subject to debate and will likely be narrower.

The agreements constitute a single undertaking of mutual rights and obligations based on reciprocity. Regardless of differences in size and development level—considerably larger among FTAA than EU members—all countries ultimately assume the full set of obligations (table 2–2). Asymmetries are addressed through specific transitory and negotiated provisions, rather than through exemptions to general rules and disciplines, allowing for more flexibility and time for implementing commitments. Technical assistance programs help to implement obligations.

The focus on transitional time frames and provision of technical assistance follows a shift in thinking on development and trade policies. Until the mid-1980s, the prevailing view was that the dynamics of development were different in developing countries. In particular, patterns of economic specialization—high level of dependence on commodities with low-income elasticity of demand—and the associated balance-of-payments vulnerabilities were viewed as obstacles to income convergence. Efforts at promoting industrialization and changes in the international economic order were required to overcome asymmetries (ECLAC 2003; Ocampo 2001; Whalley 1999). In the multilateral trade system, these changes translated into preferential access by developing countries to developed country markets, flexibility in the application of disciplines and, more broadly, nonreciprocal trade relations between developed and developing countries. At the same time, more favorable, nonreciprocal access to markets in devel-

Table 2–2. Size and Development-level Disparities for Various Years

Indicator	1960	1980	1999
GDP per capita (constant 1995 US$)			
Coefficient of variation			
EU	0.46	0.36	0.37
EU and candidates	0.52	0.65	0.78
FTAA	1.16	1.16	1.26
Highest/lowest			
EU	5.95	3.70	4.28
EU and candidates	10.76	20.55	41.49
FTAA	25.87	34.57	83.24
GDP per capita, PPP (current international $)			
Coefficient of variation			
EU		0.22	0.26
EU and candidates		0.38	0.49
FTAA		0.79	0.85
Highest/lowest			
EU		1.95	2.77
EU and candidates		4.54	8.43
FTAA		9.02	21.76
Population (total)			
Coefficient of variation			
EU	1.09	1.07	1.07
EU and candidates	1.19	1.16	1.18
FTAA	2.81	2.55	2.42
Highest/lowest			
EU	231	215	190
EU and candidates	231	215	190
FTAA	3,543	5,118	6,806

Sources: ECLAC and World Bank (*World Development Indicators*, 2001).

oped countries was granted through GSP and other preferential schemes that developed countries determined unilaterally.

The emphasis on unilateral liberalization over the past two decades led to revisiting ways in which asymmetries were dealt with and the usefulness of differential treatment as originally conceived. The concept's focus changed from preferential access and differential provisions to developing countries' difficulty in implementing WTO commitments. An alternative paradigm emerged whereby trade relations' basic objective was to provide a level playing field for the efficient operation of free market forces. This practice led to the adoption of common obligations (rules and disciplines) in trade agreements. As trade negotiations began to encompass new areas (e.g., services, intellectual property rights, and competition policy), common obligations began to deal with domestic policies and economic structure and functioning.

While adoption of common rules and disciplines is not undesirable, it may impose significant trade-offs and may exacerbate asymmetries. As argued below, the LAC region's greater macroeconomic vulnerability to external shocks and weak linkages between exports and economic growth underscore the need to properly account for asymmetries in order to strike a balance between liberalization, stability, and growth. The ways in which asymmetries are dealt with at the hemispheric level are crucial in determining the capacity of developing countries—particularly smaller ones—to benefit from an expanded market.

Policy Autonomy for Stability and Growth

Obligations that constrain policy autonomy in the use of instruments to manage external shocks may exacerbate asymmetries. As regional experience in the 1990s suggests, the flexibility to impose restrictions on capital flows to facilitate adoption of countercyclical macroeconomic policies may be necessary to reduce countries' vulnerability to cyclical swings in external financing.[1]

[1] Debate on financial integration's effects on developing countries is resurging. A recent review of the empirical evidence concluded that, despite theoretical claims regarding financial integration's positive effects on promoting economic growth, it is difficult to establish a strong causal link. In developing countries, capital account liberalization, in some cases, appears to have been accompanied by increased vulnerability to crises. In fact, the evidence suggests that countries may have experienced greater consumption volatility as a result of financial globalization (Prasad et al. 2003).

In addition, the capacity to benefit from an expanded market depends on strengthening the export-GDP growth linkages. This, in turn, involves preserving flexibility to adopt active production development policies with which to stimulate and diversify exports and accelerate innovation and technological development.

Financial liberalization and external vulnerability

In the 1990s, LAC's unstable growth pattern depended on external capital flows. Variations in capital flows were the main factor underlying pronounced business cycles, whereby a severe slowdown or recession followed brief periods of economic growth. While external credit booms facilitated rapid growth in 1991–94 and 1996–97 and a recovery in 2000, these periods were followed by deep adjustments in 1995, 1998–99, and 2001–02, respectively. The result was unstable, mediocre regional growth, averaging 2.6 percent between 1990 and 2002.

Reliance on volatile financing flows—particularly short-term credit lines and portfolio flows—was a key factor in vulnerability to fluctuations in external financing. A procyclical pattern of macroeconomic management accentuated sharp swings in international financing. An upsurge in capital inflows was accompanied by excessive liquidity, expansion of domestic credit, and appreciation of the exchange rate, which led to deterioration of the current account of the balance of payments. When external capital inflows were reversed, liquidity contracted, fear of depreciation accelerated the loss of reserves, and a severe adjustment in the current account followed. Booms in external financing, which occurred against a backdrop of financial liberalization and weak prudential regulation and supervision, ended in domestic financial crises.

Developments in the 1990s underscore the imperative to design policies that protect against crises and that are consistent with the realities of developing countries. Thus, autonomy must be sufficient to adopt countercyclical macroeconomic policies, including capital account regulations. In this vein, capital account regulations are important complementary tools to well-designed macroeconomic policies; they provide additional degrees of freedom to avoid excessive borrowing and an unsustainable appreciation of the exchange rate. The capital account regulatory mechanisms that Chile and Colombia adopted in the 1990s succeeded in managing financial account surges through unremunerated reserve requirements on capital inflows (Ffrench-Davis and Tapia 2001; Ocampo 2003; and Ocampo and Tovar 1998, 2003).

Stability of real macroeconomic variables, particularly GDP and employment, is essential for trade liberalization to contribute to efficient resource allocation. In addition, a favorable and stable real effective exchange rate (REER)—one that fluctuates on the basis of long-term factors and is not overly correlated with short-term capital movements—must be maintained to stimulate production of tradables. Through its effect on the real exchange rate and its stability, the REER may also serve a sustainable transformation of productive structures in the face of deeper trade liberalization. In addition to maintaining autonomy to use capital account restrictions for macroeconomic purposes, particularly to reduce capital account volatility, exchange rate policy should not be subject to trade agreement restrictions. This does not include macroeconomic convergence schemes in subregional agreements, which may be considered essential to deep integration processes and should thus be allowed.

Exports, competitiveness, and growth

Common obligations that fail to consider existing asymmetries appropriately may end up limiting the creation of comparative advantages. This would be the case if constraints were imposed on policies that foster innovation, technological development, and strengthening of the export base.

Despite overall advances in certain countries, economic opening is an insufficient condition for improving LAC's growth performance. During the 1990s, the region had one of the world's highest growth rates for merchandise trade in terms of volume and value. The average annual increase in merchandise exports amounted to 8.4 percent in volume, surpassed only by China and several other Asian economies. However, the

Table 2–3. Changes in Market Share and Relative Specialization Index for High-growth Products, 1990–99

Country or subregional market	Market share (%)				Relative specialization index for high-growth products*		
	1990	1993	1996	1999	1990–93	1993–96	1996–99
Mexico	1.292	1.446	1.911	2.441	0.515	0.844	0.679
Mercosur	1.552	1.528	1.545	1.499	0.645	0.828	0.655
Andean Community	0.888	0.822	0.913	0.822	0.298	0.622	0.369
CACM	0.190	0.230	0.274	0.350	1.550	0.975	1.323
CARICOM	0.182	0.163	0.145	0.131	0.787	0.711	0.348

* Ratio of high-growth to low-growth exports.
Source: ECLAC, based on data from the Competitive Analysis of Nations Program (2002).

region's strong export performance had weak economic growth returns—since 1990, an average annual rate of only 2.6 percent, less than one-third that of real export growth.

The above situation was the net result of the opposing effects of export growth on aggregate demand and a sharp increase in the import coefficient associated with reduced protection levels, tendency toward revaluating the exchange rate, and high import content of inputs in robust export industries, especially in the manufacturing sector (Moreno-Brid 2002). On the other hand, static comparative advantages led the economies to specialize in sectors of reduced world-trade dynamism. Although import penetration contributed to the modernization of production and new exports based on increased incorporation of imported inputs, it also weakened linkages between exports and overall economic activity.

Over the 1990s, the region's share of international trade rose from 4.5 to 5.5 percent, largely because of Mexico's outstanding export performance. Overall, this increase resulted largely from competitiveness gains in sectors characterized by slow world-trade growth rather than gains in more dynamic trade flows. The region's export specialization over this period, measured in terms of relative weight of high-demand products in the export basket, reveals its poor quality (table 2–3).

Three export specialization patterns have prevailed:

- Integration into vertical flows of manufacturing trade centered mainly on the U.S. market (Mexico and certain countries of Central America and the Caribbean). These countries have benefited from dynamic manufacturing markets (more so in Central American markets than in Mexico), but at the cost of reduced domestic linkages, given the high import content of such manufacturing.
- Horizontal production and marketing networks, mainly of raw materials and natural resource manufacturing (South America). This pattern has allowed the region to enjoy more domestic linkages (including technological developments), but countries have been forced to specialize in goods that are losing global share; this problem has been particularly acute in Andean countries. Interestingly, intra-regional trade was a major feature during the 1990–97 expansion. It provided a large share of manufactured goods with domestic linkages, but such flows were hampered significantly by the broad-based, regional slowdown that followed the Asian crisis.
- Predominance of export services (tourism, finance, and transport) (Panama and Caribbean countries). Tourism is undoubtedly a dynamic component of world trade; however, it has also been characterized by high import contents, particularly in smaller economies.

The LAC region's overall export performance in the 1990s suggests that greater economic openness does not automatically result in strong export-to-GDP growth linkages or improved competitiveness, particularly in dynamic segments of world trade. Unless countries engage in a coherent effort to stimulate linkages between export sectors and domestic economic activities—thereby increasing the value added GDP of exports—and encourage dynamic knowledge-based comparative advantages, export-to-GDP linkages will be weak and exports will be concentrated in products for which global demand is less dynamic and more vulnerable.

LAC countries' active participation in international trade flows requires an accelerated rate of innovation, including technology transfer, production sector development, and learning processes support. Such innovation involves devising strategies to promote new firms and activities, restructure uncompetitive sectors, and support small- and medium-sized enterprises (SMEs) to strengthen ties between exports and productive sectors and thus participate competitively in new trade flows. Building competitive export-supply capacities demands creating linkages between activities that succeed in international markets and the rest of the production system. A stronger export orientation, based on promoting exports that are knowledge-intensive or involve a high level of value added, is crucial for translating export capacity into greater economic growth.

In this regard, valuable lessons can be drawn from the East Asian experience. Recent research notes that East Asian economies' successful integration into global trade flows rested in large part on discretion in using a variety of policy measures and incentives targeted at specific sectors and industries to build competitive export-supply capacities. Strategic integration was not limited to trade; it also included policies that promoted technology transfer (Amsden 2001; Akyüz, Chang, and Kozul-Wright 1998; Chang 1994). One key lesson is this: a deliberate, active approach to integration through a measured, properly sequenced set of trade and investment policies cannot guarantee economic success; however, in its absence, success is the exception, not the rule.

Although WTO disciplines have reduced the scope for using East Asia's approach of more generalized policy interventions, this type of strategy requires flexibility in how countries commit to common trade obligations. For example, it is necessary to preserve margins of autonomy for adopting open economy-oriented policies to improve competitiveness (including intellectual property schemes that promote technology transfer, incentives to support export-supply diversification, and mechanisms to increase the national content of exports).

Financing and Labor Mobility to Foster Convergence

Even with special provisions that take asymmetries into account, free trade may be an insufficient force for income convergence among participant countries in the trade agreement. Two fundamental, complementary elements are 1) cohesion and integration funds and 2) increased labor mobility.

Resources to support trade liberalization and foster growth

The results of empirical work on whether trade liberalization is a force for between-country income convergence are ambiguous. Certain studies suggest that trade liberalization plays a key role or may even suffice for income convergence, while others emphasize the role of non-trade factors. Barro and Sala-i-Martin (1991) suggest that, among regions that are open to each other, the poorer grow faster on average. These authors found that, in U.S. and European cases from 1960–85, poorer regions converged with wealthier ones at a pace of about 2 percent. In turn, Ben-David (1993, 1996) found that removal of trade barriers among the main European Economic Community (EEC) countries was followed by significant income convergence. These studies indicate that convergence, while far from a worldwide phenomenon, could prevail among countries that trade extensively with one another.

Rodríguez and Rodrik (2001) and Slaughter (2001) have challenged these studies' empirical evidence on grounds related to measurement of openness and the time period of analysis; in short, they have questioned the empirical results that trade liberalization necessarily leads to faster convergence. Even if convergence occurs, they argue that many non-trade factors—common laws and institutions, labor mobility, and income transfers—are potentially at play.

Obviously, the case where these factors have been present most forcefully is the EU. Indeed, deepening economic integration accompanied by increased use of explicit cohesion policy is symptomatic of the political philosophy underlying European integration in the 1990s (Marín 1999). Moreover, this policy was extended to Central and East European countries that are EU candidates.

As table 2–4 illustrates, the EU significantly reduced the income gap between wealthy and poor countries in a relatively short time. During 1986–99, per-capita GDP in the four cohesion countries—Greece, Ireland,

Table 2–4. GDP Growth in EU Cohesion Countries, 1986–99

Change in GDP	Greece	Ireland	Portugal	Spain	EU-4[b]	EU-11[c]	EU-15[d]
Average annual % change							
1986–96	1.6	6.2	3.5	2.8	2.9	2.0	2.1
1986–91	2.2	5.3	5.1	4.3	4.1	2.8	3.0
1991–96	1.0	7.1	1.8	1.3	1.7	1.5	1.5
1996–99	3.8	9.2	3.8	3.6	4.1	2.6	2.8
Average annual % change in population							
1986–96	0.5	0.3	–0.1	0.3	0.3	0.4	0.4
1986–91	0.5	–0.3	–0.3	0.2	0.2	0.4	0.4
1991–96	0.4	0.1	0.1	0.4	0.4	0.4	0.4
1996–99	0.5	0.1	0.1	0.1	0.2	0.3	0.3
Per head (PPS)[a] EU-15 = 100							
1986	59.2	60.8	55.1	69.8	65.2	107.7	100
1991	60.1	74.7	63.8	78.7	73.1	105.5	100
1996	67.5	96.5	70.5	78.7	76.6	104.8	100
1999	69.3	105.1	71.8	79.6	78.2	104.5	100

[a] PPS = Purchasing Power Standards (formula for reducing the distortion effect of exchange rates in order to compare the relative income of people in different countries).
[b] EU-4 = Greece, Ireland, Portugal, and Spain.
[c] EU-11 = Austria, Belgium, Denmark, Finland, France, Germany, Italy, Luxembourg, Netherlands, Sweden, and United Kingdom.
[d] EU-15 = EU-4 + EU-11 (the 15 member countries before 2004 enlargement).

Source: Pastor (2001).

Portugal, and Spain—increased from 65 to 78 percent of the EU average. Ireland's economic advance was outstanding; per-capita GDP rose from nearly 61 percent of the EU average in 1986 to more than 105 percent by 1999.[2]

Numerous studies have focused on regional EU policies and their success in narrowing income disparities between wealthy and poor member states (Pastor 2001). Major factors that narrowed the gap included 1) establishment of a single market; 2) foreign investment; and 3) massive EU programs (some disagree over which factor was most relevant). In the

[2] Countries closed the gap faster than did regions. During this period, per-capita GDP in the 10 poorest regions rose from 41 to 50 percent of the EU average and, in the 25 poorest regions, from 52 to 59 percent (Pastor 2001).

case of Ireland, three mutually reinforcing variables identified as responsible for the economic turnaround were 1) accumulation of human capital; 2) fiscal control and maintenance of wage competitiveness; and 3) sharp increase in EU funds. As a percentage of 1996 GDP, EU funds for the four cohesion countries were 3.1 percent (Greece), 1.6 percent (Ireland), 2.5 percent (Portugal), and 1.1 percent (Spain).

The European experience illustrates that, on the one hand, no single factor can explain the narrowing gap between wealthy and poor countries. On the other hand, all models that have assessed the EU funds' effect on growth suggest that the funds were responsible for some growth, although the relative weight of this factor varies (Pastor 2001).

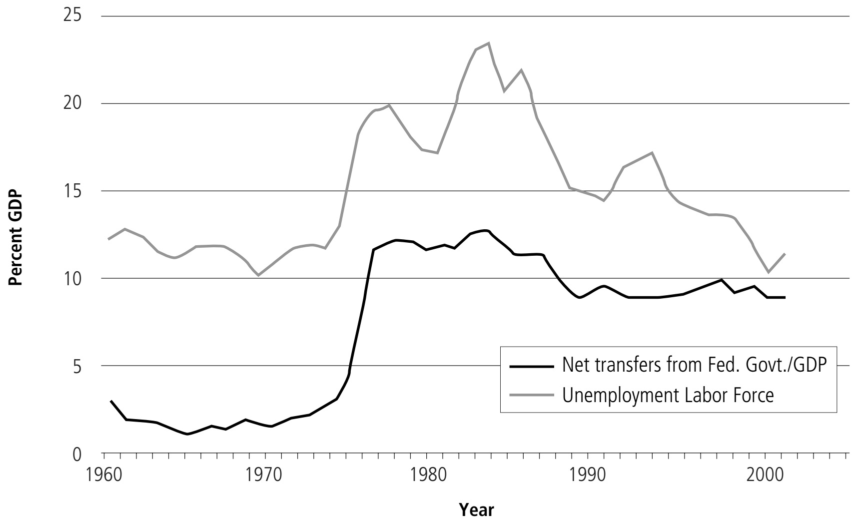
In the Western Hemisphere, Puerto Rico's experience illustrates the links between trade openness and income convergence and the role of non-trade factors, particularly industrial incentives, payment transfers, and labor mobility. Over a 20-year period, the per-capita income gap between the United States and Puerto Rico declined rapidly, from a factor of nearly six in 1950 to four in 1960, to less than three in 1970 (Dietz 2001). After 1970, the relative gap between the two economies' incomes converged no further. In the 1990s, the gap began to narrow again, albeit slowly, declining to a factor of 2 by 2001.

The main ingredient of Puerto Rico's strategy, known as Operation Bootstrap, was U.S. capital for investment in industries aimed at exports to U.S. markets, in a virtually tax-free environment. Labor mobility, with unrestricted out-migration to the United States, and a large positive inflow of U.S. payment transfers were key elements.

Federal transfers have played an important countercyclical role since 1960 (figures 2–1 and 2–2). Representing nearly 10 percent of Puerto Rico's GDP since the mid-1970s, federal transfers are strongly correlated with the business cycle (Hausmann 1995). Figure 2–2 shows the strong positive correlation between federal transfers and unemployment, thus indicating the countercyclical nature of federal transfers.

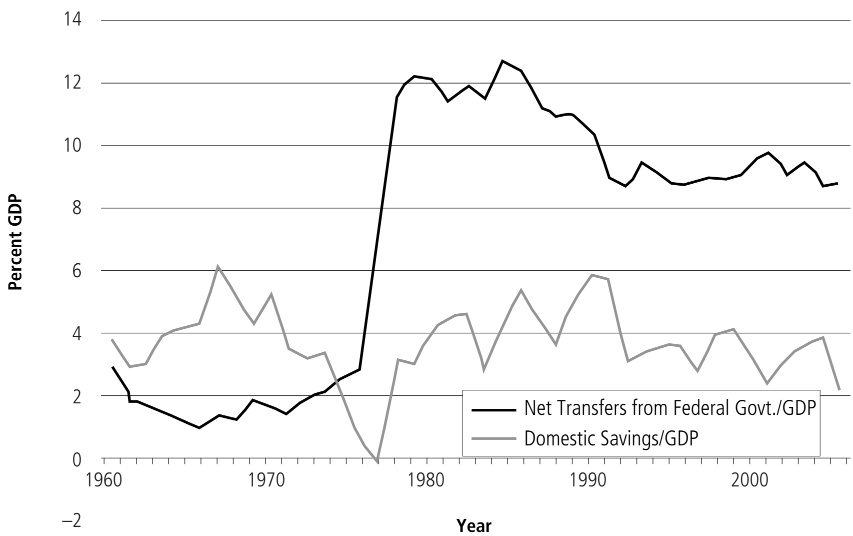
Moreover, the net flow of official transfers compensated for low savings rates over the period, helping to maintain consumption levels when income and employment levels fell. Since 1974, federal transfers, as

Figure 2.1. Puerto Rico: Net Transfers from U.S. Federal Government and Unemployment, 1960–2000



Source: ECLAC, based on data from Puerto Rico Planning Board (various years).

Figure 2.2. Puerto Rico: Net Transfers from U.S. Federal Government and Domestic Savings, 1960–2000



Source: ECLAC, based on data from Puerto Rico's national accounts.

a percentage of GDP, have been significantly higher than domestic savings (figure 2–2). From 1960 to 2001, domestic savings, as a share of GDP, amounted to 3.7 percent, while net transfers to individuals totaled more than 10 percent.

Despite differences in the nature and purpose of their integration schemes relative to such initiatives as the FTAA, both EU and Puerto Rican experiences highlight the importance of complementing trade liberalization with non-trade factors for economic growth. Thus, in 2001, the idea was put forward to establish a cohesion or integration fund to provide the necessary backing for the FTAA.[3]

In the Western Hemisphere, mobilizing resources to assist countries in their trade liberalization efforts has gained recognition in the negotiations under way. For example, in November 2002, as part of the FTAA process, trade ministers met in Quito, Ecuador to launch the Hemispheric Cooperation Program (HCP). The HCP aims to provide technical cooperation to address the institutional constraints that can impede meeting obligations assumed under the agreement. It also recognizes that overcoming trade liberalization challenges in the FTAA involves more than technical assistance to implement common disciplines. In addition, the HCP envisages cooperation in integration adjustment, including strengthening of productive capacity, fostering competitiveness, and encouraging innovation and technology transfer. Successfully developed and implemented, the HCP can contribute significantly to addressing many constraints faced by smaller, less-developed economies.

It is too early to assess whether the HCP initiative can mobilize sufficient resources. If enough resources are channeled to address the countries' own development priorities, this initiative could play an important role in helping to develop the institutional, infrastructure, and human capital needed to benefit from improved market access.

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[3] Heads of state presented the idea at the Summit of the Americas, held in Quebec in April 2001. The President of Mexico referred specifically to a cohesion fund, and various Caribbean prime ministers drew attention to the importance of integration funds. The Government of Ecuador, which coordinated negotiations until November 2002, later proposed that a competition-promotion fund be established.

Putting labor mobility on the agenda

Contrasted with liberalization of trade and capital flows, efforts to increase international labor mobility, especially for low-skilled labor, have not moved forward on the multilateral or regional agenda. Lack of labor mobility relative to capital skews income distribution against the less mobile factor, particularly the abundant low-skilled labor in developing economies (Rodrik 1997).

For labor mobility to contribute to equity, it must include less skilled, as well as skilled, workers. Winters (2002) estimates that movement of workers from developing to industrialized countries for limited time periods could produce gains that exceed the full liberalization of trade in goods.[4] These results suggest that global gains from unskilled labor mobility exceed those from skilled labor mobility.

A selective migration policy that favors skilled labor mobility increases income gaps in source countries. It also drains their human capital, generally a scarce production factor, and thus may become an additional determinant of income divergence. Furthermore, skilled labor may end up being employed in jobs requiring lesser skills in the recipient countries owing to other disadvantages (e.g., lack of knowledge of foreign language or recipient labor markets and inadequate educational accreditation agreements). Thus, from a source country's perspective, a more balanced migration policy in recipient markets or even a bias toward unskilled labor would be preferable.

Labor mobility is a controversial issue. Economic theory indicates that an inflow of low-skilled workers from developing countries would put downward pressure on wages of unskilled workers in industrialized countries. This theory is supported by empirical evidence, which indicates that the inflow of unskilled workers to the United States has contributed to a

[4] The effects of increasing temporary workers' permits in industrialized countries by 3 percent of their current skilled and unskilled forces would produce economic benefits exceeding $150 billion per year, compared with those of $66 billion for complete goods trade liberalization, shared between developed and developing countries.

decline in the relative earnings of unskilled workers, thus exacerbating the skill bias of technological change (Borjas, Freeman, and Katz 1997).

One mitigating factor suggested is that demographic trends in the United States and other industrialized countries would lead to rising relative wages for unskilled labor. The result would be a good potential for increased flows of unskilled workers in an environment of stable relative wages (World Bank 2002). Moreover, immigrant workers can play a crucial role in meeting a country's growing labor needs. As recent research suggests, the U.S. economy of the 1990s depended overwhelmingly on immigrant workers for its employment growth (Sum, Fogg, and Harrington 2002).

Along with liberalizing trade and investment, including labor mobility in the hemispheric agenda could have an equalizing effect and contribute to more equitable distribution of trade integration gains, particularly in small countries. This action involves favoring movement of persons with lower skills. Greater collaborative action on this highly sensitive economic and political issue could occur within the Summit of the Americas process, which provides the broader framework for the FTAA. The Summit already offers opportunities for greater collaborative action; its agenda includes explicit commitments on migration, human rights, and equity, calling for strengthened cooperation among countries to meet these challenges.

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CHAPTER 3

Comparative Integration Patterns: Transatlantic Lessons

*Raúl Hinojosa-Ojeda**

How should one understand the process of economic integration and its asymmetrical effects on developed and developing countries? What lessons do policy experiences from around the world teach about the best mechanisms for distributing the benefits of regional integration among and within countries? Most importantly, which strategies can create more optimal patterns of economic integration and institutional development to promote rapid growth and a symmetrical upward convergence of income and productivity levels in both rich and poor lands? This chapter explores these questions in the context of the North American Free Trade Agreement (NAFTA) in light of experiences of the European Union (EU).

The historical results of these two integration experiences represent perhaps the world's most extreme examples of regional economic convergence/divergence and related differences in approaches to regional policies and adjustment investments. Their lessons are central to today's polarized debate over globalization, which unfortunately is dominated by those who either defend or attack it blindly.

This author aims to refocus discussion on the economic, political, and institutional dynamics needed to achieve what both sides in this debate claim is their goal: a pattern of global economic relations that produces higher living standards and reduces inequalities among and within world regions.

* The author wishes to thank Nicholas Navarro for his excellent research assistance.

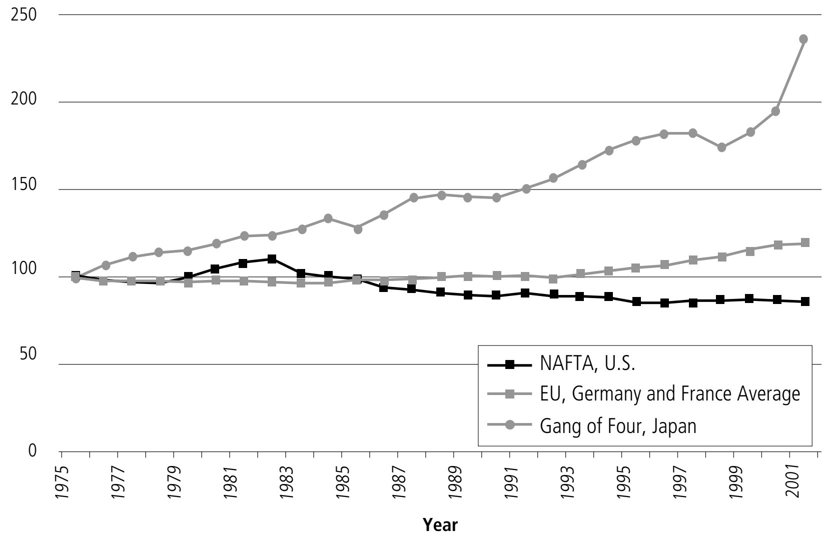
Global Perspective on North American Integration

In a comparative context, NAFTA is not the best example of globalization. Indeed, the North American experience is inferior to recent global experiences in trade openness with persistent inequality and poverty and other major patterns of regional integration—most importantly that of the EU. The fundamental question is this: why has North American integration resulted in persistently stark income inequalities, while other patterns of regional integration have produced a rapid, upward convergence of income levels? Crucial to the U.S. policy debate are the factors that explain the current North American dynamics; whether NAFTA alone can fundamentally change these dynamics; and, if not, what other policy choices must be made to shift toward a pattern of integration. From a global perspective, what conditions are required for regional integration and globalization generally to generate integration with income convergence?

Accelerated North American integration is occurring within the context of a rapid rise in trade between developed and developing countries worldwide and specifically within major regions of the world economy: Europe, Asia, and the Americas. While integration is occurring rapidly in all regions, income gaps in North America remain wide compared to income convergence in both Europe and Asia. As global trade has grown, it has also become more concentrated in these major regions.

Despite similar trends toward concentrated intra-regional trade, rates of per-capita income growth between countries have differed within these major world regions; in NAFTA and the Western Hemisphere zone, regional income gaps have widened, while incomes in the EU and Asia have converged. Most interesting has been the relative position of Mexico and the U.S., compared to developing and developed countries in East Asia and Europe. Forty years ago, Mexico's per-capita GDP was similar to that of Spain and higher than that of South Korea; since then, both Spain and South Korea have progressed significantly relative to Mexico, particularly in comparison with U.S. income levels. Finally, while the relative income gaps in East Asia and Europe have converged toward increasingly higher income levels over the past 40 years, North American gaps have remained virtually the same (figures 3–1 and 3–2).

Figure 3.1. Regional PPP Convergence Indices, 1975–2001*

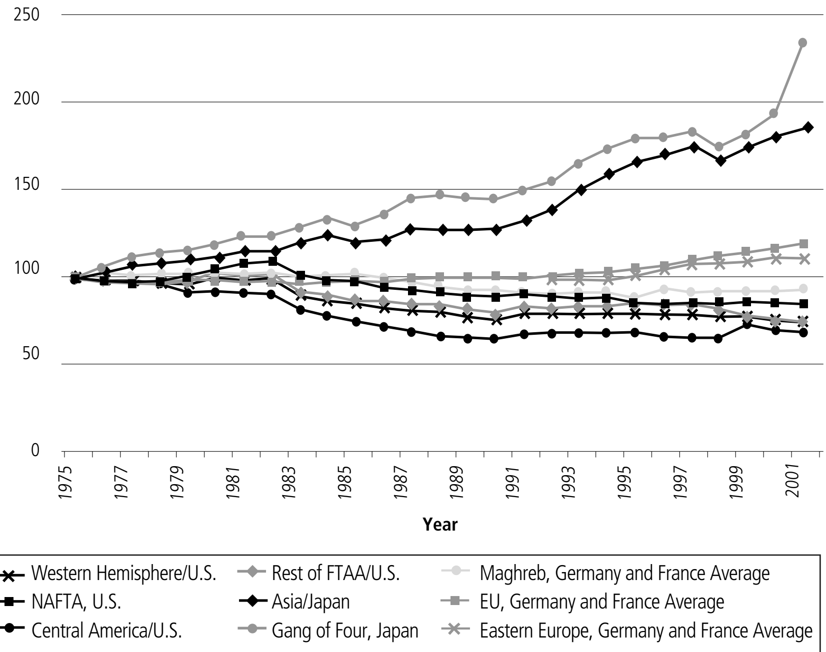


* 1975 = 100 (base year).
Note: NAFTA, EU, and Gang of Four (Hong Kong, Singapore, South Korea, and Taiwan) convergence indices are calculated in reference to leading economies (U.S., Germany/France average, and Japan).
Source: *World Development Indicators*, World Bank.

Another key global and regional trend is the relationship between trade openness and poverty reduction. Recent World Bank studies indicate that, in general, increased global trade has resulted in a reduction in absolute and relative poverty levels for the world overall. This relationship is particularly significant as an average result for so-called "globalizer" countries (Dollar and Collier 2001). On closer inspection, however, this statistical significance applies better to Asian and European globalizers than to Latin America and the Caribbean (LAC) (Garrett 2004). Mexico, in fact, stands out as a major exception, even among LAC experience with poverty increasing over the last 15 years (Székely 2001). Contrary to global average correlations, Mexico's recent experience with trade and capital openness has also been correlated with increasing income inequality (Behrman, Székely, and Birdsall 2001).

Trade expansion between rich and poor countries can be correlated with relatively different development experiences, a key issue typically ig-

Figure 3.2. Regional PPP Convergence Indices, 1975–2001*



* 1975 = 100 (base year), except for Eastern Europe, where 1992 = 100.
Note: NAFTA, EU, and Gang of Four (Hong Kong, Singapore, South Korea, and Taiwan) convergence indices are calculated in reference to leading economies (U.S., Germany/France average, and Japan).
Source: *World Development Indicators*, World Bank.

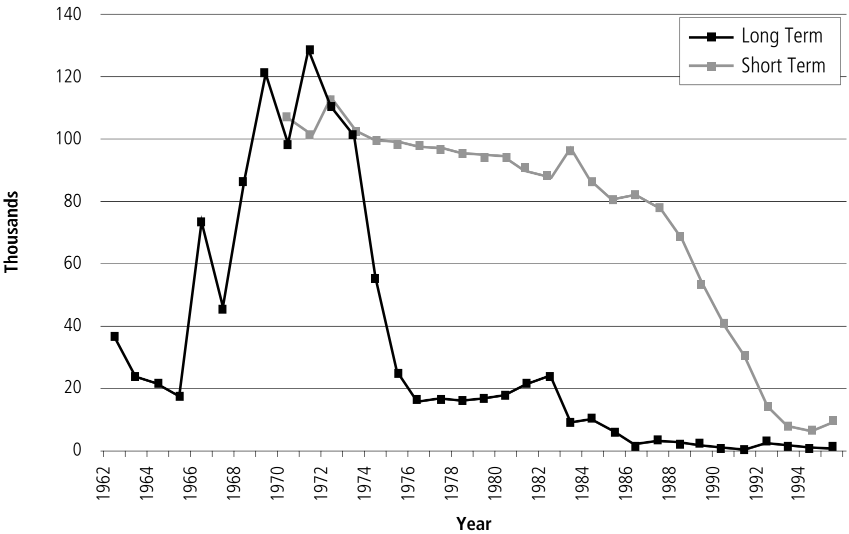
nored in the U.S. debates on NAFTA and globalization. The main concern for North America and the U.S., which should have been the major focus of the NAFTA debate, is to explore the particular factors, parameters, and dynamics behind North America's persistent pattern of uneven development.

Parameters include relative factor endowments (labor and capital), goods and factor mobility (capital goods and labor), and relative regional inequalities of income and wealth. Also important is the role of investment in public goods, measured as government share of GDP and region/transnational transfers from international institutions, corporations, and individuals. What stands out, but were often ignored during the NAFTA debate, are: 1) absence of regional transnational macro-stabilization or development funds; and 2) the role of migration and remittances flows, compared to trade and capital flows (both have the potential to play a critical role in the evolution of income gaps in low-wage labor markets on both sides of the border).

Mexico and Spain: comparing integration strategies

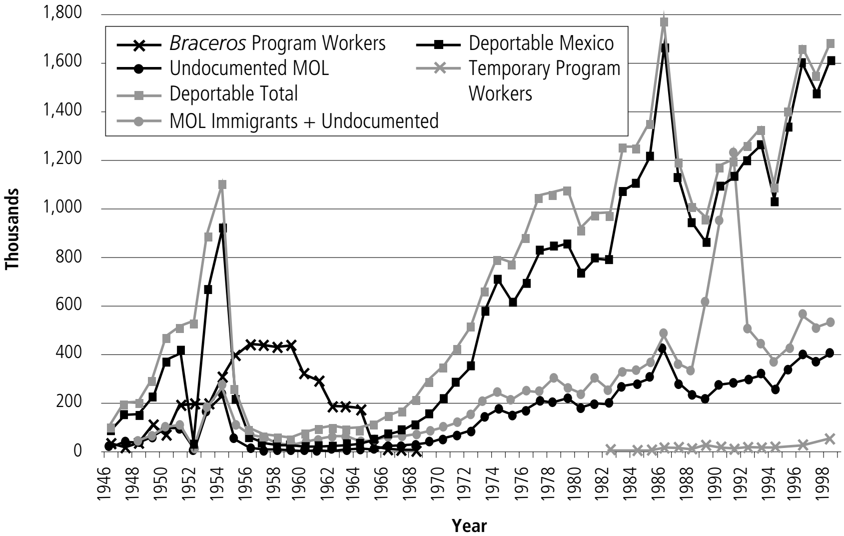
Comparing Spain's regional experience in the context of EU integration with Mexico's experience in the NAFTA region is particularly interesting, given the two countries' similar profiles only 40 years ago. At that time, Spain and Mexico had similar levels of per-capita income, high levels of out-migration, relatively closed economies, and politically authoritarian States with minimal levels of social expenditure. Both countries were large net exporters of workers to wealthier regional neighbors related to lower regional per-capita income (figures 3–3 and 3–4). However, the experiences of the two countries have differed in terms of per-capita income

Figure 3.3. Spain: Comparing Long- and Short-term Emigration, 1962–1994



Source: Instituto Nacional de Estadística, Anuario Estadístico de España. Vol LXX. Madrid, 1995.

Figure 3.4. Mexico: U.S. Emigration, 1946–1998



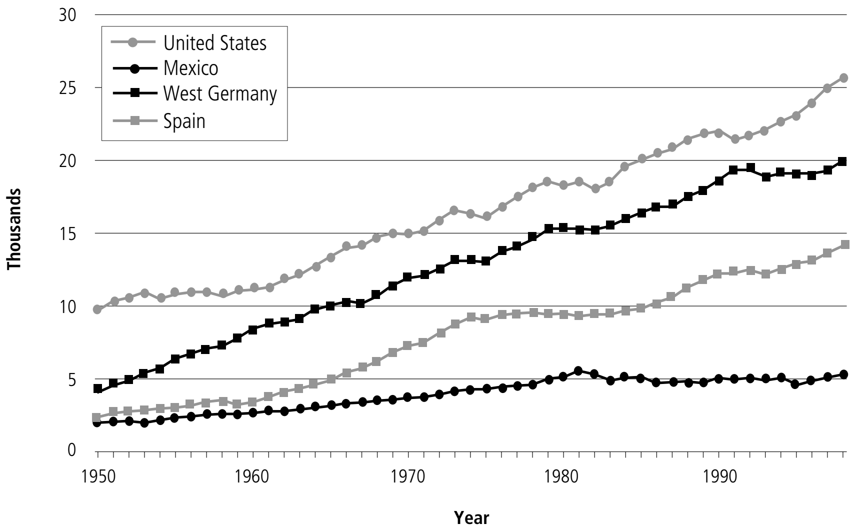
Source: Authors' compilation from various sources, based on Campbell and Lennon, 1999.

relative to their richer regional partners (figure 3–5). One major difference, as economic migration theories would predict, is that Spain's out-migration fell rapidly as income gaps in Europe narrowed, while migration from Mexico and the U.S. grew as their income gaps remained highly unequal.

Key differences in European and North American experiences include the relationship between trade/investment openness, macroeconomic stability, and public expenditures. Asia, the EU, and Spain moved toward greater trade openness years before NAFTA, the Western Hemisphere, and Mexico (figures 3–6 and 3–7). Although causality and its direction cannot be established from the graph,[1] 1950–98 data for Spain show a general correspondence between trade openness and per-capita GDP growth. Generally, both have increased greatly, although faster at certain periods. Spain's peak period of trade openness (1981–86) coincides with its preparing to become a full member of the EU. In Mexico during the second half of the

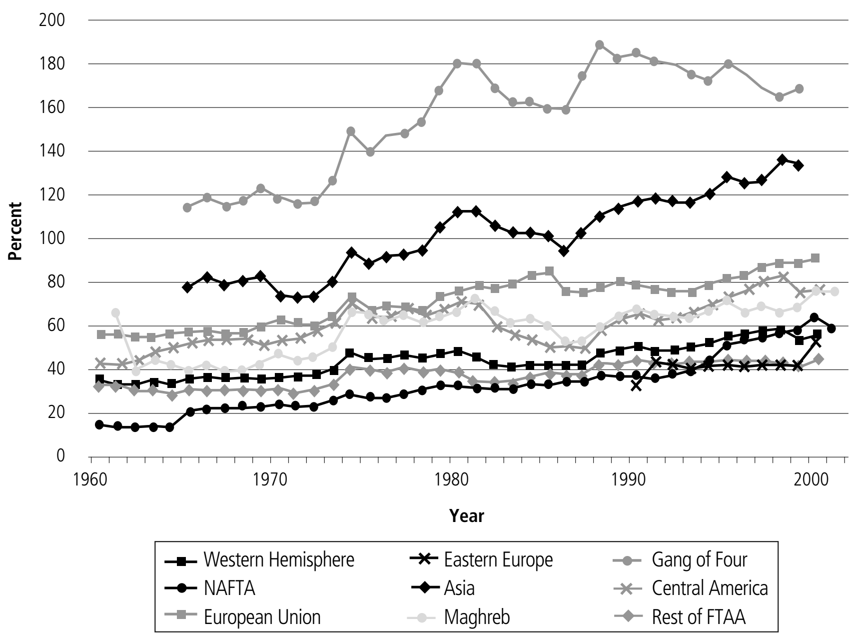
[1] One must also consider time lags and whether trade liberalization policies caused or resulted from economic changes.

Figure 3.5. Per-capita GDP for Selected Countries, 1950-1998*



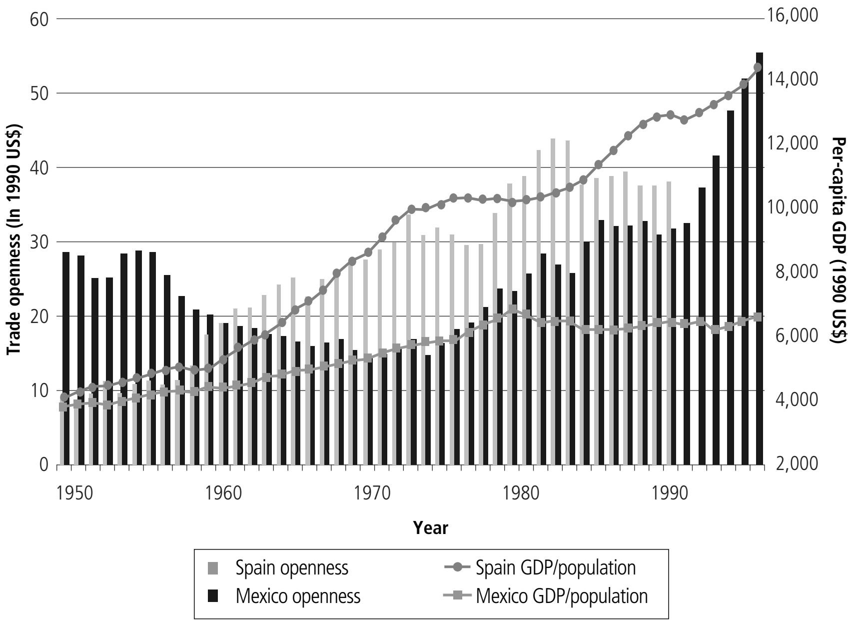
* In 1990 US$.
Source: *World Development Indicators*, World Bank.

Figure 3.6. Regional Trade Openness, as a Percent of GDP, 1960–2000



Source: *World Development Indicators*, World Bank.

Figure 3.7. Mexico and Spain: Trade Openness and Per-capita GDP, 1950–1998

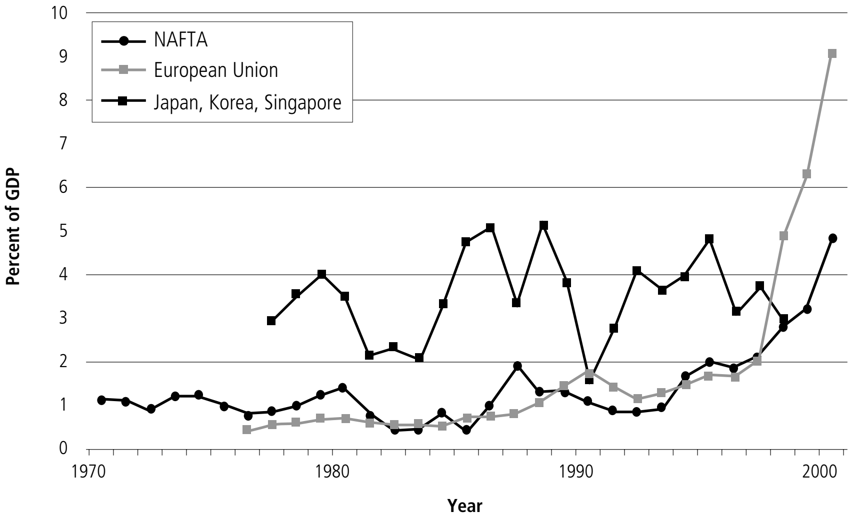


Note: Trade openness = exports + imports/GDP.
Sources: Penn World tables for 1950–92 (http://datacentre.chass.utoronto.ca/pwt); 1993–98 data adjusted with that of the International Monetary Fund (IMF) and *International Financial Statistics Yearbook*.

20th century, trade openness played a far different role. While per-capita GDP grew at a slow and steady rate overall, trade openness was fairly high in 1950, declined from the late 1950s until the mid-1970s, and did not reach its 1950 level again until the late 1980s. This pendulum swing toward openness with NAFTA apparently does not correspond to any such movement in Mexican per-capita GDP, owing partly to Mexico's ongoing macroeconomic instability.

Openness to foreign direct investment (FDI) has been important in all zones (figure 3–8), although the timing, relative dimensions, and effect differ in significant ways. Until the mid-1980s, Spain and Mexico had similar levels of total FDI, including similar shares of FDI to GDP, even though Spain has always had higher FDI per capita. With Spain's entry into

Figure 3.8. Average Foreign Direct Investment for Selected Regions, 1970–2000

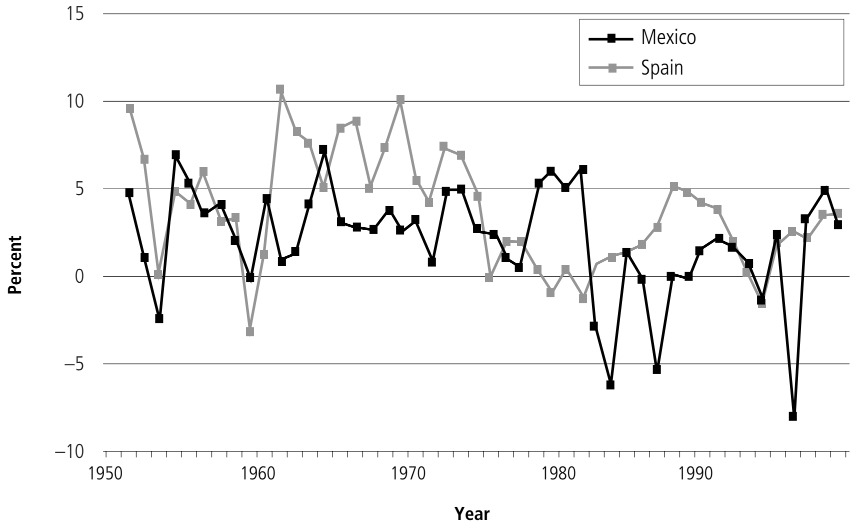


Source: *World Development Indicators*, World Bank.

the European Community (EC) in 1985, however, inflow of FDI exploded and peaked a few years later, only to be overtaken by an enormous outflow of FDI (much of it to Mexico and other LAC countries). Mexico experienced a similar inflow of FDI with the announcement of NAFTA negotiations only a few years after Spain joined the EC, although the effects on relative macroeconomic stability and regional income convergence have differed greatly.

In the 1950s, Mexico's growth rates were as stable as those of Spain, and their stability increased from the mid-1950s to the mid-1970s (figure 3–9). Since then, however, Mexican instability grew, clearly illustrating the macroeconomic difficulties of the early 1980s and peso-crisis effect of the mid- and late 1990s. By comparison, Spain in the early 1950s to mid-1960s was characterized by highly variable growth rates. By the 1970s, when Spain entered the European Monetary Union (EMU), and particularly during the 1990s with full EU membership, the country's growth rates stabilized, varying only slightly when averaged over five-year periods.

Figure 3.9. Mexico and Spain: Annual Percent GDP Growth, 1951–98

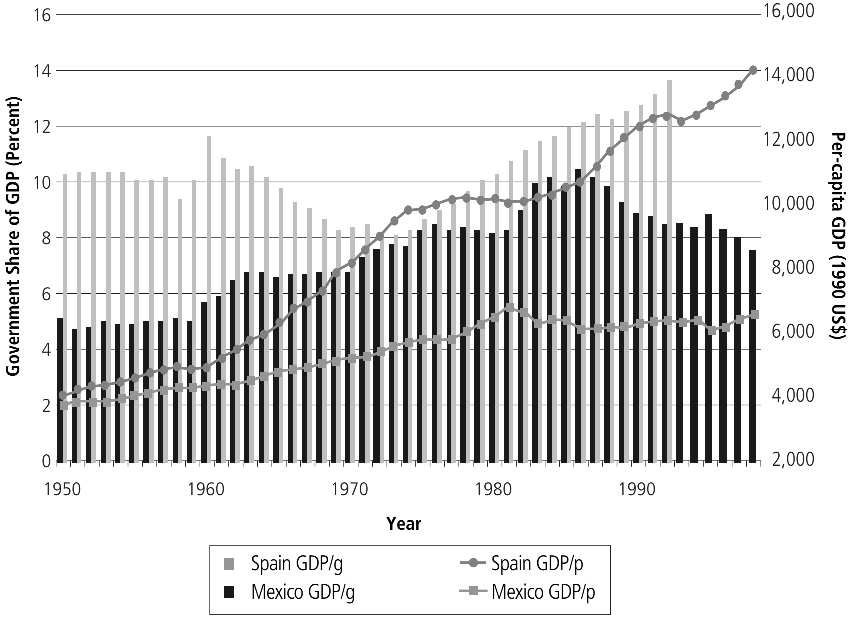


Source: Penn World tables (http://datacentre.chass.utoronto.ca/pwt)

With regard to government expenditures as a percentage of GDP, Spain's first period of rapid and sustained per-capita GDP growth in the early 1960s throughout the oil crises of the 1970s coincides with a decline in its government's share of GDP. However, its second period of rapid per-capita GDP growth in the early 1980s through the early 1990s coincides strongly with an increased share of government taxation and expenditure in the national economy (particularly education and social welfare expenditures). This period coincides with the harmonization of Spanish fiscal policies with EU norms to qualify for single currency membership.

Mexico's relatively lower, yet steady rise in government expenditures as a percentage of total GDP between 1950 and the mid-1980s coincides with its higher growth of per-capita GDP. Since this period, however, government expenditures as a share of GDP declined, while per-capita GDP growth stagnated. Although Mexico is the LAC region's second largest economy, it currently has one of the region's lowest tax collection rates, at about 10.5 percent of GDP (figure 3–10).

Figure 3.10. Mexico and Spain: Government Share and Per-capita GDP, 1950–98



Sources: Penn World tables for 1950–92 (http://datacentre.chass.utoronto.ca/pwt); 1993–98 data adjusted with that of the International Monetary Fund (IMF) and *International Financial Statistics Yearbook*.

Comparative role of labor migration

A significant difference between the North American and European experiences is the role of migration, and increasingly, the role of remittances. As the New Economics of Labor Migration (NELM) has documented (Stark and Bloom [1985] and Taylor [1999]), the role of migration and remittances is critical to understanding the dynamics and potential options of positive or negative cumulative causation across linked low-wage sectors of the labor market, just as FDI movement is crucial to understanding the potential dynamics in industrial trade relations. European migration and remittance flows were complementary to North and South growth. Kindelberger (1967) pointed out how labor surplus in the South helped to meet the North's labor market needs, providing remittances for investment in the South.

Critical differences between the Spanish and Mexican cases involve mobilization of private and public resources for development in immigrant sending areas. Spain's expansion of a well-developed financial sector for intermediation of remittances was critical in complementing availability of regional development funds. (It should be noted that most European development funds focus on immigrant sending regions and that migration declines precipitously as structural funds begin to flow—a concrete signal to support a change in potential migrants' expectations that remaining in a region has a future.) NELM suggests that migration is a function of relative wages, as well as a response to imperfect capital markets and reduced risk. The European example makes the case that addressing these issues can have a significant effect.

Like postwar Europe, North America exhibits key demographic and migration/remittances complementarities (Hinojosa-Ojeda et al. 2001; Fishlow, Robinson, and Hinojosa-Ojeda 1991). Labor market interdependence (LMI), via migration between the U.S. and Mexico, far outweighs the linkages between labor markets via trade and investment flows. Transnational migration stock now represents 20 percent of the Mexican and 10 percent of the U.S. labor markets. In contrast to Europe, where migration was an organized and orderly policy, North American migration has become embedded as an extralegal socioeconomic dynamic that benefits the more politically powerful interests on both sides of the border. Rather than maximizing the benefits of migration and remittances for both countries, the current LMI pattern reproduces the conditions of low pay/low productivity sectoral dynamics on both sides of the border.

On the U.S. demand side, undocumented status lowers relative real wage/human capital levels in low-wage labor markets, providing a subsidy to U.S. employers and thus increasing their demand for more undocumented labor. The high costs of remittance transfer, related to lack of an efficient financial sector between the U.S. and Mexico, makes it difficult to translate remittance funds to any activity other than dependency developing consumption in immigrant sending areas and the financing of more out-migration. On the Mexican supply side, agricultural policies and an inefficient financial system have resulted in large-scale undercapitalization of the rural sector and extremely low levels of human capital investment, generating the persistence of poverty-exacerbated, high-population growth pressures, which outstrip employment-generating capacities.

Transatlantic counterfactual experiments

Much discussion has centered on the role of the EU Structural Funds in explaining the differences between European and North American experiences and Spain's performance relative to that of Mexico.[2] Over the 1989–99 decade, efforts through the EU Structural Funds and Cohesion Funds totaled about 6.5 percent of Union GNP (Mairate and Hall 2001). By contrast, under the Marshall Plan (1948–51), the United States granted 1 percent of GNP each year (representing some 2 percent of the recipient countries' annual GNP) or 4 percent over the period (De Long and Eichengreen 1992). Since joining the EU, these funds are estimated to have contributed 2 percent to Spain's annual GDP growth, providing a basis for stable macroeconomic performance and investment funds for trade adjustment and new activities in lagging regions.

Counterfactual exercises have estimated the effects of similar structural funds for NAFTA, Central America Free Trade Agreement (CAFTA), and Free Trade Area of the Americas (FTAA). Such experiments have been used to propose more modest versions of this policy approach in the case of NAFTA (Fishlow, Robinson, and Hinojosa-Ojeda 1991). Table 3–1 presents the results using a formula derived for expenditures of EU Structural Funds, EU Enlargement Funds, and EU-Maghreb. These formulas are then applied to NAFTA, CAFTA, and FTAA. In the case of NAFTA, it is estimated that, if Mexico were admitted to the EU under the same policy rules that applied to Spain, it would be entitled to nearly $100 billion per year in

[2] These include the European Regional Development Funds, European Social Fund, European Investment Bank, and Cohesion Funds related to the move toward the single currency.

Table 3–1. Counterfactual Experiments of EU Regional Funds Formulas Applied to the Western Hemisphere
(in millions)

Agreement	EU Regional Funds	Eastern European Enlargement Funds	Maghreb/EU Free Trade Agreement Assistance Funds
NAFTA (Mexico)	99,925.3	10,482.4	489.8
CAFTA	36,532.6	3,832.3	179.1
Rest of FTAA	351,275.0	36,849.4	1,721.9

Note: Per-capita assistance for EU = $1,020, EEE = $107, Maghreb = $5.00 multiplied by total regional population.
Source: North American Integration and Development (NAID) Center calculations, based on data from the World Bank (*World Development Indicators*) and the European Union online (www.europa.eu.int).

direct public investment transfers.[3] Under these circumstances, it is estimated (using a dynamic computable general equilibrium [CGE] model) that the relative income gaps in North America would experience similar rates of intra-EU income convergence within a decade (Hinojosa-Ojeda and Robinson 1992; Hinojosa-Ojeda 2003).

The globalization debate can learn much from the opposing regional integration experiences of Europe and North America. Trade and capital liberalization between rich and poor countries in itself can be correlated with relatively different development experiences.

NAFTA Debates and Effects

The conceptual and policy challenges of North American integration require an analytical framework that simultaneously analyzes trade, foreign investment, migration, and remittances. This framework must also account for two vital dynamics that are only now beginning to be understood theoretically and empirically: 1) dynamics that produce accelerated productiv-

[3] Unlike the North American Development Bank, EU Structural Funds are not loans but direct transnational fiscal transfers.

ity growth (e.g., through economies of scale, innovation, or agglomeration); and 2) political and institutional dynamics across borders that engender complementary strategies by social actors (e.g., through improved international conditions for long-term capital investment, distribution of gains to workers, and a new vision for the State's international role in providing social investment, appropriate safety nets, and enhanced investment in innovation and lagging regions).

NAFTA appears to have only slightly accelerated both the positive and negative dynamics of cumulative causation. This author argues that the critical issues for U.S. policymakers should have been—and continue to be—factors and policies that can transform the pattern of North American integration toward greater growth, development, and income convergence on both sides of the border. The ongoing fundamental issue involves factors driving alternative paths of cumulative evolution in 1) investment-production-trade dynamics; and 2) employment-wages-migration-remittance dynamics. Together, these are the major drivers of regional income convergence and divergence.

While patterns of positive cumulative causation are clearly evident in sectors throughout North America, these dynamics are not necessarily sustainable (in terms of incentives for innovation and future productivity growth) or expanding rapidly enough to be a major source of employment absorption, particularly in Mexico. The dynamics of negative cumulative causation linked across national economies continue to drag on low-wage labor markets, reducing incentives for productivity-enhancing investments in low-wage sectors, as well as the entire regional economy. This author's analysis points to the need for major policy development efforts directed at both the investment-production-trade dynamics and employment-wages-migration-remittance dynamics.

Review of NAID findings

The author's review of the North American Integration and Development (NAID) Center's report on NAFTA's effects includes five major findings (Hinojosa-Ojeda et al. 2000).

1. ***The overall pattern of U.S.-Mexico trade and investment began to change radically nearly a decade before NAFTA, with Mexico's unilateral trade liberalization. This ushered in dramatic growth in the two-way trade of manufactured intermediate goods; this growth has continued and matured since NAFTA's implementation.***

The most significant change in U.S.-Mexico trade relations over the past few decades has been an explosion of exports and imports since the late 1980s, driven almost entirely by an expansion of Mexican manufactured exports based on processing imported intermediate inputs. As a result, a large proportion of Mexican imports have become predominantly linked to the demand for Mexican exports rather than to fluctuations in Mexican domestic demand. This new import-export dynamic has grown even faster than the rapid expansion of Mexico's cross-border assembly plants (*maquiladoras*), as the export-manufacturing strategy is adopted by many other Mexican regions, sectors, and types of firms. The period following NAFTA implementation has witnessed a continuation, maturation, and even slight deceleration of this previously initiated shift.

2. ***Lowering of tariffs through NAFTA has not significantly affected growth of Mexican exports to the United States; in fact, exports to the U.S. have grown faster in those sectors not directly liberalized by NAFTA.***

U.S. imports from Mexico grew an average of 6.3 percent annually in the three years before NAFTA and an average of 20 percent in the years following implementation. While the effect of NAFTA's tariff liberalization on the level of trade appears positive and statistically significant, such liberalization by itself can only statistically explain a small portion of these changes. A larger effect on trade levels and patterns should be attributed to the collapse and recovery of Mexican growth related to the peso crisis and the ongoing binational industrial integration.

In fact, analysis of the U.S.-Mexico trade pattern since NAFTA indicates that U.S. imports in commodities liberalized by NAFTA rose slower than those commodities not affected by NAFTA liberalization.[4] This finding corroborates the earlier findings of this author (Hinojosa-Ojeda et al. 1996). In addition, it is unlikely that NAFTA—or any other tariff liberalization—determined the evolving structure of trade significantly; rather, other causes were responsible.

3. ***Jobs put at risk annually from imports number about 37,000 because of Mexican imports and 57,000 owing to Canadian imports. (The NAID report derived these figures using a partial equilibrium method to estimate North American trade's direct and indirect effects on U.S. employment since NAFTA implementation.)***

The NAID Center developed an alternative method for tracking the potential employment effects of trade, using partial-equilibrium, constant elasticity of substitution (CES) aggregation functions at a four-digit SIC sectoral level to estimate U.S. domestic demand for domestic production, given a particular import level. These production estimates are then translated into domestic labor requirements using direct and indirect input-output labor coefficients. Using the econometrically estimated Armington elasticities, these functions attempt to account for complementarity in production between the United States and a given country in a particular sector.

This model's usefulness lies in isolating the import's effect and showing that—even in the most exaggerated scenario with fixed demand and productivity—the potential effect on jobs is relatively small. Estimated totals across sectors are small.[5] During 1990–97, Mexican and Canadian imports' total estimated effects on potential U.S. jobs were 299,000 and 458,000, respectively; that is, an average of 37,000 jobs per year resulting from Mexican trade and 57,000 per year stemming from Canadian trade. Considering that the U.S. economy creates more than 200,000 jobs monthly

[4] These import commodities were liberalized before NAFTA, by other means, or are not yet liberalized.

[5] Because these are partial equilibrium estimates, one has no theoretical basis on which to add them or interpret the magnitude of the sum. Certainly, however, the sum is an overestimate of the true general equilibrium effect.

and separates about 400,000 workers from their jobs per month, the relatively small share of potential job effects from this trade is apparent.

Applying more realistic productivity and demand changes experienced since NAFTA significantly reduces potential U.S. job effects caused by imports.

4. *The NAFTA-Trade Adjustment Assistance (TAA) program is a relatively better indicator of estimating employment losses owing to plants moving to Mexico; however, it is less reliable as an indicator of employment losses resulting from import penetration.*

Through early July 1999, the U.S. Department of Labor had certified 238,051 NAFTA-TAA workers, an average of 3,662 per month. Workers certified owing to trade effects were 46,826 (700 per month) for Mexico and 23,250 (350 per month) for Canada. Remaining certified workers were from unspecified causes or those not directly linked to Mexico or Canada.

The NAID-Armington estimate of potential trade effects is 75–90 percent higher than the NAFTA-TAA numbers. Even conceding a high estimate and the shifting of import results from certain certified plants back to the United States, it is likely that NAFTA-TAA is undercounting trade effects.

5. *Estimates of trade-related employment effects have a limited but important role to play in the public discussion of trade.*

In general, jobs gain/loss accounting methods should not be used to evaluate the relative benefits of trade. Changes in aggregate demand created by a changing trade balance or trade policy are likely to be counteracted by general macroeconomic policy; thus, trade policy changes are unlikely to affect overall employment significantly over the short term or at all over the longer term. A more significant measure of trade policy is the effect on economies of scale, technological change, new investments, productivity growth in liberalized sectors, and the economy's overall ability to reap benefits from these productivity increases.

However, the trade and employment-effect methods presented here should be central to an understanding of the adjustment costs of trade effects. Accurately identifying employment displacement risks is important in helping workers and communities to take adequate steps to prepare for a positive adjustment. Failure to identify and address adjustment risk inevitably generates exaggerated political opposition to trade liberalization (in certain cases, this opposition is based on ignorance and fear; while in others, it is a legitimate defense of uncompensated individual costs incurred on behalf of overall societal welfare).

Empirical analyses of cumulative causation

To consider the extent of cumulative causation—positive or negative—in the process of North American integration, this author used a specially constructed database that included: 1) macro data at the economy-wide level; 2) 11 subsectors (based on U.S. definitions of end-use categories); and 3) a detailed 39-subsector analysis (constructed at the most disaggregated level of concordance between published data in the three NAFTA countries).

Both before and after NAFTA, elements of an integration process with positive cumulative causation (PCC) and negative cumulative causation (NCC) had been operating across parts of the U.S., Canada, and Mexico. U.S.-Mexico economic integration exhibited a similar PCC dynamic, beginning with Mexico's unilateral opening in the mid-1980s, while U.S.-Canada integration had begun a decade earlier. In all three countries, a common cluster of industrial subsectors is undergoing a rapid process of transnational industrial restructuring; as a result, all three countries are experiencing higher trade growth, employment, and productivity and wages in sectors linked across borders. The dynamics are led by high FDI growth, associated with expanded trade of intermediate goods to facilitate the transnational coproduction of final goods exported throughout North America and the world.

In light of the exaggerated expectations that the NAFTA debate generated on both sides of the issue, an important finding from the ongoing tracking of North American integration is the lack of a fundamental shift in pre-and post-NAFTA patterns of trade, investment, and production. North America had already begun a dramatic transformation in trade relations in the mid-1980s, about a decade before NAFTA became operational. Years before NAFTA was contemplated, Mexico had opened to international trade and investment, ushering in a period of rapid trade growth, large trade and current account deficits, and large capital inflows. Thus, the period surrounding NAFTA implementation has been characterized by rapid acceleration of previously initiated trends, their maturation, and more recent deceleration.

FDI began to grow at about the same time NAFTA negotiations started, and that growth accelerated post-NAFTA. Yet, this FDI level represented a declining share of both U.S. and Mexican GDP. Foreign investment, more broadly defined to include speculative portfolio investments and loans, contributed to the overheating of the stock market in 1993–94. Thus, while NAFTA may have created the unrealistic expectations that led to Mexico's dramatic crash, it may also have contributed to the country's ability to mount its most rapid macroeconomic recovery (via exports and FDI), indicating NAFTA's significant "policy-fix" power.

In general, however, NAFTA did not significantly alter preexisting differences in the macroeconomic and sector performances of Mexico and the United States, either before or after NAFTA's 1994 inception. For the Mexican economy, the pre- and post-NAFTA period was an export boom (growth of net imports and capital inflow), characterized by modest employment growth, relatively flat productivity growth, and declining real wages; the result was a net improvement in per-unit labor cost and Mexico's relative global competitiveness position. The correlation between Mexican productivity and wage growth, though weaker than expected, is still greater than that of the U.S. Similarly, rapid technological progress tends even more strongly to lead to employment losses in Mexico. In contrast to the United States, however, one can observe a distinct negative relationship between wage and employment growth, implying that Mexico will have difficulty moving beyond its role as a low-wage complement to U.S. industry while employing its rapidly growing labor force.

The U.S. economy post-NAFTA outperformed Mexico and Canada in terms of output, real wages, and even employment and productivity. Meanwhile, sectors in which U.S. exports to Mexico and Canada grew had strong employment performance. In more than 66 percent of the sectors in which U.S. imports from Mexico grew, U.S. employment also increased. At the same time, the positive correlation between productivity and wage growth before and after NAFTA is weak. While the relationship between productivity and wages is more likely to hold over the long term, the positive relationship appears extremely weak even if one observes the entire 1988–2000 period. There is no observable correlation between wage and employment growth; rather, there is a moderate negative correlation between productivity and employment growth. That is, the strongest relationship between these three variables is that rapid technological progress in a sector tends to lead to reduced employment levels.

Patterns of positive cumulative causation

A 39-sector database (with 25 traded sectors) was analyzed for evidence of strong or moderate PCC. One should note that, if the five key variables—output, employment, productivity, wages, and trade—were unrelated, then statistically there should be only one or two instances in which all variables grew faster than average. Instead, four strong PCC sectors have most variables at or above the average annual growth rate.[6] For a second group of sectors, growth of these variables was mostly positive, although not necessarily greater than average for the economy. This group of sectors exhibits moderate PCC. (While all three countries share many PCC dynamics, this chapter focuses on the import-export dynamics between Mexico and the U.S. since much of the U.S. NAFTA discussion concerns trade with Mexico.)

Table 3–2 shows clearly observable PCC in certain key sectors of the U.S. economy. However, additional elements beyond the above variables are particularly relevant to the NAFTA debate. It should be no sur-

[6] The average growth rate of employment used is that of industrial employment. Over this period, the share of manufacturing employment continued to shrink relative to service sectors.

Table 3–2. Average Compound Growth (%) of U.S. PCC Sectors, 1994–2000

PCC sector	Output	Employment	Productivity	Wages	Exports	Imports
U.S. Average*	**5.0**	**0.5**	**4.5**	**1.4**	**14.9**	**20.2**
Electronic & other electric equipment	21.3	1.6	19.3	3.8	16.7	21.1
Industrial machinery and equipment	13.6	1.3	12.1	2.4	14.4	29.0
Nonmetallic minerals (except fuels)	7.0	1.3	5.6	0.8	11.2	13.2
Rubber and miscellaneous plastic products	5.5	1.6	3.9	0.6	20.1	21.8
Farms	5.0	0.5	4.4	2.1	11.5	7.1
Chemicals and allied products	4.9	–0.5	5.4	2.9	15.2	7.7
Motor vehicles and equipment	4.6	2.8	1.7	–1.2	15.5	23.9
Stone, clay, and glass products	4.5	1.6	2.8	1.0	16.6	16.3
Fabricated metal products	4.0	2.0	1.9	0.1	15.0	23.5
Miscellaneous manufacturing industries	3.8	0.5	3.3	1.7	8.9	10.6

* Average of the 25 traded sectors.
Note: The formula used to calculate the average compound growth rate is Growth = (Y2000/Y1993) ^ (1/7) – 1, where Y2000 = the value for the year 2000 and Y1993 = the value for the year 1993.
Source: North American Integration and Development (NAID) Center database.

prise that all leading PPC sectors are in the fastest-growing quarter of the 39 U.S. sectors. However, NAFTA's opponents may find it surprising that most of the above-listed sectors also experienced faster-than-average import growth from Mexico. Hence, one observes positive cross-border linkages in the PCC sectors contributing to industrial development on both sides of the border. Equally illustrative of the potential for positive cross-border linkages is that, since 1994, leading U.S. PCC sectors have been responsible for more than 25 percent of all U.S. FDI in Mexico.[7]

[7] While beyond the scope of this chapter, a similar analysis for Mexico highlights electronics as the only sector that meets the strict requirements for strong PCC, while industrial machinery, rubber, and

To summarize the clear, but limited, pattern of PCC since NAFTA, the agreement has led to production-sharing relationships across the Mexican border. Parts and components are fabricated in Mexico, integrated with knowledge-intensive U.S. components into U.S. designs, and marketed around the world. Thus, one observes output, employment, productivity, and wage gains in the very sectors that attract U.S. investment in Mexico and exhibit an expansion in two-way trade. While these PCC sectors account for nearly 43 percent of U.S. exports to Mexico, they employ just 4 percent of the total U.S. labor force. When one further considers the moderate PCC sectors, only 7 percent of U.S. employment and 11 percent of total output are accounted for.

Patterns of negative cumulative causation

Eight U.S. sectors display the spirit, if not the letter, of NCC. These sectors exhibit below-average growth in output, employment, wages, and productivity, with an absolute decline in at least one variable. All qualify in every respect except that wage growth rates for five of the eight are higher than the national average. One hypothesis to explain this pattern is that seniority-based raises in union contracts left layoffs as the only way to adjust the labor market in these sectors when demand slumped or productivity declined. However, these sectors are not highly unionized overall. Hence, a more likely explanation may be that management has elected to trim production workers, while retaining white-collar jobs. This could explain the decline in employment, while average wages climbed and productivity stagnated. For example, apparel and leather, the two sectors with the largest percentage of employment declines since NAFTA's inception, experienced increases in relative wages above the national averages (Table 3–3).

motor vehicles display moderate PCC. Hence, these four sectors show the potential for binational PCC. No other sectors in Mexico show even moderate PCC. Thus, one can postulate that PCC can be developed in Mexico through a "pull" effect from PCC in the U.S., and perhaps only in conjunction with U.S. PCC. An important question is whether U.S. PCC, both strong and weak, can successfully exist without corresponding sectors in Mexico. A further research step concerns the economic dynamics of Canadian sectors that exhibit PCC in the U.S.

Table 3–3. Average Compound Growth (%) of U.S. NCC Sectors, 1994–2000

NCC sector	Output	Employment	Productivity	Wages	Exports	Imports
U.S. Average*	**5.0**	**0.5**	**4.5**	**1.4**	**14.9**	**20.2**
Food and food-related products	0.4	0.2	0.3	0.8	8.6	16.4
Printing and publishing	–0.6	0.3	–0.9	1.7	10.7	22.1
Textile mill products	–1.0	–3.4	2.5	1.1	26.8	34.1
Other transport equipment and instruments	–1.6	–1.1	–0.5	1.6	8.5	22.4
Paper and allied products	–2.7	–0.8	–2.0	0.7	12.4	22.8
Apparel and other textile products	–2.9	–6.1	3.4	2.1	13.5	22.6
Leather and leather products	–3.2	–7.1	4.2	2.8	24.8	23.2
Tobacco products	–5.6	–3.5	–2.2	3.0	–14.2	0.3

*Average of the 25 traded sectors.
Source: North American Integration and Development (NAID) Center database.

In these NCC sectors, GDP and employment have experienced moderate to strong declines, in contrast to U.S. average growth rates of 5.0 and 0.5 percent, respectively. In a few sectors, imports from Mexico may have been a factor (Hinojosa-Ojeda et al., 2001); however, import growth across all NCC sectors was close to the economic average of 20.2 percent. In the food and tobacco sectors, imports grew slower than average; they grew fastest in the textiles sector, even though this sector did not experience the highest job loss. Also suggesting a lack of correspondence between imports and economic performance is that both the NCC and PCC sectors exhibited similar import growth. At the same time, export growth was not much below average, with the exception of textile mill and leather products. Furthermore, these NCC sectors contributed 22 percent of U.S. FDI in Mexico, less than the share drawn by the sectors showing PCC characteristics, despite representing a larger share of U.S. output and employment. Hence, the negative U.S. dynamic cannot be attributed to either a large surge in imports or an outflow of investment.

The dynamic becomes even more interesting if one considers such non-traded sectors as construction. Boosted by increasing demand in the U.S. economy and a ready supply of low-wage immigrant labor, the construction sector expanded 4.5 percent per year—slightly exceeding the average growth rate of the U.S. economy, despite falling productivity. The boom in employment (5.4 percent annual growth) may have been caused by a crowding-in of immigrant labor, as blue-collar manufacturing jobs contracted in the above eight sectors (excluding food).

This observation regarding the construction industry raises a serious issue. Construction is a cyclically sensitive sector subject to economic slowdowns during recession, significantly affecting low-skill and immigrant workers in the United States. A recent study by the Pew Hispanic Center,[8] which confirms this expectation, cites unemployment levels that are higher than national levels for operators, manufacturers, and laborers (8.7 percent compared to 5.4 percent for the nation in October 2001), and a higher rate for Latinos (7.9 percent compared to the 5.8 percent national rate in December 2001). At least a portion of this greater vulnerability to recession can be attributed to NCC, enhanced by NAFTA.

Observations on North American cumulative causality

Contrary to the pro-NAFTA perception, many current PCC patterns are not necessarily sustainable in terms of expanding technological innovation and productivity growth throughout North American economies. Nor are PCC sectors expanding fast enough to become a major employment creator for low-wage U.S. and Mexican labor markets. Meanwhile, low-wage manufacturing cannot provide a sustainable basis for growth, given increasing global competition (from which NAFTA has temporarily exempted Mexico and parts of the United States). Mexico must soon address the challenge of finding a comparative advantage position based on innovation and productivity growth (product and process innovation), given its present

[8] For detailed information, visit www.pewtrusts.com/pdf/vf_pew_hispanic_recession.pdf.

assembly role in the industrial integration process. This transition is complicated by the fact that export growth has not been extended to small and medium enterprises (SMEs), often key sources of innovation. Exports remain dominated by large firms dependent on external financing.

Mexico's lack of productivity and income growth and its skewed regional concentration can also be a drag on U.S. productivity and income growth. If China and Southeast Asia exhibit stronger productivity and income growth, Northeast Asian producers will benefit in terms of global competitiveness. Similarly, if countries of Southern, Central, and Eastern Europe enhance their role as complementary producers and trade partners with the EU core, overall European productivity and competitiveness will be enhanced. The United States has gained much from the integration of a select group of PCC sectors across North American economies; however, it must also recognize that its long-term interests are tied to expanding PCC dynamics on a broader basis throughout North America.

The United States must also acknowledge that the current pattern of North American integration clearly exhibits NCC dynamics, although not based on the simplistic race-to-the-bottom, anti-NAFTA metaphor. As in the PCC case, there is evidence of a common cluster of sectors on both sides of the border that share similar characteristics and linked dynamics. These sectors exhibit slower growth in trade, employment, productivity, and wages. They also share immigrant labor markets, linking migrant sending regions in Mexico with immigrant receiving and Latino regions in the United States.

This low-wage, binational labor market also comprises the bulk of NAFTA's employment-displacing effects, including trade realignment and plant relocation. For example, these sectors include Mexican corn production and U.S. garment production. Not only are negative employment effects highest in these sectors; these low-wage, binational labor markets also exhibit the lowest spending levels on education and training. Finding employment to sustain similar low-wage levels after layoffs is difficult, let alone transitioning to higher-skilled export jobs. Negative pressures on these migration-linked labor markets are compounded by a lack of productivity-enhancing capital outlays, exacerbated by low levels of human and social capital investment.

Demographic growth is also highest in low-skilled rural and urban sectors with low social investments on both sides of the border. Adding to negative causality is that this binational labor market has limited access to labor, migration, and political rights, thereby compounding the inability to demand higher wages and increased social investments for cross-border communities.

Mexico has substantial remittances transfers (nearly matching FDI); currently, however, their role is to maintain basic consumption levels among large segments of the poorest communities and perpetuate external dependence on family networks in the poorest U.S. communities. Low-wage migration is thus functionally maintained and reproduced, yielding U.S. consumers of low-wage goods and services a shortsighted subsidy. Over the long run, this approach keeps cross-border communities in poverty and maintains high levels of inequality in both countries. The United States must recognize its long-term stake in leveraging the migration-remittance dynamic toward increased financing of productive savings and investments in immigrant sending and receiving regions.

Political Economy of North American Adjustment Mechanisms

A U.S. economic slowdown would reveal the weakness in the integration pattern that NAFTA enhanced but did not initiate. The U.S. services sector (primarily construction, personal services, and wholesale and retail trade) might not expand rapidly enough to absorb labor from contracting manufacturing subsectors on both sides of the border, along with offering options to Mexican corn farmers. With this safety value threatened, the unsustainability of the current integration and growth pattern may be painfully revealed.

Whether proposed integration is regional or global, the United States faces the same fundamental questions: what integration scenario is in the best interest of U.S. output and income growth? Can the existing pattern of regional integration be improved to maximize positive and minimize negative cross-border externalities?

This analysis points to the need for a policy framework that could promote positive dynamics. Such a framework would harness the potential productivity and income benefits of integration, while addressing the adjustment costs of increased integration.

Destler (1995) views NAFTA side agreements as a dual failure by a "less protected Congress facing unprecedented trade-political pressures generated mainly by unprecedented trade deficits" and an Executive under Clinton, who, according to Destler, "ceded the field to the NAFTA critics." Destler shows, however, that traditional congressional control over the trade agenda in the House Ways and Means Committee began to erode in the mid-1980s, even before the FTA with Canada and the GATT round were launched. Yet, many analysts have pointed out that it was only with NAFTA, especially the side agreements, that "the relationship between trade liberalization and consumer and environmental protection became visible for the first time in the United States" (Vogel 1998). This liberal formulation is thus insufficient to explain why it took the U.S.-Mexico context and NAFTA to produce a large-scale emergence of new issues and actors, despite the relatively smaller effect on the U.S. economy, compared to Canada and GATT.

The new reality of antitrade politics is more complex, especially with respect to Latino and environmental organizations, whose negotiating role cannot be labeled as protectionism, as in the traditional liberal formulation. They did not oppose trade in specific sectors or even trade generally; rather, they sought to adapt the trade regime to more general and collective concerns of an appropriate adjustment process, enforcement of labor rights, and sustainable development.

Understanding the Clinton administration's role in NAFTA side agreements requires moving beyond traditional liberal formulations of State-society interactions in the making of trade policy and an apparently two-level game formulation of interstate negotiations with national domestic actors. Rather than an analysis of Clinton "ceding the field to the critics," the administration's actions must be viewed in the context of more complex bargaining with international and global players and domestic constituencies developing transnational linkages and alliances with their own alternative transnational policy agendas. Finally, experience of the Clinton administration and NAFTA side agreements must include the colateral emergence of transnational societal networks and organizations, as well as transnational multistate institutions, which open up arenas for transnational political contestation and new types of transnational strategic actors.

In the 1990s, the politics of international economic policy formation in the United States, the world's largest trader and investor, became increasingly divisive. Throughout the decade, U.S.-Mexico economic relations became the focal point for discussing global costs and benefits of trade and investment growth, along with the increasingly pivotal role of three related issues not traditionally a part of trade policy debates: 1) environmental sustainability; 2) labor rights and standards; and 3) community economic adjustment and development. When Mexico's top government officials came to Washington in January 1990 for a hastily arranged meeting announcing to the Bush administration that Mexico would take the U.S. up on its often rhetorical offer to negotiate the NAFTA, the prospect that these three issues were important was completely absent (Hinojosa-Ojeda 1991). By the time the final vote on NAFTA was taken by the U.S. House of Representatives in November 1993, an unusually effective strategic coalition of Latino and environmental groups had succeeded in forcing the establishment of a new set of transnational institutions as a part of the "NAFTA Plus" legislative package, which became the determining factor in attaining the slim congressional majority needed to pass the agreement (Destler 1995; Audley 1997; Grayson 1995).

To address the issues of environment, labor rights and standards, and community adjustment and development, this author argues four basic points:

1. The NAFTA and side agreements experience are a significant milestone in the emergence of societal actors into the traditionally closed arena of international economic policymaking, long dominated by a limited set of state agencies and economic interests, with potentially important global implications.

Ironically, successful development of an alternative grassroots approach in the North American context was caused by the highly uneven pattern of development and rapid integration led primarily by societal actors (multinational capital and immigrant labor), combined with substantially uneven access of political rights by poorer communities in the United States, Mexico, and Canada and limited avenues of political redress concerning the unequal consequences of the historical pattern of transnational integration. While the effect of North American integration is highly asymmetrical (it is much less significant for the United States than for Mexico or Canada), various U.S. societal actors took advantage of negotiating a free trade agreement initiated by governing states primarily for geopolitical purposes, highlighting the long-neglected consequences of global integration and uneven development.

2. Within this new context, the Latino community played a unique role in providing a transnational perspective and North American vision that recognized the inevitability and potential benefits of integration, while focusing attention on its costs, which lower-wage Mexicans on both sides of the border had experienced long before NAFTA became a hot political issue. This transnational Latino perspective and emerging identity as a political actor were rooted in a long and harsh experience with the process of economic integration, particularly during the postwar era, when most U.S. groups were uninterested in Mexico. This alternative perspective was adopted in light of and despite evidence that NAFTA would disproportionately affect the Latino community more than any other U.S. constituency (Hinojosa 1992, 1997).

The emerging difference and complementarity of strategies among various Latino, environmental, and other activist groups forced national states to reopen the NAFTA agenda and eventually enter into globally unprecedented agreements, which created unprecedented, publicly oriented transnational institutions for addressing labor, environmental, and community development issues. Other, more staunchly anti-NAFTA environmental and labor groups effectively used NAFTA as a way to discuss globalization's negative effects. While falling short of developing concrete, popularly based legislative proposals, they were critical in establishing a strategic counterweight, which allowed the NAFTA-Plus coalition to provide a politically credible alternative (Audley 1997).

3. Uneven construction and performance of NAFTA-related institutions can be traced back to differences in strategic interactions between societal actors and national states, particularly the underdeveloped capacity of groups to have already constituted a transnational network with well thought out and coordinated visions of the short- and medium-term steps necessary for North American strategic cooperation. It is argued that the fragile nature of the original coalition, which forced the new agenda items onto the states, led to the emboldening of conservative opponents of the NAFTA-Plus consensus and withdrawal of North American states' tentative support to aggressively follow through on consensus approaches and the institutions they represented. It was this failure of State actors to forcefully implement and expand side agreements that led Latino and environmental groups who supported the NAFTA-Plus consensus to withdraw crucial support, contributing to the current stalemate.

4. International economic policy formation is still a fluid political arena that is being reshaped by ongoing strategic interactions between national societal actors, governing states, international institutions, and transnational activist networks in ways that are setting new norms, principles, and terms of the coming debate on future trade agreements.

How the North American integration and development pattern—as well as the scope and efficacy of agreements and institutions—evolves depends on the evolution of transnational societal networking and coordinated action, including strategic choices that will influence the agenda of states and traditional economic actors.

Within this context, the key issue will be the capacity of groups to implement activities in at least four areas:

- A broad popular vision of socially just and environmentally sustainable patterns of economic development, with ongoing integration through trade, investment, and migration.
- A coordinated strategy to move governments and legislatures to build on and expand the elements of a NAFTA-Plus approach for the next round of fast-track authorization and future trade agreements.
- Immediate campaigns to move NAFTA institutions to test their limits of activity through continuous exemplary uses and exhaustion of institutional potential to leverage ongoing labor, environmental, and community development organizing efforts.
- Coordinated programs of transnational network capacity building among a wide range of groups with potentially complementary strategic objectives in North America, the Western Hemisphere, and other areas around the globe.

Concluding Remarks

For North America, the key issue is how to shift from the current pattern of unequal integration toward equitable integration. Fundamental for the U.S. is North America's future ability to expand patterns of high productivity and wage coproduction, while, at the same time, addressing regional dependence on low-wage labor migration, which accounts for cross-border patterns of inequality.

Clearly, the historical trajectory of NAFTA and FTAA differ from the EU's formation and enlargement. In the Western Hemisphere, the process is based more on societal institutional constructions, with lagging State-centered initiatives. In the resulting dynamic, states anticipate social movements and act in a new form of social spillover effect. Europe is already considering how to open State-centered processes directly to societal participation, not only through established state-to-state EU mechanisms. Such participation is crucial for adjustment investments and the integration process to succeed.

The major policy and political challenge is how to complement the productivity of trade integration with cross-border social investments. Short-term effects on jobs and bilateral trade balances are irrelevant to the countries involved. The key questions are how to enhance cross-border complementarities that can lead to mutual productivity growth, specialization, and trade, which, in turn, can lead to income growth and a better quality of life across rich and poor countries alike. Trade flows and their effects must be assessed as one dimension of a complex set of economic relationships, including investment and capital flows, labor flows, and social and institutional strengths and constraints.

Identifying sectors that exhibit PCC and NCC across countries is an important first step toward detailed sectoral studies that probe the socioeconomic and institutional causes of these dynamics.[9] A next step is to design macroeconomic models that reflect these added dimensions of interdependence and can better anticipate the results of economic integration between countries at vastly varying levels of development. The final challenge will be to design economic and social policies that harness gains from economic integration, while providing safety nets and social infrastructure spending to boost wages and productivity levels in the region. Since an economic slowdown would threaten a substantial portion of the post-NAFTA period's income gains, particularly for the transnational migrant class, design and implementation of such policies should be a priority.

Finally, this effort requires broadening the participation of a wide range of economic actors into an emerging integrated economy. This process requires the support of SMEs, together with new private and public investment in low-wage labor markets and marginalized regions. In this way, integration can lead to expanded productivity, income, and consumption. Concerted institutional changes must be encouraged to support new accords on cross-border productivity, income distribution, and social investment. All are needed to sustain integration with both political and economic convergence.

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Chapter 4

Compensating Asymmetries in Regional Integration Agreements: Lessons from Mercosur

*Roberto Bouzas**

The case for designing and implementing policies to address asymmetries and distributive issues in regional integration agreements (RIAs) has both an empirical and theoretical basis. First, all regions and countries will not necessarily benefit from increased market integration (Viner 1950; Johnson 1962; Vanek 1965; Kemp 1969). Even if RIAs raise aggregate members' welfare, the distribution of costs and benefits will likely be uneven across countries and regions. This well-known proposition of the theory of trade discrimination is true either in a partial or general equilibrium framework, and is confirmed by recent insights of the new economic geography school (Krugman and Venables 1990; Krugman 1991). One major conclusion of these analyses is that, unless redistributive policies are put in place, RIAs are unlikely to be sustainable on a voluntary basis.

Similar conclusions can be reached using a dynamic framework. When a group of countries integrates its markets, specific dynamic reasons explain why regional disparities may persist, or even increase, over long periods of time. For these same reasons, no compelling case can be made for convergence in either output growth rates or per-capita income levels. In fact, theoretical models of cumulative causation and endogenous growth provide accounts of the persistence of disparate economic performances

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over long periods.[1] As a result, polarization may deepen preexisting regional disparities, rendering RIAs politically or economically unsustainable and strengthening the case for public policy intervention.

That asymmetries provide a case for public policy interventions must be subjected to public choice qualifications, including a decision on assigning policy responsibilities (Robson 1998). Regional policies can be decided and enforced either at the national or community level. Left in the hands of member states, regional policy is more likely to reflect member states' preferences. National governments, positioned closer to the source of problems, may be better informed than distant community authorities and thus more efficient in deciding and implementing corrective measures.

Conversely, if national authorities have exclusive responsibility for regional policies, other problems may emerge. First, national policies may distort competition and thus prove inconsistent with increased market integration. Second, since funding resources and institutional capacities will likely be unevenly distributed across nations, poorer members will be at a disadvantage. Third, coordination and centralization may bring about gains when there are regional cross-border spillovers. In this context, community policies can help to prevent regional aids and domestic policies from distorting competition and reduce community-wide disparities.[2]

Both structural and policy asymmetries are relevant to RIAs. While structural asymmetries usually demand implementation of policies of agreed-on discrimination (i.e., enforcement of a preferential treatment), those created by public sector policies or regulatory interventions are likely to create pressures for deeper policy coordination or even harmonization. Structural asymmetries are determined by factors that shape the economies' ability to benefit from increased market integration: economic size, factor endowments, per-capita income, flexibility of goods and factors markets, and level of economic development. These attributes change slowly

[1] Original contributions on cumulative causation models are those of Myrdal (1957), Hirschman (1958), and Kaldor (1970). For classical works on endogenous growth theory, see Romer (1986) and Lucas (1988).
[2] The precise assigning of policy responsibilities also depends on the characteristics of member states, as well as the degree of economic integration they aim to achieve or have attained.

over time. If they constrain an RIA member's ability to benefit from increased market integration, the community may choose to adopt agreed-on policies of discrimination.

Policy asymmetries, by contrast, are rooted in preferences, choices, and institutional characteristics. Policy asymmetries may produce allocation and macroeconomic cross-border spillovers. These, in turn, may lead to efficiency losses and undermine market integration. Policy asymmetries may appear easier to tackle than structural asymmetries. However, the experience of Mercosur and other RIAs disproves this assumption. Harmonization of policy asymmetries demands an intrinsically unstable compromise between legitimate differences in national preferences and the need for a level playing field. Policy harmonization also demands institutional capacities and resignation of national policy autonomy, which may be beyond the scope of the countries involved.

Mercosur Structural Asymmetries: An Overview

Mercosur's spatial dimensions, effects of structural asymmetries, and regional effects have been poorly researched. These gaps remain unfilled, despite preliminary evidence that Mercosur has contributed to deepening economic concentration (Calfat and Flores 2001).[3] Although most available studies emphasize these issues' relevance, they provide little empirical evidence. For example, using a general equilibrium model, Terra and Vaillant (1998) have shown that the path and content of integration policies can soften or deepen regional disparities. Their simulations, based on an economic geography "center-periphery" model, show that Mercosur's regional disparities can be strengthened by incomplete liberalization. By contrast, deeper liberalization (including the free movement of production factors) and implementation of infrastructure policies can reduce regional disparities, contributing to a more even distribution of output and population across regions.

[3] The main reasons are lack of adequate statistical information and that Mercosur is relatively young.

Other studies on Mercosur have similarly emphasized the potential for agglomeration effects and an uneven distribution of benefits. In the case of Brazil, Porto and Canuto (2002) and Haddad, Domíngues, and Petrobelli (2002) conclude that the South and Southeast regions are best positioned to gain from regional economic integration, owing to their proximity to larger markets, diversified productive structures, and reasonable availability of transport infrastructure. Masi and Bittencourt (2001) argue that smaller economies have had less opportunity to benefit. Similarly, Quijano (2002) argues that Uruguay's gains from increased market integration have been small or nonexistent. Other findings reinforce this conclusion (e.g., the number of export firms have remained stable, exports remain concentrated in a few large firms, and there is little evidence of an export-learning process). Borda and Masi (2002) reached similar conclusions regarding Paraguay.

Indeed, Mercosur's cross-country, structural asymmetries are significant. In 2001, Brazil accounted for nearly 75 percent of regional GDP (at purchasing power parity [PPP] exchange rates), Argentina for less than 25 percent, and the smaller economies (Paraguay and Uruguay) for about 3 percent (table 4–1). Population asymmetries are even more notable: Nearly 80 percent of Mercosur's total population lives in Brazil, 17 percent in Argentina, and only 4 percent in Paraguay and Uruguay. In 2001, the gap between Mercosur countries with the highest (Argentina) and lowest (Paraguay) per-capita output (in terms of PPP) was 3.4 times. This disparity compares unfavorably with the European Union (EU), where, in the mid-1990s, the gap between countries with the highest (Luxembourg) and lowest (Greece) per-capita output was only 2.5.[4]

Mercosur member states also show significant asymmetries in sector composition of output. In 2001, agriculture accounted for 6 percent of GDP in Argentina, 9.6 percent in Brazil, 10.2 percent in Uruguay, and 29 percent in Paraguay. Industry represented more than 33 percent of total GDP in Brazil, 28 percent in Argentina, and about 25 percent in Uruguay and Paraguay. These differences in production structure reflect, in part, the

[4] In the mid-1980s, the ratio between the highest (Luxembourg) and lowest (Portugal) was 2.4.

Table 4-1. Mercosur: Cross-country Structural Asymmetries, by Selected Indicators

Indicator (%), year	Country				Mercosur
	Argentina	Brazil	Paraguay	Uruguay	
Share in regional GDP (PPP),[a] 2001	24.8	72.5	1.1	1.6	100.0
Share of regional population, 2001	16.9	79.0	2.6	1.5	100.0
GDP per head (PPP)[a] (Mercosur = 100), 2001	152.8	95.7	45.3	106.2	100.0
GDP-distribution by sector 2001,					
Agriculture	6.0	9.6	29.0	10.2	8.6
Industry	28.1	35.2	25.6	25.1	32.5
Export-sector distribution, 2001					
Primary products	35.4	18.4	60.0	14.9	23.9
Industrial products	62.8	79.5	40.0	84.6	74.1
Traditional industries	24.7	29.4	31.9	66.2	28.9
Unemployment rate, 2002	21.4	7.1	18.3	15.9	9.9 [b]
Urban population, 2000	88.0	81.0	56.0	92.0	81.8 [b]
Infant mortality rate (per 1000 live births), 2000	17.0	32.0	23.0	14.0	28.9 [b]
Illiteracy rate, adult males, 2000	3.0	15.0	6.0	3.0	12.6 [b]
Life expectancy at birth years), 2000	74.0	68.0	70.0	74.0	69.2 [b]
Foreign trade coefficient (X + M/2)/GDP, 2001	9.8	8.4	35.1	37.3	9.5
Exports to Mercosur as share of total exports, 2001	28.0	10.9	52.4	54.8	18.2
Exports to Mercosur as share of GDP, 2000	2.9	1.3	7.2	5.1	2.0

[a] PPP = Purchasing power parity.
[b] Population weighted regional average.
Source: Author's calculations, based on data from CEI, ECLAC, EIU, IBGE, INDEC, IPEA, and World Bank.

sector composition of exports. In 2001, primary products accounted for 60 percent of Paraguayan exports and more than 33 percent of Argentine exports, while they represented only 18.4 percent and 14.9 percent of Brazilian and Uruguayan exports, respectively. The share of industrial exports was highest in Uruguay (84.6 percent)—traditional industries, including natural resources processing, accounted for more than 66 percent—and Brazil (79.5 percent). These differences are also apparent in the commodity composition of intra-regional trade, which depicts a clear North-South pattern (Brazil exports manufactured goods and imports foodstuffs and unprocessed raw materials from its regional partners).[5]

Disparate levels of regional interdependence among Mercosur member states heighten the implications of these asymmetries. In 2001, for example, Paraguay and Uruguay sold more than 50 percent of their total exports to their regional neighbors, compared to only 28 percent for Argentina and less than 11 percent for Brazil.[6] Since the Mercosur economies also display varying degrees of openness to international trade (partly as a result of size), the ratio of intra-regional exports to GDP ranged between 1.3 percent for Brazil and 7.2 percent for Paraguay.[7]

Cross-regional asymmetries are equally marked. Argentina's Pampean region and Brazil's South and Southeast account for more than 65 percent of Mercosur's total population and nearly 75 percent of regional output (table 4–2). These three regions, along with Argentina's Cuyo region and Uruguay, comprise the highest per-capita output districts, all of them above the Mercosur average.[8] Cross-regional asymmetries are clearly shown by the large gap between Mercosur's best- and worst-off regions. In terms of per-capita output, the best-off region (Patagonia) has an index nearly five times that of the worst-off region (Brazil's Northeast) (table 4–3). This ratio is higher than that of the EU, where important redistributive policies have been put in place.[9] Mercosur's best-off region, Patagonia,

[5] Intra-regional commerce, particularly between Argentina and Brazil, also shows a higher index of intra-industry trade than foreign trade with the rest of the world.

[6] After the macroeconomic crisis of 1998, trade interdependence declined dramatically. As a share of total trade, intra-regional trade fell from a record peak of 25 percent in 1998 to just over 18 percent in 2001.

[7] Over the past decade, the average ratio of foreign trade to GDP for Argentina and Brazil was below 10 percent, compared to more than 33 percent for Paraguay and Uruguay.

[8] Paraguay and Uruguay are each considered regions.

[9] In the mid-1990s, the per-capita output of the best-off EU region was 4.5 times that of the worst-off region. This gap is similar when measured in terms of unemployment rates. However, in comparing

Table 4-2. Mercosur: Cross-regional Structural Asymmetries (%), by Selected Indicators

Country or region	Share in regional population, 2000	Share in regional GDP (PPP),[a] 2000	GDP per head (PPP)[a] Mercosur = 100, 2000	Unemployment rate, 2002
Argentina	**16.7**	**25.9**	**155.4**	**21.4**
Cuyo	1.2	1.5	128.5	14.2
Northeast	1.5	1.1	71.5	17.1
Northwest	2.1	1.6	79.0	21.3
Pampean	11.1	20.0	180.4	23.4
Patagonia	0.8	1.6	205.8	17.1
Brazil	**79.2**	**71.4**	**90.2**	**7.1**
North	6.0	3.3	54.4	na
Northeast	22.3	9.3	42.0	7.2
South	11.7	12.5	107.1	5.2
Southeast	33.7	41.3	122.2	7.1
West-central	5.4	5.0	91.4	na
Paraguay	**2.6**	**1.1**	**42.2**	**18.6**
Uruguay	**1.6**	**1.6**	**101.1**	**15.6**
Mercosur	**100.0**	**100.0**	**100.0**	**9.9**[b]

[a] PPP = Purchasing power parity.
[b] Population weighted regional average.
na = not available.
Source: Author's calculations, based on data from DGEEyC, EIU, IBGE, INDEC, and INE.

accounts for less than 1 percent of the total population. Together, Patagonia and the Pampean region—its per-capita output is slightly less than that of Patagonia—account for 12 percent of Mercosur's total population. By contrast, Brazil's Northeast, the worst-off region, accounts for nearly 25 percent of Mercosur inhabitants.

Cross-regional data also show that few regions account for the bulk of intra-regional foreign trade. The Pampean region and Brazil's South and Southeast account for more than 70 percent of total intra-Mercosur ex-

cross-national and cross-regional unemployment rates, estimates are subject to significant methodological differences.

Table 4-3. Mercosur: Gaps between Best- and Worst-off Regions

Region type or ratio	GDP per head (PPP)[2] Mercosur = 100, 2000	Unemployment rate (%), 2002
Best-off	205.5	5.2
Worst-off	42.0	23.4
Best-off/Worst-off[1]	4.9	4.5
Three best-off	171.6	6.5
Three worst-off	46.2	21.1
Three best-off/Three worst-off[1]	3.7	3.2
Standard deviation	49.2	5.9

[1] For the unemployment rate, the ratios are inverted.
[2] PPP = Purchasing power parity.
Source: Author's calculations, based on data from DGEEyC, EIU, IBGE, INDEC, and INE.

Table 4–4. Mercosur: Regions and Foreign Trade, 2000

Country or region	Share in total intra-Mercosur exports (%)	Relative concentration of exports in Mercosur Index = 100*	Share of Mercosur in total exports of the region (%)	Intra-Mercosur export coefficients (% GDP)
Argentina	**48.3**	**na**	**32.3**	**3.1**
Cuyo	2.6	110.4	35.3	2.8
Northeast	0.8	94.7	30.0	1.3
Northwest	2.4	83.3	27.0	2.5
Pampean	33.7	105.0	33.9	2.8
Patagonia	7.5	95.1	30.7	7.5
Unclassified	1.3	na	19.3	na
Brazil	**42.9**	**na**	**14.0**	**1.3**
North	2.1	80.0	11.1	1.3
Northeast	2.7	84.9	12.0	0.6
South	11.3	112.9	15.8	1.9
Southeast	25.9	106.9	15.0	1.3
West-central	0.4	27.3	4.0	0.2
Unclassified	0.5	na	5.3	na
Paraguay	**3.1**	**na**	**63.6**	**7.2**
Uruguay	**5.7**	**na**	**44.6**	**5.1**
Mercosur	**100.0**	**na**	**20.9**	**2.0**

* The index was calculated as the ratio between the share of exports to Mercosur in the region's total exports and the share of exports to Mercosur in each country's total exports.
na = not applicable.
Source: Author's calculations, based on data from Alice Web-MDIC, CEPAL, IBGE y Base SAM, INDEC, and Ministry of the Economy.

ports (table 4–4). These three regions, along with Argentina's Cuyo region, have the highest relative-export-concentration ratios.[10] However, intra-Mercosur export coefficients (as measured by exports to Mercosur as a share of GDP) reveal a different picture. According to this indicator, Patagonia is the region most closely linked to Mercosur. In 2000, exports to Mercosur accounted for 7.5 percent of regional output, an even higher ratio than those of Paraguay and Uruguay. In Brazil, the highest intra-Mercosur export coefficient was that of the South (1.9 percent).

Despite the high concentration of foreign trade in a few regions and the heterogeneous importance of Mercosur as an export outlet for each, certain regions that experienced the fastest rate of export growth and increase in intra-Mercosur export coefficients were also the least engaged in intra-regional trade. Intra-regional exports increased the fastest for Argentina's Northwest and Patagonia and Brazil's North, Northeast, and West-central regions (table 4–5). Intra-Mercosur export coefficients also increased the fastest in Argentina's Northwest and Patagonia and Brazil's North. Except for Patagonia, all of these regions were only marginally engaged in Mercosur.

Structural Asymmetries and Agreed-on Discrimination in Mercosur

Since its inception, and despite these significant asymmetries, Mercosur has failed to adopt policies to reduce cross-regional and cross-national disparities. Moreover, the Treaty of Asunción assigned no formal role to the principle of special and differential treatment. A cornerstone of both the Latin American Free Trade Association (LAFTA) and the Latin American Integration Association (LAIA), this principle became an integral part of multilateral trading rules after the General Agreement on Tariffs and Trade

[10] The relative-export-concentration ratio measures the share of exports to Mercosur in total regional exports, compared to the national average. When measured in absolute terms, the share of intra-regional exports in total exports is higher in the smaller economies of Paraguay and Uruguay, considered here as separate regions.

Table 4–5. Mercosur: Regions and Percent Foreign Trade Growth, 1993–2000

Country or region	Intra-Mercosur exports	Intra-Mercosur export coefficients*
Argentina	**136.4**	**93.7**
Cuyo	91.1	64.7
Northeast	69.5	62.5
Northwest	228.9	177.8
Pampean	133.3	100.0
Patagonia	210.2	150.0
Unclassified	30.1	na
Brazil	**43.2**	**0.0**
North	392.5	333.3
Northeast	105.3	50.0
South	61.6	18.7
Southeast	24.2	–13.3
West-central	92.3	0.0
Unclassified	300.6	na
Paraguay	**46.2**	**71.4**
Uruguay	**92.6**	**0.0**
Mercosur	**79.2**	**33.3**

* Calculated as a percentage of regional GDP.
na = not applicable.
Source: Author's calculations, based on data from AliceWeb-MDIC, CEPAL, IBGE y Base SAM, INDEC, and Ministry of the Economy.

(GATT) contracting parties adopted Part IV;[11] however, the Treaty of Asunción (Article 2) explicitly states that "the common market will be founded on reciprocal rights and obligations on the part of all member states."

That Mercosur did not formally adopt the principle of special and differential treatment resulted, in part, from the architecture of the agreement having been a byproduct of a bilateral agreement between Argentina and Brazil.[12] The governments of Paraguay and Uruguay were conscious

[11] In the 1980s, the principle of special and differential treatment was increasingly challenged and was sharply circumscribed during the Uruguay Round of multilateral trade negotiations.
[12] In 1988, the Argentine and Brazilian governments signed a bilateral agreement (*Tratado de Integración, Cooperación y Desarrollo*), which was ratified by both countries' legislatures in 1989. Article 2 of the agreement committed member states to implement all agreements "according to the

of this political fact but were nonetheless eager to participate; thus, neither country formally requested preferential treatment.[13] Instead, each emphasized more flexible conditions (particularly longer terms) under which to achieve full intra-regional trade liberalization. Accordingly, the Asunción Treaty (Article 6) states that "member states acknowledge designated differences in the pace (of trade liberalization) in the case of Paraguay and Uruguay."

The Trade Liberalization Program included specific differential treatments, as follows:[14]

- one additional year for Paraguay and Uruguay to complete the Program,[15]
- more tariff items in smaller countries' lists of exceptions to intra-regional trade liberalization,[16] and
- more flexible rules of origin for Paraguay (50 percent instead of 60 percent of regional value added).

At the sector level, sugar and motor vehicle industries were temporarily exempted from intra-regional liberalization and, after 1994, from common trade disciplines. Exclusion of sugar from Mercosur's general disciplines stemmed from large differences in productivity, the asymmetric structure of public sector aids prevalent in that sector (particularly the implicit subsidies granted by Brazil's pro-alcohol program), and the strong influence of sugarcane growers and refineries in Argentina and Uruguay.

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principles of gradualism, flexibility, equilibrium, and symmetry." In July 1990, the two governments signed the Buenos Aires Act, thereby enforcing the Trade Liberalization Program based on linear, automatic, and across-the-board tariff cuts.

[13] In the case of Uruguay, incentives to join Mercosur were heightened by the expected erosion of existing bilateral preferences (PEC with Brazil and CAUCE with Argentina) (Abreu 2000).

[14] Bilateral preferential agreements between larger and smaller economies, which preserved the special and differential treatment principle of LAIA, remained in force until taken over by Mercosur commitments.

[15] Paraguay and Uruguay were given until the end of 1995 to eliminate all exemptions to intra-regional free trade.

[16] Uruguay had 960 tariff items and Paraguay had 439 items, while Argentina and Brazil had 394 and 324, respectively. The number of tariff items in national exemption lists was to be cut back 20 percent each year. Argentina and Brazil cut the first 20 percent in December 1990, while Paraguay and Uruguay did so one year later.

Motor vehicles trade, also exempted from Mercosur's general disciplines, was governed by bilateral agreements. Argentina and Brazil adopted a trade-administered program based on tariff-free quotas and balanced trade requirements. Uruguay, in turn, maintained its bilateral preferential agreements with Argentina and Brazil, which granted Uruguay tariff-free export quotas; these were decisive in maintaining that country's small-assembly capacity focused on supplying neighboring markets. The Argentine-Brazilian agreement (combined with the Argentine motor vehicles sector program) offered a stimulus for locating assemblers and component makers in Argentina, particularly prior to devaluation of the Real in January 1999 (Bastos Tigre et al. 1999). While the exceptions of sugar and motor vehicles were temporary, they were regularly extended for more than a decade.

Designated differences in treatment were also acknowledged at the end of the Trade Liberalization Program, when member states enforced the Customs Union Final Adaptation Regime (*Régimen de Adecuación Final a la Unión Aduanera*) and implemented the Common External Tariff (CET).[17] Differential treatment acknowledged under the Customs Union Regime was 1) more temporary exceptions to intra-regional free trade, especially for Paraguay and Uruguay (Uruguay had 958 tariff items and Paraguay had 432, compared to 212 for Argentina and 29 for Brazil); and 2) an additional year (December 1999 instead of December 1998) for Paraguay and Uruguay to conclude the Customs Union Regime and enforce 100 percent preferences over Most Favored Nation (MFN) tariff rates. Differential treatment acknowledged under the CET scheme included 1) more temporary exceptions (399 instead of 300 tariff items); 2) longer terms (2006 instead of 2001) for Paraguay to eliminate all national exceptions and converge in capital goods (900 tariff items); and 3) longer terms (2006 instead of 2001) for Paraguay and Uruguay to converge in computer and telecommunication products (220 tariff items).

[17] Extension of national admission programs until 2006 can also be regarded as a concession made to the smaller economies, particularly to Uruguay, which had verbally demanded the program's continuation; however, its benefits were exploited by all member states.

Mercosur Policy Asymmetries: An Overview

Policy asymmetries—especially when their cross-border spillover effect is negative—usually demand a certain degree of policy coordination or harmonization. In the case of Mercosur, negative allocation and macroeconomic spillovers have created significant pressure to increase protection through nontariff barriers and other ad hoc measures, thereby increasing market fragmentation and reversing the regional integration process.

Allocation cross-border spillovers

Cross-border spillovers occur when the effects of allocating public goods through national budgetary or regulatory actions extend beyond the borders of the implementing state. Negative cross-border spillovers produce efficiency losses, which may be counteracted by regional policies aimed at internalizing the prevailing externality. Policy areas with negative cross-border spillovers include pollution and other environmental issues and state aid and tax competition.[18] Macroeconomic spillovers also arise from increased interdependence of national economies produced by the freer movement of goods, services, and production factors. These effects can provide a rationale for coordinating macroeconomic policies, which may become more compelling—eventually leading to closer policy harmonization—as interdependence deepens.

Since its inception, Mercosur has ineffectively dealt with the cross-border spillover issue. Progress was slow even in identifying which practices should potentially be subject to coordination or harmonization. Not until 2001 was a preliminary inventory of national and subnational public-sector incentives drafted. The inventory was expected to list all the incen-

[18] Positive cross-border spillovers also occur in such areas as transport infrastructure. Regional policies may also help to fully exploit their benefits. Mercosur has taken initiatives to coordinate infrastructure development in the areas of transportation and energy transmission. Similarly, in policy areas where indivisibilities are large (e.g., research and development), regional policies can have positive effects. Mercosur has made virtually no progress in these areas (Laplane, Sarti, Sabbatini, and Britto 2001).

tives in force and to briefly describe their content, legal base, authority of application, and eligibility criteria. Although the inventory did not assess the effects of existing incentives or measure their relative size, its results have not been made public.

Throughout the 1990s, Mercosur member countries exhibited significant asymmetries in the extent and type of state aids used. In Brazil, the main instruments now in use are geared at stimulating exports and providing investment finance.[19] Brazil also enforces a regional promotion scheme in the Manaus Free Zone (*Zona Franca de Manaus*) and two sector regimes (computer and motor vehicles) with various tax benefits. In the late 1990s, local government tax subsidies increased significantly; this form of public sector aid has partly compensated for the reduction in federal funds produced by the Central Government's fiscal adjustment. Since local governments' contribution to total tax collection is significantly higher in Brazil than in other Mercosur countries, there is more room for activist policies of subnational administrations.[20] Subnational government incentives have given rise to tax competition among local jurisdictions, which have had negative cross-border effects.[21]

Throughout most of the 1990s, Argentina's public sector aids targeted exports and activities focused on foreign markets. In contrast to Brazil, Argentine production and investment incentives generally played a minor role, with the exceptions of special regimes for the mining, forestry, and

[19] Excluding the Brazilian Development Bank (BNDES)/export-import (Exim) financing, in the late 1990s, export incentives accounted for nearly 20 percent of total public sector incentives. The most important were exemption from the Government Employee Savings Program (PIS/PASEP) and Social Contribution Tax (COFINS), the presumed credit against the Tax on Industrialized Products (IPI), and Proex-interest rate equalization. Financial investment aids granted by the BNDES and Constitutional and Regional Investment Funds (including export finance granted by BNDES/Exim) account for nearly 9 percent of total public sector subsidies.

[20] Both Argentina and Brazil are federal states; however, in the late 1990s, Brazil's local governments collected taxes amounting to nearly 10 percent of GDP, compared to Argentina's 4 percent. Brazil's Tax on the Movement of Goods (ICMS) is a type of value-added tax that state governments levy; much of Brazil's interstate tax competition has used differential ICMS tax rates.

[21] Although subnational government aids are only one factor and regional fundamentals play a central role in explaining Brazil's investment patterns, evidence suggests that their effect was not negligible (Volpe Martincus 2002).

motor vehicles industries.[22] Argentina also enforces two national regimes with regional effects: 1) Tierra del Fuego special-customs area; and 2) tax rebate program on exports shipped from Patagonian ports. Since Argentina is a federal state, subnational governments have considerable formal leeway to provide the private sector tax incentives. For example, the major industrial districts of Buenos Aires, Córdoba, and Mendoza have offered tax exemptions and dedicated infrastructure; however, local governments' fiscal constraints have severely limited their ability to grant significant amounts of direct aid.

Uruguay and Paraguay also enforce several incentive regimes. In Uruguay, the two main ones are: 1) Investment Promotion Law (a horizontal program that authorizes the executive to grant fiscal incentives to targeted investments; these may also benefit from local real estate tax exemptions); and 2) Forestry Promotion Law (program that grants fiscal benefits to forestry investments). With regard to export incentives, the Central Bank offers credit and a 9 percent tax rebate on wool textiles. In Paraguay, the two main instruments are: 1) tax exemptions on new investments (including tariffs on extra-zone imports of capital goods, inputs, and raw materials); and 2) Assembly and Free Zone Law (*Ley de Maquila y Zonas Francas*) (special tax regimes for export-oriented investment and production facilities). Paraguay also enforces a forestry reimbursement tax scheme.

Reimbursement of indirect taxes on exports has been a source of Mercosur disputes. All cascading indirect taxes make it difficult to ensure that indirect tax incidence is neutral (i.e., that indirect taxes are paid in the consuming, not the producing, country).[23] When governments try to com-

[22] In early 2001, Argentina's government enforced sector competitiveness plans granting a wide array of discretionary and non-transparent tax benefits. Sector competitiveness plans are scheduled for phase-out in 2003.

[23] In Argentina, the IIB is a state and local government-levied, general consumption tax with cascading effects. In Brazil, the Services Tax (ISS) is levied on all services (except for transportation and communications, which are subject to the ICMS) and administered by municipal governments. Since the ISS is applied separately from the ICMS, there are cascading effects between the two. Brazil also applies two social security contributions (COFINS and PIS/PASEP), whose effects are equivalent to those of a general consumption tax (the tax base is total business sales). Cascading effects arise when taxes charged at one production stage become part of the base on which taxes are levied at the next stage.

pensate for the effects of cascading indirect taxes through tax rebates on exports, calculating the exact incidence of the tax—a virtually impossible task—becomes a source of attrition. The most frequently used method has been to set fixed tax rebates that may bear little relationship to real tax incidence. The Argentine government enforces several categories of indirect tax rebates, depending on the type of export product. In Brazil, although exports are exempted from the COFINS and PIS/PASEP, they are affected by the tax accumulated in earlier stages of production. To compensate, the Brazilian government offers a presumed tax credit on IPI tax liabilities.

Macroeconomic cross-border spillovers

Although regional economic interdependence in Mercosur is still low, it rose significantly during the 1990s. Aggregate demand interdependence, as measured by the contribution of exports to the region to regional GDP, is nearly 2 percent, significantly below the 9 percent level reached by the EU in the early 1970s. This is the result of a relatively low share of intra-regional trade in total foreign trade and economies relatively more closed to foreign trade (as measured by the foreign trade coefficient). In addition, aggregate demand interdependence in Mercosur is asymmetric: there are significant disparities between the largest economy, Brazil, and the others, including Argentina.

Foreign direct investment (FDI) interdependence is also modest. In fact, during the FDI boom of the 1990s, all member states were net recipients of funds from the rest of the world. According to official estimates, only 2 percent of total FDI inflows originated in the region (Paraguay and Uruguay had a higher share). Financial markets are also poorly integrated regionwide, as all member states are capital-importing countries. One partial exception is Uruguay, which has played the role of an offshore banking center for Argentina. The strong correlation in the performance of Argentine and Brazilian Emerging Market Bond Index (EMBI) spreads until 1998 suggests that shocks were external to both countries and correlated. Labor-market integration is even more limited, as the free circulation of labor remains only a programmatic statement.

The empirical evidence about Mercosur's depth of economic interdependence and recent changes confirms what may be expected from these structural features. Carrera, Levy-Yeyati, and Sturzenegger (2000) found that, prior to stabilization of the early 1990s, the business cycles of Argentina and Brazil were not synchronized. However, after macroeconomic stabilization of the early 1990s, their synchrony increased markedly. Although aggregate trade interdependence has been low, regional trade flows have been sensitive to domestic macroeconomic conditions, and have made cross-border spillovers relevant. Macroeconomic impulses transmitted through trade flows have been significant in the case of smaller economies and not negligible in the case of Brazil. In most economic studies, one consistent feature is the asymmetry in the effects of conditions prevalent in the exporting and importing countries on trade flows: the latter have consistently been more significant than the former.[24] This finding was confirmed by the behavior of Argentine-Brazilian trade flows after devaluation of the Real in January 1999: Although exports from Argentina to Brazil decreased, exports from Brazil to Argentina decreased more so. Consequently, by the end of 2002, Argentina still enjoyed a trade surplus with Brazil (although the value of trade was lower than before the crisis).

The first significant spillover episode occurred at the beginning of the 1990s when Argentina's aggregate demand recovered quickly and the peso appreciated considerably. The result was larger Argentine trade deficits, both bilateral and global, which stimulated ad hoc trade measures and managed trade initiatives.[25]

The second episode occurred in the mid-1990s, when the strong economic recovery that followed Brazil's Real Plan (*Plano Real*), together with its currency appreciation, caused Argentine exports to surge and helped

[24] Heymann and Navajas (1998) estimate that the aggregate effect (considering the lags) of a 1 percent increase in Brazil's real GDP was a 2.5 percent expansion in Argentine exports to that country. The long-term elasticity of Argentine exports to changes in the real exchange rate of the Brazilian currency was estimated at about 0.9 percent. This figure confirms an elastic response of exports to changes in activity levels in the importing country.

[25] The Argentine government increased export tax rebates and applied new import levies. The Brazilian government decided to import wheat and oil from Argentina to restore the bilateral trade balance. The management of these spillover effects was made easier by the abundance of external financing.

that country move beyond the effects of the "tequila crisis."[26] Although size asymmetries meant relatively more modest effects of regional exports on Brazil's economy, that country's worsening trade balance led its government to enforce protectionist measures, which frequently did not exempt Mercosur partners.

The third and politically most troubling example of stabilization spillover was the exchange rate crisis of the late 1990s. Although Argentina had entered into a depression before the Brazilian crisis caused by negative external shocks (i.e., East Asian crisis, nominal appreciation of the U.S. dollar, falling trade terms, and international credit rationing), devaluation of the Real in January 1999 severely worsened the external environment. The outcome was again a proliferation of ad hoc trade measures, including the application of antidumping duties and imposition of new nontariff barriers or voluntary export restraint agreements. The tensions that followed put into question even the feasibility and desirability of implementing a common external tariff and customs union.

Mercosur's increased economic interdependence raised the relevance of macroeconomic spillovers (including contagion effects) considerably. Although interdependence remains low and incentives to coordinate asymmetrically distributed, there is sufficient evidence that negative stabilization spillovers have created strong tensions in the process of regional economic integration. These tensions not only hinder integration; they reverse the process.

Mercosur: Policy Asymmetries and Coordination/Harmonization

Although the Asunción Treaty (Article 1) explicitly recognized the potentially troubling role of policy asymmetries, it set forth a programmatic principle rather than specific mechanisms or policies for coping with these

[26] In 1995 and 1996, Argentine exports to Brazil increased 49 and 21 percent, respectively (doubling the growth rates of exports to the rest of the world). Uruguay also benefited from faster growth in Brazil and appreciation of the Real.

types of asymmetries. In 1992, the issue was taken up by the Leñas Agenda (*Agenda de las Leñas)*, when member states reiterated that harmonization of national macroeconomic and microeconomic policies was a key target and set a schedule to achieve it, revealing a concern to reduce asymmetries in national policies and instruments. In 1993, the document *Consolidación de una Unión Aduanera y Transición para el Mercado Común* formally recognized that the ambitious targets set in the Leñas Agenda would not be met, opting instead to promote trade convergence and other policy instruments required to implement the Customs Union. However, proposals to harmonize all trade policy instruments simultaneously (e.g., tariffs, export incentives, rules of origin for products excluded from the CET, free trade zones, nontariff restrictions) and even certain government subsidies were dismissed; instead, the emphasis was placed on CET negotiation and enforcement.[27]

After 1995, the lack of progress in dealing with allocation and macroeconomic spillovers led to increased market fragmentation. As preferences over MFN tariff rates reached 100 percent, the use of NTBs became increasingly more frequent. The enforcement of common trade policies has made only partial progress. This became more evident as the transition periods to fully implement the CET came to an end.

Administering allocation spillovers

Mercosur member states have progressed little in implementing disciplines to deal with state aids and incentives that distort intra-regional competition. They have also failed to design collective instruments to level the playing field (Laplane, Sarti, Sabbatini, and Britto 2001). Wide differences in tax and incentives structures can distort trade flows and investment location, leading to significant pressures for increased protection and market fragmentation. In Mercosur, the first priority was given to discipline in-

[27] Proposals to implement structural adjustment programs or extend the safeguards regime after the transition period were similarly discarded. Adoption of the Final Adaptation Regime (*Régimen de Adecuación Final*) in 1995 proved an imperfect substitute.

centives on intra-regional exports. Common Market Council (CMC) Decision 10/94 determined that 1) tax incentives should not be used for intra-regional exports (except under special circumstances); 2) export incentives should be GATT-compatible; 3) the concession or creation of a new incentive (or maintenance of existing ones) should be subject to consultations; and 4) member states should refrain from using multiple exchange rate regimes.[28] To enforce these commitments appropriately, CMC Decision 10/94 requested that member states implement adequate verification and auditing mechanisms, particularly those concerning indirect tax rebates. However, no precise instructions were given with regard to the content of these procedures. The lack of practical mechanisms was a major drawback.

CMC Decision 10/94 did not explicitly address domestic production and investment subsidies, as these were to be dealt with by a special group aimed at disciplining competition-distorting, public sector policies, created by CMC Decision 20/94. The committee was to classify measures according to their relative compatibility with the Customs Union, taking into account economic efficiency criteria and GATT obligations.[29] The committee's report was to include guidelines for harmonizing compatible measures and progressively eliminate those that were incompatible with the Customs Union.

Although the list of measures was to be submitted in mid-1995, the technical committee remained inactive during 1995 and 1996. In mid-1996 (CMC Decision 15/96) an ad hoc group was created to draft recommenda-

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[28] Special circumstances were: 1) long-term financing of capital goods exports granted under conditions, terms, and costs compatible with international practices; 2) indirect tax rebates on exports up to an amount equivalent to the tax paid during the production process (or alternatively, to exempt exports from indirect taxes until production taxes were harmonized); and 3) those established by special customs regimes (temporary admission and drawback) for intermediate products, parts, or components used to produce goods in the process of convergence to the CET, or for products charged with the CET but in which inputs, parts, or components in the process of convergence to the CET accounted for more than 40 percent of the product's FOB value. The reimbursement, suspension, or exemption of import tariffs was never to be higher than the amounts effectively paid, suspended, or exempted.

[29] Measures were to be classified as: 1) exemption from common trade policies; 2) tax; 3) credit; 4) government procurement; and 5) rules governing public sector firms or monopolies.

tions on how to deal with competition-distorting, public sector policies. The next year, this group asked member states to submit a list of competition-distorting, public sector policies with which to prepare a consolidated list of national distorting practices; however, it set no submission date. Finally, in 2001, an inventory was drafted but not made public.

In the mid-1990s, competition defense and the need to harmonize existing legislation entered Mercosur's negotiating agenda. CMC Decision 21/94 defined basic principles to guide competition defense; it established that, before March 31, 1995, member states should submit detailed information on existing national legislations.[30] Based on this information, the Common Market Group was asked to draft a Competition Defense Statute by midyear. In 1996, CMC Decision 18/96 passed Mercosur's Competition Defense Protocol (not yet in force). The Protocol would apply to all acts that may affect competition in the region. It listed the practices that limit or constrain competition or market access and those that constitute an abuse of dominant position. Member states were asked to adopt common rules to control practices and contracts that may affect competition or lead to a dominant market position. The Trade Commission and Competition Defense Committee (formed by the competent national agencies) were designated as the agencies responsible for enforcing the Protocol.

The Protocol established that, within a period of two years, member states "should draft common rules and mechanisms to discipline state aids that may limit, restrict, falsify or distort competition and may affect intra-regional trade." (This commitment led to creation of the ad hoc group on competition-distorting, public sector policies mentioned above.) Lack of progress led to ongoing enforcement of national antidumping regimes. Argentine authorities, in particular, refused to stop applying domestic anti-

[30] The basic competition defense principles agreed on included: 1) definition and prohibition of a set of agreements and concerted practices aimed at impeding, restricting, or distorting competition; 2) definition and prohibition of what constitutes abuse of the dominant position; 3) examination of concentration initiatives that would lead to a market share equal to or higher than 20 percent; and 4) definition of cooperation and coordination criteria between national authorities in charge of enforcing competition defense law.

dumping and countervailing legislation to intra-regional trade until an agreement had been reached on state aids and competition defense had extended its reach to state aids.

Mercosur members have signed two protocols on extra- and intra-regional investment; however, neither provides explicitly for minimum treatment standards. Moreover, neither has been implemented (congressional approval is still pending). The Buenos Aires Protocol (1994) defined general treatment principles for extra-zone investors, while the Colonia Protocol (1993) addressed disciplining intra-regional investment. Neither made progress on disciplining investment incentives. The Buenos Aires Protocol established that member countries should not "grant third parties a treatment more favorable than that established by the present Protocol." However, since the Buenos Aires Protocol made no reference to incentives or instruments with which to attract investment, the statement applied only to legal treatment. The Protocol left the door open for divergent national incentives regimes since it established that "each member state will promote in its own territory the investment of third parties and will admit those investments according to its own legislation and regulations."

The Colonia Protocol was even more explicit in authorizing divergent national treatments for intra-regional investors. Article 2 established that investors from other member states should be treated no less favorably than local investors or third-party investors, although transitory and limited exemptions could be maintained. However, this wording opened the potential for more favorable treatment; Article 7 states: "If the legislation of one member state…or an agreement between an investor from a member state and the member state where the investment was made have agreed [on] more favorable treatment than…that of the present Protocol, it will prevail over the present Protocol." The Protocol also established that there will be no "performance requirements as a condition for establishment, expansion, or maintenance of investments demanding a certain level of exports, the acquisition of domestic inputs, or services or any similar conditions." Argentina and Brazil reserved their right to temporarily maintain performance requirements in the motor vehicles industry.

Handling macroeconomic spillovers

Apart from general statements in the Asunción Treaty and Leñas Agenda, macroeconomic coordination was not taken up until the Ushuaia Agreement (*Acta de Ushuaia*) of 1998, which established that member countries should work toward macroeconomic harmonization and address issues relevant to monetary unification. An initiative of the Argentine government, the Agreement was geared more toward promoting regionwide extension of the currency board system (and eventually dollarization) than fostering intra-regional coordination. Partly for this reason, Brazilian authorities received the proposal unenthusiastically.

In 1999, following commitments undertaken in the Ushuaia Agreement, the governments decided to standardize macroeconomic statistics as a first step toward enhanced macroeconomic cooperation. In 2001, member countries set medium-term targets for selected macroeconomic indicators, including the inflation rate, ratio of public sector debt to GDP, and ratio of public sector deficit to GDP. A system was also established to correct deviations from the agreed-on targets; however, it did not include an enforcement mechanism.[31] Given the divergent national preferences concerning the exchange rate regime—an inflation-targeting regime with managed floating (Brazil) and a currency board (Argentina)—the underlying assumption was that the best option would be to promote convergence in a set of nominal variables, with the expectation that this would prevent major disruptions in real variables. The specific targets agreed on were never met. Argentina's 2002 foreign exchange and financial crisis radically changed the macroeconomic policy coordination environment; while a major obstacle to enhanced coordination (the currency board) had been removed, Argentina's crisis opened up a period of significant macroeconomic volatility.

[31] The targets agreed on included a 5 percent maximum inflation rate for the 2002–05 transition period, followed by a convergence toward 3 percent; a 3.5 percent maximum of GDP public sector deficit until 2003 and 3 percent thereafter; and a declining trend for the ratio of public sector debt to GDP after 2005, followed by a convergence toward a 40 percent ratio thereafter.

In 2002, talks resurfaced about creating a Mercosur Monetary Institute to promote macroeconomic convergence. However, progress on macroeconomic cooperation will be gradual. Initially, partners may exchange views and information to reduce uncertainty and increase mutual knowledge and understanding. At a second stage, they may engage in mutual consultation and discussion, and may be ready to craft a coordinated response to perceived common threats (dilemmas of common aversion). Eventually, common policy instruments or explicit targets may be agreed on. One concern is that economic authorities in Mercosur member states have failed to maintain regular, systematic, and structured exchange of information and analysis, which forms the basis for later engagement in deeper macroeconomic cooperation.

Concluding Remarks

Mercosur's significant structural and policy asymmetries have not been adequately addressed. As a result, after a period of rapid market integration led by the removal of tariffs, market fragmentation resurfaced through less transparent and more discretionary measures. In this context, common trade policies have been increasingly difficult to enforce, making the Customs Union (and even the free trade area) more formal than substantive.

Enforcement of agreed-on discrimination policies and creation of regional funds with which to compensate structural asymmetries face various obstacles. One major obstacle is the need to resolve sensitive distributional issues. For example, which countries or regions will be net contributors and which will be net recipients? In terms of per-capita output, the poorest region is Brazil's Northeast, while Uruguay's small economy has a per-capita output that is higher than the Mercosur average. A second major obstacle is political and institutional. Regional aids usually require pooling national competences in a community authority, which thus far has proved difficult, even in less demanding areas, such as CET enforcement. The most promising areas for deeper cooperation are infrastructure investment and, it is hoped, other regional initiatives aimed at fostering firms' competitiveness and technological development. In these areas, extra-regional resources may catalyze a learning process that may eventually be extended into other policy areas.

Perhaps more urgent is the need to deal adequately with policy asymmetries. However, coping with this challenge requires that Mercosur member states gradually move toward shared preferences and develop equivalent institutional and financial capacities. This is an area where external support can contribute decisively by helping to develop common policy frameworks and institutional resources. Whether the recently created Competitiveness Fora will play such a role remains to be seen. Such initiatives as the proposed BNDES scheme to extend financial aid to Brazilian firms investing in other Mercosur countries could be considered a first, though insufficient, step.[32]

In summary, unless progress is made in coping with structural and policy asymmetries, Mercosur cannot take sustained steps toward increased economic integration. At best, it will follow the ebb and flow of the economic cycle—that is, alternating periods of growing interdependence and increased market fragmentation. One urgent task is to bring the most distorting public sector policies currently in place under a common discipline. If such a modest degree of policy harmonization or centralized oversight cannot be secured, it is difficult to imagine progress toward deeper forms of policy coordination, such as regional policies for compensating structural asymmetries, regional competitiveness programs, or enhanced macroeconomic coordination.

[32] In 2002, BNDES decided to facilitate the financing of Brazilian firms to invest in Mercosur; however, the Bank's decision has not yet become operational.

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Part II

Territorial Development Policies

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Chapter 5

Differential Regional Competitiveness: Opportunities and Constraints

Ann Markusen and Clélio Campolina Diniz

Over the past 20 years, Latin America and the Caribbean (LAC) have witnessed accelerated world economic integration, the product of global economic organizations and national governments' efforts at liberalization. Local producers vis-à-vis more efficient producers on other continents have forced cities and regions to specialize and focus more strenuously on exports. Provincial cities can no longer count on their hinterlands as markets. They must expand existing comparative advantages or find new ones to cover the cost of imported goods and services to avoid sustained crisis and outmigration. As a result, competition among cities, both within countries and across continents, has intensified.

Despite its contributions to aggregate growth, global integration has been accompanied by stagnant or worsening income distribution in most LAC countries. Does this trend manifest itself spatially? Are some regions falling behind while others are amassing capital and skilled labor? Regrettably, these authors' answer is "yes." Based on their review of Argentina, Brazil, Chile, and Mexico—countries representative of the overall LAC experience in their range of relative national growth rates—the authors show that urban/regional shares of GDP per-capita and growth rate differentials have widened over the past two decades. Four major factors account for this phenomenon:

- Favoring the largest metropolitan areas by globally oriented firms, investors, and business services;

- Lopsided infrastructure provision (both physical and human capital);
- Abandonment of concerted regional policy since the 1970s; and
- Failure of devolution as a national and regional economic development strategy.

While the authors' analysis recognizes the importance of local economic development (LED) efforts, it demonstrates that such approaches are limited in the LAC region because of technological backwardness and prevailing macroeconomic and structural policies (e.g., rapid trade opening, privatization, and abandonment of regional policies). In addition, the legacy of paternalist states and difficulties in developing local governmental, entrepreneurial, and civil society organizations impede easy transfer of such models from Europe or North America. Although enclaves of successful industrial district formation can be found, most urban economies do not take the form of Marshallian industrial districts; rather, they depend heavily on large, often externally owned, "anchor" corporations and key government facilities and expenditure streams. Indeed, many of LAC's urban and regional development success stories—including the Brazilian Campinas and São José dos Campos examples—are attributable to much-maligned regional and industrial development policies of prior decades.

These authors suggest that achieving growth with relative regional inclusiveness requires that national governments complement trade and investment strategies with regional policy and LED initiatives. Thus, LAC policymakers must build a regional lens into national planning to monitor expected policy consequences on regions and regional equity. They should study, anticipate, and shape the emerging system of cities and towns, both within their borders and in neighboring nations. In addition, explicit pacts should be negotiated with regional and local leaders, stating mutual expectations for enhancing subnational growth; and sustainability and environmental quality should be built into all development schemes. Infrastructure and human capital investments remain powerful forces for growth, and their spatial distribution pattern should enhance regional development. To stem growing regional inequality, governments must supplement devolution of responsibility for various public functions, including economic development, to provincial and local governments with adequate technical assistance, financial resources, and anticorruption campaigns, while creating conditions for a culture of cooperation and collective governance. Doing so may require restructuring of the intergovernmental system.

Integration and Exclusion: The Two Faces of Globalization

The globalization phenomenon of the past two decades has been characterized by an increasing openness of national economies and a rapid rise in traded components of output and consumption as a share of GDP. This accelerated integration is the product of the Washington Consensus, an explicit strategy developed in the 1980s and promulgated by such international organizations as the World Trade Organization (WTO), the World Bank, and the International Monetary Fund (IMF) (Stiglitz 2002). In many LAC countries, the Washington Consensus has been accompanied by sharp reversals in national development strategies:

- fiscal austerity and curtailment of public investment,
- abandonment of regional and industrial policy,
- devolution of responsibility for public services and economic development to provincial and local levels,
- privatization of public services and industrial corporations, and
- extensive deregulation (policies that economists generally consider neoliberal).

Promoters of the strategy held out the promise that such a regime would maximize and generalize economic and social benefits for all nations and their citizens.

The process of globalization is reinforced by the exploitation of technological advances in information and communications technologies for rapid and far-flung coordination and redistribution of economic activity and social and political relations. These advances have enlarged the integrated market for industrial and agricultural products. Easier storage and transport of an increasing range of services means that service activity is subject to redistribution within nations and across borders (Harvey 1989; Daniels 1993; Marshall and Wood 1995).

The result has been the integration of most countries and regions into a global market, especially for imports, and the simultaneous undermining of many other regions' economic base (Castells 1999; Swyngedouw 1997; Brenner 1999). Each region or locality has its unique heritage and economic attributes that condition its prospects in the emerging global sweepstakes (Lefebvre 1991; Santos 1978; Conti and Giaccaria 2000). Many regions lose their traditional regional and national market specializations to new, unexpected international competitors, while imports undercut local-serving industries. Under these circumstances, a region's ability to attract and retain capital—to serve as a "sticky place in slippery space" (Markusen 1996)—depends on its local attributes: geographical location, entrepreneurial conditions, labor market, infrastructure support, and governmental and civil institutions. Many of these are difficult to alter in the short run.

Spatial Frame of Reference

Regional development theory has always revolved around a central tension: Industrial development, innovation, and increasing returns to scale tend to create spatial polarization of economic activity, while the drive to lower costs and maximize profits tends to create dispersion. In the early versions of development theory—development economists Myrdal (1957) and Hirschman (1958) were the first to articulate this contradictory process—the canvas for such activities was largely bounded by each country's borders. Location and migration theories provided the microeconomic foundation for understanding firms' decisions on where to locate production and workers' choices on where to live and work. It was hypothesized that firms would be drawn to major cities in faster-growing, wealthier regions by the proximity of competitors, suppliers, customers, and lower transport costs. They would be repulsed, however, by the relatively high cost of land and labor and the diseconomies of congestion, pollution, and crime, all of which would make smaller cities in peripheral regions more attractive. Provincial workers—generally those with more education and resources—would be attracted to higher-wage centers if they could manage the cost of migration and urban living.

Myrdal termed this process *cumulative causation*. In his view, high wages in the major industrialized cities would attract skilled provincial labor faster than capital would flow to low-wage enclaves in the countryside. Others believed that the process would equilibrate the regions. However, evidence through the 1950s supports the development pessimists. Kaldor (1970) argued that regional policy intervention was crucial in reversing or ameliorating this process.

Evolution of spatial development theory

From the 1950s to the 1970s, active regional policies, along with urbanization diseconomies, made headway in certain countries. By the 1980s, several scholars asserted that "polarization reversal" was occurring in developing countries, including several in the LAC region (Richardson 1980; Townroe and Kean 1984). Brazil's largest cities, like those of other developing countries on other continents, began losing ground to second-tier cities. For example, during 1970–91, Belo Horizonte added jobs at more than three times the rate of São Paulo and Rio de Janeiro, while 17 other Brazilian cities did so at more than twice the rate (Markusen, DiGiovanna, and Lee 1999). Others pointed out that, although smaller cities were growing faster in relative terms, in absolute numbers, the largest cities were still adding jobs faster than even the most impressive medium-sized cities (Storper 1991). Still others pointed out that decentralization away from the largest cities was modest and tended to be contained within a few growth poles not far from the largest conurbations (Diniz 1994).

Beginning in the 1980s, new ideas and restatements infused spatial development theory with fresh insights and arguments favoring the force of polarization. One body of work posited the significance and incidence of increasing returns to scale, reinforcing Myrdal's disequilibrating polarization argument (Fujita, Krugman, and Mori 1999). Previously, neoclassical economists had assumed that decreasing returns would set in at some point, resulting in equilibration, and spatial theorists had applied this assumption to the regional distribution of economic activity. If, instead, increasing returns were predominant, then economic activity would continue to accumulate in the faster-growing, more sophisticated urban centers, even if costs were considerably higher. A complementary body of work stressed the role of "world cities" as centers of management, finance, and business services engaged in facilitating trade, investment, and labor flows (Friedmann and Wolff 1982; Sassen 1994). Conversely, new work on innovation posited that existing regional cultures and centers, in addition to their higher costs, could become overly specialized in aging industries and technologies and, as a result, be unable to adapt to new opportunities and realities (Markusen 1985; Scott 1988; Storper 1997). Entirely new regions might emerge as centers of new industries and even new ways of organizing the production process (e.g., flexible versus Fordist work systems). They might emerge because of government policy, through direct regional intervention (e.g., Japanese, Korean, and Brazilian sitings of new industrial complexes and patterns of infrastructure provision) or strategic concerns (e.g., siting of military industrial facilities) (Markusen 1991).

Globalization factor

How might globalization interrelate with these push-and-pull factors to generate new regional convergence or disparities? Several hypotheses are offered. First, global integration, by widening the markets reachable by a single firm or facility, would only quicken the process by which increasing returns would favor agglomeration in wealthy "world" cities (Krugman and Venables 1996). Second, the activities involved in managing increased trade and international investment, including business services and efforts to negotiate with government regulators, would most likely gravitate toward existing primary centers; to the extent they would favor new regions, these would be those with the good fortune to be located in trade corridors. Third, because international investors are generally more risk averse and less aware of business conditions in outlying regions than are national firms and investors, these actors would tend to favor the largest centers where their national competitors are already located. A study of transatlantic American and European manufacturing investments conducted in the 1970s and 1980s, chiefly for market penetration reasons, found that multinational firms were most likely to locate in the largest cities, even when their counterpart national competitors were more spatially dispersed (Schoenberger 1985).

Although the locational tension between high-cost, high-information lead regions and lower-cost and/or less culturally encumbered regions still challenges firms making site choices, the above reasoning suggests that heightened international economic integration tends to again reverse the regional tides in favor of wealthier regions. Locational behavior favoring these centers is reinforced by pressure on governments to dedicate infrastructure provision to the benefit of these global entrepôts, deferring national integration and aid projects to underdeveloped regions.

Trade and growth performance, 1980–2000

Over the past two decades, particularly during the 1990s, the LAC region experienced accelerated engagement in international trade, labor, and capital flows. While globalization favored certain cities and regions outside the traditional metropolises, the more common scenario was that the largest, wealthiest agglomerations attracted the lion's share of internationally related activity, while already poor regions were further undermined. Over this period, exports rose from nearly US$92 billion to $406 billion, while imports rose from more than US$93 billion to $418 billion (table 5–1). The largest jump occurred in Mexico, where exports increased from about US$16 billion to more than $180 billion.

Overall, heightened trade resulted in a small increase in the current account trade deficit. It was also associated with a large increase in the capital account deficit, caused by both the cost of carrying the stock of international debt already incurred and persistent capital flight. LAC international debt, which rose from US$205 billion to $740 billion over the two decades, intensified pressure on national balance of payments and placed most LAC countries under IMF scrutiny, constraining domestic economic policy.

Table 5–1. LAC Balance of Trade over the Past Two Decades (US$ millions)

Country or Region	1980 Export	1980 Import	1980 Balance	1990 Export	1990 Import	1990 Balance	2000 Export	2000 Import	2000 Balance
Argentina	8,022	9,395	–1,373	14,796	6,437	8,359	30,828	32,594	–1,766
Brazil	20,132	22,955	–2,823	37,495	24,110	13,385	64,470	72,741	–8,271
Chile	4,075	5,469	–1,394	8,102	9,207	–1,105	22,087	21,209	878
Colombia	4,092	4,420	–328	8,658	6,845	1,813	15,608	14,301	1,307
Mexico	16,241	18,551	–2,310	38,411	41,214	–2,803	180,136	196,509	–16,373
Peru	3,899	3,062	837	4,076	4,151	–75	8,552	9,578	–1,026
Venezuela	19,057	11,318	7,739	18,818	9,452	9,366	35,239	20,583	14,656
LAC	91,973	93,285	–1,312	137,374	113,974	23,400	406,000	418,000	–12,000

Source: Economic Commission for Latin America and the Caribbean (ECLAC); 1981, 1993, 1994–95, 2000–01.

Moreover, it has made it difficult for countries to pursue policies to help stem rural-to-urban migration and stimulate lagging regional economies.

In the 1980s, the LAC region's annual economic growth rate was only 1.2 percent in real GDP (table 5–2). Since population grew faster than this rate, annual per-capita income growth was negative (1.1 percent). In the 1990s, average annual real GDP growth rates improved to 3.2 percent but only 1.2 percent per capita. Given LAC's high unemployment and pov-

Table 5–2. LAC Annual Growth Percentages over the Past Two Decades

Country or Region	1980–1991	1991–2000
Argentina	–0.4	4.1
Brazil	2.5	2.6
Chile	3.6	6.1
Colombia	3.7	2.5
Mexico	1.2	3.6
Peru	–0.4	4.1
Venezuela	1.5	2.4
LAC	1.2*	3.2

*1981–90

Sources: Economic Commission for Latin America and the Caribbean (ECLAC); 1981, 1993, 1994–95, 2000–01 and World Bank, *Annual Report* 1993.

erty rates—and low growth rates compared to such Asian countries as China, South Korea, and Singapore—these rates were unacceptably low. Growth was not accompanied by improvements in income distribution or poverty reduction (Stiglitz 2002). Furthermore, economic crises in Argentina and Uruguay precipitated regional problems that centered on the Southern Cone Common Market (Mercosur) countries.

Growing Regional Disparities: Evidence from Four Countries

Across LAC, global integration has reinforced the traditional primacy of major financial and manufacturing cities at the expense of smaller cities and outlying regions, often reversing gains achieved in the 30 years following World War II. It has also created new centers of growth, chiefly along trade corridors or surrounding ports. At the same time, stagnating regional economies and small farmers disadvantaged by trade integration contribute to large streams of poor migrants in cities of all sizes. Heightened regional disparities, in turn, contribute to regional political unrest and growing concentrations of urban poverty, even in the more prosperous regions.

Argentina, Brazil, Chile, and Mexico rank among LAC's larger countries in terms of relative size and GDP (table 5–3). Even so, these countries have not uniformly exceeded the overall LAC growth rate: Argentina in the 1980s and Brazil in the 1990s lagged substantially (table 5–2). The

Table 5–3. LAC Population and Gross National Product, 2000

Country or Region	Population (millions)	GDP (US$ billions)
Argentina	37.0	284.3
Brazil	170.4	593.8
Chile	15.2	70.5
Colombia	42.3	83.2
Mexico	98.0	580.1
Peru	25.7	53.5
Venezuela	24.2	121.3
LAC	516.0	2,000.0

Source: World Bank, 2003 (www.worldbank.org/data/countrydata/countrydata.html).

authors consider these four countries representative, while offering a more expansive regional canvas on which to chart the effects of neoliberal globalization.

Argentina: programmed public intervention and channeling of private capital

Argentina has undergone one of the region's most dramatic examples of neoliberal economic reform. In addition to a rapid privatization process, market opening, and deregulation, a fixed parity (1 to 1) peso-dollar regime, known as the Convertibility Plan, was in force from 1991 to 2002, resulting in a severely overvalued peso. During the 1990s, free market views governed economic policy, and concerns about equity, regional inequality, and social justice were largely sidelined. Privatization and plant closings—a process often better managed in other countries—proceeded rapidly without regard for the disposition of human and physical assets (Cavicchia 2003). The experiment, which initially brought inflation under control and resulted in modest economic expansion, largely failed. Official unemployment jumped 9 percent over a three-year period (from 7 percent in 1992 to 16 percent in 1995), reaching astronomical figures by 1999, the time of the model's demise; a much-publicized social catastrophe resulted.

Trade-related changes in Argentina's productive structure have favored the country's largest cities and contributed to the marginalization of vast territories. Investments in services associated with managing globalization have been concentrated in the largest urban centers. As provincially based, traditional industrial sectors—many with a history of poor, often corrupt management—fail to compete with imports, the prospects for these towns and regions deteriorate. Moreover, as a result of prolonged overvaluation of the peso, several outregion commodity export sectors are in serious trouble: agricultural activities (Pampas), cotton (Chaco, Corrientes, Formosa, and Santiago del Estero), sugar (Jujuy, Salta, and Tucuman), grapes (Cuyo), fruits (northern Patagonia), and petroleum (southern Patagonia). The Brazilian exchange correction of January 1999, more than three years before Argentina's devaluation, facilitated the expansion of Brazilian cotton and fruit production, thereby disadvantaging Argentinean exports to Brazil.

In addition, the integration of Argentinean cities and regions into Mercosur has been crafted in ways that disadvantage regions outside the circuit. Infrastructure investments and foreign interest are channeled into corridors linking Buenos Aires with São Paulo (Brazil) and Santiago (Chile) (Gorstein 1998). The São Paulo-Buenos Aires-Santiago axis has received the bulk of developmental attention, including enormous projects for enhancing cargo transport and highway improvement. The reach of the axis will be extended with a bridge linking Buenos Aires and Colonia (Uruguay) and a tunnel through the Andes Mountain Range linking Argentina and Chile. The aim to benefit the great urban centers and complementary zones is explicit in a study prepared by the French company Lyonnaise des Eaux-Dumez for the Buenos Aires-Colonia bridge (Laurelli, Montaña, and Schweitzer 1998).

The external opening and privatization prompted swift foreign capital entry, heavily focused on real estate and service sectors in large cities, especially Buenos Aires. Between 1991 and 1993, some 70 percent of all authorizations for new civil construction were granted for the metropolitan area of Buenos Aires (60 percent was for the city of Buenos Aires). The ensuing real estate boom encompassed residential and commercial building (banks, hotels, restaurants, and shopping centers) (Ciccolella 1998). Two other cities, Córdoba and Mendoza, also benefited: Córdoba (which attracted foreign investment to its automotive sector) and Mendoza (an outpost for economic integration with Santiago, Chile). Other cities were relegated to a secondary role.

Had liberalization succeeded, Buenos Aires' dominance would have been strengthened even further. Other large projects on the drawing board included an airport built on a manmade island on the La Plata River, the Buenos Aires-La Plata Highway, road ring and access to the North Pan-American Highway; redevelopment of the Puerto Madero harbor, and redevelopment of the La Plata's northern coast (Laurelli, Montaña, and Schweitzer 1998). These projects were shelved because of economic and political crisis. Should they be resuscitated, they would exacerbate divergent regional trajectories.

Argentina's failed liberalization and privatization experiment precipitated an in-depth economic, social, and political crisis. Regional disparities fed the crisis, as poor rural and dispossessed workers and farmers left the countryside to seek urban work. The unemployment rate surpassed 30 percent of the working population, and income distribution worsened. In 1990, the poorest 10 percent of Argentineans earned 2.1 percent of income, a figure reduced to 1.5 percent by 1999. The share of the wealthiest 10 percent increased from 34 to 37 percent over the same period (Rofman 2002). Scarcity of employment, income concentration, crisis in traditional industrial and agricultural activities, and lack of a social safety net fed into a state of unrest or "estado del malestar" (Laurelli et al. 2002).

The Argentinean crisis persists. After a period of transition, the temporary government altered the exchange rate, gained control of the political situation, and laid the groundwork for a new election in 2002. The new administration is trying to improve economic development and social policies. Collapse of neoliberal policies and a more favorable exchange rate are benefiting the export sector, mainly rural activities, possibly at the expense of greater Buenos Aires. In addition to beef, corn, and wheat, such commodities as cotton and fruits, whose exports were curtailed by the adverse exchange rate, are positioned for recovery. At the same time, the current exchange rate is protecting traditional industry and services oriented to the internal market. Argentina's economic recovery depends on that of neighboring Brazil, the most important market for Argentinean exports. The new government is exercising restraint in proceeding with large infrastructure projects concentrated in Buenos Aires and the Brazil-Chile corridor. As Rofman (2002) argues, it will take time and hard work for the government to compensate for the damage caused by decades of economic mismanagement and to develop an effective regional policy.

Brazil: trade, infrastructure investment, and atrophy

The historical process of regional economic and demographic concentration that began in Brazil during the late 1880s continued through the 1960s.

By 1970, the state of São Paulo accounted for 40 percent of Brazilian GNP. The metropolitan area of São Paulo reached 8.1 million inhabitants, accounting for 44 percent of Brazilian industrial production, while metropolitan Rio de Janeiro reached 6.9 million inhabitants, with 12 percent of industrial production. That year witnessed the start of policy-induced economic deconcentration. This new era was based primarily on:

- strong regional incentives for the Northeast and Northern region,
- state-owned companies' investments outside São Paulo and Rio de Janeiro,
- natural resources exploration,
- interfirm competition in new markets,
- diseconomies of agglomeration in metropolitan São Paulo and Rio de Janeiro, and
- agglomeration economies emerging in other large urban centers (e.g., Belo Horizonte, Curitiba, and Porto Alegre) (Diniz 1994).

In the 1970s, a new wave of economic growth and many new projects and massive investments facilitated deconcentration. Although economic stagnation in the 1980s slowed its rate, the impetus persisted throughout the decades that followed. From 1970 to 2000, São Paulo's share of GDP fell from 40 percent to 35 percent. Shares of most other regions, notably the southeastern and southern regions, increased. The northeastern region advanced its share modestly; it still accounts for 28 percent of total population but only 13 percent of Brazilian GNP. The metropolitan areas of São Paulo and Rio de Janeiro continued losing shares in national industrial production.

The annual rate of demographic growth in metropolitan São Paulo fell from 4.5 percent in the 1970s to 1.9 percent in the 1980s; over the same period, Rio de Janeiro's metropolitan demographic growth fell from 2.4 percent to 1.0 percent. Even at truncated growth rates, the population of metropolitan São Paulo reached 17.8 million in 2000, while metropolitan Rio de Janeiro grew to 10.9 million and metropolitan Belo Horizonte to 4.2 million. Brazil's liberalization-era economic reforms and structural changes have hampered the process of economic deconcentration. Chief among these reforms are:

- economic openness,
- privatization, and
- technological change.

Brazil's economic openness, which increased imports, generated a strong deficit in the balance of trade, thus pressuring the Brazilian government to create policies to stimulate exports. These policies and the more than 100 percent devaluation of the Real against the dollar in 1999, in a situation of inflation control, have since stimulated exports. This set of policies has benefited sectors that already had a tradition in exports, especially agricultural commodities from southern and west-central states, mineral commodities from the North, and industrialized products from São Paulo and neighboring states.

Brazil's Southeast and southern region account for 83 percent of the country's exports. São Paulo is particularly well-positioned to export under current liberalization regimes, given its large share of the nation's most advanced technological sectors. Aerospace, centered in São José dos Campos, São Paulo, is the most successful industrial export sector in recent years, competing well in the small- and medium-sized civil aircraft market (Diniz and Razavi 1999).

Brazil's Northeast, the country's poorest region, has not improved its export performance; its share of Brazilian exports dropped from 12 percent in 1980 to 7 percent in 2001. Its mature sugar sector, unable to compete with that of São Paulo, has stagnated. Emerging textiles, clothing, and shoe sectors, stimulated by fiscal incentives and low wages, are oriented to domestic, rather than international, markets (Galvão 2002).

In the 1990s, Brazil experienced one of the LAC region's most rapid and complete processes of privatization. Banks, electricity, telecommunications, steel, railroad, and mining companies, as well as roads and ports, were privatized. Because most privatized companies are located in the more developed regions, productivity gains are concentrated there, increasing centripetal tendencies in the country as a whole. By contrast, private companies are unwilling to take over public services (especially infrastructure) and factories in lagging regions because of poor profitability prospects. Thus, privatization, which exacerbates the tendency for economic activity to reconcentrate in core regions, is contributing to the problem of lopsided regional development.

Similarly, a quickened pace of technological change will benefit urban and industrialized regions, especially in the Southeast and South (particularly the state of São Paulo), where most of the country's scientific, educational, and research infrastructure are located. These authors have documented elsewhere a relative deconcentration from the São Paulo metropolitan area toward other cities in the state that are beneficiaries of state-level redistribution of infrastructure, education, and research resources (e.g., Campinas, São José dos Campos). Relatively new medium-sized industrial centers in the Southeast and South have gained modest shares at the expense of the São Paulo conurbation, particularly the state capitals of Belo Horizonte, Curitiba, Porto Alegre, and Florianópolis (Diniz and Crocco 1996).

Integration of industrial structure in the network of industrialized cities among these regions will reinforce the macro-spatial concentration of economic activity, mainly industry and services, in the South and Southeast (Diniz 1994). The grand core of this system is the São Paulo-Rio de Janeiro extended metropolitan region, a large industrial and services complex stretching from the Campinas region to Rio de Janeiro, including the metropolitan area of São Paulo and the regions of São José dos Campos and Volta Redonda. In 2000, this single axis of economic activity hosted 36 million inhabitants and some 60 percent of Brazilian industrial production (Tolosa 2002). These authors expect that this conglomeration will dominate the Brazilian economy for decades to come.

Brazil's federal structure, once considered a powerful positive factor in national integration, has played a destructive role in the current liberalization process. States like São Paulo are able to redistribute their considerable economic surplus through taxation and public expenditure to other locales within the state (Diniz 2000). Over the past decade, the autonomy of the Brazilian states has been strengthened. Divergence in regional fortunes with globalization has been complemented by an overt fiscal war among the federal states in which the strongest have emerged the winners.

Differential regional growth rates and evaporation of concerted regional policies dovetail with a worsening income distribution in compounding poverty and high migration rates. Brazil's income distribution is one of the worst in the world, ranking 92 out of 94, ahead of Malawi and South Africa. Despite considerable GDP growth over the past three decades, income inequality has not been reversed (Neri and Camargo 2000). Brazil's poverty rate is 34 percent, compared with 8 percent for other countries with similar per-capita GDP (Barros, Henriques, and Mendonça 2000).

Both rural and urban areas host growing numbers of poor and unemployed. Enormous pools of poor people remain in rural areas, mainly in the Northeast, their numbers having increased 1.5 million (from 18.6 to 20.1 million) between 1980 and 1990. As the influx of migrants to cities has grown, so has the number of poor people in metropolitan areas (from 10.9 to 19 million over the same decade) (Rocha and Tolosa 1993). By 1999, 44 million of Brazil's citizens lived below the poverty line, 29 million in cities, and 15 million in the countryside (Instituto da Cidadania 2001). High-speed urbanization in a period of slow economic growth has produced 16 urban agglomerations, each with more than 1.0 million inhabitants. (In these enormous concentrations of urban poor, Brazil resembles Mexico.) Unemployment, homelessness, violence, drugs, and lack of sanitation prevail in these settings, creating vast urban neighborhoods of what Brazilians call "the without"—those people without jobs, housing, food, education, and health care.

Chile: capital-centered investment

Following the coup d'état commanded by General Pinochet in 1973, Chile has implemented neoliberal reforms, including economic opening, privatization, and deregulation. Because Chile is a significant resource-based commodity exporter, trade liberalization might have been expected to produce a relatively benign regional distribution of heightened economic activity. Chilean exports are strongly concentrated in natural resources: copper in the North, timber and wood products in Bio Bio, fisheries in the southern regions, and fruits and wines in the Central Valley and southern regions. Despite its historically modest role as an export center, even at the beginning of the new millennium, the greater Santiago region has been the major beneficiary of globalization, increasing its share of both total and industrial GDP.

Santiago's lopsided economic gains were made at the expense of other regions. Even nearby industrial regions, including Valparaiso (which serves as Santiago's harbor) and Concepción, lost industrial share between 1980 and 1990. While metropolitan Santiago's share rose from 45 to 49 percent, Concepción, which still outpaces Santiago in export share, experienced a fall in industrial share from 21 to 19.5 percent; Valparaiso's share fell from 15 to 10 percent. Together, all other regions posted a small share increase—from 19 to 21.5 percent—owing to improved natural resource sectors (Rifo and Silva 1998). Disadvantaged because of their remoteness, Arica in the extreme north and Punta Arenas in the extreme south exhibited the poorest growth performance.

The external opening prompted large inflows of foreign investment and service sector expansion, which favored the capital city of Santiago. Over the decades, Santiago assumed the role of financial and capital market center and has been the locus of considerable national and international service sector investment. It is the site of all major national and international financial institutions, the bulk of all bank deposits, virtually the entire stock market, and the most modern portion of services (De Mattos 1998). From 1974 to 1993, 67 percent of foreign investment in Chilean services was committed to Santiago. The city also started to attract the more modern segments of industry; over the same period, 56 percent of foreign industrial investment was committed to Santiago. The city's share of the country's aggregate industrial value rose from 37 percent in 1985 to 46 percent in 1993. As a result, Santiago experienced a disproportionately high demographic growth rate, increasing its population share to almost 40 percent in 2000, up from 34 percent in 1982. As a result, the companions of hyper-urbanization—congestion, pollution, social ills, and criminality—increased dramatically.

Over the past several decades, Chile devolved responsibility for education, health care, and other State functions to provincial and local governments. Scholarship on the results suggests that such devolution produced uneven results across regions. Those with already well-developed economies and public sector competences were able to afford and manage these responsibilities well; in many other cases, however, increased responsibilities were not matched by greater resources. Furthermore, poorer regions lacked the technical ability and human capital to make programs work. Compared to other countries that engaged in extensive devolution following regime change (e.g., Nicaragua), Chile produced better results, having begun its devolution experiment with a highly educated population and high levels of literacy. Nonetheless, the result was a widening gap between richer and poorer regions in the quality of education and health care (Llanes 1998).

With regard to poverty and living standards, Chile is an exception in the LAC region. For example, from 1987 to 2000, the percentage of poor people decreased from 28 to 15 percent overall and from 25 to 12 percent in metropolitan Santiago. The country's high rate of economic growth over the last decades—GNP growth of about 7 percent annually from 1988 to 1998—enabled a dramatic rise in GNP per capita, from US$1,907 in 1988 to US$4,922 a decade later. Income distribution, however, is highly uneven and has not changed. From 1987 to 1998, the share of the poorest 10 percent of the population remained at 1.2 percent of total income, even lower than in Argentina, while that of the richest 10 percent remained at 45 percent (De Mattos 2002). Thus, although the standard of living has improved, Santiago remains divided both socially and geographically: The wealthiest people live in the north (barrios altos), while the popular neighborhoods are found in the south. Urban and rural areas also mirror this duality (De Mattos 2002).

Mexico: results of rapid trade integration

Following the North American Free Trade Agreement (NAFTA) of the early 1990s, Mexico demonstrated globalization's power to concentrate economic activity, create new growth centers, and undermine regional decentralization gains of past decades. Since NAFTA, Mexico, like other LAC countries, has experienced greater regional and national income inequality; unlike its neighbors, it has also witnessed increased poverty in absolute levels (Hinojosa-Ojeda 2003). Abandonment of sectoral and regional policies of earlier eras that helped to blunt hyper-urbanization and seed new centers of economic activity in far-flung regions have enabled this divergent trajectory (Dussel Peters 2000b).

Throughout the post-World War II period, Mexico experienced high rates of urbanization, as migrants from the countryside flowed into the country's largest cities, especially Mexico City, whose population rose sharply—from 5.4 to 13.0 million—between 1960 and 1980. Guadalajara and Monterrey, large cities considerably smaller than Mexico City and its surrounding area, both exceeded 2.0 million inhabitants by 1980. During the pre-liberalization era, the Mexican government's regional and industrial policies partially succeeded in stemming hyper-urbanization and directing economic activity to other regional centers (Nicolás 1998). The economies of Guadalajara and Puebla were stimulated by import-substitution policies, while the GDP share of Mexico City and the four main states (Distrito Federal, Estado de México, Nuevo León, and Jalisco) fell from more than 49 percent to 44.7 percent (Dussel Peters 2000a).

Under accelerated trade integration, the primacy of Mexico City has been reinforced, new growth centers have emerged in Mexico's northern region, and the rest of the country has lost ground. Liberalization policies—market deregulation, privatization of the productive system and infrastructure, massive foreign capital investment, and increased trade with the United States—greatly strengthened the central (Mexico City and Toluca) and north-central (Querétaro, León, San Luis Potosí, and Aguascalientes) exporting corridor between Mexico and the United States. Mexico City's population, including Toluca, reached 17.9 million by 1995, and was growing at an annual rate of nearly 2 percent by the new millennium. The Central Valley conurbation (Mexico City, Toluca, Puebla, Cuernava, Querétaro, and neighboring cities) is home to an estimated 25 million people (Parnreiter 2000). One scholar estimates that, by the middle of 21st century, this conurbation could reach 50 million inhabitants (Garza 1999). Without effective income-distribution policies, this conurbation will become the world's greatest enclave of poverty when lack of housing, employment, and income are taken into account.

Liberalization has favored the Monterrey-led northern and northwestern urban system, which includes the cities of Tijuana and Ciudad Juárez; these two cities are physically linked to San Diego and El Paso and have become the preferred sites for factories aimed at U.S. markets. Two emerging northern belts are forming along the frontier: one encompassing the cities of Tijuana, Mexicali, Nogales, Ciudad Juárez, and Nuevo Laredo and a second encompassing Hermosillo, Chihuahua, Monclova, Saltillo, and Monterrey.

Not all large Mexican cities and regions, however, have benefited from such explosive growth. Indeed, liberalization has weakened the large western, southeastern, and southern regions, and the cities of Guadalajara and Puebla, which thrived during the era of import-substitution policies, are losing ground to Mexico City and new northern cities. The globalization dynamic is especially complex in Mexico, where free trade has undermined large segments of agriculture, thereby reinforcing urbanization. Current patterns of trade-oriented growth strengthen the formation of a polycentric urban system, dominated by five large cities: Mexico City, Monterrey, Guadalajara, Puebla, and León (Garza 1999). Thus, large cities, including Guadalajara and Puebla, still attract migrants although their economies are disadvantaged in the heightened struggle for competitiveness.

Globally oriented services and finance, which tend to locate in Mexico City and Monterrey, and manufacturing, which favors locations close to the United States and on major transportation corridors, account for lopsided urban growth. During 1989–98, the Federal District accounted for approximately 60 percent of foreign direct investment (FDI) in Mexico. The northern states (Nuevo León, Baja California, Chihuahua, and Tamaulipas) increased their participation from 11 to 26 percent of FDI, while the rest of the country's share, including Jalisco, fell from 26 to 11 percent. Guadalajara and Puebla have failed to attract foreign investment in the financial and service sectors, which has gravitated toward Mexico

City and Monterrey. In 1998, for example, 61 percent of the headquarters of the 100 largest companies operating in Mexico were located in Mexico City while another 23 percent were in Nuevo León, Monterrey (Parnreiter 2000). Guadalajara no longer enjoys a role as financial center because it is located outside the axis of integration between the central region and the United States (Nicolás 1998; Garza 1999).

Guadalajara is also experiencing a trade-related crisis in traditional manufacturing industries (e.g., textile, apparel, and shoes), developed under import-substitution policies and oriented toward domestic markets. Although Guadalajara has been attracting export-oriented computer plants, this industry relies on imported inputs and adds little value locally (Dussel Peters 2000b). The case of Puebla illustrates that being a regional neighbor of Mexico City is not necessarily advantageous. Located southeast of the capital, not along the axis of integration, Puebla has been overshadowed as a site for industrial and service investments. Monterrey, on the other hand, strategically located near the northern frontier, is emerging as an international industrial, trade, financial, and service center (Villarreal 1998).

Mexico's reorientation of industrial activity has been dramatic, and expansion has occurred in the northwestern, northern, northeastern, and north-central regions. Between 1985 and 1993 alone, the share of these four regions in industrial employment rose from 35 to 44 percent (Nicolás 1998). At the same time, the share of the west-central (including Guadalajara) and Gulf regions decreased from 62 to 51 percent, while that of the South Pacific and Yucatán regions increased from 3.4 to 5.1 percent (although it fell somewhat between 1993 and 1997). Although the southern and southeastern regions account for 23 percent of Mexico's population, they comprise only 15 percent of GNP (Lopez 2000). To make matters worse, petroleum and electricity enclaves, which are independent of other activities in the region, generate its largest share of income. The remainder of the economy consists chiefly of subsistence activities based on rural small holdings or *minifundios*, with low levels of technical development. In southern and southeastern regions, 40 percent of people live in rural areas and 18 percent of those over 15 years of age are illiterate, compared to 18 percent and 8 percent, respectively, for the rest of the country. These regions are relatively isolated, have low human capital endowments and enterprise initiative, and lack dynamic hubs.

In the coming decades, Mexico's regional trajectory may consist of continued divergence among its regions. Nicolás (1998) argues that a true rupture between the economic dynamics of northern and southern Mexico is under way. Recent evidence suggests that southern Mexico is becoming increasingly isolated and stagnant economically as a result of the northern and central regions' integration with the U.S. economy. The abandonment of offsetting regional policies, a casualty of the liberalization era, has served to exacerbate this divergence (Nicolás 1998; Garza 1999; Cenecorta 2002).

In recent years, Mexico has posted high economic growth rates and increased its commerce with the United States dramatically; at the same time, social problems have been aggravated. Some 53 percent of Mexicans remain below the poverty line (Cenecorta 2002). In the large cities, social disorder is exacerbated by lack of housing, employment, water and sewerage systems, as well as poor public health and education services, which increase misery and violence.

Causes of Reconcentration

The four cases documented above demonstrate the general trend toward regional economic reconcentration and the worsening income distribution exacerbated by regional divergence. In Argentina, programmed public investments and channeling of private capital have favored the Buenos Aires region and undercut lagging ones, especially northern and northwestern areas. In Brazil, the central polygon—stretching from Campinas east to Rio de Janeiro and north to Belo Horizonte and dominated by São Paulo—has been reestablished through trade, infrastructure investment, and atrophy of regional programs. In Chile, private capital, infrastructure, and public investment have focused on the central region, especially Santiago. In Mexico, accelerated integration with the U.S. economy has resulted in abandonment of traditional sectors and southern regions, reinforced the primacy of Mexico City, and fueled the growth of emerging centers along trade corridors. These findings confirm the dominance of reconcentrating tendencies over decentralizing (toward lower cost sites) ones and newly emerging cities (except where their position on trade corridors enhances their attractiveness).

Four major causes account for reconcentration. First, LAC countries have experienced a rapid opening of their economies, whereby exports and imports have risen disproportionately. This process has chiefly benefited the more competitive, higher-income regions. Technological and institutional changes that amplify the need for skilled human resources, educational infrastructure, and research act as location factors benefiting the more developed regions and large cities.

Second, liberalization and privatization processes have attracted large foreign investments, especially in the service sectors (e.g., banking and real estate). The disproportionate growth of services, necessary for the management of globalization, reinforces the concentration of financial and business services in the largest metropolitan areas (e.g., Buenos Aires, São Paulo, Santiago, and Mexico City).

Third, earlier beneficial deconcentration and regional development policies have been abandoned or weakened as national planning has been delegitimized, fiscal austerity imposed (often by external organizations), and greater faith placed in the markets. Infrastructure investments aimed at incorporating lagging regions into the economy have been abandoned, often replaced by ones that favor the core regions. New policies that devolve responsibility for public services and economic development to lower levels of government, often without concomitant resources or technical assistance, exacerbate divergent trajectories of regions.

Fourth, heightened activity in core cities and deceleration in outlying regions accelerate migration, which brings millions of displaced, uneducated poor people to the largest conurbations. Despite their lion's share of new economic growth, these cities are unable to absorb the new poor; their inability is worsened by the elimination of social programs, which is associated with liberalization. Deteriorating income distribution and higher unemployment lead to social unrest, both in the countryside (e.g., Chiapas) and in cities, where burgeoning slums and social pathologies (e.g., drug addiction) compound human misery.

Throughout this process, the pace of change matters greatly. When large numbers of managers, workers, and farmers are thrown out of work by a sudden influx of imports or because an artificial exchange rate renders their products uncompetitive, they have no time to assess the potential for new products or alternative uses of their skills. All their energies are channeled into sheer survival, as they lose their homes or are forced to migrate. Comparative work on defense industrial downsizing across various key countries, including Argentina, in the 1990s shows that countries that moderated this process and provided incentives and technical assistance to enable producers to shift to new forms of economic activity did far better than those that relied strictly on the market to absorb redundant people, buildings, and technology (Markusen, DiGiovanna, and Leary 2003).

Local Development Efforts: Prospects and Constraints

The liberalization agenda repudiates national efforts to shape the regional distribution of economic activity, characterizing such efforts as expensive and inefficient. It counsels LED initiatives and embraces a language of competitiveness in which cities and regions are asked to take responsibility for their own futures. A relatively broad array of practices and instruments comprise LED strategies, among them traditional business attraction and retention efforts; cluster promotion; high-tech and research parks; partnerships among government, business, and community groups; and entrepreneurial supply-side tools, such as incubators, venture capital, and entrepreneurship training (Eisinger 1988).

The notion of localities taking the lead in economic development originated in the United States and Europe. It is a product of:

- documented cases of successful, locally initiated development;
- new theoretical and normative work by academic and think tank researchers; and
- opportunism at the national level—the need for fiscal discipline in public budgets, especially in the face of IMF strictures, and an ability to abandon regional policy politically.

Success stories

Two sets of empirical experiences give reason for optimism about locally initiated development. The first includes successful cases of regional development based on earlier initiatives that resulted in growth of traditional industry sectors. Brazilian examples include the shoe industry in Vale dos Sinos (Rio Grande do Sul), Franca (São Paulo), and Nova Serrana (Minas Gerais); furniture in the Serra Gaucha (Rio Grande do Sul) and Ubá (Minas Gerais); apparel in Nova Friburgo (Rio de Janeiro); and other industries (Tironi 2001). It also includes diversified industrial districts created in closed communities, such as the Italian colony of Rafaela, Argentina (Cassiolato and Lastres 1999). In both cases, externalities that enhanced specialization and concentration have been created without central government support. Based on these successful historical cases and on international experience, particularly in Italian industrial districts (Goodman and Bamford 1989), consultancy companies and policymakers are attempting to generalize them as a way to promote economic and regional development; however, to date, they have proven difficult to replicate.

The second set of experiences focuses on innovation and technological change as a way to create new industrial or services centers based on high-tech industry and services. These efforts are modeled on the U.S. examples of Silicon Valley and the Research Triangle area (Saxenian 1994; Luger and Goldstein 1990). States and localities are counseled to construct industrial districts, incubators for new firms, technology parks, and other local productive experiments as components in promoting local or regional development.

These success stories have jumpstarted the new LED line of thinking—they precede theorizing rather than constitute tests of well-developed theory. Furthermore, characterizations of famous examples of endogenous local development, such as Silicon Valley or the Third Italy, are vigorously debated in the literature, and their applicability to situations in other regions, even in developed countries, is broadly questioned. Harrison (1994) argues that research on the Third Italy phenomenon underplays the significance of large firms and the model's durability. The Silicon Valley experience has been widely misinterpreted; its dependence on ongoing massive infusions of government military research and procurement dollars has been neglected, and its reliance on large multinational firms is considerable (Gray et al. 1999; Harrison 1994). Even with regard to the valid elements of the Silicon Valley and Third Italy experiences, the ability to replicate them, even within the same countries (e.g., the Italian mezzogiorno or the American South), is severely limited by the absence of comparable external interest (e.g., government military contracts) or different local political and social cultures.

Evaluating the evidence

Although it is possible to point to successful cases, no satisfactory evaluative work has been done to determine the likelihood of success or to identify structural and programmatic features that distinguish between localities that succeed and fail. Practice is proceeding on the basis of anecdotal evidence and the showcasing of the few successful cases. Other elements of the local economic development agenda are similarly coming under evaluative fire. Fainstein (2003), summarizing a decade of studies on efforts in the UK to induce both competitiveness and social cohesion at regional and local levels, concludes that neither partnering nor clustering has succeeded. Partnering, by requiring the participation of numerous actors, often divides and diffuses responsibility, thereby hindering development effectiveness. Clustering can lead not only to synergy, but also to overproduction, collusion, and failure. Fainstein finds that investments in human capital and physical infrastructure are far more important for development success at the local level and that the role of national government is crucial in establishing the institutional basis for effective local governance. If British cities and regions that enjoy excellent local planning, talent, and longstanding democratic institutions have difficulty implementing the LED agenda, how much more difficult will it likely be for the LAC region?

Moreover, the competitiveness agenda, combined with devolution, has increasingly forced state and local government in the LAC region and elsewhere to compete for international branch plants and facilities, which has set into motion a process whereby many mortgage their public sectors by granting tax forgiveness far into the future with few performance requirements. A growing body of conceptual and evaluative work critiques such competition for capital, showing that the returns are much smaller than promised, if not negative (Peters and Fisher 2002; Thomas 2002; Schweke 2000).

New Conceptual Thinking about Regions

Many scholars argue that the region, whether metropolitan or a larger environmentally or culturally homogeneous area, is becoming a more important scale for the analysis and policy shaping of economic activity. Examples from the American academy include Scott (1998), Barnes and Ledebur (1998), Storper (1997), and Florida (1998) These views are based, in part, on the assumption that globalization weakens the nation-state, which can no longer shape economic development, an assumption these authors believe is inaccurate; otherwise, on what grounds could the powers of subnational governments counter such erosion?

A more robust element in this line of thinking is that regular face-to-face contact and cooperative efforts are more likely to occur at the regional, rather than national or international, spatial scale (Rallet and Torre 1999; Oinas and Malecki 1999; Asheim and Cooke 1997). A new appreciation for learning as part of the regional development process also favors a regional focus (Cooke 1998; Lundvall and Johnson 1994; Johnson and Lundvall 2000). Critics of this viewpoint stress that new technologies, such as the Internet, permit cooperation and learning over long distances without the need for physical proximity.

Another strong argument in favor of the region as an appropriate economic development policy unit is that policies can be carefully tailored to the particularities of the place and its resources and that the ideas and expertise of leaders within the regions can be drawn into the effort. Reliance on the regional level, however, can result in special interests dominating the design of regional efforts and resource allocation to the detriment of other groups, especially in the absence of well-developed democratic and legal practices to ensure inclusiveness.

With the exception of modest efforts to implement economic development planning at the metropolitan—rather than local—level, calls for a resurgence of regions have met largely with silence in the United States. LED remains dominated by efforts to attract and retain companies, regardless of their quality or fit with any cluster, and deals to build retail and office space. The amounts spent for entrepreneurial and clustering strategies remain small. Europe's independent local initiatives resemble those of the United States in both substance and scale. The popularity of technology parks (e.g., International Association for Scientific Parks [IASP] or Spanish Association of Technology Parks [APTE]) are the subject of an analysis by Massey, Quintas, and Wield (1992). Because of the cohesion agenda and necessity to acknowledge and counter adverse effects of economic integration, the European Union (EU) has increased its commitment to regional collaborations and providing resources and support for bottom-up processes for underdeveloped regions (Le Galès and Lequesne 1998; Bonavero and Dansero 1998; Halkier, Danson, and Damborg 1998).

The potential for endogenous regional and local development is worth exploring; however, it is inappropriate to lump all regions under the same rubric as candidates for generic policy prescriptions. In confronting the broad range of uneven abilities of regions to respond to the vicissitudes of heightened economic competitiveness, researchers have articulated the significance of social, cultural, and institutional factors that differentiate among regions. For example, Storper (1995, 1997) characterizes these as relational assets and untraded interdependencies. Putnam (1993) emphasizes the central role of civil society, with his notion of social capital, in differentiating regional economic development in Italy. Saxenian (1994) emphasizes an entrepreneurial culture in the development of Silicon Valley and contrasts it to that of Boston. Amin and Thrift (1994) argue that local and regional economic life depend on the cognitive relations among cultural, social, and political institutions, which they term *institutional thickness*. These authors warn that regional economic success is highly dependent on complex institutional factors that must be taken into account in tailoring any economic development strategy.

Applicability to Latin America and the Caribbean

The call for endogenous development and the nurturing of Marshallian-type industrial districts has been sounded for nearly 20 years since publication of Piore and Sabel's *Second Industrial Divide* (1984), with its focus on the Third Italy. How closely do successful cases of regional development in LAC and other developing continents follow these prescriptions? Comparative work on Brazil, Korea, and Japan in the 1990s found that few emerging cities or successful efforts to spread economic activity to laggard regions are the product of such local economic development efforts (Markusen, DiGiovanna, and Lee 1999). Most emerging second-tier cities are not high-tech or Third Italy-type industrial districts; rather, they are characterized by 1) hub-and-spoke industrial structures, where one or more industries and large firms dominate; 2) satellite platforms, where the bulk of new activity is carried out in externally owned branch plants; or 3) state-anchored economies, built around a national or state capital, a large public university complex, a military base or military industrial facility or similar concentration of state-related employment (Markusen 1996). Most successful emerging regions are the products of concerted regional and industrial policies promulgated by central governments.

In Brazil, for example, several capital cities in the South have diversified into new sectors, although major contributors to their growth remain large branch plants, as in the auto industry. Government policies and incentives have fueled recent industrial developments in the Northeast. Examples include the petrochemical center built by the federal government in alliance with private capital; the new Ford plant in Salvador (Bahia); and the textile and shoe industries supported by fiscal incentives, combined with cheap labor, in Ceará. In addition, enclaves of local crafts and small business networks reminiscent of the Third Italy are successfully competing in the globalizing economy. Other examples include the chicken industry in western Santa Catarina; furniture in several cities, oriented mainly to domestic, but also export, markets; and tropical fruits in the irrigated valleys of São Francisco and Açu. Excellent studies on emerging local production clusters include Cassiolato and Lastres (1999) and Tironi (2001). Brazil has successfully nurtured small firms through targeted government intervention, such as the SEBRAE (*Serviço Brasileiro de Apoio às Empresas*). High-tech industries have boosted the growth rate of other provincial cities. Almost universally, however, these turn out to be the beneficiaries of targeted public expenditure on infrastructure, education, and publicly owned high-tech companies (e.g., Campinas and São José dos Campos) (Diniz and Razavi 1999).

Research conducted under an agreement between the Economic Commission for Latin America and the Caribbean (ECLAC) and the German Agency for Technical Cooperation (GTZ) analyzed 22 LED cases in 7 LAC countries (Aghón, Alburquerque, and Cortés 2001); however, these studies were descriptive, not methodologically comparable, and failed to offer a convincing rationale for the cases selected. From this set, Helmsing (2001) extracted and compared 12 cases, arguing that a third generation of regional policy is under way in LAC, focusing on LED and stressing the roles of interfirm cooperation, business associations, unions, and government interaction. Helmsing recommends creating meso-institutions and focusing on the ways that actors cooperate, develop partnerships and networks, and learn. He indicates that the case studies do not evaluate success and failure, and there is little evidence that they have more than a marginal effect.

Although evidence in favor of the efficacy of LED is not compelling, such efforts could facilitate desirable growth if implemented under optimal conditions. Across the LAC region, experimental efforts are under way to encourage partnership and strategic planning at the local level. One example is the proprietary Participatory Appraisal of Competitive Advantage (PACA), developed by the European firm Mesopartner and being implemented by consultants in Argentina, Bolivia, Dominican Republic, Ecuador, and Peru.[1]

[1] For more information, visit www.paca-online.de.

Conclusions and Recommendations

In LAC, LED should be pursued through a combination of central policies and local initiatives, especially in large countries facing tough economic conditions and great social inequities. In this era of accelerated global economic integration, successful regional development outside the largest metropolises is found in only a few enclaves; of these, only a handful are truly endogenous and without the benefit of external investments or central government resources. These are worthy of careful study to understand not only the apparent elements of success but also the unique institutional and cultural traits that condition their success. Both central governments and local institutions should encourage local ingenuity and innovation. Producers in such regions may possess new products or production methods; however, they may require technical assistance from experts at universities and research institutes. A good example is the irrigated fruit culture in Brazil's Northeast, based on introducing new technology appropriately matched to the region's year-round hot and dry climate.

Top-down strategies that are inappropriate in terms of human capital and environmental conditions should not be imposed on regions; the disastrous effort to make an electronics export platform out of Manaus is an example of poor industrial policy linked to strategic and regional aims (Diniz and Santos 1999). Nevertheless, there is a clear danger in relying too heavily on endogenous local development or assuming that devolution of economic development responsibility to subnational governments—especially without concomitant resources—will reverse the process. The above-documented forces for regional divergence are robust. Most regional and local economies are simply not equipped with the expertise, infrastructure, and investment resources to compete with large metropolitan centers and emerging cities fortuitously located along trade corridors.

In such regions as the Brazilian Northeast, southern Mexico, and northeastern Argentina, endogenous and local development policies will fail without a sustained willingness of national economic policymakers to provide the needed guidance and resources. For example, the new Brazilian administration has decided to reinstate the Northeast Brazil Regional Development Agency (SUDENE) and the Amazon Development Agency (SUDAM), which the prior administration had abolished. Despite inherent corruption, these agencies had been effective; without them, economic and social conditions would have been worse (Diniz and Basques 2003). LAC countries may find that, done well, LED might prove more expensive than the regional policies it displaces. A case in point is the United States, where state and local governments gave away billions of dollars in tax and other incentives to lure new plants and hundreds of millions more in other economic development programs. Such a massive investment may prove worthwhile if it entails creating greater expertise and capabilities at state and local levels.

Finally, to reiterate, any approach to regional development is vulnerable if macroeconomic infrastructure policymaking, placement, and design fail to consider a country's regional economic development goals. This is a corollary to the impassioned arguments of Stiglitz (2002), former chief economist of the World Bank, that one-size-fits-all policies are harmful because they ignore the crucial questions of sequencing and pacing.

Elements for regional policies

Regional development policies can be effective when appropriately gauged to regional potential and matched to competitive conditions. Many of world's strongest economies have moderated hypercentralization using infrastructure, education, land distribution, transportation, and industrial policies with beneficial results. Both the United States and Germany, for example, have cities with relatively flat hierarchies, substantial ongoing national redistribution of fiscal and public capital resources and state and local economic development authority. Over time, regional disparities have decreased in both countries. Intelligent regional policy efforts by the EU are succeeding in improving the competitive performance of various countries and regions, as are national efforts in Spain and Portugal. The rapid growth and diversification of Andalusia, Sicily, Crete and other southern regions of Europe are a powerful testimonial to the efficacy of regional redistribution and development programs.

In the U.S. case, under the Homestead Act, national allocation of land and resources for canals, railroads, major water projects, universities, and highways have had a powerful decentralizing effect on American economic activity. Over a 30-year period (1930–60), military bases, academies and research labs, and publicly owned defense plants further decentralized industrial and service activity, helping to jumpstart new industrial complexes (in such places as Los Angeles, Silicon Valley, Seattle, and Colorado Springs) and raise per-capita incomes in the Gunbelt (southwest) regions (Markusen et al. 1991). The federally funded, interstate highway system, which provides an excellent network of highways linking many cities and regions, has had a demonstrably positive effect on regional economic development (Isserman, Rephann, and Sorenson 1989). The two largest regional development programs targeting rural areas—Tennessee Valley Authority (TVA) and Appalachian Regional Commission—both succeeded in improving economic performance (Isserman and Rephann 1995). All of these programs helped to bring regional per-capita income differentials—in the late 19th century, southern states languished at 50 percent of the national norm—to a modest contemporary gap; few U.S. states have per-capita incomes below 90 percent or above 130 percent of the national norm (Markusen 1987).

More recently, developed nations have demonstrated how investment and compensatory policies that build expertise and infrastructure can create new areas of activity, stem hypermigration, and enhance diversification in the productive structure. Japan and South Korea are examples of more recently developed countries where the deliberate siting of large industrial complexes outside capital metropolitan regions has helped to ameliorate regional growth and income differentials. In Korea, the population flow toward Seoul has been stemmed by 30 years of sustained commitment to the creation of industrial centers throughout the country: steel (Pohang), textiles and electronics (Kumi), parts production for export (Masan), heavy machinery and auto parts (Changwan), autos (Ulsan), and the underdeveloped southwest (Markusen, DiGiovanna, and Lee 1999). Both Japan and Korea have begun to decentralize higher education and high technology by building new science and technology campuses away from major urban centers.

Despite flaws in program design and inefficiencies in implementation (Oliveira 1977; Araújo 2000; Furtado 1989), Brazil's federal-government efforts to revitalize the Northeast and develop the northern and west-central regions have provided a powerful developmental stimulus. The building of Brasília, a deliberate attempt at decentralization and national integration, has helped to integrate the country and incorporate the west-central agricultural frontier into the national economy (Fundação Israel Pinheiro 2002). National construction of a road system with Brasília as the central node (with spokes to Belém, Salvador, Belo Horizonte, Cuiabá, and São Paulo) has played an integrating role for the country. Concerted efforts to build an industrial center in the Northeast have had an enduring effect on diversifying that region's—Brazil's poorest—sugar monoculture (Gomes 2002; Diniz and Basques 2003). The Brazilian vision of a multipolar, federal nation integrated with roads and decentralized higher education has contributed to relatively rapid growth in several formerly lagging regions. Political distortions, such as the military government's geopolitical designs on northern and west-central regions, led to costly mistakes, such as the Trans-Amazonia road, subsequently abandoned, and the attempt to build an electronics complex in Manaus. Although Brazilian regional inequality remains high, it would be worse without these policies. Lessons from these efforts can be combined with realistic assessments of a region's ability to specialize and compete in the rapidly globalizing economy to craft a policy that will ameliorate the worrisome differentials charted above.

National governments, however, are in a bind when faced with investment and expenditure decisions in times of resource constraints. The need to increase exports, especially as imports from lower-wage nations flood in as trade barriers fall, may impel politicians to favor the largest metropolises, ports, and trade corridors. In an increasingly integrated world, every nation and locality must specialize more than ever (Howes and Markusen 1993). Governments cannot afford regional development policies that fail to promote long-term efficiency and productivity, especially given rapid technological and organizational change.

Actions for regional equity

The elements for a new regional strategy appropriate for a rapidly integrating world economy and attentive to unique subnational aspirations and capabilities must be adapted to each country's economic, geopolitical, and physical conditions (e.g., territorial size, level of inequalities, economic potentialities of regions, social problems, and evolving international integration). Working with their constituent regions and localities, national governments can undertake a series of actions to improve regional equity and spread the fruits of growth more broadly (Diniz 2002). These authors recommend the following actions:

Screen national strategy for regional outcomes. Central governments should incorporate the goals and tools of regional planning as an integral part of national planning, identifying potential bottlenecks to regional and local development. Every economic policy initiative should be evaluated from the perspective of its consequences for regional distribution of economic activity and its potential to enhance or undermine regional goals. The practice of planning for isolated regions, apart from the general context of the national economy, should be discarded as both expensive and ineffective. National economic policymaking should be required to take into account territorial, economic, social, and political integration goals.

Craft regional pacts. Central governments should articulate a federative, provincial, or regional pact with regional governors and urban mayors that would commit them to a vision for urban/regional evolution, indicators of progress, and realistic methods for meeting the goals. In smaller countries, such a pact would articulate a vision for major cities versus smaller towns and rural areas, including methods for ameliorating rural-to-urban migration, decentralizing access to good quality education and health care, plans for infrastructure placement and investment, and methods for local participation in initiatives that shape economic development prospects.

Shape the urban hierarchy. Attention to the emerging system of cities and towns could become an active policy exercise for national economic planners. Policy decisions—from resource use to educational commitment to transportation infrastructure investment—will induce shifts in the hierarchy of cities. For example, policies could be favored to support strengthening of medium-sized cities as service and production centers, which, in turn, would help to halt disproportionate concentration of people and economic activity in the largest cities. One example is Korea's success in inducing faster growth rates in provincial cities than in Seoul; Brazilian infrastructure, regional programs, and federalism—at least through 1990—achieved similar results.

Evaluate development strategies for sustainability. Development strategies should be evaluated for sustainability and effects on environmental quality. Large construction or resource extraction projects, attractive in their immediate generation of jobs, often produce employment bubbles, leaving localities coping with long-term environmental degradation. International and domestic groups' emerging commitment to sustainability as a criterion for selecting economic development initiatives is a welcome development and should help policymakers contend with technological and economic policy choices in the contexts of particular countries and regions.

Use infrastructure to integrate regions. Along with human capital investments, infrastructure commitments (implemented intelligently) are among the most potent tools nations have for contributing to regional diversification. Placement of transportation infrastructure can be a crucial tool for regional integration, as recent experience in Brazil, Mexico, and Argentina demonstrates. Smaller countries also need their transportation infrastructure integrated into the larger regional and international trading system. If new investments are dedicated simply to routes that enable goods and service to enter and exit ports, they will do little to integrate nations and trading areas, thereby contributing to worsening national and regional differentials. The payoffs for new transportation investments are long term. In the United States, the North outpaced the South economically in the

19th century by concentrating its transportation investments on linking eastern manufacturing cities with the agricultural interior (the South squandered its funds on building canals to lengthen cotton-transit rivers upstream); thus, an integrative transportation system made the North more productive (Markusen 1987). Similarly, over the centuries, European integration flourished with investments in its transportation system and infrastructure commitments remain central to ongoing European efforts. LAC countries, with support from the Inter-American Development Bank (IDB), have prioritized the drafting and implementation of a joint program for transportation integration.

Decentralize educational resources. Efforts to decentralize quality education and training pay off handsomely in terms of creating pools of regional human capital, forming small firms, and encouraging innovation. LAC countries have made important strides in equalizing resources for elementary and secondary education; however, resources for higher education remain concentrated in the wealthiest regions.

Overhaul the federal system. Governments should redesign institutional systems to enhance the process of reintegrating regional development into national development planning. The institutional restructuring required may be dramatic—most LAC countries lack an intermediate government unit (e.g., county or administrative region) to coordinate large, economically integrated economic regions. Proliferation of municipalities, which makes it increasingly difficult to design and implement local policies, calls for revamping a territory's political and institutional divisions into governmental scales (federal, state, province, and municipality). Careful assignment of responsibility for public goods, services, regulation, and economic development among public (federal, state, and municipal) and private (companies, civil organizations, universities, and research institutions) spheres can facilitate an inclusive regional development process. Central governments must resist pressures from wealthy regions to allow them to keep all of their tax revenues or to continue favoring them as national champions. A certain degree of redistribution of revenues and resources is essential to moderate regional divergence and stem hyper-urbanization.

Design local capacity. Sound regional policy must encourage and support local initiatives and institutions in designing development strategies that are realistic and appropriate to the economic, social, political, and environmental attributes of each locality and region. This recommendation appears obvious; however, in practice, it is difficult and costly to achieve. Central to success is the know-how to create local institutions, partnerships, and governance structures that foster cooperative, associative, collaborative, and synergic activities in a world of competition. Stubborn traditional animosities and cultures may have to be overcome, most localities lack the expertise and technical abilities to begin, and local elites can easily capture planning to advance their own economic interests. Nevertheless, local participation and creativity are central to success in LED and complement a more savvy generation of regional policies. Recently designed programs in the United States and Europe (e.g., U.S. empowerment zones and EU regional partnerships) offer examples of local leadership that has been built, as a central element, into redistributional policies and programs.

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CHAPTER 6

The Regional Challenge: European and Latin American Experiences

Francisco Xabier Albistur Marin

The challenge of globalization involves taking active, participatory stances and mobilizing both markets and institutional relations that affect companies, citizens, governments, and institutions in each developed or emerging society. Globalization requires great imagination to analyze and then identify a region's capabilities and bases for competitive advantage to enable it to establish a strong presence in the global marketplace and choose the best strategy, either individually or in collaboration with other societies.

Development theories and concepts are changing, despite economic theorists' resistance to accepting the relationship between their discipline and political decision-making. The change in economic development concepts is related to the crisis of the State, processes of continental integration, and extending democracy via new channels that allow for civil society's participation in political processes.

Economic research has abandoned the concept of spaces in favor of territories. Spaces optimized a territory's location and organization using a combination of political and economic opportunity. In practice, society was not considered since it was created or transformed by the development promoted. Territories, on the other hand, involve a set of economic, sociocultural, political, and institutional factors and agents with specific organizational and regulatory formulas. This development concept leads one to consider that all socio-territorial organizations use and mobilize resources that constitute their potential for development and have the capacity to take the lead in the process.

This development approach identifies the influence of local production systems on growth processes. Local initiatives, also known as endogenous development, have become the preferred instrument for regional development policy; their main goals are to:

- encourage the accumulation of capital in local production processes;
- make efficient use of local economic potential;
- link each territory with the network of relations that determine the State's cultural, social, economic, and political identity; and
- make local public and private agents responsible for investments, growth control, and income distribution.

In the context of globalization, regional development exchanges conventional economic growth for locally based growth aimed at raising a local community's living standards in at least three ways:

- economically—based on a production system of interrelated businesses that efficiently use production elements and achieve market levels of productivity and competitiveness;
- culturally—with the development process supported by social institutionalization; and
- politically—so that local initiatives promote a social climate favorable to investment, business creation, and increased training and technological know-how.

Europe's Regional Development Experience

In Europe, regions and local initiatives have long played a lead role as instruments for economic growth. However, certain globalization phenomena (e.g., attention to international market demand caused by lower tariff barriers and interior economic mobility caused by European integration) have strengthened recognition of the added value regions bring to the growth of member states and internal convergence in the European Union (EU) (Madariaga 1994).

Europe's regional development evolution has been characterized by:

- socioeconomic demands on the central government for greater initiative and control over political, economic, social, and cultural matters affecting the regions;
- consolidated regionalization resulting from efficient action by Europe's constitutionally recognized regions; and
- central governments' decision to decentralize, thereby strengthening the roles of mid-level administration and government.

The founding documents of the European Economic Community (EEC) refer to regions as an administrative and economic reality; however, not until the 1970s did the EEC formally recognize regions as a political force with a role to play in European integration. In the 1980s, regional recognition was based on the decisive territorial solutions proposed for sectoral restructuring, combined with the need to reduce socioeconomic imbalances among states and regions. In the 1990s, regions took a lead role, participating in state reforms vital to the process of European integration (e.g., control of the public deficit and institutionalization of regional representation in community bodies).

At the start of the new millennium, only three of the EU's 15 member states lacked a decentralized administrative organization. In 2002, France undertook administrative reforms that contain a broad decentralizing process that recognizes the asymmetric autonomy of the established regions. This action demonstrates a feature of Europe's political construction: giving regional and local governments shared responsibility for the territorial administration of the State and, by extension, the Union. This feature has become a dominant trend in European policies and constitutions, not only through legislative changes introduced at the national and community levels, but also through development of programs and budgets that focus specifically on regional and local levels. What results is a new organization of community power based on political pragmatism that sets out to address serious needs, but not according to preconceived political theory; however, the element of regional power in the EU's political future cannot be ignored.

This development in the exercise of forms of government has helped to transform the meaning of public administration. Today, reinforcing Europe's regionalizing process is associated with the effects that globalization has had on states to strengthen continental integration. Thus, European states have abandoned certain traditional, regional planning policies in exchange for integration-related functions. But their doing so is also a response to the new endogenous development policies, which reassess territorial resources, quality of life, skilled labor, and the environment—all of which have been proven to be better managed at the subnational or regional levels.

Decisions to reduce the State's presence through restrictions on budget programs or increased privatization have promoted decentralizing reforms, including educational planning and assistance, agriculture, reindustrialization, support for tourism and new services, transport networks, and introduction of advanced technology. The new form of public management that has resulted does not imply a weaker state; rather, it involves a different concept of how a modern state functions in a continentally integrated, globalized economy. In short, it means less government at the central level in order to achieve better government overall.

While this trend affects all EU member states, it does not imply the existence of a regional European space since Europe has no uniform or homogeneous level of regional government in the juridical, political, or administrative spheres. Europe's regional reality is heterogeneous in terms of its territorial makeup, forms of government, and regional policies.

Determining and homogenizing the functions that correspond to European regions is a complex task. It is generally agreed that the regions:

- can participate in the fiscal income of the State and have the capacity to establish their own taxes and spend independently in their competency areas;
- have the capacity to plan and implement essential public services (e.g., education, health, and social assistance);
- promote cofinanced local and regional economic activity;

- participate in zoning and development of urban and industrial lands and environmental regulation;
- promote social policies that aim to mobilize the labor market to assist the unemployed and youth; and
- play an influential role in promoting culture, particularly where linguistic specificity is involved.

The scope of regional power varies according to each country's political system. Differences depend on whether the region is a decentralized administrative body or a political institution with constitutionally guaranteed powers and the recognized right to participate in state politics through direct election to legislative chambers.

New forms of regionalism: cooperation and association

The EU's heterogeneous regional level does not reduce the influence of regional policies on those of member states and EU policies. In fact, a clear movement common to all regional formulas—one of the unplanned consequences of European integration and globalization—is what regional development analysts call bottom-up activity; that is, a regionally based movement based on cooperation through association among regions, as well as the political will to participate in processes of integration and globalization (Gizard 2000).

This movement is characterized by:

- being a position assumed by regional political and economic institutions;
- promoting action involving cross-border and transnational, interregional cooperation;
- viewing internationalization of regions as a function that completes and determines the dimensions of a region's political and economic actions; and
- reducing customs barriers and mobility of goods and persons and supporting free competition aimed at creating and promoting market integration and globalization.

Neo-regionalism, a new feature of regional activity, is legitimized by the internationalization of the economy, which enables regions to associate and cooperate with each other to build and mobilize a network in which their public and private agents can act. In this case, a region's political and economic actions are collective and transnational. Its goal is interregional relations; exchange of knowledge and information; generation of social and economic synergy; and cooperation on projects necessary for development, regardless of their shared effects. All of these activities extend beyond traditional borders, and regions have no need to share a common border.[1]

The bottom-up movement makes use of a fundamental European Community (EC) policy—cooperation among constituent members; however, it also regionalizes and frees it from the inertia and interests that limit integration, making it an instrument for endogenous, regional, and social development—the reason it was listed as a founding principle.

Neo-regionalism must be understood and analyzed as a movement that contributes to integration since it increases all the effects on territorial relations resulting from the removal of border and tariff barriers and free movement of persons and economic resources. Monetary union has also helped to facilitate interregional cooperation. The two forms of cooperation—bilateral and multilateral—are both characterized as transborder and transnational. Whichever form is adopted, interregional cooperation tends to become institutionalized with the creation of intergovernmental working groups and interregional bodies that manage the cooperation, which are complemented by interregional parliamentary councils. Cooperation and regional associationism also tend to become specialized through the creation of special commissions that deal with key issues for interrelated regions (e.g., agriculture, infrastructure, technology, and environment).

[1] The Euroregion, a new model of regional associationism, involves cross-border associations of several European regions from various countries. Seven Euroregions were created through interregional political agreements, as established under the 1980 European Framework Convention on Cross-border Cooperation. These are: Galicia-Northern Portugal Working Community, Pyrenees Working Community, Insubrica Region, Sarre-Lorraine-Luxembourg-Rhineland-Palatinate-Wallonia Cross-border Cooperation, Meuse-Rhine Euroregion, Ems Dollart Region, and Baltic Euroregion. Switzerland and Russia also participate in these regional associations.

Interregional cooperation has promoted relations not only between regional government institutions but also—in most cases with independent management—between regional parliaments, universities, chambers of commerce and business organizations, research centers, and cultural associations. Combined action at the regional level has taken other, more informal forms of association, known as interregional clubs, to exchange experiences, agree on specific projects of interest, and conduct consultations on integration and international cooperation for development.

The bottom-up movement is a new formula for regionalism that complements historical regional action. It gives European regions a new role in European integration and influences the decision-making of member states.

Delays in the process of European construction have not favored the development of regional and local policies. As a result, the regions have set out to guarantee themselves an important place among the European Commission and Parliament, as well as the ability to implement European regulations directly. To meet these objectives, the Commission has created representative bodies and regional programs.

In 1984, backed by the European Parliament, several associated regions established the Conference of European Regions, which in turn led to the creation of the Assembly of European Regions (AER), an independently structured body for regional representation without direct links to member states. The AER now brings together more than 300 European regions, representing 400 million people and 95 percent of EU-generated GDP. Its value for regional representation stems from the fact that it was the first structure formalized by the regions to recognize their capacity for political and administrative action without the protection of member states and has proven influential in its dealings with the European Commission and Parliament.

This form of association has enabled the regions to plan EC-level strategies that:

- ensure that the subsidiarity principle prevails in the juridical basis of the EU Treaty;

- recognize regional representation in the EU institutional system;
- have direct access to the Court of Justice; and
- by restructuring article 146 of the EC Treaty, enable certain regions to exercise the right to vote along with their country in the European Council.

In 1996, the AER promoted and approved what is considered the founding document of the European regionalizing process, known as the Declaration on Regionalism in Europe.

Progress on regional European policy is undeniable; however, a rigorous analysis inevitably leads one to conclude that certain powers attributed to the regions are merely symbolic in governmental bodies of the EU and in its parliamentary representation. Nonetheless, the powers subject to EC law and implemented by regions as endogenous development policies (e.g., environment, regional planning, aid to business, agriculture promotion, job creation, education, and social assistance) have required legislative and constitutional changes in member states in order to transfer to the regions powers previously exercised by the State (e.g., control over economic, social, and cultural issues, with the corresponding provision of material and human resources, budget allocations, and legal recognition of the capacity to apply EC law in the transferred areas).

Institutional coverage of regional policy and financing

The regions' increased political and administrative activity pressured EEC institutions and later EU ones to establish specific regional policies supported by budgets based on the Structural Funds used originally to develop the most disfavored regions of the EC. The Structural Funds and complementary European Regional Policy Funds are the second largest item—behind the Common Agricultural Policy—in the EC budget (Isla 1998).

Initially, the Funds were aimed at reducing economic and social disparities between member states and their regional counterparts. However, the bases of regional policy have been modified by the persistence, and even increase, in regional disparities, better analytic understanding of the potentialities of the territory, and rigorous evaluation of the projects financed. Application of new theories of endogenous development emphasize the management of social, political, institutional, and cultural factors, as well as the mobility of production and free competition factors.

The Commission and general offices that apply regional policy have focused on allocating Structural Funds to promote factors that determine opportunities for regional development. Factors that constitute a territory's capacity or potential are:

- training and professional quality of human capital,
- local entrepreneurial initiative,
- efficiency of public administration,
- supply of diversified and specialized services,
- economic dynamism of the urban structure,
- quality of habitat and environmental protection,
- effective use of technology,
- capacity to adapt to organizational and cultural changes, and
- generating permanent institutional relationships with external and institutional agents.

The Structural Funds are distributed in five groups, according to their specific purposes:

- ERDF (European Regional Development Fund—aims at reducing regional disparities, reconverting regions in industrial crisis, and promoting underdeveloped rural areas;
- ESF (European Social Fund)—finances training programs for the reentry of long-term unemployed, self-employed, and young workers' entry into the labor force.
- EAGGF (European Agricultural Guidance and Guarantee Fund)—finances the adaptation of agricultural operations in declining regions to new forms of agriculture and development of new economic sectors in rural areas.

- FIFO (Financial Instrument for Fisheries Orientation)—provides financial support to coastal regions with traditional fishing industries affected by the sector's decline.
- Cohesion Fund—finances infrastructure projects, European transport networks, and environmental programs in states with a GDP below 90 percent of the European average to facilitate their convergence with more developed states.

Access to the Structural Funds is through the initiative of regions, either on their own or in association with their corresponding member state and the Commission. This rigorously coordinated process follows a predetermined methodology. Funds management is based on five principles that form the basis for eligibility of proposed projects and programs and their subsequent control, monitoring, and evaluation. These principles are:

- *Concentration*. Programs must address economic and social development goals.
- *Coordination.* Interfunds must be coordinated in order to obtain synergy in the resources provided and increase efficiency of public intervention.
- *Multi-annual programming*. Plans and programs have a multi-annual budget allocation (six years), which covers development of the committed investment.
- *Cooperation*. Programs require coordination among EU institutions and state, regional, and local authorities in each member state; this requirement also extends to economic and social agents.
- *Additionality*. Member states may not substitute their own territorial investments with those provided by the EU; they must justify their financial contributions.

These principles are complemented by monitoring and evaluation, which is essential to appropriate management of the modern public sector and required of bodies of the Commission, states, and regions. Experience in this system of intergovernmental control has proven that evaluation results have made it possible to provide new solutions to the main problems of regional policy and development.

Is there a future for the regions of Europe?

The draft version of the future European Constitution was recently presented for parliamentary debate and possible referendums. Once again, the regional issue is controversial because its present and future political relevance has not been recognized. While this controversy is beyond the scope of this chapter, the EU must soon address a basic issue: what is the role of the regions in the decision-making and governing bodies of the EU in the 21st century?

The answers proposed by European regional institutions and associations are to:

- guarantee homogeneous representation of the regions on the consulting councils of regional and local bodies;
- recognize the decision-making capacity of the Regional Committee in European Regional Policy;
- allow regional representatives to participate directly in the meetings of the Council of Ministers of member states;
- transform the Committee of the Regions from a consulting body into an institution that participates in and has power over EU decision-making processes;
- use this Committee as the basis for a European Senate, whose legislative powers are coordinated with the European Parliament, to create a democratic legislative power comprised of two parliamentary chambers, one of which would enable the regions to participate in European policy implementation;
- effectively apply the subsidiarity principle recognized by the Maastricht Treaty to these policies;
- consolidate the INTEREG Community Initiative as part of EU policy, with three basic areas of action: cross-border cooperation, interregional cooperation, and transnational cooperation; and

- recognize regions' capacity to use their competencies to export their experiences and projects to external institutional agents and other non-European regions.

In sum, a new stage of reflection and political action, whose goal is to construct European integration on the basis of shared responsibilities, has begun. However, this requires a shared commitment by EC institutions, states, regions, municipalities, parliaments, political parties, and citizens.[2]

Regions and enlargement of the European Union

In May 2004, 10 Central and Eastern European countries joined the EU, resulting in 25 member states. Except for Poland, the new member states are not territorially or demographically larger than an average European region.[3] Likewise, their per-capita income is similar to that of the most disfavored regions of southern Europe (e.g., Extremadura, Peloponnesus, or Calabria).

Enlargement has forced significant changes in the EU's governing bodies and parliamentary representation; it has led to changes in the European Regional Policy and its application. Significantly, 47 administratively recognized regions are to be added to the 211 existing ones. In the six smallest countries, where administrative organization takes the form of districts, a process of regional grouping or incorporation is beginning, whereby groups of municipal districts will become formal regions with recognized administrative functions and the corresponding constitutional reforms.

Poland is the country that best suits the framework into which it will eventually be integrated. In 1998, the Polish parliament sanctioned a

[2] To learn more about the debate on participation of all levels of EC power in the process of European integration, see "Contributions au Livre Blanc sur la Gouvernance Européenne," CPMR, December 2000.

[3] According to the INSEE (France), the average European region has a surface area of 15,000 km^2, a population of 2–4 million, and wealth creation equal to 36 billion euros.

new political/administrative structure divided into 16 regions (first tier), and subdivided into 373 districts (second tier) and 2,489 municipalities (third tier). The EU process of incorporation was instrumental in reforming the central administration and aimed at the greatest possible administrative decentralization. The goal was to limit the central government's potential interference in managing microeconomic processes, focusing its role instead on preparing development policy and regulating macroeconomic processes. The political/administrative development of the Czech Republic, Slovakia, and Hungary, each with its own nuances, has followed along the lines of Poland.

Incorporation of new states and regions has clearly affected the regions' actions in terms of:

- relative competitiveness; and
- resources allocated for development.

The regions' relative competitiveness has affected the structure of production costs in regional economies, particularly those with larger sectors that rely on mature technologies and high labor costs. An emerging market of 75 million people with strong potential growth and stability is attractive to investors looking for lower labor costs, government incentives for setting up businesses, and greater flexibility by the European Commission's competition-regulating bodies in their interpretation of government subsidies. This new situation puts the new member states in a favorable position for exporting.

For regions of the 15 EU countries, relative competitiveness also means revising the Common Agricultural Policy, since, in the new member states, more than 10 percent of the active population is involved in agriculture and livestock with relatively uncompetitive productive structures. Debate is currently under way at state and regional levels with the European Commission and Parliament. It is not easy to predict the results, but limited resources will undoubtedly lead to a necessary reform that will focus the Common Agricultural Policy (CAP) on production more in line with the potential and productivity of the land, climatic features of the territory, and appropriate training of human resources—all aimed at achieving a turnaround in declining agricultural areas.

Allocating regional development resources—Structural Funds, Cohesion Funds, and Regional Development Funds—has led to partial reform of regional policy on financing. On the one hand, certain member states that currently receive funds will become contributors. As the result of a statistical effect, their recipient regions will lose their status as targets for regional resources. On the other hand, the Presidency of the European Commission plans to turn most of the current Regional Funds into a Fund for Growth; also distributed regionally, it will be stricter in its application and objectives since the total resources will not increase and the newly incorporated regions have the most urgent needs. The Commission is not changing the Regional Policy's spirit, direction, or goals; rather, it is adjusting the instruments and more rigorously choosing the goals to rationalize budget policies and public spending goals, whereby member states provide the remainder of the resources allocated for the regions.

To be considered a preferred recipient of Regional Funds, a region must have a per-capita income below 75 percent of the average European income. This criterion will remain in force in the future distribution of funds to be decided for 2007–11. Since the per-capita income of the regions that joined the EU in May 2004 is low, the pre-May regions saw their averages statistically raised in the enlarged Union. Before May 2004, 11 of Spain's 17 regions had been preferred recipients; however, the enlargement's statistical effect reduced the number to three.

The European Commission believes that the statistical effect could be unfair to certain regions that are converging toward higher levels of development; as an alternative, it has proposed that such regions be reclassified as preferred recipients *bis,* meaning that, in the first and second years of the next five-year financial period, they would receive 90 percent of their hypothetical share in an unenlarged EU.

For this formula to work, net contributor countries to the EU's budget would have to increase their contributions. This proposal has met strong resistance since such countries favor renationalizing a large part of regional aid so that each country can decide how to allocate funds to its least-favored areas and (following the German model since unification) have a stake its own regional development policies and European policy.[4]

Regions and the European Constitution

In June 2003, the European Convention presented the European Council a text it hoped would serve as the basis for formulating a treaty establishing the European Constitution; this text proposed better distribution of EU- and State-held powers; however, it referred only briefly to the regions as participants in the desire to found a new Europe and as constituent parts of its institutional structure.[5] The regions are not considered state representatives in government institutions or in the composition of the European Council or Council of Ministers, which are restricted to representatives of member state governments.

Of the 15 EU member states (before May 2004), 8 include 74 regions with legislative capacity and constitutionally recognized independent governments and parliaments. These regions represent 60 percent of European GDP and 57 percent of its population; nevertheless, this weight has not yet led to recognizing the capacity to be represented in EU institutions directly, to participate in decision-making, or to apply EU policies and regulations. The respective member states determine the form and means of defending regions' interests before official EU bodies, which results in unequal representation subject to special interests.

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[4] At the time of this writing, the policy debate over financing future EU regional development focused on two main lines: 1) European rural aid directed to the states and regions of the enlarged EU; and 2) creation of a Growth Fund whose resources would be directed at developed regions for action on infrastructure, the information society, telecommunications, and science and technology.
In the interim, the new regions are in a state of frenetic activity. Their politicians and administrators are visiting other European regions to share experiences in various areas of public management and institutional organization. In short, the Europe of the Regions is turning out to be attractive.

[5] Regional references are found in Article 5.1, where respect for local and regional autonomy is included as part of respect for national identity; Article 9.3, which recognizes that the principle of subsidiarity can be applied to political action at regional and local levels; and Article 31.2, which establishes the Committee of the Regions as the Consultational Body of the Union, lays out its function, and recognizes the independent appointment and action of its members.

In practice, however, Europe has recognized that relations among regions and between regions and EU administration have an important role to play in community integration. The policy instruments for these relations have been the Community Initiatives and Structural Funds described above. The five-year Community Initiatives promote interregional relations so that borders between states do not impede balanced development and European territorial integration. At the same time, they help boost socioeconomic cohesion through cross-border and transnational cooperation, financing joint actions in multiple areas (e.g., education, health, culture, environment, energy, technological research, transport, and telecommunications).

Although the new European Constitution considers the regions a political and administrative reality, the project's authors—not fervent backers of regions' role in the configuration of their own states—cannot ignore this European practice when they propose the "protocol on the application of the principles of subsidiarity and proportionality." With regard to legislative action, the protocol states that the European Commission must consult on the "regional and local dimension of the action considered." Furthermore, in the case of framework legislation, national parliaments must consult with the "regional parliaments with legislative powers" regarding potential effects on regional legislation and any area of legislation that affects compliance with the principle of subsidiarity.

Therefore, the wording of the Draft Constitution affirms European regions as an underlying but active reality. In this author's opinion, the Draft should include an article that recognizes the regions' institutional rank since this would reflect the organizational configuration and powers of the member states, draw European institutions and citizens closer, and increase democratic legitimacy. The Constitution cannot leave development of internal institutional mechanisms aimed at enabling regional participation in European decision-making to the political will of state governments.

In 2003, this author had the opportunity to contrast opinions on the Draft Constitution with the reality of national and regional parliaments of several European states. In countries with a long federal tradition, parliamentarians were generally optimistic about broad application of the subsidiarity principle and certainty of an agreement between national and regional governments to guarantee regional representation in the EU. The British consider it a problem yet to be solved, the French do not perceive it as a problem, and certain Spanish parliamentarians are concerned since a restrictive interpretation of the text reaffirms a move back toward centralism.

Latin American Regionalization

Increasingly, the LAC region is predisposed intellectually and politically toward focusing development policies on implementing models for political and economic decentralization and formulas for endogenous or local development already tested in other developed economic areas. The idea is to explore these instruments and experiences to discover more efficient ways to better position the respective countries—and the continent generally—to respond to and obtain results from market globalization.

There is a general need to change the development model for LAC countries. Specifically, the model must:

- respond to a territory's cultural characteristics and inherent potential, as well as provide opportunities for political, social, and economic interaction with neighboring territories, nations, and states; and
- be supported by a strong, internally cohesive state institutionalized at the public and private levels, with fair and redistributive tax policies, and influence either inherent in the State or achieved through alliances of the integration processes in which it participates.

After decades of testing for development with statistically spectacular economic ups and downs, half of all citizens of the subcontinent believe that their parents' generation lived better than they do and are pessimistic about the prospects of their children living under better conditions in the future.

Economic decisions have taken precedence over individual or institutional political decisions, contributing to the devaluation of development planning, regulations, and participation of development agents. The tremendous resources generated have sent wealth outside the LAC region. The development model has consisted of permanent growth, enriching those who provide financial resources; supported by renowned politicians, multilateral institutions, and economists from prestigious universities, it has made it possible to work to pay; however, it has not favored work to accumulate wealth since the model generated constant growth and permanent debt. Under these conditions, the State collected and invested little in the territory, relying, in the end, on international cooperation to complement development.

An analysis of current LAC politics in general reveals that this form of public action is being abandoned. Leaders of the new democracies indicate that the goal is not only consolidation of political freedom, but also construction of legitimacy, both internal and external, as well as sufficient governability to change development models (Isla 1998).

The 20th century ended with the relativization of structural adjustment programs based on less government, general deregulation of the economy, devaluation, and privatization. The net result of these measures—implemented by such multilateral institutions as the Inter-American Development Bank (IDB) and World Bank, which have provided information and control—bear witness to the insignificant results of development not accompanied by radical reform of State institutions and efficiency.[6]

Consistent monitoring of LAC's development situation—applying only the most conventional indicators—clearly reveals that, since the Washington Consensus, no LAC country has been able to maintain long-term reductions in poverty levels or improve the living standards of its population. As a result, as one political analyst concluded, it is not the present-day State that must be refounded; rather, a necessary State must be created, with functions and institutions appropriate to the new development model.

In this regard, three tasks are essential across the LAC political and economic panorama:

[6] See the annual reports of the IDB and World Bank for years 1998 through 2002.

- re-creation of the institutional State;
- increased integration among States; and
- inclusion of the market in the globalization process.

Decentralizing formulas and local development are effective instruments for correcting the State's development failures, as well as contributing to integration and the globalization process. Proponents of the development and political and economic reform option consider it a theoretical groundwork that can be applied practically to create the necessary and efficient State since it facilitates greater participation by and strengthening of civil society, as well as allowing the implementation of expansive and redistributive public policies.

Decentralizing formulas to create the State

Transforming the State's territorial action—that is, processes of decentralization and regional recognition—now play a key role in political and economic dynamics and management of the so-called new democracies. Public and private institutions' demand to implement decentralizing formulas is:

- socially significant and influential in countries characterized by rapid integration, exporting economies, and territorial structures (states or provinces);
- significant among local institutions' political leaders and economic agents and in countries where the State is immersed in serious political and social crises that limit or incapacitate its internal development functions;
- growing in countries whose communities carry significant demographic weight or have special ethnic, linguistic, or cultural features;
- weak in countries that are small demographically or territorially, have little urban growth, or are uninvolved in integration processes (however, proposals for local endogenous development are strong in such countries); and
- weak in countries with centralist or federal traditions that have been governed by regimes with pronounced populist tendencies and where socio-

economic activity has been conditioned by elites and institutions closely linked to the governing regime (however, the demand for decentralization and local power is included in new proposals for political change).

In summary, until the 1990s, development-related policies were implemented through central governments. The new millennium has witnessed increased regional and local participation, based on new arguments that defend their participation as a key factor for social and economic development.

However, the practical construction of these regionalization processes in LAC political and economic activity means overcoming various obstacles and contextual inertia. If regional policies are characterized as a key factor, it is because of their potential for introducing many innovations in public functions affecting politics, the economy, and culture.

Considerations in the political arena are:

- introduction of a State-organization, conceptual model;
- adjustment of State structures, governmental management, and public policies to achieve greater social integration and political cohesion;
- decentralization, which, by applying the subsidiarity principle, promotes the efficient use of public resources at all levels (central, regional, and local);
- increased political capacity of regional and local governments through transfer of decision-making powers, financing, and management;
- reorientation of political parties toward new institutional reference points with autonomous political activity and direct public control; and
- more political actors and institutional representatives, accompanied by greater social control over the actions of public political agents.

Significant economic factors include:

- reduced State presence and therefore changes in its relationship with economic and social actors, which are taken over by other public management bodies;

- development strategy aimed at consolidating an interior market and promoting territorial opening (internationally);
- changes to State standards and regulations to offer decentralized services that are an exclusive public sector responsibility;
- introduction of fiscal policies for self-financing of decentralized powers and services;
- adoption of specific regional and local policies to boost economic activity; and
- implementation of policies and compensation funds to address economic imbalances among regions.

Cultural considerations include:

- developing coherence among decentralization and cultural diversity decisions;
- promoting greater social coordination;
- promoting citizen participation—directly and indirectly—by recognizing and stimulating civil association;
- developing widespread respect for the legitimacy of government institutions and their democratic representation; and
- providing administrative channels for citizens' demands to participate in identifying and managing pressing community problems.

The development model

In the LAC context, the development model is based on policies of territorial decentralization and endogenous development rooted in a plurality of cultures. Obtaining a positive response is essential for establishing a development model with which people can identify and reach the social consensus needed to accept the conditions of public and private co-responsibility required to sustain growth. It is especially important to adopt fair fiscal policies, reallocate public resources, make production more competitive, and implement austere budgetary policies.

Today it is possible to accept the idea that the centralist model of government belongs to the past and that regional and local problems have become national and international in nature. Decentralization has become universal; as a result, its theory has become widely accepted. Its practical application in LAC involves particular limitations and potential: The correction or maintenance of these will affect the future of regional development in LAC countries, the development model adopted, and development itself.

Identifying and analyzing the limitations of this nascent process are useful in determining how to mobilize local political, social, and administrative action. These limitations include:

- interference of national political processes in local development;
- legislative systems that lack the necessary transparency to determine central, regional, or local powers and functions;
- budgetary policies that fail to support decentralized public financing or programs for fiscal co-responsibility for income and spending;
- manipulation of the resources regionalized by central authorities along political party lines;
- lack of programs for developing local government capacity;
- insufficient citizen participation in local electoral processes;
- little substitution of traditional bureaucracy by modern public management methods;
- lack of incentives to include private sector leaders in public management; and
- little relationship between regional and local governments with the business, cultural, and university communities and thus their inclusion in the regional development process.

The regionalizing process in LAC has the potential to:

- enable regional and local leaders to become recognized nationally and internationally and influence the focus of their political organizations;

- enable regional governments to gain the authority, legitimacy, and capacity to reach agreements with territorial agents on strategic plans and ensure that they are implemented;
- make the commitment to construct a regional society and promote employment opportunities to overcome exclusion and marginalization;
- increase public investment in infrastructure and basic services;
- support local and regional public investment through association agreements with business entities in the territory or international missions for attracting investment;
- develop associationism among the regions in order to develop economic integration policies of common interest to influence the pending process of integration;
- create an international opening for establishing relations with the U.S., Canada, and EU in order to obtain information on models of development and regional government, thereby facilitating direct trade and business contacts; and
- create informal structures, such as interregional clubs, to train leaders, exchange experiences, develop synergies in consulting and international action, take joint action across the continent, and establish a regional network for international exchange and cooperation.

Will regionalization work in LAC?

Though slow and dispersed as an innovative political phenomenon, LAC regionalization is growing. In states in political crisis, such as Colombia, it is growing from the social grassroots (bottom up), while in politically stable states, such as Mexico, it is growing from both government institutions (top down) and social grassroots (bottom up) (IDB 2001, 2002).[7]

More significant than the political initiative is the abundant theory from universities and other academic sources related to experiments with

[7] As a European academician who has studied LAC regional development for more than two decades from the perspectives of political theory, sociology, and economics, this author is not optimistic about the presence of a well-rooted process of regionalization in the continent; however, there is data that indicates the process is neither at a standstill nor reversing.

modern regional development in LAC, complete with empirical and field research completed throughout most South American and many Central American countries. The ultimate goal of most of these case studies is to correct a social or economic anomaly in a specific place, not to analyze a development program in an area or territory. These studies generally lack perspective and methodologies capable of analyzing the headway made in the political implementation of regional development experiences and their influence on social change and development in various LAC countries. They also lack the conclusiveness required of ongoing political and institutional initiatives aimed at consolidating best practices for application in other similar situations.

Empirical works are valuable as a way of verifying the existence of regional and local development experiments; their publication can stimulate the spread of similar initiatives. However, they do not involve planned or enduring political decisions either within or beyond the states in which they occur.[8] Despite the abundance of research and publications that promote decentralization and regional development policies, it should be noted that these works have had little influence on government institutions, parliaments, and political parties in terms of putting these policies into practice or initiating a change in the State model. However, they do point in the right direction.

Despite their weaknesses, LAC regionalization movements share certain common features with Europe's regionalizing process: Both originate in spontaneous policies that are pragmatic responses to unaddressed needs and lack of development decisions. They are not planned movements or the result of a preconceived program based on political theory. Rather, the processes are active, uncoordinated, diversified, unstoppable, and clearly occur from the bottom up. Examples include Europe's interregional associations (e.g., Euroregions) promoted within states or LAC's cross-border and transnational associations (e.g., Crecenea-Litoral Region, which affects Argentina, Brazil, and Paraguay, and central Mexico or Association of the

[8] The IDB, World Bank, Economic Commission for Latin America and the Caribbean (ECLAC), and other multilateral organizations have financed and monitored this intellectual concern.

Province of Mendoza with the Central Region, which affects Argentina and Chile).

Rigorous observation and analysis are required of politically inspired movements that have arisen from regional institutions with historical roots and federal experience. A case in point is the Club of the Regions, founded in Santiago de Compostela by 35 LAC regions and European Autonomous Regions to exchange experiences in government and promote their economies, markets, and cooperation for development. This organization promotes regular interaction with political leaders of provinces and states in Southern Cone Common Market (Mercosur) countries and Mexico. Institutional representatives of European regions and associations also participate, and consideration is given to how to promote and influence decentralization and regional development in LAC within the existing framework of integration processes. The Club has received requests to include regional representatives of the United States and Canada.

Development of the regionalizing process in LAC is necessarily related to advances in existing processes of integration. State action in the integration process will promote the transfer of internal development tasks to administratively decentralized bodies and recognition of regions with unique identities as units of political action. A spontaneous interregional and transnational association movement will likely coalesce as a result of the need to influence the integration process among states as a way to guarantee fulfillment of social responsibilities.

Conclusions: Regionalizing processes in Europe and Latin America

While one cannot draw direct parallels between regionalization and local development processes in Europe and LAC, both processes share the potential of integration policies and their inexorable link to the political and economic transformations brought about by the globalization process in the economic development of states and economic blocks.

Regional and local initiatives in economic globalization and national and international public policies are unstoppable. New actors constantly appear in the exercise of government (i.e., governability) at multiple levels of government and civil society. Regions and their forms of governance are at the forefront since modern government finds its greatest challenges in local areas. Regions and local authorities must guarantee basic conditions of liberty and human dignity. They must build a network of services and infrastructure on which to base initiatives for training and respect for efficiency, innovation, and competitiveness. In addition, they must promote private initiatives to generate wealth, employment, savings, and investment.

The regionalizing processes in Europe and LAC require observation and monitoring since both will provide new formulas for public management (though there may be distances in time and context). In Europe, the process focuses on active participation in European construction. It attempts to influence State policies that affect integration and maintain State-like participation in the bodies that debate and make decisions in the EU. In LAC, the priorities are to participate in the successful reform of the State, contribute to changing the development model by creating a market economy at the regional and local levels, promote this market internationally, generate endogenous resources for investment, provide training and technology, and achieve a society motivated to work on its own development. Regionalization plays a necessary role in promoting the processes of integration among states since their continuity and future development depend on the success of these processes.

Europe's regionalizing process has become strongly institutionalized in terms of its external relations; although this may be only symbolic, it gives regions a presence and can influence the future of the EU. The LAC regionalizing process must overcome the consolidation stage and become recognized in its own states and the integration movements under way. The process has initiated interregional institutionalizing processes that extend beyond individual states, suggesting other forms of cross-border and transnational political relations. Regional action for future development will depend on the strength with which these types of formal and informal associations and cooperation are consolidated.

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CHAPTER 7

Globalization and Local Policy Implementation: The Challenge to Practitioners

Greg Clark

Much has been written about how economic globalization has affected subnational territories, especially cities and regions that can now play a prominent role in hosting key segments of the most globally traded services, products, and processes. Researchers have progressed significantly in explaining how globalization has transformed urban populations, environments, and economies in many parts of the world. What is lacking for practitioners is an equal treatment of the extent to which cities and regions have responded effectively to these changes and challenges and what the detailed content of the responses should be. This situation is not surprising; for many thousands of people, managing the development of a city or region is a full-time job that affords little time for reflection.

Taken alone, global economic trends and dynamics are insufficient to ensure that policy goals of social cohesion and economic development are achieved at the local level. Indeed, in most localities, global economic trends and dynamics are likely to contribute to an aggregate worsening of local socioeconomic conditions without concerted action from a wide range of parties. Without effective interventions, globalization will make many cities more polarized and segregated. Global economic integration will work best when coupled with investment in local capacities to add value to external investment; in this way, these investments can perform better commercially and from a local development and public policy perspective.

For the global economy to succeed, local, national, and multinational policies must have a goal of investing in local capacity. The European

Union (EU) and the Organisation for Economic Co-operation and Development (OECD) provide clear lessons on how to make long-term investment in local development capacity vis-à-vis economic internationalization. Achieving the right combination of globalization and devolution requires a dedicated role for national/federal governments and multinational institutions in consciously building the local capacity and expertise required to manage and shape local development effectively.

Globalization presents cities both opportunities and challenges. On the one hand, it offers them the chance to free themselves from old regional and nation-state urban systems and to place themselves more thoroughly in an international context, pursuing new forms of investment and trade. On the other hand, it requires them to create new tools and implement new policies rapidly.

Cities must invent new mechanisms for social inclusion and economic participation in the context of dynamic labor markets, underskilled urban populations, and highly mobile international labor. They must address the fundamentals of the business environment they offer, its attractiveness to external and mobile investment, and the clarity with which it is communicated. They must reengineer their land use and infrastructure around the new forms and nodes of trade, often reorienting the city's entire economic geography in the process. Moreover, in most cases, they must invent a new form of governance at the metropolitan scale in order to provide basic coherence to development efforts, marshal resources for investment, and provide a mechanism for strategic decision-making. Each task is difficult and can work well only if the city is clear about its territorial—social, economic, and environmental—assets. Lack of clarity about these often translates into misdirected development efforts.[1]

In local development terms, there is a broad set of debates about policy goals, but limited discussion about the means required to achieve

[1] As a practitioner of local economic development concerned that international lessons from doing and managing local development are well learned, this author believes that implementation, rather than policy or strategy, is the key variable—that is, the factors that help to achieve (or fail to achieve) policy goals at the local level.

them (this is especially true when countries and continents are encouraged to borrow or copy policy initiatives). As a result, situations are created whereby sophisticated, clever policies and strategies are put together, but no real effort is made to deliver them because the capacity to implement them is missing. In other situations, policy and strategy are limited, but robust and courageous action at the local level leads to good outcomes.

There is no direct link between sound local development policies and the ability to achieve them. The capacity to implement local development must be carefully built. This point has been made clearly in assessments of how local development capacity has been built in the EU, compared with NAFTA countries. The questions are about how to proceed, rather than further discussion of what is needed.

Accounting for Local Success in the Global Economy

No one city or locality is uniquely successful; yet some have clearly achieved economic trajectories that outstrip the performance of their national economies, main regional trends, or other cities with apparently similar assets and opportunities. What factors made Barcelona grow faster than Valencia, Frankfurt more rapidly than Cologne, Atlanta more than Birmingham, or Sydney more than Melbourne?

National economic policies around the world are converging. Growing global and regional trade arrangements, shared currencies, external fiscal disciplines, and multinational investors fuel this convergence. Local leaders realize that the greater locational differentiation may now be possible at the subnational level. Cities and metropolitan regions might exploit their natural assets and investments in distinctive ways that provide a significantly enhanced platform for commercial success and job creation relative to their basic trend rates, as well as to other cities and metropolitan regions.

The mandate to encourage local leaders to pursue local economic development objectives continues to grow. Localities and cities may be able to differentiate themselves from one another in ways that nations and federations of states find more difficult. They may achieve differentiated economic performance, and therefore provide distinctive investment opportunities that offer returns not easily available elsewhere. This assumes that localities and cities must have certain distinctive and diverse assets and opportunities in economic development terms, relatively coherent and effective means of promoting their own advantages, and proactive ways of "setting out their stall" in the international economy. Many have the territorial assets and goals, but do they equally possess the necessary territorial development tools and means to participate and succeed?

Current debates remind one that, without such means, local actors may find it difficult to lead their own development process. Over the past 10-20 years, there has been dynamic growth in most of the developed world to promote local development. Not all development tends in the same direction, but there are now few fundamental differences in philosophy.

As an overall framework, local economic development now takes dynamic macroeconomic change as a starting point. Indeed, in many developed countries, the beginnings of actively promoting economic development can be traced back to broader processes of deindustrialization, massive technological change, or continental economic integration. Recently, the larger drivers of change have tended to have highly divergent subnational effects. Recent economic history has emphasized economic internationalization, its relationship with a new global trade regime and trading blocs (with shifts in the global geography of supply and distribution chains), evolution of new generation ICTs, widespread public sector reform and decentralization, and large-scale (mainly pro-urban) demographic shifts.

Together, these factors have combined to accelerate subnational economic differentiation and trigger reorganization of the economic functions within and between continents, nations, regions, and cities. Certain localities, cities, and metropolitan regions have faced substantial problems, and some have gained significantly. Overall, the world is becoming more urban as a result, and de-urbanization in the developed world has been reversed. Global processes have had discernable differential effects locally.

Cities and metropolitan regions have been reestablished as fundamental economic units, and some have done better than others.

In this context, key dimensions of local economic development have become more clearly visible and definable. For example, it is now possible to state that a key aspect of local economic development involves local attempts to manage and shape economic change positively, capture the benefits that changes can offer locally, and be proactive in doing so. Essentially, such local development efforts are attempting to position their locality to benefit from the new demand-side drivers in the international economy. To the uninitiated, local development may look like a series of ambitious but disconnected projects and programs to help workers, small firms, and others adjust to new crises and opportunities. In fact, local economic development is fundamentally a change, risk, asset and relationship management activity undertaken within a territorial framework.

Local economic development efforts must recognize the dynamic external contexts in which a local economy operates and seek to actively manage and shape them, bringing forward improved supply-side responses at the local level and, in so doing, negotiating a better deal for the locality. While national and federal governments pull the macroeconomic levers, local economic development attempts to intervene at the subnational level, which can enhance the beneficial (or remedy the negative) effects of macroeconomic trends and higher-tier policies.

Today, local economic management is at least as important as local economic development. Localities, cities, and metropolitan areas must manage their economic environment and important client relationships with existing key industries and investors, as well as with workers, consumers, and firms, if they are to optimize macroeconomic changes and mitigate their risks. Local government officials and other promoters of local development must become account managers with local economic stakeholders. This explains why, over the past two decades, local economic development has shifted away from chasing key outcomes (e.g., foreign direct investment [FDI] deals) and moved toward strategic management functions. This shift is reflected, in part, by how the organization of local economic development has changed from a departmental activity within local governments to a civic leadership and partnership activity, whose management involves multiple stakeholders and capable development agencies (often covering a new geography that includes several municipalities).

However, these shifts in how local economic development is implemented echo in other discussions. Many observers have noted that globalization has changed the task of local development; it is now more complex, more challenging and, in certain ways, more dangerous. This dramatic shift broadens the mandate to invest in local development capacity if the global economy is to become a partner, rather than an enemy, of local development.

Economic Development: A Distinct Activity of Local and Metropolitan Governments

Economic development differs from many other activities of local and metropolitan governments. For example, it is unlike municipal service functions where units of service delivery and performance can be easily monitored and measured (e.g., sanitation services). Economic development influences market-based processes and activities by positioning the locality effectively to address them; it is not simply about delivering public services (although certain services are a key part of any locality's economic development offering). Equally, local government is rarely a monopoly provider of all local things that economic development must embrace.

This is a key reason why local development agencies are established as partnership vehicles. For example, local utilities, banking and investment, higher and vocational education, trade and tourism, crime prevention, and many other services can be key aspects of local economic development; however, they are not always delivered directly by local governments. Thus, there is often a requirement to build alliances or implementation vehicles to achieve coherent delivery of any economic development strategy.

In 2001, this author undertook an analysis of local government's unique role in economic development in the UK. The assessment identified key rationales for local government's role, the most fundamental of which was the need for accountable, farsighted leadership. Other justifications included the following:

- Strategic decision-making capacity is a key contribution of local government;
- Prioritization of economic choices must be backed by democratic accountability;
- Local government must lead the diverse strands of the public sector locally;
- Linking economic development with social and environmental protection is a key role;
- The contribution of publicly owned land assets should be a central focus.
- Local government should use its land-use planning and other functions to influence the behavior of developers and investors;
- Local government should take the lead in addressing intra-municipal inequality;
- Local government should lead in involving the public sector in contributing locally and being more partnership-ready;
- Local government should work to improve the local business environment in terms of tax and regulation, planning, licensing, and traffic.

Because local development involves complex tasks—managing risks and relationships, setting priorities and mobilizing resources, and negotiating with external and often powerful partners—it requires a robust local mandate to perform them.

An important recent development is the recognition that local economic development is fundamentally about taking a view of the locality's potential and offering it as a location, from the perspective of various key economic and social stakeholders. For example, a locality can repeatedly ask: "What is our actual or potential offering as a location for jobs, workers, incomes, consumers, large and small firms, investors, asset holders, tax revenue, donors, and lenders?" Asking these questions consistently and well brings insights and perspectives otherwise absent in municipal thinking.

They can remind local players that the local business environment requires active management, a key component of local development.

A typical example of this approach from Europe and North America concerns local governments' pursuit of business retention programs. Many localities now understand that successful businesses spend 80 percent of their marketing effort retaining and expanding the value of their current client base and only 20 percent seeking new clients. So too with local economies. Successful cities and localities now spend more effort liaising with existing business investors to learn about how those businesses and their networks of suppliers and key collaborators could be helped to expand, as well as any perceptions their businesses have of weaknesses in the way the local business environment operates.

While FDI remains important to localities, it is recognized that a precondition of successful and enduring FDI is effective management of business retention and expansion at the local level. FDI and business retention are complementary, not competing, policy goals. Importantly, however, a business retention and expansion program will likely lead a locality to systematically address product improvements in the local economic environment more so than FDI efforts alone, which will likely be oriented more toward marketing. A locality focused on improving its local economic environment will have more leverage in negotiating with global investors.

Good Governance and Metropolitan/Municipal Reform

Local economic development efforts frequently highlight the need to align economic geography with administrative and governance geography at the subnational level. Many interventions that economic development strategies might seek to encourage have optimal effect at the level of the functional subnational economy (often a widely defined metropolitan region). This level often involves an overlapping series of market-based spaces (e.g., a labor market geography bounded by acceptable daily travel to work distances; an acceptable supply chain distance for a smaller company; or a user-geography for logistics facilities and infrastructures, such as a major train station or an airport). The sum of such spaces is a functional, subnational regional economy.[2]

Few subnational economies have a governance system that covers all of the included areas. This gap creates fundamental challenges for local economic development as it increases the scope for unintended negative consequences arising from local development activities. Predatory competition between neighboring municipalities may include:

- substitution, whereby what happens is zero sum, but locations are changed;
- spillover effects, whereby an action's effects are spread well beyond the target territories;
- displacement, whereby one effect of an intervention prevents the occurrence of other desirable actions; and
- dead weight, whereby a significant portion of the effects would have occurred anyway.

Thus, local economic development interventions are likely to have effects across the entire functional subnational economy; any notion that these effects (e.g., jobs created, investment attracted, or procurement decisions) can be captured solely within certain administrative jurisdictions is fanciful. For these reasons, local economic development has been a strong driver of or imperative for metropolitan/municipal reform and broader metropolitan governance processes, and local economic development strategies developed at the metropolitan level have been better informed by a clearer understanding of detailed economic geography.

Metropolitan reform processes have also enabled a series of local administrative units to share the costs of key local economic development infrastructures from which they all benefit. One example is the growing range of Metropolitan Economic Development Organizations, whereby several municipalities "club" with business-leadership organizations, utility companies, universities, and other entities to form a metrowide eco-

[2] In Europe and North America, one would use the term *regional economy*; however, in other world settings, regional often refers to larger continental subdivisions.

nomic development agency and program, recognizing the fundamental economic interdependence of all parts of the region.

Role of National and Federal Governments and Multinational Agencies

In the context of changing local economic development, what is the role of governments (national, federal, state, and provincial levels) and multinational agencies? Cities and metropolitan regions have started to learn how to adjust to the new international economic order in ways that often reflect changing perspectives and practices at the national and federal levels. Today national macroeconomic policy more readily admits its limitations, just as it simultaneously seeks to reinvent and pool its power in the global context. In developed countries, many national and federal governments have begun to address the renewed importance of subnational economies by reviewing and updating their policy tools, which have brought localities, cities, and metropolitan regions to the fore.

For example, over the past decade, national urban policy reviews (formal and informal) in various countries (Australia, France, Germany, Italy, Japan, the Netherlands, and UK) have explored many of the themes that the World Bank and other multinational organizations have addressed in their urban strategies documents; several of these reviews have resulted in new national policies. Fundamentally, they have stated that the large drivers of change are creating a more urban world in which cities are the most basic form of human settlement, as well as fundamental units of economic production. As such, cities are viewed as offering the principal infrastructures for both economic growth and social justice. To fulfill both roles, cities require the help of higher-tier governments, which must be calibrated in ways that empower cities and help to create a national system of cities and metropolitan regions that will move beyond the zero sum of interjurisdictional competition. This redefines the purpose of local economic development; that is, cities are also the places where destabilization will occur if economic, social, and environmental imperatives are not met.

The past decade has also witnessed a series of national regional policy reviews (formal and informal).[3] Such countries as Mexico, Poland, Portugal, and the UK analyzed their subnational economies and attempted to put in place new arrangements to address these regions. In Europe, such reviews have resulted in efforts to create and sustain Regional Economic Development organizations and agencies; in the United States, they have led to a more regional focus of national economic development programs (e.g., Economic Development Administration and Housing and Urban Development) with efforts to encourage more intra-regional cooperation between local development actors. They have also led to stronger regional alliances and partnerships (e.g., the growing number of U.S. metro-regional economic councils).

From these reviews and resulting policies, two clear policy lines can be drawn:

- Today cities and regional economies are viewed fundamentally as economic assets and building blocks, not as problems and challenges. As a result, city and regional economic development are more easily accepted as a national priority.
- In the context of an increasingly global economy, national policies have shifted toward helping all cities and regions do better, rather than simply helping the worse off by seeking to redistribute national economic activity and public expenditure from other cities and regions.

These basic policy changes have two clear implications:

- National and federal governments, as well as multinational agencies, have started to reinvent their role in supporting city and regional economies and economic development.
- City and regional organizations have started to reinvent economic development more fundamentally in order to respond to higher-tier criteria for greater investment (e.g., eligibility for the European Re-

[3] The term *regional* is used to mean subnational.

gional Development Fund [EU], access to the Economic Development Administration's technical assistance funds [U.S.], or preparation of an investment program, such as a City Development Strategy, for World Bank support).

These implications have started to unfold in four main ways:

- First, the focus of interest has shifted toward finding and defining subnational economies. More detailed economic analysis conducted at the subnational level has revealed how little is known about the local interdependence of places. Old enmities between cities and suburbs, neighboring cities, or urban and rural areas have not disappeared; however, new evidence shows they are more economically interdependent (mutually reinforcing) than was previously understood. They cannot "go it alone" but must work across their subnational region to create the tools to steward their business environment, promote new forms of employment, deal with image problems, and tackle the challenge of limited infrastructure.
- Second, this changed definition of the appropriate site of local economic action has resulted in the need to create new vehicles for addressing the new local economy viewed as the more appropriate site of economic development activities. One result has been a large expansion in the creation of both local economic development agencies and other special-purpose organizations and partnerships, many of them working at the metropolitan and neighborhood levels.
- Third, to better address the territorial development imperative that such reviews have highlighted, attempts have been made to build new metropolitan governance structures (e.g., metropolitan/municipal reorganizations over the past seven years in Berlin, Mexico, Miami, Montreal, London, and Toronto).
- Fourth, the goals of local economic development have broadened substantially. They no longer simply include job creation or generation of municipal tax revenue. Local economic development objectives now frequently include quality-of-life objectives, economic diversification as-

pirations, income and disposable income targets, labor market participation rates, business formation rates, productivity and innovative measures, and precise local investment targets and mechanisms. What is now known about developing a sustainable subnational economy is translated directly into economic development efforts.

Changing Practices in Local Economic Development

Recently, Europe and North America have experienced significant shifts in how local economic development programs use their available resources. They have moved from:

- crisis response to long-term analysis and strategy-led interventions;
- focus on sites and buildings to one of firms, people, and skills;
- direct management of individual site developments to a wider role in master planning, setting design standards, organizing architectural competition, and the phased/planned release of land/sites into local real estate markets;
- hard infrastructure to soft infrastructure;
- focus on FDI to one of building a balanced regional economy;
- business attraction to business retention and expansion;
- working with large individual firms to working with networks and clusters of smaller linked firms and supply chains with tradable capacities;
- focus on tax- or cash-based incentives (price) to one of local product and environmental improvements (quality) and relationship management (customer care);
- job creation initiatives to employment strategies that emphasize income goals, skills enhancement, employment preparation, labor market access, and on-the-job development and support;
- municipal economic development offices to leadership councils, development agencies and corporations, and public-private partnership;
- community involvement to community empowerment through asset transfers, community development corporations, and balance sheet strength;

- narrow focus on private sector partnerships to a broader one that also includes public and community sectors;
- provision of ongoing subsidies to public sector-enhanced, market-based financial engineering and investment instruments;
- short-term to longer-term visions, missions, and strategic goals;
- stand-alone economic development programs to long-term economic development strategies integrated with growth management, public transport and infrastructure, quality public services, good governance, livability, bankability, and community safety; and
- local development being everyone's job to more defined professional niches and roles.

This list highlights the dynamic changes now occurring. In short, local economic development is being integrated into the main flows of public sector reform and reinvention at the subnational level, and key lessons are being learned from its private sector involvement.

Strategy Implementation: Role of Local Development Agencies

A major response to the challenges of glocalization concerns the creation of local development agencies. Creating an organized vehicle for pursuing local development goals is an option many localities consider necessary once they realize that local development activity goes beyond providing services, requiring local actors to become the agents of their own future. This phenomenon is observable in OECD member countries, where some 10,000 such agencies now exist. International experience is extremely diverse, and no one formula fits all situations. Nonetheless, three basic variables can be isolated to help develop an approach:

- The complexity of local economic development challenges and their sensitivity to local interventions. These challenges are unique, even if they increasingly occur in the same global context. Some are amenable to local and regional interventions; others require substantial national and international efforts. Some respond well to national economic growth; others will see their fortunes diminish while the nation prospers. Cities or localities tend to undergo cycles of opportunity and need, not necessarily in sync with the national economy's performance. Different types of local development agencies and strategies are needed at various points in the redevelopment process.

- Political, financial, and fiscal contexts in which local development agencies are established. These vary enormously—from centralized national efforts in certain parts of Europe (1940s and 1950s), to the municipal and business efforts in U.S. rust-belt cities (1960s and 1970s), to the wide-ranging establishment of local development agencies in the developing countries of the Asia Pacific region and accession countries to the EU (1980s and 1990s). A key variable is which government tiers are the key agency sponsors and to what extent those tiers have financial and fiscal freedom. For example, local development agencies sponsored directly by national and federal governments tend to have greater financial resources and freedom than those sponsored by municipal governments alone.
- Interinstitutional functions of a locality's overall economic development program. Some local development agencies are comprehensive, providing or coordinating the main inputs of the economic development process at the local level; others are niche agencies, providing a particular aspect of the process (e.g., site preparation and master planning, inward investment promotion, or small business support and finance); still others are sectoral, focusing largely on a single key dimension of the local economy (e.g., tourism, sports, or manufacturing). Many have succeeded in shifting from niche to comprehensive agencies and vice versa. An additional issue concerns the agency's links with those responsible for organizing business leadership, infrastructure advocacy and development, public land management, skills training and vocational education, housing, and broader international promotion or marketing of the locality.

At the international level, these three variables provide the backdrop for what must be considered in terms of local development agencies' international experience. The prevailing conditions within the context of each variable significantly shape what such an agency is and can do.

Local development agencies are potential mechanisms for strengthening local development efforts; they are a source of new local development tools. While the justifications for establishing, maintaining, and expanding a local development agency differ, all include the need to create an entity that can:

- negotiate directly with developers and deliver services to businesses and other actors,
- respond to a crisis or challenge for which there is no other agent (e.g., closure of a key site or facility),
- focus on the specific needs of an identified redevelopment area,
- serve as an independent and more flexible vehicle for partnership co-investment,
- integrate the inputs of a diverse range of public and private partners,
- cover a geographical area that has no other ready governance structure,
- fulfill an outward-facing role for the city,
- develop more flexible procedures and human resource arrangements,
- undertake a focused task over a defined time period unencumbered by other missions and goals,
- achieve a legal or fiscal status that allows it to use or develop tools and interventions otherwise lacking,
- manage a transparent process for delivering financial assistance and incentives to businesses in ways that are not directly controlled politically, and
- share risks and costs effectively across a range of interested parties.

Local development agencies are essentially special-purpose vehicles. Justification for their creation or role enhancement rests on defining how they could achieve more than preexisting municipal arrangements. Working relationships with other local players are also important. In addition to bringing together key partners within its structure and constitution, the local development agency must foster distinctive working relationships with:

- other city-government areas (e.g., planning, transport, policy, housing, estates, infrastructure, education, culture/amenities/leisure),
- economic development entities in neighboring municipalities and regions,
- politicians at all levels (to provide them insight into the agency's activities),
- other public sector areas (e.g., universities, hospitals, and housing),
- business leaders and other specialist economic development groups, and
- community interests and organizations.

None of these relationships is especially easy, but all are important. Much of their management and coordination is invisible in terms of the development agency's delivery of key programs; yet these relationships are critical to smooth working. Development agencies have often been set up as business-facing entities; however, they also need to be partner- and colleague-facing. Depending on local institutional arrangements, these priorities can be variously addressed. Explicit, planned, and agreed-on mechanisms involving the most senior officials of the entities concerned are key to managing these relationships.

Today it is generally accepted that most cities and regions require more than one type of development agency. Recent U.S. trend analysis, for example, suggests that most major U.S. cities and metropolitan regions have a range of development agencies covering varying geographies. Coverage types include:

- Citywide—single multifunctional economic development agency,
- Central Business District—range of business improvement districts and other targeted efforts,
- Neighborhoods—range of community-based development entities, and
- Metropolitan—regional cooperation/marketing coalition and perhaps technology diffusion entities.

In Europe, by contrast, regional efforts are more developed, most metropolitan regions have fewer jurisdictions, and boundaried cities at their center are larger. Typical European coverage types are:

- Citywide—single multifunctional economic development agency with several specialist agencies working alongside it (e.g., small- and medium-enterprise [SME] support),
- Regional—one main regional development agency operating as a partnership between business and government, and
- Others—a wide range of specialist local development agencies without a strategic statutory remitment.

If the use of local development agencies is to spread, it is important to better understand how various arrangements work, rather than simply borrowing or copying a particular model.

Financing Local Development: Role for Multinational Institutions

Leveraging private finance in localities, cities, and regions is a fundamental imperative for all types of government. OECD countries and their subnational governments have embarked on a quest for effective means to encourage private investors to view localities, cities, and regions as good places to secure a return on investment. Bankers, fund managers, and investment advisors are taking note. Investments that help local economies to perform better can also add value to other localized transactions by providing a more competitive platform for business, raising local incomes and revenue, and improving asset values.

Today, mayors and regional leaders advocate local economic development strategies that increasingly seek to play the role of investment prospectus for their territories, demonstrating to financiers that they have the ability to grow in ways that can sustain borrowing to support economic expansion and provide an acceptable return on capital. Certain local and regional financial instruments already demonstrate a competitive performance relative to more established investment vehicles. Put simply, more private investment can help a city or region achieve more than public investment cycles alone can afford, especially in times of tight fiscal discipline.

Thus, a critical local economic development activity is to make cities and regions more investable (i.e., they must clearly demonstrate how good returns can be made on investments in their territory and be ready to help make those deals attractive) and investment ready (i.e., they must focus directly on helping to stimulate a strong deal flow of good quality propositions for financiers to evaluate). Cities and regions not only need to expend significant effort to attract international corporate investments through FDI; they also need to attract institutional and commercial investment in their locally focused financial instruments and assets.

Over the past decades, major changes in global economic development have produced a different set of financing propositions at the local level. Nowadays, economic development in localities, cities, and regions is less about roads, bridges, and factories (tangible collateral), and more about reused brownfield land, high-tech space, creativity hubs, science parks, supply chains, knowledge capital, small companies, joint promotion, and community development (less tangible collateral). These assets offer more variable revenue covenants. The public sector can use its resources flexibly to help the private sector find ways to commercially finance this new generation of job- and wealth-creation activities. National assistance through tax relief and incentives can be coupled with more localized participation in financial instruments to improve returns or reduce risks and costs for private coinvestors.

This is happening more quickly in certain places than in others. For example, Catalan Banks have played a major role in financing Barcelona's redevelopment; New York City's financial services sector has been an important investor in community development successes; and, in Australia and New Zealand, fast-growing smaller companies are witnessing their growth supported by public- and private-capital programs. In London, municipal pension funds are now significant investors in small capable firms and urban regeneration. Its banks provide patient capital for disadvantaged entrepreneurs. In poorer neighborhoods, social housing is regularly financed through private debentures, bonds, and European Investment Bank lending. In addition, community development organizations are starting to leverage bank lending for capitalization projects.

It is now recognized that investment opportunities that are principally territorial (localized) can be competitive for commercial finance, compared to other opportunities in business stocks and shares, government bonds, or other traditional investment instruments. However, issues of credibility and profitability gaps, scale and risk, and cost and confidence must be addressed if cities and regions are to attract private investment over the long term. Improved flow of sound local proposals (allied with clear investment instruments) must be built if local investment markets are to grow. Localities, cities, and regions can better attract private investment if they diligently build the basic dimensions of a healthy local investment market. To do so, most localities, cities, and regions need help from their national governments and multinational financial institutions, as well as robust advice from partners in the financial services sector.

For those seeking to build local economies, private coinvestment can add important ingredients otherwise lacking. Increasingly, economic development programs are moving away from traditional attempts to substitute for the lack of private investment, and are more concerned with explicit attempts to leverage private investment. The focus is tackling market failure through market-making. Private finance is key to economic development because it:

- provides more capital than otherwise available more quickly and efficiently;
- helps to rebuild local investment markets and averts other disinvestment;
- builds a more sustainable finance strategy into economic development initiatives, allowing for gradual unlocking of public funds for alternative actions;
- creates a greater commercial and professional discipline within economic development policies and initiatives;

- attracts wider interest from other commercial players, providing confidence that something of value is occurring that might merit their interest; and
- repositions sound economic development activity as an investment, rather than an expenditure in the modern economy.

Thus, localities, cities, and regions are increasingly in search of the best proposals and instruments with which to attract commercial investment. Equally, for private finance providers, participation in economic development programs can provide important contributions to a business strategy by:

- using public sector support to help develop new business and market sectors that would otherwise not be easily accessed, acting as a research and development activity for future product lines;
- contributing to diversification of asset classes over which investment is spread;
- helping to achieve ethical and/or local investment priorities;
- providing some predictable returns in periods of instability;
- building relationships with a wider set of partners from which other business might evolve; and
- strengthening local and regional economies in ways that can safeguard or improve other investments or expand the market for other financial services.

Multinational institutions have a key role to play in facilitating working effectiveness between local and regional governments and private financiers. Encouraging local economic development to attract and sustain external coinvestment in a robust manner should be a deliberate focus. For example, multinational institutions can invest in:

- improving corporate and project finance skills at the local level, especially among local development agencies and practitioners;

- creating simple and robust templates for public/private coinvestment in local development projects so that proposals can be generated in a standard format that is legally tight and inexpensive to appraise;
- developing local programs to stimulate proposals for external financing (e.g., investment-readiness programs for local real estate or growth-oriented SMEs); and
- financing instruments to help offset costs, improve returns, or mitigate risk by supporting good quality projects that are close to market thresholds. Many local development initiatives can effectively service external financing, but cannot provide equivalent returns or security. (These factors must be addressed directly to keep external financing engaged.)

It is hoped that this brief discussion stimulates an important debate on the future significance of local economic development in the new era.

CHAPTER 8

Local Economic Development: What Makes It Difficult; What Makes It Work

Jörg Meyer-Stamer

Around the globe, local economic development (LED) is attracting attention, particularly in developing countries and the donor community. What accounts for the increased interest? Many developing countries pursue decentralization policies, which include delegating responsibilities for promoting economic development to provincial and local governments. The hope is that local governance may be easier and that developmental local government may be feasible since key challenges—low national cohesion and ethnic tensions on the one hand and overburdening governmental bodies and increasing differentiation and fragmentation of problems, policies, and governmental institutions on the other—are less problematic at the local level.

In addition, many developing countries, for a variety of reasons, lack sound governance and delivery capacity at the national level. Gone are the days of centralized industrial policy as successfully practiced in newly industrializing countries because of external pressure (based on The Washington Consensus) and the weakening of internal governance capacity. Moreover, World Trade Organization (WTO) agreements have banned traditional development policy instruments, such as import barriers and local content regulations. Irrespective of decentralization policy, local actors become engaged in economic promotion activities since the problems of unemployment and poverty are felt most urgently at the local level.

Industrialized Countries' Track Record

The LED profile in Organisation for Economic Co-operation and Development (OECD) countries is changing. First and foremost, LED's scope is widening. Traditionally, LED revolved around three issues: 1) zoning and development of industrial estates; 2) attraction of external investors; and 3) reducing friction and communication problems between private business and local government. Recently, local governments have become more proactive, using such instruments as entrepreneurship promotion, business and technology incubators, and cluster promotion. Many locales have begun to approach economic development more strategically, attempting to shape a specific profile to create a local competitive advantage (European Commission 1998; OECD 1999, 2000, 2003).

Second, it is difficult to discern a convergence of practices across industrialized countries. Certain instruments are becoming fashionable and more widely used; however, answers to basic questions—Who is in charge? What is the governance structure? What is the scope? What is the overall objective?—continue to diverge, not only between Anglo-Saxon countries and the European continent but also among European countries (with their diverse histories regarding devolution of power, federalism, and regional policy) (Raines 2000).

In those developing countries where LED has been implemented for some years, it is difficult to discern stunning success stories; for example, Aghón et al. (2001) provide little evidence of the outcome and effects of the case studies described. Even in OECD countries, LED success stories are not that numerous. One cannot help but wonder whether LED's popularity stems more from desperation than a convincing track record.

Given industrialized countries' long experience and enormous resources spent on LED, it is striking how little evidence exists on its effects. This author has argued elsewhere that it reflects the political economy of economic promotion (Meyer-Stamer 2000). Economic promotion is not a scientific exercise; rather, it is part of the everyday political struggle. Political actors launch economic promotion activities in response to their constituents' problems and demands. They are, first and foremost, measured by the resources they can mobilize on the input side. For example, if a steel plant is closed down in a given location, a politician who mobilizes several million euros as a compensation measure becomes a popular hero, regardless of how effectively the funds are used. In fact, the politician is unlikely to be interested in this issue unless an evaluation paints an unambiguously positive picture that provides ammunition for his or her political opponents.

The scant findings available tend to indicate that LED makes little difference:

- Regional policy, a key LED funding source, matters little. Research in Germany on the main regional policy program (*Gemeinschaftsaufgabe*) found that, despite substantial efforts, regional disparities increased (Deutscher Bundestag 1999). With respect to European regional policy in terms of reducing disparities, the evidence is, at best, mixed (Fagerberg and Verspagen 1995; Moucque 2000; Ederveen and Gorter 2002).
- Cluster promotion, a specific type of LED, is frequently addressed as a territory-based activity. In his research on the evolution of 160 clusters worldwide, Enright (2000) found that, except for education and training activities, government action is irrelevant.
- Enterprise zones, traditionally a common LED instrument, offered businesses tax breaks and regulatory relief to lure them into deprived urban areas. The success of this approach has been extremely limited (Ladd 1994).
- Technology incubators are another popular LED instrument. In Germany, for example, more than DM 1 billion was spent to create more than 50 incubators in Northrhine-Westphalia over a 12-year period (1984–96). One evaluation found that companies inside incubators fared only slightly better than the control group, and that the net number of jobs created amounted to only 2,000–4,000 (Elle et al. 1997).

How should one react to such sobering findings? Ignoring them is not an option as long as democratically elected politicians face their constituents' expectations of creating jobs and income. One might point to methodological problems. Any given LED initiative involves a variety of instruments; appraising their combined effect on growth and structural change is highly difficult. In addition, the counterfactual question remains: what would have happened without them? Maybe they failed to create growth, but perhaps the decline of a given location would have been much steeper without them.

A more straightforward reaction is this: one cannot assume that experiences from OECD countries provide a model for LED in developing countries. Not only is there the issue of transferability, which cannot be taken for granted because of differences in institutional structures and other factors. More importantly, if it cannot be proven that LED efforts in OECD countries have made much of a difference, there is no point in trying to transfer these experiences.

Variations on LED in Developing Countries

Several common types of LED approaches currently pursued in developing countries are based explicitly on experiences in industrialized countries. The dominant approaches of developing country governments and donor agencies are:

- Strategic planning of local development. This approach is widespread in Latin America and the Caribbean (LAC) (Aghón, Alburquerque, and Cortés 2001). Problems include its high cost, requirements in terms of planning skills, and bias toward elaborate documents and against implementation.
- Local economic development agencies (LEDAs). LEDAs are also widespread in LAC and, to a certain extent, in Eastern European transformation countries (ILO, UNOPS, EURADA, and Cooperazione Italiana undated; EU undated). This approach is informed by experience from Mediterranean countries, particularly Italy and Spain; it is being transferred internationally by such agencies as the ILO. Results are mixed, particularly for those LEDAs with exaggerated expectations.
- Cluster promotion policies. In many developing countries, local, provincial, and occasionally national governments pursue cluster promo-

tion policies, which are based on Michael Porter's conceptual and advisory work (Fairbanks and Lindsay 1997). Such institutions as the World Bank have supported this approach in numerous countries. Results are mixed; indeed, transforming agglomerations of uncompetitive producers into highly specialized, competitive industrial districts is a daunting task (Altenburg and Meyer-Stamer 1999).

- ECOLOC (*Economies locales*). In certain African countries, the Club du Sahel and OECD promote a method known as ECOLOC to launch LED initiatives (Club du Sahel and OECD 2001). The basic concept involves several months of studies and several subsequent months of consultation and strategy formulation, followed by implementation.
- Mandatory task of local government. In South Africa, LED is a required government task.
- Participatory Appraisal of Competitive Advantage (PACA). This approach is based on a bottom-up, pragmatic, and action-oriented concept (Meyer-Stamer 2003). Increasingly, German technical assistance pursues this approach.

To date, little evidence suggests that any of the above approaches have had a major effect. Helmsing (2001) and Llorens, Alburquerque, and Castillo (2002) observe that LED research in LAC did not even request hard evidence on impact. Tomlinson (2003) finds that in South Africa, LED makes little difference.

What Makes LED So Difficult?

Based on his research and practical experience, this author argues that LED initiatives in developing countries have four major, inherent problems:

- A strategy- and planning-driven approach, driven by local authorities whose capacities are already overstretched.
- Confusion between community development and LED. Any successful LED initiative is based on involvement of the local community. However, LED is about creating favorable conditions for business and

alleviating local market failure, while community development is about health, housing, education, crime prevention, and support for the disadvantaged.

- Unclear theoretical and conceptual background and confusion between business and LED. LED initiatives ought to enable private business; they cannot substitute for it.
- Profound confusion about good LED governance practices. Should there be a dedicated agency? What should be the roles of the public and private sectors? How should they coordinate their efforts?

LED strategy and local government

Why is LED often conceptualized as a public task that involves planning and strategy?[1] This author hypothesizes three reasons:

- LED is often government-driven. For government, planning LED activities (possibly in terms of several-year plans) fits into its usual operational framework. The opportunity-driven, flexible way of approaching matters, which comes naturally for business people, is alien to public servants.
- Many LED practitioners have an urban planning background. For them, operationalizing their work in terms of a planning approach comes naturally.
- The LED discussion has, to a certain extent, been shaped by earlier concepts of strategic development planning, integrated regional rural-development planning, and strategic industrial policy.[2] Actors with backgrounds in these fields tend to spend much time formulating strategies and plans, as opposed to implementing practical LED activities.

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[1] For example, the standard textbook is entitled *Planning Local Economic Development* (Blakely and Bradshaw 2002), even though most of its contents center on delivering LED.

[2] In the context of development cooperation, the rise of LED has led to turf wars in many organizations, with varying outcomes; for example, in the World Bank and Inter-American Development Bank, the LED issue is driven by the Urban Planning and Development departments, which tends to reinforce the strategy-driven approach (see, e.g., Webster and Muller 2000).

The planning- and strategy-driven approach to LED presents a twofold problem:

- It requires substantial resources: manpower, skills, and money; and
- Even if a local government makes those resources available, it is difficult to strategize and plan something that is difficult to imagine.

Planning LED—especially a multiyear LED strategy—is usually based on a thorough analysis of the local economy. Preparing such an analysis requires at least several person-months, if not person-years. Rarely does a local government have personnel with the needed skills; more likely, it contracts outside experts, typically from academia or a consulting firm; even in OECD countries, this is common practice. Given that the daily rates of skilled persons in developing countries are not necessarily low, a local government will quickly consider at least a five-digit figure in U.S. dollars just to prepare a diagnosis of the local economy. On top of that are the efforts of costly outside specialists and local stakeholders that commit much unpaid time to turn the diagnosis into an action plan. Cases in which a plan is formulated often involve numerous, non-prioritized proposals for local-government action, requiring already thinly stretched resources.

A major question for a locality with little or no LED experience is this: how do you plan something you cannot imagine? A local community with many years of LED experience may find it feasible, and in fact useful, to engage in an effort to formulate a LED strategy. However, in most developing countries, LED is a relatively new topic; thus, local stakeholders are often unclear about what they are supposed to do. The confusion is exacerbated by local stakeholders who refer to experiences in far-off countries with vastly different LED histories and local economic structures and capacities. Telling newcomers to LED that, before doing anything else, they must formulate a strategy is tantamount to asking continental Europeans to advise on tactics for a cricket match. The outcome of such an exercise is often an enormous document, but no action.

Moreover, nothing can prepare local government officials for such tasks as preparing appropriate terms of reference for outside experts, educating local stakeholders about LED issues, or moderating and facilitating stakeholder dialogue. On top of all this, local government is already busy with multiple other activities, including building and maintaining roads and other infrastructure and providing education, health, and housing. LED will no doubt become entangled with these activities; thus, at the end of the day, LED is about roads, education, health, and housing—not about local environment for business. This outcome leads directly to the second problem: confusion between LED and community development.

LED and community development

Confusing LED and community development is not unique to developing countries. In industrialized countries, particularly the United States, Porter (1995) has formulated scathing critiques of a confused approach to redeveloping decaying inner cities; for example, the U.S. government created multiple regulatory and bureaucratic obstacles for businesses, while training people for "nonexistent jobs in industries with no projected growth." In Porter's view, a vital element of a promising approach to inner-city development in the United States is a clear distinction between LED and community development—not only in terms of policies but also in terms of organizations in charge of each activity. Despite the United States' well-documented experience, which is potentially instructive to policymakers in other countries, the confusion between LED and community development is pervasive.

In South Africa, where LED has been a major political issue for years, the country's Department of Provincial and Local Government states:

> From central government's perspective, the most important objectives for municipal LED are job creation, sustainable urban and rural development, and explicitly pro-poor approaches within a holistic LED strategy. The LED approach promoted in this policy paper is innovative, creative and redistributive. LED is to be broadened [to include the] disabled and people

> living with HIV/AIDS. Within newly-demarcated districts, small towns should be given higher priority.[3]

That is, from the Department's perspective, LED means bringing together employment, urban and rural development, social, family, and health policies; thus LED's economic component is marginalized. Notably, South Africa's situation is not unique. The confusion between economic and social development is commonplace.[4] The outcome is gridlock—that is, a constellation where neither economic nor social objectives are met. Because LED activities tend to lack a clear business focus, they often rely on unsustainable subsidies.

A constructive way to tackle this confusion is to distinguish between community development and involvement. Obviously, community involvement in the LED process—not just that of local businesses, but also that of the local educational and academic community and nongovernmental organizations (NGOs)—is desirable, and indeed necessary. In fact, the more effectively organized these societal segments are, the better the preconditions for a successful LED process: It contributes to creating the social capital vital to trust-based interaction between various local groups—the key prerequisite for effective problem solving.

In short, LED cannot be separated from the community. However, community involvement and mobilization are distinct from community development. Community development is part and parcel of social policy. Its objectives, target groups, and incentives differ markedly from those of LED. Community development is about supporting and empowering the weak and disadvantaged, whereas LED is about business and competitiveness.

One must understand that LED is part of a larger venture, namely local development. One way to conceptualize local development is to dis-

[3] "Local Economic Development Policy Paper: Refocusing Development on the Poor," February 2002.
[4] This type of confusion is not limited to developing countries. In addition to the U.S. cases, German experience reveals confusion between economic and social policy objectives in active labor market policy; for example, the outcomes are employment and skills development projects that directly compete with private business in such activities as landscaping and brownfield rehabilitation.

tinguish among three core development types: 1) economic; 2) social; and 3) physical infrastructure. What makes distinguishing between economic and social development so difficult is the problem of allocating activities to each of the two fields (the distinction is less straightforward than one might expect). Moreover, this distinction must not lead to an either/or discussion. Economically and socially driven approaches to local development are both highly important (table 8–1).

LED for or instead of business?

What makes for a good LED project? This question is bound to raise a variety of responses across countries and settings. In some locales, LED practitioners will point to the successful acquisition of an outside investor, informal meetings for local business start-ups organized at regular intervals, or a major real estate development where substantial public investment has leveraged an even more substantial amount of private investment. In other locations, LED practitioners will point to a group of vegetable producers, comprised of formerly unemployed, unskilled persons or a small local bakery set up with government money employing persons who could not compete in the formal labor market.

From a purely economics perspective, LED is justified only to the extent that it remedies market failure. From this angle, numerous opportunities

Table 8–1. Matrix Showing Allocation of Economic and Social Development Activities

Policy type	Business promotion	Employment promotion
Economic development	SMEs*	Skills development
	Entrepreneurship	Retooling and ongoing training
	Investment	Labor market information systems
Social development	Support for informal sector (subsistence-oriented, microenterprise)	Unemployment benefits Food for work

* SMEs = small and medium enterprises.
Source: Meyer-Stamer (2001).

abound. A typical problem is lack of visibility of new businesses, which is basically a problem of scale—that is, if the business were not new and small, it could afford costly advertising; its limited resources run the risk of a vicious circle. Another typical problem is lack of access to capital; a start-up business with no track record and little collateral hardly qualifies for commercial credit. In many places, LED targets such problems by organizing informal and formal networking events, as well as introducing business schemes.

The vegetable-producer and bakery projects are not rare in LED initiatives; however, these types of projects can hardly be justified in terms of remedying market failure. Basically, they are a quick fix. As policymakers are under pressure to present visible results quickly, they implement these types of projects instead of addressing the underlying problems, such as inadequate supply of skills-formation opportunities or entry barriers for business-oriented start-ups. Such projects do not necessarily create viable businesses (in fact, the issue of sustainability is seldom considered); they usually create unfair competition for commercial producers of vegetables and bakery products. In a worst-case scenario, they ruin those producers—an issue about which local politicians may care little—which is detrimental to LED's overall objective: to stimulate economic dynamism. Ironically, one is led back to the issue of strategic planning. With too much strategizing and planning and too little visible LED results, politicians will tend to promote not-too-sensible projects.

Roles of public and private sectors

LED governance has no first-best model. One pursued by several European countries centers on creating a dedicated LEDA; such organizations as the ILO and UNOPS are attempting to transfer this model to developing countries. But it is unclear whether it has succeeded in Europe; thus, there are sound arguments for doubting its effectiveness in a developing country context. If the local-level institutional structure is poorly developed, then a newly created LEDA will be overwhelmed by the variety of tasks it is expected to fulfill. If a structure with various uncoordinated organizations pursuing LED activities is in place, it will tend to perceive the LEDA as a competitor rather than a welcome coordinator. In any case, setting up a LEDA before initiating LED clearly violates the form-follows-function principle. ILO's approach, for example, refers to the Italian experience; however, research shows that LEDAs in northern Italy do not follow a single model. Their diverse profiles reflect the diverse local conditions that shaped their emergence and evolution (Pietrobelli and Rabelloti 2002).

In addition, this type of approach is inherently technocratic. It completely neglects the fact that LED not only involves polity and policy, but also politics. Not only is there petty politics, which, as every practitioner knows, obstructs successful LED activities. There is also the problem of identifying an effective and legitimate governance structure for LED, which raises three issues:

1) What is the division of functions between the legislative and executive branches, and what part of the executive branch should be involved?
2) Which nongovernmental actors should be involved in LED governance?
3) How can government and nongovernment be connected?

Regarding the first issue, the body of LED literature mostly neglects the politics of local development efforts. It is strongly biased toward the executive branch and a rational, systematic process of policy formulation and implementation; it thus reflects the view of many practitioners, who tend to perceive the legislative branch (i.e., local politicians) as a nuisance. This view, however, neglects a main reason for LED's existence: local politicians must deliver economic development to create jobs and income for their constituencies. For this reason, local politicians are key actors in any LED effort. Their aspirations and activities do not necessarily simplify a LED initiative. The literature is replete with romantic concepts of dialogue, consensus, and roundtables. Occasionally, these occur; however, the real world is one of contradictory concepts and conflicting viewpoints and objectives. This also applies to LED at the point that politicians come into play. When it comes to defining overall objectives for a LED initiative, democratically elected, local politicians play a key role. Persuading them not only to channel resources to their clientele, but also observe the big picture, is a major task of other actors, including LED officers in the executive branch. Clearly, LED cannot be left up to the executive branch alone.

Regarding the second issue, the first question is whether the private sector has a legitimate voice. One might expect that business associations or chambers play this role; however, in developing countries, these often function more like clubs than professional associations for member companies (Moore and Hamalai 1993; Müller-Glodde 1993; Doner and Schneider 1999). Thus, these business associations and chambers are hardly reliable or competent partners in LED initiatives; they have few resources, and their representatives cannot rely on their members to comply with agreed-on commitments.

The second question is whether other nongovernmental actors want to play a role in LED. Some segments of the local community, such as educational institutions, usually participate in LED initiatives. However, matters become complicated as soon as higher levels of government earmark financial resources for LED; from that moment on, every group has a strong incentive to label its demands as LED proposals. Such labeling leads to a complete loss of focus and effectiveness.

Regarding the third issue, a substantial body of literature argues that LED should involve public-private partnership (PPP) (Birnstiel 1995; Blakely and Bradshaw 2002). At first glance, this suggestion appears sensible. Closer examination, however, reveals a more difficult situation. For starters, the United States and continental Europe define the term differently. In the U.S. context, PPP centers on the private sector assuming tasks traditionally ascribed to the public sector. In continental Europe, by contrast, PPP refers to a model, whereby the private sector takes a minority share in activities traditionally pursued by the government alone. In developing countries, PPP refers to an unusual model (except in the traditional incarnation of public and private agents conspiring to embezzle taxpayer money).

Moreover, PPP requires that both the public and private sectors meet certain requirements. The public sector must have an interest in economic development, a basic idea of business principles, and a non-paternalist view of private businesses. Meeting these criteria is not easy. Often government officials have no business experience. In many developing countries, government officials and business people—particularly those in small or microenterprises—have starkly different class backgrounds, which makes communication difficult. Regarding the private sector's role, the abovementioned problems with business associations and chambers apply.

Interim conclusion: strategy and LED

It was long ago argued that having a strategy does not necessarily mean having a written strategy document (Mintzberg 1987, 1994a and b; Porter 1996). This line of reasoning never really reached the economic development discussion. Most LED manuals currently available introduce it as a strategy- and planning-driven activity, as opposed to an opportunity- and action-driven one. Strategy still tends to connote an exercise involving numerous consultants and researchers, numerous stakeholder workshops, and an enormous volume of printed materials.

The reason why businesses often prefer to avoid an elaborate written strategy is that they must survive in competitive markets, which requires flexibility and rapid adjustment to changing challenges and opportunities. Government, on the other hand, does not have to compete (or at least thinks so until it recognizes that investment and jobs are moving elsewhere). Rather than opportunity-driven, government is problem- , lobby- , and pressure-driven. But LED is supposed to be about economic development. Since the fall of the Berlin Wall, hardly anyone will challenge the statement that economic development is essentially based on business entrepreneurship. Thus, even if LED is government-driven, it should not follow government's standard procedures. Simply put, the meaning of strategy in the LED context should differ from that of other contexts (e.g., poverty alleviation).

In the LED context, what should the meaning of strategy be? Mintzberg (1987) distinguishes five strategy concepts:

1) Plan—a conscious and purposeful course of action developed in advance;

2) Ploy—maneuver intended to outwit an opponent or competitor;
3) Pattern—consistent behavior, whether intended or not (the successful approaches gradually merge into a pattern of actions that becomes the strategy);
4) Position—means of locating an organization in a competitive market or environment (involves seeking a niche within an environment); and
5) Perspective—ingrained, shared perception of the world (culture, vision, character, ideology) by a collectivity of individuals united in their thinking or behavior.

This author argues that, particularly in the early phase of LED, the pattern concept is most appropriate. At this time, the crucial point is to do LED, typically by implementing small practical projects that immediately improve the business environment and opportunities, rather than strategizing. Only after local actors have learned about LED through implementing practical activities can other strategy concepts become relevant.

Another way to define what strategy means in the early phases of LED relates to the concept of systemic competitiveness (Esser et al. 1995; Meyer-Stamer 2001). Using this concept, one can argue that the factors determining successful industrial development are found at four analytical levels: 1) micro (companies and markets); 2) meso (specific policies and specialized business-support organizations); 3) macro (generic economic-framework conditions); and 4) meta (slow variables, such as basic economic model, a society's capacity to learn and adjust, collective memory, social capital, and the social status of entrepreneurship). From this perspective, strategy- and planning-driven LED focus mainly on the micro and meso levels—that is, selecting business sectors for preferential promotion and targeting specific sectors through creating dedicated meso-institutions. Opportunity-driven LED, conversely, would not bother with this type of micromanagement. Rather, it would address macro- and meta-level factors: 1) remove unnecessary regulatory obstacles; 2) streamline licensing procedures; 3) create a setting that encourages entrepreneurship; and 4) negotiate a consensus about the necessity of doing LED among local stakeholders.

In negotiating consensus, it is important for local actors to reach agreement on some type of LED; however, it is not preferable to create consensus about how to do LED. In its early stages, LED is a radical innovation for local stakeholders. Early on, LED commonly launches inventive project proposals that are often difficult to understand and implement, particularly those driven by outside consultants. Given that most people have difficulty coping with radical innovation, it is unwise to propose too much at once, which reduces chances of success.

This leads one to the PACA approach (Meyer-Stamer 2003), which acknowledges that one radical innovation—launching LED—suffices and that the initial LED activities should be modest to avoid overwhelming local actors. Moreover, it suggests running LED like a business (remaining flexible and seeking opportunities and a quick return on investment) rather than a bureaucracy. In fact, taking a business approach is a prerequisite to raising the private sector's interest. However, that companies get quick tangible benefits does not guarantee their active participation, which depends more on specific aspects of globalization.

Paradoxes and Ironies

It is often argued that increasing globalization of economic activities creates pressure to launch LED initiatives (Vázquez-Barquero 2002). Corporations put increasing demands on the quality of locational factors, and more locales compete for investment. Furthermore, locales find themselves at the fringes of the globalization process, gaining few, if any, benefits, and hoping to reap more from local efforts to get more involved with the global economy.

At the same time, LED initiatives, particularly those located where local companies have a certain degree of mobility, confront typical paradoxes and ironies:

- Life cycle paradox. Companies in emerging and growing industries rely more on localized factors, particularly those that must be created through collective action or by government, than companies in mature and declining industries. At the same time, companies in emerging and growing industries tend to be less organized, making them difficult partners for LED initiatives.

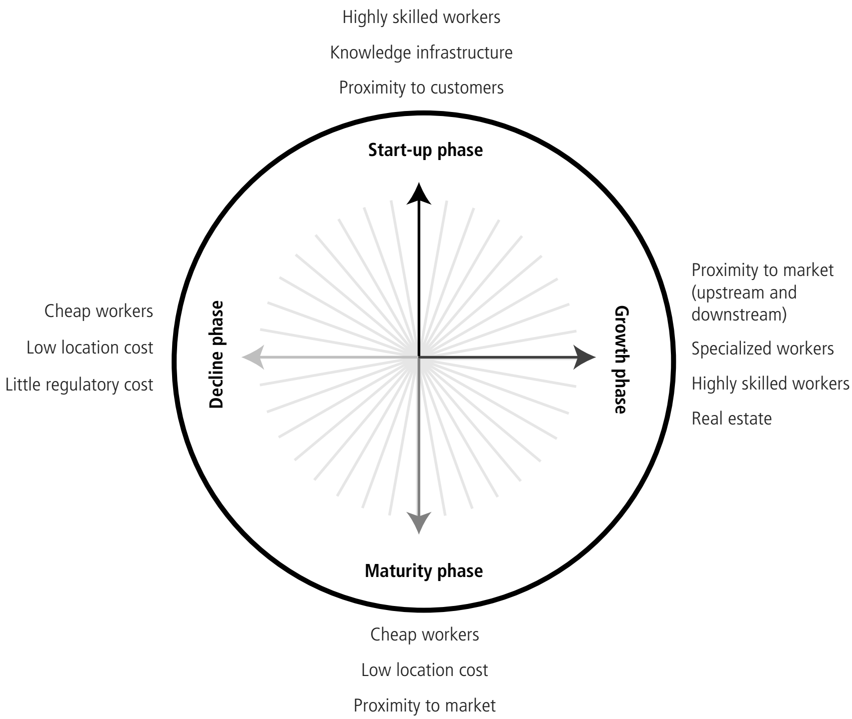
- Irony of upgrading in global value chains. In developing countries, a typical LED objective is to facilitate upgrading of local companies so they can become part of global value chains. When this happens, the latitude for local, collective upgrading efforts tends to diminish as the lead companies in global value chains take over the role of governing upgrading.
- Location and globalization paradox. Although mobile companies may be interested in high locational quality, their propensity to get involved in efforts to create such quality tends to be limited, particularly in the case of branch plants of multilocation companies. Successful LED initiatives tend to be based on strong local networking and trust among local stakeholders; frequently rotating chief executives of branch plants rarely fit into this pattern. More importantly, they tend to find the ratio unfavorable between the cost of understanding local governance networks and getting involved in time-consuming negotiation/coordination processes and potential benefits of locational upgrading. They prefer sponsoring activities, which have a clear benefit in terms of visibility and prestige and relatively limited cost.

Territorial upgrading and the life cycle paradox

The implications of the industrial life cycle for location have been addressed from the perspectives of both practitioners and researchers. Figure 8–1 illustrates the practitioner's straightforward viewpoint: in the early phase of the life cycle, companies rely on a sophisticated environment. In the later phases, they move to locations where production factors, particularly real estate and labor, are cheap.

Interestingly, the practitioner's perspective, based mainly on experience and inductive reasoning, is confirmed by more systematic research that addresses the issue of locational quality from an innovation economics perspective (Gelsing 1992).

Figure 8.1. Practitioners' View of the Industrial Life Cycle



Source: Pieper (1994).

What this upgrading means in terms of locations is simple and, to some extent, discouraging. While much can and should be done to support the emergence of new industries, little can be done with respect to mature and declining ones. At the same time, new locations (e.g., greenfield sites in developing countries that cater to relocated plants in mature industries) have few options in terms of locational policy. On this issue, the practitioner's viewpoint is straightforward: minimize the cost of infrastructure, real estate, labor, and skills development—precisely what has been happening in locations that have successfully attracted greenfield investments in mature industries (Kanter 1995).

What about companies in mature industries that become involved in elaborate locational policy efforts? One example is Volkswagen's involvement in locational development and upgrading in the region around Wolfsburg, its main facility. However, this case is somewhat special. The company started as a State enterprise, and the government remains an important minority shareholder, which creates a form of pressure different from the usual one involving financial returns.

Therefore, one would expect that locations with emerging or growing industries would be favorable places for locational policy. However, this expectation is based on an analysis that considers economic factors; the scenario changes if one introduces political factors. This leads one back to the issue of appropriate governance patterns for locational policy. Basically, there are two options:

1) hierarchy; and
2) networks.

Hierarchy is the traditional pattern of public governance. Government formulates and implements a policy after a certain amount of fact-finding and interaction with special interest groups. This may be an adequate pattern for such areas as environmental policy, where government should protect the common good and the citizenry. However, the pattern is inadequate with regard to such activities as national-level industrial policy and local-level locational policy. Neoliberal economists put forth a convincing argument that there is no reason to assume that government coordination is superior to market coordination with regard to business promotion. However, their argument does not imply that government must limit itself to facilitating markets since there are cases where market failure persists (Meyer-Stamer 2001). Industrialized country experience shows that government actors are involved in policy networks that also include various nongovernmental actors and that may be effective in formulating and implementing sectoral policy (Messner 1997). Policy networks are rarely designed and created intentionally. Instead, they emerge as a spontaneous response to governance requirements (e.g., market failures that block rapid adjustment processes in older industrial regions).

Networks are problematic for locational policy. Functioning policy networks involve collective actors rather than many individuals or companies; however, effective networks for locational policy require effective business organizations. In emerging industries, entrepreneurs feel little pressure to organize themselves and seek political support. Similarly, rapidly growing industries and firms do not feel the need to fight for their interests since they are preoccupied with managing rapid growth. As a result, there is no immediate logic for collective action under such circumstances. Although policymakers may strive to support such industries to defend common interests, they still face the challenge of establishing adequate communication links with new firms that have yet to organize themselves.

At the same time, older industries tend to be well organized, owing to the logic of collective lobbying for defensive measures to slow the adjustment process. For government policymakers, it is easy to tap into policy networks with mature and declining industries. However, as this author argues above, this type of industry is not interested in locational policy.

The life cycle paradox of locational policy can be summarized thus: Industries potentially interested in locational policy are unlikely to be well organized, making it difficult to establish the networks required for policy formulation; older industries, though well organized, are not interested in locational policy.

Value chains and the irony of upgrading

One major LED objective is to improve local companies' competitiveness so they can expand their markets nationally and internationally. Most companies do not supply commodities to anonymous markets, but rather feed into well-structured value chains (Humphrey and Schmitz 2000; Kaplinsky 2000). Accordingly, promoting the integration of local companies into national and international value chains becomes a core objective for LED.

With regard to the interaction of locations and value chains, a given location may or may not be on the radar screen of a given value chain coordinator. Increasingly, such coordinators are global buyers who systematically scan the globe for potential suppliers. If the location is not yet on the radar screen, then the conditions for locational policy are fairly reasonable. This scenario, on which much SME promotion is based, is typical of emerging locations in developing countries. The objective is to increase local firms' competence in production, quality, technology, human resources, and financial management so they can manufacture products of acceptable quality at competitive prices to attract global buyers. ISO 9000 plays an important role in this respect, as it indicates to global buyers that a local firm can potentially become a supplier (Quadros 2002; Nadvi and Wältring 2002).

Before global buyers' detection, upgrading means learning within local markets or elsewhere how to improve competitiveness in order to be noticed by value chain scouts. Government may play an important role; for example, it may pursue a carrot-and-stick approach; that is, pushing and pressuring firms while supporting them through dedicated efforts to raise their profile (e.g., through missions abroad, presence at fairs, or joint marketing).

The most likely result of raising their profile and attracting orders is rapid growth. Firms spend most of their time managing rapid growth and thus have little time to interact with government or other players not directly related to their day-to-day business activities. With orders pouring in, there is little urgency for collective action. Such constellations have been observed in the early growth phases of the footwear cluster in Sinos Valley, Brazil (Bazan and Schmitz 1997), and the furniture cluster in São Bento do Sul, Brazil (Meyer-Stamer 1998).

Another key aspect is that, once they have raised their profile, the chain governor (usually a global buyer) is unlikely to expect local government to play an active role in day-to-day management. Instead, s/he expects government to remove obstacles to doing day-to-day business (e.g., red tape or deficient infrastructure). For the chain governor, shaping the chain is a crucial element in his or her effort to create a competitive advantage; thus, it is unlikely s/he would want to share concepts and strategies with other players, particularly local governments where suppliers are located. The chain governor becomes the main source of information, training, and advice. Local producers prioritize communication with their new large customer;

while government officials become increasingly isolated from the communication loop, relying on second-hand information on evolution of the chain.

For local companies, becoming part of a global value chain may imply four scenarios:

1) Product and process upgrading. This scenario involves joint upgrading with other participants in the value chain, but it does not imply a change of position in the value chain. This is a challenging task involving only limited risk. It is in everyone's interest (including that of the global buyer, who is also interested in fundamental activities) to improve locational quality (e.g., infrastructure or vocational training institutions).
2) Strategic functional upgrading. This scenario entails assuming functions that other companies—usually from other locations within the same value chain—previously handled. This option implies more risk, as the competitors to be replaced will probably fight back. Global buyers may be expected to tolerate this situation (as long as it does not threaten their own core competence), as fierce rivalry between locations strengthens their bargaining position vis-à-vis each.
3) Improved competitiveness in order to shift to another value chain. In any given sector, various value chains cater to different segments of the consumer market. As long as margins are higher in more sophisticated or differentiated markets, it may be tempting to switch to a value chain that serves higher-margin markets. This involves the risk of reaching an impasse; the old buyer may anticipate this situation and move to a different source, while the prospective buyer may fail to close the deal.
4) Attempting to take over the value chain or its main power position. This is clearly the most challenging option. It may be viable in cases where the buyer's power position is limited (e.g., ceramic tile industry) (Meyer-Stamer, Maggi, and Seibel 2001).

All four scenarios contain strong incentives against collective private sector action. In scenario 1, one might argue for a positive-sum game, which might persuade firms to go for collective efforts to upgrade, particularly in a situation where all firms in the location are experiencing superior competition from another location. However, it is more likely that firms will think in terms of a zero-sum game (i.e., a firm perceives local competitors' losses as its own gain). This is particularly likely in places where collective action has experienced early export growth.

In scenarios 2–4, collective action is even less likely. In a given location, it is highly unlikely that all company decision-makers will display the same level of risk-friendliness; the most important potential risk is to be abandoned by current buyers. If the degree of risk-friendliness diverges, one might expect that some decision-makers will view all of these scenarios as plausible, whereas many others will not. One can expect that particularly risk-friendly, strategically oriented firms will choose one of these options, thus creating a split among business executives within the location.

In all four scenarios, the government would try not to stand in the way (i.e., reduce transaction costs) and excel in providing basic and advanced factors. The Halder (2002) case study on the surgical instruments cluster in Tuttlingen, Germany illustrates this point. Government is unlikely to play a major role, particularly with respect to scenarios 2–4 since it lacks the in-depth, up-to-date knowledge needed to assess their viability. Government's most likely contribution may be to contract a specialized consultancy firm to support local businesses and associations in their decision-making process.

The irony of entry into and upgrading value chains can be summarized thus: government can play a vital locational policy role by helping local firms become so competitive that global buyers subcontract them. However, as the firms become involved in the value chain, the government's potential role in locational policy declines substantially, and collective private sector action is also likely to suffer.

The location paradox

Globalization of companies happens when a local company establishes branch plants, taking over companies in other countries, or when foreign investors take over local companies. This author argues that locational policymakers confront a paradox: globalizing companies are increasingly demanding with regard to locational quality, but show a declining propensity to become actively involved in locational policy.

Increasing locational quality demands apply to various locational factors: high-quality, low-cost infrastructure; swift execution of licensing and permit processes; low tax burden; and substantial worker training.[5] The relationship between location and competitiveness, discussed below, focuses on industrial manufacturers and services firms that supply global markets.

The declining propensity of companies—particularly large, multi-locational ones—to become involved in locational policy is well documented (Heying 1997; Dörre 1999). Yet, why would one expect these companies to become involved in such activities? Despite globalization, companies seldom pick locations randomly. Space and location have ongoing relevance for globalized manufacturing and service companies (Porter 2000). Companies seek specific locational qualities, implying that companies are interested in creating and improving locational qualities; therefore, they may be willing to take an active role.

A company is located in a particular place for one of the following four reasons:

1) historical accident (i.e., the company was founded at that spot or acquired a firm located there);
2) seeking proximity to other firms (e.g., an IT company sets up an affiliate in Silicon Valley);
3) striving to build up a presence in proximity to dynamic markets; or
4) seeking other locational factors, such as natural resources or cheap labor (Renschler [1995] gives a detailed account of the criteria Daimler-Benz applied when it scanned possible locations for its U.S. SUV factory).

These reasons do not necessarily mean that a company deliberately contributes to improving locational quality. Reasons 2–4, in particu-

[5] The companies discussed in this section sell a large portion of their output elsewhere; this section does not address such local companies as developers or utilities, which often play an active role in locational policy. Locational upgrading is a key element of these companies' business strategies, which aim to maintain and attract new customers.

lar, involve receiving locational advantages. Companies often improve locational quality inadvertently (i.e., while enhancing their own competitiveness, they create positive externalities). Conversely, a major obstacle in getting companies involved in a locational strategy is free riding (i.e., companies assume that collective action renders too little outcome to appropriate for themselves and too much externality that benefits local competitors).

One would expect this problem to be less relevant in two locational types:

1) hub-and-spoke clusters (Markusen 1996). This locational type is dominated by one hub company (e.g., Toyota City or Wolfsburg), which controls the external effects;
2) cohesive clusters, with minimized free rider effect through social control. The free rider phenomenon occurs less often when cohesive clusters of local firms become involved in international value chains, and external firms enter into local clusters to benefit from specific locational qualities (Grabher 1993). Strong cluster cohesion is probably more closely related to the life cycle of companies and their industry than to location.[6]

Companies do benefit their locations, usually through sponsorship (e.g., museums, theatres, or sports facilities). For large corporations, sponsorship has a high cost-benefit ratio—low cost and high visibility—which is more predictable than locational policy involvement. Understanding the structure of and participating in local policy networks involve substantial time input (i.e., high transaction and opportunity costs), while the outcome of visibility is unpredictable. How does a company driven by the rationale of maximizing shareholder value justify this type of involvement? This logic becomes more convincing if one considers that companies tend to run operations in many locations and likely have an exit option that is potentially attractive in cases of simple screwdriver operations.

[6] Bazan and Schmitz (1997) emphasize this key point in their analysis of the evolution of social capital in an industrial district of Southern Brazil.

Conclusion: A Typology of LED Approaches

Given the various obstacles and limitations discussed above, what are the most promising options for LED?

Generic locational policy

The most straightforward option is a generic locational policy, whose goal is to create favorable business conditions overall, without targeting specific companies or sectors (i.e., the functional equivalent of operational effectiveness within companies). Companies are often highly appreciative for a certain time and to a certain extent (i.e., as long as other locations are too disorganized to do the same) and may enjoy a locational advantage.

Nowadays, government action on locational policy is often, explicitly or implicitly, based on Porterian concepts, particularly the development of specialized factors. However, highly competitive firms have moved beyond such concepts.[7] They now focus on a value chain-oriented strategy (e.g., ceramic tiles [Meyer-Stamer, Maggi, and Seibel 2001]) or strategic positioning in restructuring/merging markets (e.g., surgical instruments [Halder 2002]). They take the availability of specialized factors for granted; if they encounter deficiencies in that respect, they often prefer to buy them somewhere than opt for a locational policy effort with the unfavorable cost-benefit ratio explained above.

However, the government's role is not passive. To the contrary, local government may develop a business-friendly disposition, and think in terms of multiple contexts about how to make the lives of businesses easier. This change reflects decreasing latitude for locational policy stemming from pressure within value chains and the behavior of companies with extra-local headquarters. In addition, it addresses one of the firms' main objectives: removing government-induced obstacles, particularly clumsy and complicated licensing and permit processes. Yet generic locational policy is

[7] Moreover, numerous case studies demonstrate the difficulty in verifying Porter's emphasis on diamond-related factors as the basis for competitiveness; see Davies and Ellis (2000) for an overview.

not just another incarnation of neoliberal orthodoxy; rather, it may include numerous proactive initiatives.

In practical terms, a generic locational policy may include:

- a systematic effort to assess the consistency, necessity, effectiveness, and efficiency of local rules and regulations on which their streamlining is based;
- an effort to make local and national rules and regulations more transparent and easier to handle, and raise public agencies' awareness of private companies' needs and demands;
- creation of first-stop or one-stop agencies;
- provision of efficient real estate information systems; and
- locational marketing efforts.

These items are not easily implemented, particularly with regard to making public agencies more private sector-friendly, which requires a long-term effort. For example, in Northrhine-Westphalia, Germany, local public authorities have worked on this issue for many years. However, their self-assessment of their service delivery quality differs substantially from the private firms' perception.[8]

In the context of generic locational policy, two types of stakeholders must be distinguished: 1) chambers, business associations, and other collective actors; and 2) supporting institutions (e.g., training or technology extension). The first stakeholder group can contribute to locational quality simply by doing a good job (i.e., being agile, in close contact with member firms, and constantly adjusting to new challenges). In the case of a chamber, this means providing efficient, good quality, and constantly updated services to its member firms and pursuing effective lobbying.

The second stakeholder group, supporting institutions, must compete on markets. Preferably, these are real markets where customers pay

[8] The MOVE poll found that 90-95 percent of local government respondents rated the quality of their service delivery as "very good" or "fairly good," compared to only 20-50 percent of private sector respondents (for details, visit www.move.nrw.de).

(e.g., training courses or firm-commissioned research and development projects). Often, however, these are distorted markets where a third party, usually the government, pays a substantial portion of the price of the service (e.g., as part of employability or technology-and-innovation programs).

A more active, but still generic, element of locational policy comes to mind when introducing the issue of local markets. Local-level market failures are common, particularly in the labor market, which is highly segmented and has serious information problems. SMEs' lack of explicit human resources planning (including employee training) creates serious problems for local training providers, who can neither count on a defined medium-term perspective of SME training demands nor customize courses for job seekers compatible with employers' demands. The result is what Schönfeld (1998) terms *invented demand* or *researched needs*, which must be distinguished from *articulated demand*.[9]

The same rationale of attempting to make markets work better also applies to other markets. One typical example is the organization of formal or quasi-informal events for business contacts to stimulate supply relationships between local firms. Formalized supplier fairs may serve the same purpose, but often at a lower cost-effectiveness ratio. Another typical example is to organize local consumer fairs to raise consumer awareness of products and services that are locally produced.

A variation on generic locational policy is the entrepreneurial city approach,[10] which Wilson (1995) describes as an exercise in which "the local growth coalition works with the local public sector to market the city to increasingly footloose land developers, businesses, and consumers." It

[9] *Invented demand* refers to training providers who simply guess at market demand. *Researched needs* refers to assessments of companies' problems and necessities, usually conducted by third parties (e.g., university researchers or consultants), which tend to be objective (i.e., not necessarily the subjective needs for which a given businessperson would be willing to spend money). *Articulated demand* refers to a pattern whereby direct communication is established between training providers, companies, and possibly third parties (e.g., governmental employment agencies); the idea is not to plan the evolution of the local labor market, but reduce information asymmetries and make the local labor market work more effectively.

[10] See, for example, Center for Civic Innovation (1999) for the practitioner's guide and Hall and Hubbard (1998) for reflection.

involves public-private partnership, but the private side includes mainly local developers and utilities. The idea is not to turn a city into an actor that aggregates all business interests (what Marx termed the *ideeller Gesamtkapitalist*), but to make a city a business-friendly place.

Strategic locational policy

Strategic locational policy is a major focus of discussions on clusters (Knorringa and Meyer-Stamer 1998) and local innovation systems (Braczyk, Cooke, and Heidenreich 1998). This policy concept does not leave upgrading to the invisible hand of the market, but attempts to define specifically where to upgrade (i.e., agree on a direction and goal). Formulation of a strategic locational policy is the outcome of a decision-making process that involves and defines the tasks and responsibilities of government, firms, and other local stakeholders. Reaching an agreement, however, involves enormous effort grappling with difficult governance issues.

Strategic locational policy can be defined ironically as a consolation for those academicians who cannot accept the demise of strategic industrial policy; who still mourn the end of the glory days of the race to the moon, the Airbus, and the VLSI Programme; and who think that a functional equivalent is necessary. Like the case of industrial policy, the landscape of strategic locational policy does not lie exclusively in ruins; it also offers a few elegant constructions (i.e., vibrant locations that owe their dynamism, in part, to the strategic behavior of local stakeholders).

But it is unfair to refer to strategic locational policy as merely researchers' creative interpretation of reality, despite cases of fuzzy concepts and scanty evidence (Markusen 1999). Indeed, in a few cases, strategic locational policy is happening,[11] although there is virtually no evidence of it working (Buss 1999).

[11] In the case of Germany, such locales as the city of Dortmund and the Aachen region would probably qualify (Meyer-Stamer 2000). In the case of the UK, one might consider Wales (Cooke 1998). In the U.S., Pittsburgh may be an example (Parks 1999). In Brazil, the Greater ABC region would be a candidate (Cocco and Sperotto 2001; Klink 2001).

Constructing two scenarios might help to explain why strategic locational policy sometimes occurs. First, one can imagine a local community with a long tradition of collective action and strong social capital. It never underwent disruptive external shocks (positive or negative), which erode social capital.[12] It has a consistent history of strong economic performance that can be linked to collective action to constantly improve locational quality. For stakeholders in such a location, strategic locational policy might be business as usual.

In the second scenario, one can imagine a local community undergoing radical structural change (e.g., because of closure of the largest local employer or decline of the locally dominating industry). Strategic locational policy is the only alternative to economic and social decline. This has been the motive in several parts of Germany's Ruhr Valley (Maggi 2000) and throughout the LAC region (Aghón, Alburquerque, and Cortés 2001).

In the context of the life cycle argument, the second scenario describes locations where dominant industries are moving from maturity into decline and where emerging industries (or locations that have not yet experienced industrial development) provide the only promising option. The first scenario is also linked to the life cycle, but in a less obvious way. There are locations where local firms always remain on the emerging growth side by constantly devising innovations and where the local milieu stimulates the creation of new businesses that reinforce this pattern. This explains why several industrial districts in Italy continue to thrive (Belussi 1999), even though the relative importance of collective action to strengthen locational quality is unclear; in any case, the relevance of governmental business-promotion agencies decreases (Whitford 2001).

There is also a surrogate strategic locational policy, whereby local government drives diagnostic, planning, and implementation because of its preoccupation with the long-term economic health of the location. However, this approach often leads to ineffective locational policy, as it fails

[12] The latter happened in the Brazilian case analyzed by Bazan and Schmitz (1997); in small communities of the Sinos Valley footwear cluster, traditional social capital decreased rapidly during the easy-export boom phase (i.e., positive external shock).

to confront the private sector's real challenges and options. It may lead to improved communication and coordination within the government sector, which is often highly fragmented.[13] Or it may turn into an exercise whereby government representatives meet other ones, with minimal time left for direct contact with businesses. To some extent, this was a major feature of the so-called Regional Conferences (i.e., regional-level stakeholder fora involving mostly government representatives in 15 regions of Northrhine-Westphalia, Germany) (Kremer 1999; Potratz 1999).

Why is effective strategic locational policy, based on a broad alliance, such a difficult venture, and why does it seldom occur? In addition to the above-mentioned reasons, two further points should be noted: 1) problems of network governance; and 2) local firms' resistance to attracting external investment.

Formulating a strategic locational policy would involve an enormous policy network, and the usual paradoxes and dilemmas of network governance would apply; these would include:

- a decision-making blockade owing to the buildup of inter alia veto positions related to power asymmetries;
- structurally conservative action orientation, trend toward agreement on the "smallest common denominator," functional and cognitive blockade, and collective conservatism;
- unresolved tension between too weak and too strong ties;
- problems in defining distributive criteria; and
- intended externalization of costs at the expense of the network environment or unintended externalization caused by network actors' exaggerated inward orientation (Messner 1997).

If administrative boundaries are not congruent with those of economically functional spaces, the problems of network governance will be exacerbated (Cheshire 2001).

[13] Ironically, Raines (2000) finds this to be a major effect of Europe's cluster initiatives.

Second, local firms may resist becoming involved in locational policy, particularly if it involves locational marketing and investment promotion. Local firms' resistance to attracting external investment, a feature Tendler (2001) observed in Brazil's Northeast, is neither unique to that region nor the motivation behind it (namely, the expectation that external investors would drive the wage rate up).[14]

That strategic locational policy is an unlikely occurrence does not mean that generic locational policy is the only option left. This author suggests the possibility of another option: reflexive locational policy.[15]

Reflexive locational policy

Reflexive locational policy lies conceptually between generic and strategic locational policy. It involves the organization of a collective reflection effort on tendencies and structural change in the industries, clusters, and value chains relevant for the location. Unlike strategic locational policy, it does not involve negotiating a joint strategy and action plan with a clear definition of responsibilities for various actors. Rather, it provides a basis for decentralized strategy formulation within companies and government agencies. This variation on locational policy has been observed in the ceramic tile cluster of Castellón, Spain (Meyer-Stamer, Maggi, and Seibel 2001).

Justification for reflexive locational policy lies in the existence of dynamic uncertainty. The two types of dynamic uncertainty, introduced by Camagni (1991), derive from:

- Competence-decision gap. In this case, uncertainty regards the impossibility of precisely assessing the outcomes of alternative actions, even

[14] This phenomenon is not new. For example, when General Motors (GM) and Ford wanted to set up factories in Germany's Ruhr Valley more than 40 years ago, they met with fierce resistance by established companies in the older industries. GM succeeded because the mayor of Bochum kept the project a secret; Ford failed because it could not obtain the real estate it needed, which the old industries owned (Gaigalat and Kania 2000).

[15] This concept relates to that of reflexivity, as formulated by Giddens; he states: "…it is useful to speak of reflexivity as grounded in the continuous monitoring of action [that] human beings display and expect others to display." (1984, 3).

in the presence of full and free information on past events, owing to the complexity of the decision problems and inherently imperfect foresight. The probability of choosing a wrong or inferior technology is therefore large.

- Control gap. In this case, the outcomes of present actions depend on the dynamic interaction among independent decisions of many actors, over which the firm has, by definition, minimum control.

Camagni argues that the local milieu plays a vital role in firms' efforts to deal with dynamic uncertainty through a collective, socialized process that allows for cost reductions and enhancement of the effectiveness of local firms' dynamic, decision-making process (Camagni 1991). However, one may argue that globalization and structural change and accelerated technological change overwhelm individual analytical capabilities of numerous local actors and their informal communication. The learning processes and information exchange that characterize a local milieu call for an analytical effort, organized individually or jointly by local government, business associations, lead firms, universities, or research institutes. Higher levels of government can also catalyze such an effort (e.g., the EU Commission's recent emphasis on regional technology foresight exercises). The effort may have an academic bias if it relies strongly on university researchers or a demand-generation bias if it depends heavily on consultancy firms. In any case, the effort is based deliberately on gathering intelligence that would not otherwise surface through decentralized actors and an organized reflection exercise based on seminars, workshops, and presentations involving government actors, business representatives, and researchers.

Regarding practical activities based on the reflection exercise, government focuses on generic locational activities; however, it can achieve greater effectiveness and efficiency since its action is based on better information. Companies pursue individual strategies, but their internal strategy formulation process is likewise based on improved information.

If one chooses reflexive locational policy, s/he has two options. The first (an ironic one) is to start a strategic locational policy initiative. Once the stakeholders realize that they cannot agree on a problem definition (let alone a shared goal and practical proposals for achieving it), much discussion and research may follow, which will provide local institutional and business decision-makers additional information with which to improve the quality of their decisions. The second option is to sell a reflexive locational policy effort for what it is—that is, try to convince local stakeholders to spend time in seminars, workshops, and presentations.

Which of the two options is the more promising? This is a tricky question. Many local stakeholders may not be convinced by proposing a reflexive locational policy initiative because the product is not tangible. A strategic locational policy initiative, on the other hand, aims at a tangible product: a documented strategy (even if no process is achieved). Therefore, it is crucial to design reflexive locational policy in a way that convinces local players, particularly those in companies, that the cost (especially the opportunity cost) of the effort will be low, while the benefit will be reasonably high; in this respect, the regional technology foresight exercises appeal to businesses. However, plausibility of the exercise is also likely to be linked to who organizes reflexive locational policy.[16]

Closing Remarks: LED and Learning

Initiating LED is no easy task. More often than not, it involves overcoming political, organizational, and societal fragmentation. LED is, most of all, development. Unlike administration, development, understood as a deliberate effort, suffers if it is based on excessive specialization and division of functions. However, division of functions is deeply entrenched. In a typical LED project, it is likely that persons with diverse backgrounds (e.g., business management, skills development, and urban planning) must collaborate. Each has specific training, perspectives, and jargon that those from other disciplinary backgrounds may not comprehend. Accordingly, doing LED implies learning at multiple levels. It is not only about instruments, but also about interdisciplinary work. Moreover, it is about collaboration

[16] In the case of Castellón, the bank, perhaps a more convincing actor than a public agency, assumed this role.

between government and nongovernment. It is also about making the public sector more business-oriented and business-minded. Learning all of this at once is an enormous challenge.

Why is it then that LED initiatives tend to be overambitious—that is, they address multiple and/or highly complex projects that cannot be realized within a short period of time? It probably involves LED role models: such grand projects as revitalizing the London Docklands, restructuring Barcelona, or converting the Ruhr. Observers often overlook that these grand projects evolved over an extensive period. In the Ruhr, for example, management of local and regional economic development started in the 1960s when the coal industry began to decline. Comprehensive development initiatives, such as the 10-year IBA Emscher Park program, were based on policy and political experience and institutional structures built over several decades (Dussel Peters 2000).

As LED gets under way in developing countries, the shadow of grand role models creates a paradoxical problem for local actors (as well as foreign donors and national governments who want to roll out LED programs). Local actors who initiate research on other LED experiences immediately come across the grand projects. If they try to launch similar ones, they will likely fail since they have not yet experienced the cumulative learning and institution-building processes that are the basis of LED in locations with decades of field experience. However, if they attempt a modest LED activity, they face criticism for precisely that reason from local actors who are aware of grand projects elsewhere and who lack the patience to tolerate a cumulative, local learning process.

The PACA concept is designed to resolve this dilemma (Meyer-Stamer 2003). It introduces LED in a business way, looking at quick gains. However, it does so in the context of a process concept—that is, conceptualizing LED as a cumulative learning process that takes local actors from simple to complex, ambitious projects over time. In this way, the more ambitious local stakeholders can accept the simple, quick-return LED activities as a stepping stone to realizing their ambitions. PACA is an appropriate tool for both generic and reflexive locational policy. It can even be applied in the context of strategic locational policy, particularly as a tool for appraising ongoing LED activities and assisting local actors in moving toward a joint problem definition. It transforms the academic concern with optimal sequencing of LED initiatives into an empirical exercise based on learning, identification of opportunities, and building of social capital among local players.

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ECONOMIC DEVELOPMENT

Latin America has responded to the challenges of globalization with a renewed interest in regional integration and by transferring more responsibility and resources to local entities.

Integration initiatives can be important policy instruments that complement national and subnational policies. However, the distribution of costs and benefits of regional and global integration may be asymmetric. Certain regions or social groups may expand their opportunities, while those that are slower to adapt to the process may face divergent development paths. The absence of policy instruments to compensate for asymmetries may hamper social cohesion and generate a backlash against integration and participation in the global economy.

This volume discusses the policy frameworks that could be adopted at the supranational, national and local levels to offset the polarizing effects that may be generated by the process of integration into the global economy.

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