Fiscal Policies for Regional Development: Lessons from International Experience

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Can intergovernmental transfers foster economic development?

Positive examples:
- Marshall Plan (1950s)
- Post-war West Germany
- European Union structural funds

Negative examples:
- Italy’s Mezzogiorno
- East Germany after unification
- Many of development aid programs

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What are the elements of successful regional policy through IGT?

- The Marshall Plan
  - fostered infrastructure investment (Europe could maintain investments of about 20 per cent of GDP)
  - required matching funds (1:1) which revealed regional preferences and had a "leverage effect"
  - used an implementing organization (OEEC)
  - had a firm "sunset date" (front loading; "aid toward self-aid")
- The EU programs contain similar elements, without a sunset date, but with exit criteria

Structural Funds: Objectives

- With the appropriations for the Structural Funds, the Union supports the following seven objectives:
  - 1: promoting the development and structural adjustment of economically lagging regions;
  - 2: converting regions affected by industrial decline;
  - 3: combating long-term unemployment and facilitating job creation for young people and excluded persons;
  - 4: facilitating the adaptation of workers to changes;
  - 5a: speeding up the adjustment of agricultural structures;
  - 5b: facilitating the development of rural areas;
  - 6: development and structural adjustments of regions with an extremely low population density.

SF according to objectives

EU regions: GNP per capita
EU regions: GNP/capita

The accession countries

- Index EU 15 = 100
- < 30
- 30 - 40
- 40 - 50
- 50 - 75
- > 75

How do the EU programs work

- Regionalization at an intermediate level
- Definition of qualifying criteria, which are also criteria for „maturing“ of regions
- Emphasis on financing regional infrastructure
- Cofinancing (matching provisions)
- Cohesion fund

Chile’s extreme regions policy

- The zonas extremas policy is targeted to lagging regions, and was rather successful in sustaining and developing regions
- There is no incentive for a subsidized region to „mature“ and become self-sufficient, different from the EU approach
- The instruments are variable, but the objectives are static
- The approach fostered „rent seeking and keeping“
The instruments
- "Free trade zones"
- Exemption from customs duties
- Preferential treatment under VAT
- Exemption from business tax
- Exemption from local property tax
- Wage subsidies
- Investment tax credits
- Investment subsidies (development funds)
- Civil servants wage bonus

The approach of the United States
- The US approach to regional equalization and development is totally different from the EU philosophy
- It works through "categorical grants" or "bloc grants", i.e. specific purpose grants for which the states (and other public institutions) can apply
- This makes it an extremely variable instrument for specific activities with little concern for regional economic development

Per capita personal income by region, 2001
- U.S. Average = $30,472
  - High (CT) = $42,435
  - Low (MS) = $21,750

Regional Equalization
- The distribution of per capita income by state is highly unequal (Index 68 - 146).
- There is no explicit horizontal or asymmetrical vertical equalization program.
- Equalization is implicit through
  - central government revenue raising (especially the income tax) and spending;
  - regional incidence of the numerous grants programs (specific grants, bloc grants, matching grants, personalized payments).
The grants system involved for the most part “categorical grants” for designated purposes.

The following provisions are typical:
- permitted use of the funds;
- expenditure constraints;
- matching requirements;
- record-keeping and reporting.

The specialization of grants allows the “targeting” of programs by Congress.

Categorical grants: problems

- Categorical grants have been criticized as
  - being administratively burdensome;
  - being too restrictive to allow for tailoring to specific regional conditions;
  - producing duplication and overlap among grants programs;
  - provoking a proliferation of grants at work in a similar geographic area, yet administered by different federal agencies without coordination.

A response: bloc grants

- Bloc grants first appeared in 1966.
- They are characterized as follows:
  - recipient jurisdictions have wide discretion within a designated program;
  - "red tap", supervision, and control is kept to a minimum;
  - grantor discretion and grantee uncertainty is reduced by formula-based allocation;
  - matching requirements were reduced.

Structure of federal grants
Are capital grants or categorical grants mandatory for success?

- It appears that focusing on capital spending and regional infrastructure is successful.
- They create employment, income, and a capital stock at the same time.
- But there are even a few examples for successful regional development based on pure equalization grants (general revenue).
- One is West Germany after WW II.

The dispersion of tax revenue by state in West Germany

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Strong growth impulses

- There was not only a strong equalization effect inherent in IGT, but there was also strong regional growth impulses in economically retarded regions.
- Bavaria and Baden-Württemberg laid the foundations for economic prosperity.
- Formerly rich regions (such as North-Rhine Westfalia) lost ground in relative terms.
- However, the system established cohesion.

Why may interregional transfers fail?

- Often there are substantial interregional government transfers and subsidies that fail to reach their goal.
- They may equalize, but may not necessarily spur regional development.
- One problem is clearly grants dependency (Saarland, East Germany).
- Another is moral hazard (much of development aid).
IGT do not tell the whole story!

- Transfers alone are not sufficient!
- Necessary ingredients of success are:
  - existing human resources,
  - entrepreneurial initiative
  - sound infrastructure,
  - access to new technologies and world markets
  - a robust legal framework and functioning bureaucracies
  - and widespread political support in the region

Basic elements of successful regional policy

- Explicit recognition of a positive relationship between economic and political stability
- Dialogue and cooperation among governments and business, not submission or coercion
- Partnership requires independent own resources
- Mutual consultation and cooperation on an institutionalized basis
- Initiatives have be taken by recipient regions, implementation should be a joint endeavor, and responsibilities can be shared

Market orientation

- Free play of the market and liberalization of international and interregional trade
- Mobilization of long-run dynamic gains from interregional and international trade
- Problems:
  - fear of loss of formerly uncontested markets nationally and abroad
  - „tax and regulatory competition“ among regions
  - internal „protectionism“
  - corruption

Administrative and technical capacity

- Successful regional policy need backup through the funding of
  - technical assistance
  - the creation administrative capacity and professionalism
  - converting idle human resources of regions into purposeful actions and pessimism into forward looking strategic thinking