

WP-9

REGIONAL POLICY AND THE
ROLE OF BANKING

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PREFACE

May I take this opportunity of expressing my appreciation to the Federal Reserve Bank of Minneapolis for the invitation to prepare this paper and to the Queen's University, Kingston, Ontario, for the Fellowship which allowed me to spend some weeks in the summer of 1970 improving on the paper and simultaneously enjoying the attractions of their most pleasant city.

Edward Nevin

CONTENTS

	<u>Pages</u>
Section 1: Introduction	1-2
Section 2: The Theory of Regional Growth	3-13
Section 3: The Rationale of Regional Policy	14-21
Section 4: The Weapons and Techniques of Regional Policy	22-32
Section 5: The Effectiveness of Existing Policies	33-51
Section 6: The Theory of Regional Banking	52-63
Section 7: Existing Development Banks	64-73
Section 8: Prospects for the Future	74-80

When the task is to raise the permanent conditions
of a people, small means do not merely produce
small effects: they produce no effect at all.

John Stuart Mill

SECTION 1: INTRODUCTION

The main purpose of this paper is to assess the role, if any, which may be played by banking-type institutions in regional economic development policies. Its approach is frankly expository--that is, it seeks to survey and summarize existing thought and knowledge in this field rather than to attempt any original research. (This blatant plagiarism even extends to the opening quotation from John Stuart Mill, since this was aptly cited in this context by Stanley A. Little at a conference in Queen's University, Ontario, in 1964.) Further, it is written as a general background paper, not as a contribution to a learned journal: footnotes and specific references have therefore been avoided, and the presentation has aimed at simplicity and readability rather than academic impressiveness or a high level of theoretical rigor.

Before any view can be formed about the relative usefulness of banking institutions in regional development, two questions have first to be posed and answered:

- (1) What is meant by regional policy in terms of the nature and causes of the problems it seeks to solve?
- (2) Has the operational form of most previous regional policy been less than wholly successful?

Until the first of these questions has been answered satisfactorily it is clearly impossible to establish any criteria against which the efficacy of policy instruments, past or future, can be judged. Unless the second can be answered affirmatively there is no necessity to examine the regional banking question.

A great deal more has been written about these general issues than about the regional banking question, on which, indeed, almost nothing has been said. Inevitably, therefore, more space is occupied in this paper by the general issues than by the banking issue as such. This may not necessarily make it therefore worthless to those charged with investigating the regional banking matter; at least it might clear away a certain amount of deadwood and expose the bare outline of the major issues to be tackled.

In what follows the problem has been interpreted as the role of commercial-type banking in regional policy--commercial, that is, as contrasted with the activities of official agencies dispensing funds for specified purposes in strict accordance with statutorily defined criteria. The term does not, of course, refer to "commercial banking" in its more widely used sense of deposit, check-issuing banks. What is clearly at issue here is something akin to investment banking. The word "region" has been used in its very general meaning of any selected area forming part of a sovereign state in which it is desired to attain specified ends or to avoid (or reduce) certain specified tendencies. The word "state" itself has been used in its general politico-legal sense rather than in reference to a territorial subdivision of a Federal State. Other oddities of expression will no doubt strike the reader, but these (which, it is hoped, will not be misleading or incomprehensible) can generally be attributable to the peculiar way in which the American language is spoken and written within the United Kingdom.

SECTION 2: THE THEORY OF REGIONAL GROWTH

Much contemporary concern with regional imbalance arises from the fairly widespread belief that relative growth or decline in the regions of a country tend to become cumulative--what is often referred to in the literature as a "centripetal" tendency. It is natural to begin by asking, however, why such a cumulative process should not contain the self-correcting factors which (theoretically, at least) would be present if similar relative movements were being experienced by different states in an international setting. At first sight it is only reasonable to suppose that the theorems of international trade analysis would have their counterparts in an inter-regional trade theory; both types of analysis, after all, arise as separate cases only because the incomplete mobility of factors of production places them somewhat outside the simple mechanism of resource allocation by the free play of market forces. The object of this section is to identify the reasons why the "self-correcting" forces of international trade models are believed to be partly or totally absent in interregional trade.

Consider the standard case of two countries, A and B, trading with each other, operating gold-standard-type monetary systems and initially in external equilibrium. Then suppose a deficit appears in A's external trade and a surplus in B's, possibly because industries in A are experiencing secular decline (e.g., coal, cotton, or other primary products are being displaced by alternatives or synthetics produced in B). Theoretically, four built-in compensatory forces will come into play:

- (1) Price effects. The fall in the demand for A's products and the increased demand for B's will shift relative

prices in favor of A (the extent of the shift will depend on relative price elasticities). This will tend to stimulate A's exports and discourage B's, thus moving towards a closure of the payments gap.

(2) Income effects. The initial fall in demand for A's products and the rise in demand for B's will cause incomes to fall in A and rise in B, movements in both cases accentuated by the multiplier. One of two sets of consequences will then follow:

- (a) If wages and prices are flexible, the income effect will cause relative costs to alter in favor of A, so reinforcing the relative price movements caused by the demand factor referred to in (1) above.
- (b) If wages and prices are rigid, employment will fall in A and rise in B (unless full employment exists in B, in which case wages and prices are bound to rise) and aggregate demand will alter accordingly. The income effect will reinforce the price effect of (1) and (2a) above, reducing imports into A and raising them in B; exports will increase from A as the internal market contracts and diminish from B as the internal market expands. Again the payments gap will be reduced.

(3) Monetary effects. The deficit in A's balance of payments will require an outflow of reserves from A to

B. In principle this will cause a multiple credit contraction in A and a corresponding expansion in B. This, in turn, will cause interest rates to rise in A, reducing the rate of investment and producing a further fall in incomes through the multiplier; again, in principle, a reverse sequence will occur in B. The income effects of (2) are thus reinforced through the monetary mechanism.

- (4) Factor movements. Insofar as wage and price rigidities result in these income effects manifesting themselves in unemployment in A and labor shortages in B, there will be a tendency for labor and/or capital to move from A to B. Other things being equal, marginal productivities will tend to rise in A and fall in B, moving the relative cost position in favor of A. If relative marginal productivities moved in the opposite direction (i.e., if increasing returns to scale applied on both sides or operated so strongly on one side as to more than offset the other) then the downward pressure on employment and profits in A would be increased, as would the upward pressure in B.

In theory, all these forces would press continuously toward a removal of the initial deficit and would continue to operate until the deficit had been removed. In practice, however, these built-in tendencies might operate so slowly (if price flexibility and factor mobility were

very low) or involve such social hardship (if the required levels of unemployment, on the one hand, and inflation, on the other, were politically unacceptable) that in the real world certain policy measures would be adopted along with or instead of them, including the following:

- (1) Exchange-rate adjustment. To produce the change in relative prices described in (1) and (2a) above via the foreign exchange rate rather than through internal deflation or inflation.
- (2) Trade policy. The introduction, removal or adjustment of tariffs, import quotas, exchange control or other devices which, in effect, produce an artificial restoration of competitiveness.

All in all, then, the appearance of an international disequilibrium should automatically and/or through deliberate policy measures produce reverse tendencies which would ultimately eliminate it. These could in fact be described as a necessary part of the mechanism by which the world adjusts to the persistent, inevitable stresses imposed by a dynamic technology, which is itself the key to the long-run problem of raising per capita real income. The question thus arises: Do similar reverse tendencies exist at a regional level which ensure that periodic disequilibria will be eliminated? The answer seems to be that in the short or medium run (and especially at relatively low levels of economic development) they either do not exist or operate only in an exceedingly attenuated form at the regional level. It has been argued, in fact, that at the regional level there may exist backwash effects which are actually perverse in their operation:

- (1) Price effects. Almost by definition, the prices of traded goods do not customarily differ significantly between regions of a single country sharing common monetary and fiscal arrangements and accustomed to a high degree of intraregional buying and selling. Since they represent a relatively small part of a single large market, regions have to regard their price levels as given.
- (2) Income effects. Following upon this last point, the high degree of integration of a region implies that the regional propensity to import is very high and the "domestic" multiplier is correspondingly low.* Any fall in income in region A will therefore exert its effects predominantly on the demand for goods produced elsewhere and relatively little on goods produced within the region itself. Such internal effects as occur will be concentrated mainly (by definition) on nontraded goods--e.g., property or local services--where the corrective export-increase, import-decrease mechanism is incapable of operating except in the very long run.

* The multiplier is given by

$$\frac{1}{s + m + t}$$

where "s" is the marginal propensity to save; "m," the marginal propensity to import; and "t," the marginal rate of taxation. Thus, for example, a propensity to save of 0.2, a propensity to import of 0.5 (not implausible), and a marginal tax rate of 0.1 would result in an internal regional multiplier of no more than 1.25.

- (3) Monetary effects. In a country operating a branch banking system, a deficit in region A, causing a decline in deposits held in branches in region A, will generally have no net effect on the overall operations of the bank concerned, since the transfer of deposits from A branches to B branches will affect merely the geographical distribution of deposits, not their total level nor the central reserves held behind them. Nor is the situation materially different in a unit banking system. Given the high propensity to import mentioned in (2), a net loss of deposits will involve a loss of reserves only to the extent to which the deposits concerned would not ordinarily have been spent on imports from other regions. For example, an import propensity (including the propensity to purchase extraregional assets) of 0.75 would imply that any new deposit of \$100 would ultimately have involved a cash outflow to other regions of \$75 in any event.* A net fall in overall deposits would thus imply only a relatively small worsening of the reserve ratio position. Nor is this likely to cause a tightening of intraregional credit conditions: modern banks customarily hold a stock of transferable assets which are widely acceptable between

* Other corresponding inflows from other regions would be occurring simultaneously, of course, but these inflows are assumed for the moment to be locked up in the ceteris paribus enclosure.

different regions of a given state, balances in other financial institutions or short-term markets, government securities, and the like. These assets can be remitted to other regions, in effect, to settle net interregional clearing surpluses and deficits. Assuming the existence of acceptable opportunities (which is reasonable in view of the fact that lending has been taking place previously), a contraction of lending within a particular region is highly improbable.

- (4) Factor movements. It is precisely because factor movements are slow and/or socially unacceptable that regional economic policy has come to the fore. Empirically, these movements are unlikely to be self-equilibrating except in the very long run. Common observation confirms that migration is most likely among those least in need of special assistance; migration tends to be highest from the ablest and most enterprising sections of the population, leaving a declining region less, rather than more, able to reverse its decline. Furthermore, in the short run, labor immigration to a region implies increased infrastructure investment, which will accentuate any tendency for growth in that region to outstrip the national average. If economies of scale are important in determining relative rates of return on capital, autonomous capital movements are also likely to occur in a perverse

way: from regions with an inadequate capital base and toward those whose capital endowment is already high.

- (5) Policy measures. By definition, devaluation of the currency or commercial policy measures involving such things as tariffs are beyond the power of regional authorities. Nor are such authorities in a position to reverse a disequilibrium position with the aid of "external" borrowing or deficit financing. Because of the monetary mechanism described in (2) and (3), the effect of such operations would mostly be dissipated in other regions. This is not to suggest that such regional authorities are powerless, but in a macro-economic sense their operations are subjected to far tighter constraints than are those of the policymakers of central governments.

The general conclusion is fairly clear: A region within a larger state cannot suffer the horrors of balance-of-payments disequilibria in the ordinary sense of the term. But on the other hand, it may also lack the assistance of the built-in stabilizers associated with these disequilibria at an international level. The adjustment process is more intractable because of the constraints implicit in the regional situation; hence the need for specifically regional policy measures.

It could be argued, however, that these destabilizing tendencies believed to exist in the regional situation will diminish and will reverse themselves in the long run. Improved communications which ease the mobility of labor will equally reduce the selectivity of the migration mechanism.

The continued accumulation of capital in initially prosperous regions may lead to the eventual exhaustion of economies of scale and a steady increase in diseconomies of congestion. A secular tendency for government expenditure to rise in relation to GNP will automatically work in favor of slower-growing regions, given both the progressive nature of income taxation and the inherent bias toward equality of treatment in central government expenditure. The strength and speed of these countervailing tendencies are essentially empirical matters; unfortunately the investigation of these questions is hampered by the paucity of historical regional data and by the difficulty of defining regional inequalities quantitatively and unambiguously. The most extensive and systematic international investigation of the question is undoubtedly that published by J. G. Williamson in 1965. Using the dispersion of regional per capita incomes around the national average as a measure of inequality, Williamson stated his findings as follows:

- (1) There appears to have been a significant relationship between the level of development and the degree of regional inequality among a group of 24 countries during the 1950s, the degree of inequality being smallest in the more mature countries. This does not exclude the possibility, of course, that the political significance of such inequality may have no direct relationship with its absolute magnitude.
- (2) Historical data for ten countries lend support to the hypothesis that regional inequalities tend to increase in the early stages of development but subsequently diminish as economies mature. Some empirical evidence contradicts this hypothesis, however.

- (3) While population movement has played some part in accentuating regional inequality in some countries, as postulated above, they have more often had the opposite effect. The main causes of the inequality appear to lie in industrial structure (with regional differences in agricultural productivity being more marked than in the industrial sector), and in variations in labor participation rates.

A more aggregative, analytical investigation for the United States by G. H. Borts and J. L. Stein published in 1962 tends, however, to question the continuous trend toward reduced regional inequality as maturity is achieved. Dividing the period 1919-57 into three sub-periods, they found that in the first (1919-29), both average industrial earnings and industrial capital stock rose more rapidly in the high-wage areas of the United States than in the low-wage areas. This tendency toward a widening of differentials was sharply reversed in the middle period (1929-48). In the third (1948-57), however, industrial capital stock grew somewhat more rapidly and industrial wages somewhat less rapidly in the high-wage areas. It is difficult to derive a clear trend from such evidence. Data presented by Romans also confirm the impression that between 1929 and 1953 there was a marked inverse correlation between the rate of growth in "regional income produced" and per capita income in 1929 in eight regions of the United States. This is obviously consistent with the Borts and Stein findings but is certainly not conclusive. Overall it seems likely that when a narrowing of regional differentials has occurred, the major influences have been largely exogenous: the shift of resources from agriculture to manufacturing, a narrowing of

regional differences in participation rates (undoubtedly related to the first factor) and the redistributive nature of government taxes and transfers.

Similarly, two studies by McInnis and Chernick of income differences between the provinces of Canada over the 1926-63 period failed to uncover any secular trend toward reduced regional differentials in a developed economy. These authors found, in fact, that no significant change had occurred in regional income rankings between 1927 and 1963. Indeed, Chernick concluded that had it not been for the transfer effect of federal taxes and expenditures, the disparities between average per capita personal incomes in the provinces of Canada would have been slightly greater in 1963 than they were in 1927.

None of this substantially qualifies the case for regional policy. The latter may be directed at problems other than that of income differentials as such; for example, it may be concerned with social, especially environmental, costs. In any case, as suggested earlier, political sensitivity to such differentials may well be increasing more rapidly than their relative magnitudes. (In general, absolute inequalities have persisted with little change, even when relative inequalities have diminished.) What it does show, however, is that measures to diminish regional inequality cannot be said to be doomed to failure on the grounds that they are trying to counteract deep-seated and inevitable opposing tendencies. On the other hand, neither does this empirical evidence support the proposition that regional inequalities will diminish over time anyway, thus making special regional policy measures unnecessary.

SECTION 3: THE RATIONALE OF REGIONAL POLICY

The growth of interest in and concern for the inequalities of income and rates of economic growth among different geographic areas within the state has been virtually universal in the developed countries of North America and Western Europe during the past decade, and in some cases since the depression of the 1930s. Two fundamental factors probably underlie this concern. On the one hand, the sustained achievement of historically very high levels of employment and output has necessarily diverted attention away from problems of overall macroeconomic policy and toward the remaining "pockets" of relative depression which overall prosperity has highlighted. Moreover, the steady decline of agricultural employment compared with industrial employment makes this problem more obvious because the industrial operative on relief is much more visible than the farmer and his family who are merely underemployed.

Secondly, overall prosperity has enabled countries to afford the luxury of a conscience regarding the less fortunate. This concern has been especially striking when the underprivileged groups in question have drifted from their place of origin to form congealed groups of squalid misery in the centers of increasingly congested cities, the centers themselves physically decaying as the more fortunate citizens retreat to the suburbs.

The motivations behind regional policy are therefore a mixture of the political, social, and economic. Underdevelopment has become a political issue within countries as well as internationally, and like all

such issues, it has tended to become a means of attack by "them" and a necessity for defensive reaction on the part of "us." In the social context, the relative decay of particular regions frequently threatens (or is alleged to threaten) cultural patterns held by their defenders to be both valuable to society as a whole and irreplaceable. In some countries, the cultural patterns may involve language (as in Quebec or Brittany or Wales) or color (as in the southern United States) or religion (as in Northern Ireland or the Low Countries) or nothing more specific than a general lament about the passing of the rural way of life, a lament which seems to increase in appeal as the familiarity of its audience with the realities of rural life grows weaker.

In the United States a rather special but important element may be that the increasingly complex and detailed economic role of government is incompatible with the enormous area over which that role has to be exercised. In earlier days, when the role of government was simpler--essentially just to lay down ground rules within which the private sector could play its game largely undisturbed--the immense magnitude of the economy was less significant for the efficient operation of government. The rules, embodied in statutes or tariffs, were broad and relatively slow to change. The extent and detail of the involvement of modern government in economic life may have transformed this situation. Today more than a thousand federal programs require intervention in some sector of the economy. The efficient operational unit for many aspects of policy in such circumstances may thus be below the federal level, not only because the economy has grown too big, but also because the policy role has become too complex.

This is an economic study and is therefore not concerned with the relative merits of the political or social arguments. If certain objectives are laid down by the political authorities, the economist's business

is not to question them but rather to suggest ways in which the given objectives can be attained at least cost or, conversely, how the degree of their attainment may be maximized within a given budgetary constraint. There are purely economic reasons for the pursuit of regional policy, however, and it is worthwhile to summarize these because the design and operation of policy instruments can be efficiently achieved only if one knows precisely why those policy instruments were necessary in the first place.

The economic case for regional policy can be summarized under three headings. The first is concerned with the efficient allocation of resources and, in particular, with overcoming defects in the normal market mechanism insofar as it affects the spatial distribution of economic activities. The following points are relevant to this first consideration:

- (1) In theory, each entrepreneur carefully calculates the relative costs of different locations, but it is doubtful that this is invariably the case in practice. Inertia, ignorance, or plain irrationality may lead entrepreneurs to locate activities in areas which ultimately prove to be inefficient even on the basis of a correct initial evaluation of the entrepreneur's private commercial profit or loss.
- (2) Even when a careful, informed calculation is carried out, since it is necessarily made individually, it may be falsified because of other decisions taken simultaneously or subsequently by other entrepreneurs operating in a similar atomistic way. Labor supply in a specified area, for example, may

be perfectly adequate for an individual enterprise but may prove to be hopelessly inadequate if ten other enterprises also decide to locate there. A site which is attractive because of the proximity of raw materials, power, or marketing facilities may prove to be ruinous if the suppliers of these ancillaries cease business in that area. Locational decisions, in other words, are often inherently interdependent, and it may be impossible for them to be made efficiently on an individual enterprise basis. More generally, the efficiency of an area for any productive purpose may not be inherent in the endowments of that area but may be dependent on what development decisions are made by others (including government agencies) concerning it.

- (3) The above analysis refers to private and commercial costs and revenues. There is an increasing awareness in industrialized societies, however, of the possible divergence between private and social costs and gains and of the wrong locational decisions being made as a result. The most obvious divergence is exemplified by the existence of public services which are essential to the operation of an enterprise (e.g., transport facilities, housing, educational and health facilities) but whose true costs do not necessarily enter into the calculations of an individual enterprise. What is an efficient location from a private

point of view may therefore cease to be one when the social costs involved are taken into account. The problem is seen most strikingly in the congestion in the great conurbations where the entry of each additional enterprise may well inflict such costs as increased pressure on labor resources, higher rents, and slower traffic movement on those already there. It may also inflict costs on the community as a whole in the form of a generally deteriorating environment. None of these costs falls specifically on the newly arriving enterprise, but all have to be borne nevertheless. Such social costs may conceivably reach a point that involves diseconomies of scale for society as a whole in a location which offers positive economies of scale from a purely private view. Conversely, if regional policy measures succeed in reducing unemployment, society gains not only because relief payments are thereby reduced but also because an employed worker will pay increased taxes, directly and indirectly. It has been estimated that in the United Kingdom during the early 1960s the present value of these savings over a period of five years, discounted at 6 percent per annum, would have totaled about £1200, a considerable offset to the cost of regional policy measures.

The second strictly economic consideration is concerned with potential for growth. Given the attainment of relatively full employment nationally, the capacity for growth (productivity increases aside) is expanded

by the extent to which pockets of unused or underemployed resources can be brought into use. If labor and other factors of production were perfectly mobile within a country, the existence of full employment would imply that such pockets would be totally eliminated by normal market pressures. The same result would follow if wage rates and other costs were fully flexible in a geographical sense. Neither complete flexibility nor perfect mobility in fact exists, however, and therefore the coexistence of sharply differing degrees of pressure on resources in different regions at any one time is a feature of practically all advanced countries.

Such unused reserves of labor would not necessarily be confined to areas where unemployment is significantly above the national average. Below average participation rates frequently indicate involuntary unemployment even though the people concerned are not registered as unemployed. If they are members of a family group other than the head of the household, this idle capacity can persist indefinitely, even though formal unemployment may remain relatively low. Further, such concealed underemployment is liable to persist in areas of relatively low pressure on resources because activities such as agriculture or distribution tend to remain unduly labor-intensive until forced to change by the loss of labor attracted elsewhere by higher earnings in alternative occupations; if such alternatives are relatively rare in a region, the mechanism simply will not operate. The full exploitation of a country's potential for growth may thus require special measures to activate the unused or under-utilized capacity which imperfect market forces may continuously fail to eliminate.

The third and final economic factor in the present context is the quest for overall wage and price stability. The theoretical case for regional policy is probably weakest in this area. Virtually every central

government now acknowledges responsibility for the maintenance of reasonable stability in prices and output (and, by implication, equilibrium in the balance of payments). To this end governments manipulate the familiar weapons of monetary and fiscal policy, plus, in some cases, the rather heterogeneous expedients collectively known as incomes policy. If the relative pressures of demand and supply were more or less equal throughout a country, no regional dimension would be involved. In practice, however, bottlenecks or deficiencies in output or in the demand for labor invariably appear in some regions long before they do in others. Given the emulatory character of national patterns of wages and prices in many countries, it may thus become necessary to apply restrictive or expansionary measures throughout the country at times when they are unnecessary, or even positively inappropriate, for some of its individual regions. Once again, if perfect mobility of resources existed, the problem would not arise.

In effect, then, the economic case for regionalism tends to reduce to the question of immobility of resources, although the external economies element (or diseconomies, as in the congestion issue) is an important one. Hence the case can never be regarded as self-evident. It rests on two crucial hypotheses concerning the real world:

- (1) That these immobilities and external effects are of sufficient magnitude and of a sufficiently long-run nature to justify special measures to deal with them.
- (2) That the costs of dealing with these factors by artificial regional development at the losing end are less than the costs of

eliminating them (by increasing mobility
or removing external effects such as congestion) through action at the winning end.

There can be no a priori demonstration of the validity of these essentially empirical hypotheses; their validity will vary through time and from one society to another. The evidence, however, seems to suggest that the economic and social costs of the unrestricted gravitation of the population into a small number of large, densely populated conurbations are not only high but rise rapidly as both the extent of urban concentration and the complexity of modern urban existence increase. One might add that as societies advance in affluence, their willingness to tolerate environmental deterioration probably diminishes as steadily as the deterioration itself increases. Empirically, the costs of regional policy measures must be offset by the gains they can reasonably be expected to yield. In what follows it is assumed that such an assessment has been made and the policy measures in question are justified. But this is not an assumption which can safely be made in practice by the policymakers themselves.

SECTION 4: THE WEAPONS AND TECHNIQUES OF REGIONAL POLICY

Introduction

The battery of policy instruments which has been deployed in attempts to influence the geographical pattern of industry and population in different countries and at different times is formidable and complex. A basic distinction, however, can be made. On the one hand, there are those measures which seek to moderate or reverse the centripetal forces strongly at work in most advanced countries. On the other hand, there are measures which seek to accommodate the economy to these forces, to hasten the process of concentration by raising the mobility of resources and, perhaps, by cushioning those affected against the harsher social consequences of the process. Swedish policy is an excellent example of this type of approach. In a sense the latter could be described as antiregional policy.

Advocates of this so-called antiregional policy believe that the free market mechanism tends to approach an efficient geographical and functional allocation of resources. They argue that the centripetal tendencies of the modern economy arise essentially because of the economies of large scale operation or because of inherent locational advantages; any interference with these tendencies must therefore result in a loss of economic welfare and, in the long run, must be self-defeating. From this point of view, the inefficiency factors listed in the previous section as justification for regional policy are either insignificant in magnitude, compared with the benefits arising from centripetal development, or are better dealt with by measures facilitating geographical change rather than resisting it.

As has been remarked, the issue is essentially one of fact, to be settled by empirical inquiry in individual cases. Except perhaps in the very long run, however, the market-forces mechanism is unlikely to have the built-in tendency toward equilibrium which would be associated with factor movements between separate countries: in the short and medium term it is at least as likely to be destabilizing. Furthermore, the two approaches to regional inequality--one seeking to moderate centripetal tendencies and the other to increase social adjustment to them--may be, and often are, pursued simultaneously. Such a combination of policies could be regarded as seeking (1) to reduce the problem to its hard core by promoting factor mobility and (2) through the cushioning elements, to accept the reality of the hard core and to concentrate resources on raising the relative income level of the people involved.

The danger of this approach is the obvious one of falling between two stools: the encouragement of the emigration of capital and labor from a poor region can effectively render the elimination of the causes of its poverty more difficult or impossible, while measures designed to cushion the impact of economic decline in a region may well thwart other measures to switch resources elsewhere. There are potential advantages in tackling a problem from two directions, in other words, provided that one can somehow escape the futility of pulling in diametrically opposed directions.

One final point is worth making about the nature and degree of regional policy measures. No a priori rule can determine which are right or wrong. The choice depends essentially on two factors. First, what is conceived to be the main problem to be solved; measures aimed at limiting the size of existing cities, for example, will be different in kind from

those aimed at preserving declining communities. Second, what are the relative political values of the society concerned; what price is it willing to pay in terms of finance or official intervention in the private sector or in lower levels of government in order to secure any given end.

The definition of special areas

Since regional policy is concerned, by definition, with the geographical distribution of economic activity and thus of the population, the selection of areas to which special regional measures shall apply is the crux of the policy problem. Three aspects are involved:

- (1) The definition of such areas in geographic terms.
- (2) Their definition in "qualifying" terms--i.e., in terms of the income or employment characteristics that will qualify them for special assistance.
- (3) The administrative or policy approach, by which regions are defined as falling within the jurisdiction of local government bodies competent to administer the policy measures in question; for purposes of different policy instruments, any given community may be in several different "regions" simultaneously.

In practice the outcome is usually a rather indeterminate mixture of all three elements. Most economists would probably regard (2) as likely to make most sense in the long run, but the practical realities of political life usually dictate an uneasy combination of (1) and (3). Where local traditions are strong--as, for example, in the United States--central intervention is resisted, and the planning unit has been the county or some

combination of counties; the Economic Development Administration managed to create only a very small number of development regions crossing state boundaries out of the approximately 800 counties meeting the appropriate legislative requirements. Where there exists a tradition of strong central government, on the other hand--as in France or Italy--the "nodality" concept is much more extensively adopted.

Practice on the second aspect, defining regions by qualification (see (2) above), is much more homogeneous.* Few countries go to the U.S. extreme of specifically defining seven different statistical criteria of distress in the appropriate statute,** but practically all regard an excess over a defined level of unemployment as a reasonable proxy for regional underdevelopment; a smaller number also add the criterion of income levels (or some substitute, e.g., tax yields) which are below a specified percentage of the national level; some include the existence of a level of emigration considered to be intolerable or at least excessive.

The major and obvious weakness of all these measures is, of course, their ex post facto nature: the remedial classification can occur only after the symptoms of decline have reached significant levels and often when they have persisted for some time. The objection to this process is that reversing a decline inevitably becomes more difficult--and may indeed become impossible--once a cumulative decline has begun. In economic as in human ailments, prevention is much more desirable than cure; the treatment also tends to be cheaper and is more likely to be effective the

* Some details are shown in Appendix A.

** The Belgian Minister for Regional Economy, however, did draw up a list of 35 criteria for designating areas to be assisted under the 1966 legislation; he was, of course, an academic.

shorter the delay between the onset of the malaise and the attempt to cure it. The ideal is a continuing reassessment of regional prospects so that action can be taken to prevent the descent of an area into the distressed category. Unhappily, in practice this would open the door to the blandishments of all the special pleaders; the use of relatively objective criteria for distress is at least a defense mechanism protecting the guardians of the public purse.

Direct government action

The enormous variety of policy instruments adopted in the name of regional policy can be grouped into four categories:

- (1) Direct central government action in a region, including that taken through or in association with lower tiers of government.
- (2) Inducements to the private sector to take action in a particular area or type of area (herein called "the carrots").
- (3) Measures to discourage or prevent the private sector from undertaking developments in the "wrong" regions (herein called "the sticks").
- (4) The creation and/or support of local development institutions with executive, rather than merely advisory, powers.

A very truncated summary of the extent to which these various measures have been adopted by different governments is given in Appendix B.

Inevitably the main emphasis in direct government expenditure has been on the improvement of the economic and social infrastructure of depressed regions--roads, public utilities, housing, and the like. Generally

this emphasis has been justified by such negative (or at least passive) arguments as the following:

- (1) In general, unless government attends to such matters, no one else will.
- (2) Since these activities are generally agreed to be a proper function of government, the minimum political resistance is generated by such activity--especially since it is normally carried on by lower levels of government whose suspicions of central intervention are at least as strong as those of the private sector.

In recent years, a more positive argument has been advanced to support this concentration on infrastructure expenditure. This argument is that sensible policy seeks to remove the causes of economic weakness rather than to be perpetually compensating for them through subsidies. Since many of the features making areas attractive for modern industry arise from artificial (i.e., man-made) factors, as opposed to natural endowment, improving the infrastructure is a step in the right direction. This important point will recur later in the discussion.

Government expenditures more directly related to particular industrial developments tend to run into political difficulties and are generally avoided for that reason. This may be true even where, as in France, major manufacturing industries are state owned and the location of new plants can thus be decided in the light of regional needs. Obviously, conflict may develop between regional needs and efficient operation, as central government intervention into decisions concerning the location of new plants in the British steel industry demonstrates. This difficulty is equally

present with less tendentious forms of regional expenditures, such as deliberately steering normal government purchases toward suppliers in distressed areas or deliberately pushing new government establishments to locate within such areas. If such purchases or locations are efficient, in the market sense, official steering should generally be unnecessary; if they are not naturally competitive, the subsequent political recriminations over the higher costs may ultimately produce a reversal, thereby introducing damaging instability into a structural weakness which was bad enough in the first place.

The carrots

Because of the risks just mentioned, by far the most popular policy instrument of regional policy (apart from infrastructure improvement) has been financial inducement: the attempt to lure private enterprises into problem areas by means of various concessions designed to reduce operating costs relative to those in favored areas. In Western Europe, tax inducements are overwhelmingly the most popular carrots. During the early years of operation they take the form of lower profits-taxes or unusually large tax offsets on buildings, plants, and machinery associated with development in depressed areas. The psychological attractions are obvious: there is no question of positive payments to specific enterprises, requiring authorization by a suspicious and jealous legislature, but merely a partial foregoing of tax revenues from a broad, anonymous group of firms which any firm is welcome to join if it so wishes.

Other fiscal incentives offered to anyone willing to join the club are attractive for the same reason, although somewhat less so since positive payments out (hence corresponding taxation elsewhere) are involved

rather than merely allowing taxpayers to retain more of their own income. These usually include government grants or loans at low interest rates for new investment projects in development areas or assistance for training or retraining of labor. These loans and grants may be given either in connection with specific development projects or as a result of industrial decline within regions which are held to necessitate the deployment of labor within or beyond the region concerned. The United Kingdom has probably been unique in making outright grants (the Regional Employment Premium) on the simple basis of the employment of labor within development areas.

The political virtues of such devices are partly offset by their economic weakness. Ignoring for the moment their effectiveness in influencing location decisions, which is discussed in the following section, measures of this sort are open to the fundamental criticism that while they may compensate their recipients for the relative disadvantage of a given region, they do nothing directly to reduce or eliminate those disadvantages. Moreover, the fact that concessions granted by one political administration can always be withdrawn by a successor makes them a somewhat unreliable form of medicine; at best, a palliative rather than a cure.

The sticks

Logically the converse of the carrot measures would be fiscal penalties directed against enterprises locating or expanding in the wrong regions, much as tariffs or quotas imposed on competing imports are used to help domestic industry. In the real world, however, while discriminatory measures are frequently accepted--if not indeed applauded--when directed against foreigners, when applied by a government to its own nationals they take on a wholly different character. To reward desirable locational decisions is one thing; to penalize undesirable decisions is quite another.

The political reason for this lack of popularity of restrictive measures--the undesirable encroachment on individual liberty--is obvious enough. There are economic objections to restrictive measures too. With carrot measures, the public purse is involved only if and to the extent that development actually occurs in depressed regions. The stick technique, however, while it may succeed in reducing development in congested regions, by no means guarantees that the development so prevented will then occur elsewhere. The loss of potential output in one area may not be balanced by increased output somewhere else, a state of affairs which can scarcely benefit anyone. Once again the United Kingdom is probably alone in using restrictive controls over industrial development in "boom" regions as a basic element in its regional policy.

But if in some way the loss in output can be even partially offset, the restrictive approach may have several advantages. First, if the congestion of existing cities is a central part of the regional problem, control measures can be directed specifically against the worst congested areas with a precision which the merely hortative carrot technique cannot hope to attain. Indeed, it is by no means self-evident that a mere prevention of industrial expansion in such areas, unaccompanied by compensating expansion elsewhere, will always represent a net loss to society if the diseconomies of scale in the badly congested areas have already attained a significant magnitude. Second, the stick may be necessary in order for the carrots to become effective. Considerable evidence, certainly from British experience, suggests that even quite generous regional inducements alone will be insufficient to overcome the centripetal tendencies of modern industry. (See, for example, the investigation reported by Loasby.) The inducements may influence the choice of an alternative location; in other words, they become effective only after the first-choice location is placed beyond the realm of practical possibility. However,

they will seldom be powerful enough to determine that first-choice location itself. The sheer physical limitation of over-expanding boom centers--their shortages of sites or manpower--may have an effect similar to fiscal or physical restraints in those areas. But reliance on such limitations implies that the centripetal pressure has been accepted as a permanent feature of the economy and that the long-term regional battle has in a sense been lost.

Local development agencies

It is frequently argued that a local involvement with area development plans tends to increase the prospect of success. Presumably, the feeling of involvement results in a greater determination to make things work. In addition, the greater familiarity of local officials and entrepreneurs with the problems and characteristics of their area may actually improve the plans drawn up by outside experts.

All this involvement, however, refers primarily to advisory activities such as the preparation and discussion of the overall economic development program familiar in the United States or the surveys and reports of the regional Economic Planning Councils in the French and British systems. The actual execution and administration of development programs is another matter altogether. For the political reasons already mentioned, in countries where local independence is jealously guarded it is seldom possible to allow such powers to pass out of the established tiers of government, particularly when public funds are at stake. This is especially so when (as is usually the case) public funds, and therefore the issue of accountability, are involved.

Despite the political necessity of such arrangements, they do entail disadvantages. Local government authorities are seldom equipped,

in terms of attitude and procedure as well as personnel, to execute development projects (other than conventional infrastructure projects) with the level of efficiency desired. The same would be true in the relatively rare instances of private development groups formed by local patriots, such as the development corporations of New England to be discussed later. Furthermore, organizations dependent on popular political support tend to conduct themselves as pressure groups. A case for economic expansion at the expense of someone else will always be enthusiastically accepted; the inevitable corollary of decline somewhere else, even if only relative, will equally predictably be fiercely resisted. When a region embraces several local government areas, any ensuing development plan is likely to be seriously qualified by the need to reconcile the various divergent interests as they are conceived by the constituent political elements.

This difficulty probably helps explain why the Economic Development Administration managed to create only about a half-dozen regional areas transcending state boundaries out of more than 800 counties qualifying for assistance. It also explains why the reports of the various Regional Planning Councils in the United Kingdom proved without exception to be inward-looking and of a special pleading nature. Furthermore, it explains why such autonomous agencies have been most prominent in countries with a relatively weak tradition of local government, the conspicuous examples being the Casa per il Mezzogiorno in Italy or the various Societes Provinciale d'Industrialization in France. The European Investment Bank, the major instigator and financing agent for the European Economic Community's regional policies, is itself a major example of the type of agency whose interests extend beyond the limits of established areas of political jurisdiction.

SECTION 5: THE EFFECTIVENESS OF EXISTING POLICIES

The criteria of success

There are few areas of economic policy in which less scientific effort has been invested in the assessment of effectiveness than that of regional policy. The blame for this lack can no doubt be laid primarily at the feet of the academics working in the field who have been more eager to formulate and pronounce "right" solutions than to submit their hypotheses to empirical testing. Over and above this, however, there are two difficulties of a fairly fundamental nature.

First, even when objectives are stated precisely, their subsequent nonattainment cannot be unambiguously described as a failure. Policymakers and administrators can and do assert that matters would have been even worse in the absence of their intervention. This sort of defense is not peculiar to regional policy measures, of course, nor is the impossibility of disentangling the effects of specific policy measures from the consequences of changes in other variables.

Second, there are difficulties in defining what in fact the objective of regional policy is, or should be. In general the definition will depend on the basic philosophy underlying the policy. For example, it may be politically necessary to allocate the limited resources available in the regional budget equally among all areas classified as distressed, in which case success is judged by mere arithmetic; the economic consequences of this dispersion exercise become largely irrelevant. In contrast, a policy of "worst-first" may be adopted, in which case resources are distributed with a bias toward the poorest or weakest areas. Here again, consequences

become largely irrelevant since the operation is conceived of as a redistribution of income, which is an end in itself.

In recent years there has been a growing awareness of the long-run futility inherent in "worst-first" policies; poverty or weakness are essentially relative concepts, and as national income rises there is no obvious trend for the proportion of the population falling below any current average to decline. The commitment becomes open-ended. Hence, increasing stress has been directed away from policies supporting or compensating distressed areas and toward getting them out of that category as quickly and as fully as possible.

The operational criteria are still not totally unambiguous since they may imply either a concentration on those nearest the margin (i.e., a stress on "quickly") or an attempt to close the distress gap at a more or less proportional rate across the board--in which case the pattern of resource allocation will tend to be reversed. In practice these difficulties are compounded because various criteria may be adopted at any one time or with nothing more than gradual shifts in the relative importance attached to different elements over the course of time. Even worse, the policymakers may not be clear in their own minds what precisely their criteria are, much less what their relative importance should be.

All this helps to explain, even if it does not wholly excuse, the almost universal absence of any quantitative assessment of the extent to which the broad aims of regional policy have been attained. Nor have there been many attempts to measure the comparative effectiveness of the wide range of policy instruments used to achieve these goals of regional policy. One is therefore reduced to a collection of rather impressionistic, imprecise generalizations based on exceedingly scanty evidence. Such impressions

may not be wrong, but only political spokesmen would be inclined to make confident assertions on the strength of them. To repeat, there can be few areas of policy (apart, of course, from military defense) in which so many claims are made, and on which public resources have been expended so generously, with so little firm foundation of knowledge.

The objectives of policy

Given the ambiguity of policy criteria in this field, it is only possible to briefly indicate the general experience under the vague policy criteria that seem to form the basis of public discussions of the matter.

The first of these is obviously relative levels of unemployment within different regions of the country. Success in this context presumably means a reduction in regional disparities in average unemployment rates, although such a reduction is clearly consistent with an increase in absolute levels of unemployment in distressed as well as in prosperous regions. In the United States the number of areas with extremely high rates of unemployment was considerably smaller in 1969 than it was in 1960, for example; but this was partly a reflection of the tendency to pursue a worst-first policy in the early years of the decade. It also reflected the curious, highly political provision of the legislation that required the existence of at least one depressed region in every State of the Union. Aside from this, it seems doubtful that there has been any significant decline in the broad magnitude of regional variations in the incidence of unemployment at any one time.

In the United Kingdom, disregarding the usual statistical difficulties, the record seems no more impressive. The 1950s' level of unemployment in the three traditionally depressed areas--Scotland, Wales, and Northern

England--tended to fall while the overall national average was rising. Toward the end of the 1950s and through the 1960s, however, much of this relative gain was lost due to the deterioration of some highly localized basic industries such as coal, shipbuilding, and textiles. Except on the questionable "it could have been worse" argument, the record under this heading is not particularly impressive.

Similarly, the Dutch have grave reservations concerning the extent to which their fairly vigorous and generous regional policy has succeeded in narrowing the gap between regional unemployment rates. In February 1969 the overall national unemployment rate was 1.5 percent, whereas in the development areas percentage rates were far higher--7.1 in Limburg, 7.4 in Groningen and 10.0 in Drente. In Denmark too, despite certain favorable developments in the overall environment, similar differences persist: in February 1967 the national average rate of unemployment was 3.8 percent; in the booming Copenhagen area, however, it was as low as 1.6 percent, whereas in the problem region of Jutland it varied from 4.8 to 10.1 percent.

A second yardstick of success or failure is the extent to which migration from declining to expanding regions has been moderated. To some extent failure in this respect could generate success or conceal failure under the unemployment heading, provided that regional unemployment rates are reduced only by continuing migration. Once again the record tends to be mixed and inconclusive, but it tends to be somewhat more impressive than the unemployment record. In the United Kingdom, for example, the movement out of the traditional losers continued during the 1950s and early 1960s, as it had for some decades before, but in several cases a distinct decline was not noticeable until the period of economic stagnation in the

second half of the 1960s. In sharp contrast, from the mid-1960s on, the inflow into the fastest growing area, London and the Southeast, was sharply reduced and in 1965-66 was in fact reversed. If a reduction in mobility is judged as a virtue, regional policy can claim some success here.

The experience of the United States, on the other hand, indicates the complex and deep-rooted forces underlying population shifts and, consequently, the very marginal effect which regional development policy can exert over any relatively short period. No major modifications have occurred in recent years in the well-established drift of population away from the traditional manufacturing states of the Northeast, from the farm belt of the Midwest and from the South (except for the retirement movement into Florida), and the corresponding movement toward the West Coast and the Southwest. Some of the major identifiable factors at work, however--the rapid growth of defense industries, racial differentials in population growth rates, climatic advantages and disadvantages, and the like--could hardly be expected to respond to regional policy as conventionally understood. A recent study by Lowry has in fact shown that the most important single explanatory variable in population movements within the United States is not job opportunity but age distribution.

A third measure of success in the regional policy context could be the extent to which disparities in regional growth rates are reduced through time. Unfortunately, the statistical data required for such a comparison are almost universally lacking. Where they exist they tend to be fragmentary and unreliable; the European experience tends to suggest that, at best, regional measures have merely succeeded in putting an intermittent brake on the tendency to cumulative relative decline. In the United Kingdom,

certainly, this temporary halting of decline has been achieved during one or two periods when regional measures were pursued with exceptional vigor. On other occasions the gains so won have not been increased; indeed in some cases there has been a tendency for regions to revert to their previous relative decline.

In Belgium the record seems to have been equally dubious. Whereas real GDP for Belgium as a whole grew at an average rate of 3.8 percent per annum during 1956-64, in the Walloon region--the core of Belgium's regional problem--it grew at only 2.6 percent per annum. In the Flemish region, on the other hand, where the regional problem is less severe but still important, it grew at 4.2 percent.

For the United States the evidence is far from conclusive. One study by Borts and Stein does seem to establish, however, that while the relatively rich areas were growing more rapidly than relatively poor areas during 1919-29, this pattern was sharply reversed during 1929-48. This reversal is consistent with the study of income differentials referred to earlier. During 1948-57 a position of near stability seems to have been achieved, the tentative evidence suggesting very small differences in average growth rates.

One final criterion, changes in the relative levels of income in different regions, is worth considering. One finds, predictably, that such a comparison reveals trends similar to those underlying growth rates. Nevertheless, there is room for significant differences because of the role of net government transfer payments, which are clearly redistributive in character. Probably because of such transfers, the narrowing of regional differentials is distinctly more marked in personal income data than in

gross regional product data. In the United Kingdom, for example, between 1949/50 and 1964/65, average personal income in Wales rose from 81 to 84 percent of the U.K. average, while in Northern Ireland it rose from 58 to 64 percent. Some opposite movements--for example, in Scotland and the North of England--did occur as well.

Even if the narrowing of relative income differentials is established, however, it by no means follows that there has been a closing of the average absolute income gap between rich and poor regions, and absolute differences could easily be more influential from a policy point of view. Williamson's analysis suggests that despite regional economic policies the absolute income differential was virtually unchanged in both the United States and Canada during the 1950s, despite a slight tendency toward a closing of the relative gap; in Sweden and Italy the average regional variation in absolute income rose quite sharply during the 1950s, while a similar widening, of somewhat lesser degree, also seems to have occurred in the United Kingdom.

The only overall impression that emerges from the evidence on regional policy results is a somewhat disappointing conclusion that regional policy cannot be expected to work quickly and dramatically, and the period during which regional policy has been operating, while varying from country to country, has in general been relatively short, with the intensity of its application varying significantly within any given country. Nor have "other things" been as equal as they are expected to be in well-behaved textbook models: overall buoyancy in the economy has tended to make the regional problem more tractable in most countries but less tractable in others.

The most recent and most comprehensive survey of European experience--the OECD publication, The Regional Factor in Economic Development--tends to confirm this highly qualified conclusion. While indicating with

an air of pious politeness that European regional development policies have in general been successful, it immediately specifies, with markedly greater confidence, five serious qualifications to its success. First, the results have been very patchy, and some depressed areas have remained conspicuously unimproved. Second, the tendency of the cities to expand has not been checked. Third, industrial decline in several areas has continued at least as rapidly as curative measures have been applied. Fourth, the depressed areas continue to be especially vulnerable to cyclical recession. Finally, the income gap between north and south will still persist for at least 20 years at recent rates of growth.

In general, then, conventional regional policy measures show some signs of modest and limited effectiveness in situations of overall prosperity where the problem is relatively marginal. Over a fairly long period, they would appear to be capable of working in the right direction provided that

- (1) the economy as a whole is not gripped by major difficulties whose solution must override--and even reverse--the attempts to improve the lot of relatively poor regions; and
- (2) the regional sickness is not due to a relatively sudden, structural maladjustment whose dimensions exceed the 3-4 percent or so implied by the word "marginal."

Unfortunately these two conditions are seldom met continuously over substantial periods of time, and the setbacks periodically imposed by their absence seem to overpower the conventional policy measures. It is thus necessary to examine these measures a little more closely in order to discover why this should be so.

The policy measures

As has been noted, the most widely adopted weapon of regional policy has been the financial inducement--outright grants in cash or kind (e.g., subsidized factory buildings), low-interest loans, or tax remissions of one sort or another. Except in the case of the U.K. Regional Employment Premium, such inducements generally have been related to capital investment. Thus they have had the disadvantage of being biased in favor of capital-intensive projects, although the relatively abundant factor in the depressed regions has almost always been labor rather than capital. Furthermore, highly capitalistic industries are frequently more sensitive to locational differences than are the lighter, more "footloose" industries. The capital-biased inducement therefore suffers from the defect of being strongest for those industries least likely to possess flexibility in their locational decisions and least attracted by the abundance of labor which is the main selling-point of the depressed regions. This defect helps explain the generally rather small effect which regional inducements appear to have had. The Economic Council of Canada noted somewhat ruefully that in four years' operation by the Area Development Agency no less than 30 percent of its capital grants had gone to the highly capitalistic pulp and paper industry (with a capital-per-worker average of no less than \$127,000) and the second largest beneficiary had been chemicals and chemical products. It seemed unlikely to them, moreover, that the projects involved would have been located elsewhere in any event, while their relatively low local linkages had minimized their effective contribution to local development.

A second qualification of the effectiveness of this kind of measure is associated with the administrative mechanism through which it is applied.

If the financial inducements are negotiated with individual entrepreneurs, cases in which assistance is unnecessary (or even undesirable) will be screened out, but at the expense of inherently complex and time-consuming negotiation. Few entrepreneurs relish this sort of experience, and the formal superficial attractiveness of the inducements involved is severely qualified in practice. If, on the other hand, standard benefits are adopted on the sole qualification of capital expenditure within a scheduled area, then administrative convenience is secured at the cost of spreading available resources over enterprises which would have located within the area in any event or which may be operating there already and merely seek to replace existing capital. The average return in the form of new entrants to the area is inevitably much reduced.

Third, although the nominal level of the inducements is frequently high (e.g., grants of 45 percent toward new equipment in U.K. Development Areas and of similar magnitudes in other European countries), the net advantage offered to an enterprise is generally very much smaller in practice. In the first place, if, for example, 40 percent of profits is taken away in Corporation Tax anyway, the value of a nominal 45 percent is reduced to around 27 percent. Secondly, the depreciation on that proportion of capital financed by such a grant or allowance is normally not allowable against profits for tax purposes--not unnaturally.* All the equipment will sooner or later need to be replaced, however. The difference will thus need to be financed from post-tax profit unless the entrepreneur is prepared to assume that the benefit will continue indefinitely into the future--and few entrepreneurs place their trust in politicians to this extent.

* This is not the case in Canada, however, where depreciation for tax purposes can be calculated without taking account of the quite generous grants made for new investment in Development Districts.

For the United Kingdom, for example, it has been calculated that a nominal 45 percent grant on equipment is reduced in practice to an actual 13 percent. Allowing for the fact that capital costs are only a proportion of total costs, the final reduction of overall operating costs would probably be of the order of $2\frac{1}{2}$ -3 percent a year--useful, no doubt, but scarcely overwhelming. The concession is best put in perspective, perhaps, by recalling that in the first two or three years of a new establishment, operating costs are notoriously high; there is some evidence that in the United Kingdom the losses incurred by some enterprises in the two initial years of operation can equal its total capital costs. This feature of new industrial establishments also helps to explain the limited effectiveness of initial tax "holidays" or accelerated depreciation allowances; in the crucial stages of the exercise there are unlikely to be profits against which tax liability could arise anyway.

Finally, it seems doubtful that many entrepreneurs would feel happy about basing investment decisions even partly on the availability of official inducements of this kind, even if they were much larger. As already observed, businessmen have reason to believe that politicians change their minds and certainly change their identities: handouts can be taken away as well as given. Entrepreneurs seem to consider developments on their own commercial merits and then treat any official financial inducement as a welcome (but not necessarily permanent) bonus. If this is the case, the limited operational effectiveness of such inducements as decision-influencers is scarcely surprising. In other words, there is a basic weakness in the whole inducement concept. If small, inducements are unlikely to influence location decisions, whereas if large enough to have such an effect, they are a priori likely to lead to inefficient locations.

The experience of the United Kingdom with a kind of subsidy on labor costs, rather than capital, in development areas is perhaps too short for firm conclusions to be drawn. To a considerable extent, many of the points just made in connection with investment inducements apply equally to the Regional Employment Premium (although not, of course, the point relating to the bias in favor of capital-intensive industries). Its gross value has been estimated at about $7\frac{1}{2}$ percent of the wage bill; its net value, after allowing for tax, at about $1\frac{1}{2}$ percent of operating costs. Even this small advantage may be eroded away, on the one hand, by increased wage-rates sought and conceded due to the existence of this premium and, on the other, by a less efficient use of labor. Certainly the measure has not earned much acclaim or popularity within the United Kingdom itself.

As with the regional employment premium, it is only in the United Kingdom that extensive and continuing use has been made of the negative weapon of official control over industrial (and more recently, commercial) building in more prosperous regions of the country. In the immediate postwar period, this control was exercised through the issuance of building permits which regulated the availability of materials in those days of acute scarcity. Since this system was abandoned in the early 1950s, its place has been taken by the requirement of an Industrial Development Certificate issued by the central government for any industrial building in excess of a specified size--generally 5,000 square feet. In 1964, office buildings in excess of 3,000 square feet were brought under the same control. Such certificates are issued freely for developments in distressed regions but restricted with varying degrees of intensity in the more rapidly growing regions. There is considerable evidence that this type of control can be distinctly effective. In the two postwar periods, during which the regional dispersion

of industry has been given high priority in the United Kingdom--1945 to 1951 and 1960 to the present, especially from 1965 onwards--the proportion of "moves" by manufacturing industry into development areas (containing roughly 20 percent of the work force of British manufacturing industry) was very high, about two-thirds in the first period and up to about one-half in the second.

Effective though inducements to attract new industry to distressed regions may have been within its limits, those limits are fairly severe in actuality. In the first place, the policy operates only at the margin for enterprises contemplating transferring or developing capacity at a new site. In the United Kingdom in any given year, enterprises in this category grow collectively so as to ultimately account for $\frac{1}{2}$ percent of total employment in manufacturing. Hence establishments which had "moved" (and all of these "moves" were not necessarily beyond their own region) during the period 1945-66 were employing approximately 900,000 people--which implies an annual availability of only about 40,000 jobs in a total manufacturing work force of around 9 million. In the early 1960s, the gross cost to the Exchequer of various inducements amounted to about \$3,000 per worker, although the net cost in the medium run was probably only a third or less of this figure. In Belgium, where a similar incentive policy has been adopted, during 1960-67 a total regional expenditure of about \$1.4 billion was estimated to have created an annual average of around 9,500 new jobs out of a total manufacturing work force of 1.1 million. In the Netherlands between 1959 and 1967, a total expenditure of about \$23 million on industrial subsidies led to the creation of around 35,000 jobs. In Canada, an average Federal expenditure of approximately \$8,000 has been required for each new job created in a development district; projects

approved or under consideration in the first five years of the Area Development Agency were expected to produce 65,000 new jobs at a cost to the Federal government of just under \$500 million. It would appear that job creation is an expensive proposition.

Second, movement to new or extended capacity is likely to occur only when the limits of existing capacity have been reached and growth is continuing. In practice this implies that the controls and inducements become really effective only if the more prosperous regions continue to expand relative to the less prosperous ones. As was observed earlier, in a paradoxical sense this cure for regional inequality is inherently dependent on the continuance of such inequality. Hence, in periods when the economy is not in a state of boom the effectiveness of the policy is much reduced.

Third, like all financial inducements given on a general rather than an ad hoc basis, the policy is negative in that it depends on the size and nature of the establishments seeking to move and has no mechanism for ensuring that they necessarily constitute sensible and coherent ingredients for an integrated development pattern in the receiving area. As a result, the approach has tended to produce a rather fragmentary, ill-assorted mixture of new developments which collectively lack technical viability.

The final major weapon of regional policy has been the deliberate deployment of public sector expenditure so as to promote growth in distressed regions. The most important activity of this kind has, of course, been the improvement of the industrial infrastructure to make an area inherently more attractive for development rather than artificially so by means of special financial inducements. Transport facilities are clearly of prime importance. Striking examples of the deliberate design of regional transport

development are provided by the Italian Autostrada del sole and the Belgian Autoroute de la Wallonie from Germany to Calais. The construction of industrial estates or "farms" has also been increasingly important. With the immense advantage of encouraging development in a relatively concentrated form, these estates increase the likelihood of securing economies of scale that are impossible when efforts are dissipated over a large number of scattered locations.

The major limitations on this direct improvement approach have invariably proved to have been the strong political influence on public expenditure and the difficulty of securing acceptance of concentrated efforts embracing a number of political subunits. To construct major motorways across underpopulated and declining regions in the interests of long-term balanced development is excellent in principle; in practice, however, there are always congested localities crying out for improvements in their existing roads--and with the voting power to reinforce their point. Airports are not exclusively economic phenomena; like seats in the United Nations they tend to become visible symbols of community importance and maturity. Concentration of industrial development makes economic sense but implies at least a modest degree of labor mobility, which economic maturity appears to render less and less tolerable. The United Kingdom is probably extreme in providing a recent example of a small town proclaiming a serious crisis when the nearest employment opportunities were no less than 7 miles away, but the difference is only one of degree. Local communities have a habit of supporting industrial development only when it is located within their own political jurisdiction. The problem is all too familiar--and universal.

In theory, a logical outgrowth of building industrial estates would be for the central government itself to initiate productive units

when the crucial element of enterprise and management is missing. In practice the step appears to be one of such fundamental political significance that the governments of most Western countries have avoided it. A conspicuous exception is Italy, where the two state holding companies, the IRI and ENI, have been used as major instruments for the stimulation of growth in the underdeveloped South. The consciously designed integrated development plan for an industrial complex in the Brindisi-Taranto area of southern Italy is indeed one of the few really impressive and exciting experiments of contemporary regional development policy. (The background to the plan is set out in the EEC's Ninth General Report of the Activities of the Community, 1965-66). The general view, however, is that it is not the function of government to go into business and that even those sectors in which government is involved--i.e., public utilities or defense establishments--should base their locational decisions on operational efficiency rather than social criteria. The latter, it is generally held, are properly taken into account by specific grants or subsidies and should not be confused with the business of operating productive (or military) enterprises. There is clearly much common sense in this view, but the logic is not always beyond question. The economic viability of an area can clearly be influenced by decisions to extend or contract transport or power facilities or those involving defense establishments. It is by no means always sensible or good government for one agency to disregard consequences of its action which necessarily create additional responsibilities for another. Government, more than any other institution, is concerned with social costs and benefits rather than exclusively commercial or military considerations.

Conclusion

The broad lessons emerging from this postwar experience of regional development policy seem fairly clear. In the first place, no country can

claim conspicuous success in reversing the centripetal tendencies apparent in most highly developed economies. At best some modest success can occasionally be asserted in moderating or slowing down such tendencies, but even here it is by no means obvious that any such effect has been due to regional policy rather than to secular tendencies inherent in the system.

Second, and related to this, there has been a growing conviction that the orthodox weapons of regional policy--and especially the reliance on financial inducements--are far too weak to exert more than a marginal impact on the powerful forces of cumulative inertia which they are supposed to counteract. On the one hand, their actual magnitude is usually too small to be conclusive; for example, the Redevelopment Areas in the United States have so many obvious shortcomings that a four percent loan is no special inducement to a successful corporation. On the other hand, the administrative and political objections to the deployment of financial inducements in a discriminatory fashion has tended to produce a fragmented, widely dispersed crop of unrelated developments. As a result, the initial weakness of the distressed regions has seldom been reduced by a change in the fundamental nature of their economies. The deployment of forces in a large number of small, wide-ranging patrols may lead to the capture of a few prisoners, but it is manifestly unlikely to win a major battle.

During recent years in many countries, therefore, opinion concerning a coherent regional policy has shifted. A reliance on a wide range of financial inducements (which implicitly assume that the regional problem is one of relatively marginal adjustments) has been regarded less favorably than more positive intervention, concentrating on a limited number of designated locations and attacking in depth. Such an approach at least implicitly

recognizes that the regional problem is typically one of fundamental, structural weakness rather than a marginal one of stickiness in the labor market. Economic logic heavily supports such a shift in policy. As the century has progressed, the natural factors making one area a more suitable location for industry (raw materials, indigenous power, climate and so on) have steadily diminished in importance while artificial factors--capital infrastructure and the externalities of large-scale operation--have steadily increased. Differences in the scale of operations are now probably much more significant in determining efficiency than differences in location. Hence, a regional policy which is not based firmly on the attainment of relatively large-scale centers can have little hope of long-run success.

The political objections to such a policy of concentration have already been mentioned: the limitation of development effort to a small number of locations carries with it the inevitable and highly disagreeable political necessity of informing a much larger number of small communities that they are being written off. The necessity for this type of decision makes it unlikely that existing political subdivisions (even if they are big enough) will prove to be suitable units for effective regional planning. Furthermore, the identification and design of integrated "growth points" implies a degree of economic planning which is by no means always relished by society in general. Yet the logic of experience is remorseless: a policy which is relatively unobjectionable politically but which nevertheless shows every sign of inability to succeed in the long run has little to be said for it. Here again the implication is clear: success depends on the exercise of regional development policy by agencies as far removed from the normal processes of political pressures as possible. As long

as public funds are involved at all (and this seems almost inevitable), some public accountability must remain. But the higher the level, and the more indirectly this power is exercised, the better the prospect of success. Hence, the case for largely autonomous regional development agencies is as much political as economic.

SECTION 6: THE THEORY OF REGIONAL BANKING

The textbook case: the level of deposits

The monetary effects of an external deficit or surplus on the commercial banking system of a sovereign state and its contrasting effects on the economy of a region within such a state was sketched in Section 2. It is worthwhile examining this contrast further here. If the demand for the exports of a country falls, generating a deficit in its balance of payments, the normal consequence (ceteris paribus, of course) is that its international reserves will fall. In the simplest case of all, the pure gold standard case, this will lead directly to a reduction of central bank liabilities through open-market operations and thus to a contraction of commercial bank deposits. In practice, the chain of causation is likely to be weakened or broken at two points: (1) an exchange stabilization fund may insulate the central bank from the loss of international reserves, and (2) the central bank may insulate the commercial banks from the consequences of any fall in its own reserves. But to the extent that the monetary mechanism is allowed to work, the contraction of commercial bank deposits is the direction in which the forces generated by the deficit will operate.

The situation of a bank within a region experiencing a comparable deficit in relation to the rest of the same country differs in two fundamental respects: one concerns the magnitude of the impact of the deficit on reserves and the other the consequential impact on deposits. The impact on reserves arises from the high marginal import propensity characteristic of regions; if this were 0.75, for example, a gross fall of \$100 in regional exports would result in a net direct loss of only \$25 in regional deposits. The

difference in impact on deposits arises because a regional bank, unlike a national banking system vis-à-vis foreign countries, customarily maintains a substantial volume of relatively liquid assets which can be disposed of to compensate for the loss of reserves caused by the net deposit decline. For example, a net transfer of \$25 from deposits in region A to deposits in region B would in principle involve a loss of \$25 cash from A banks to B banks (through the central clearing) and thus a secondary deposit multiplier effect. If, however, A banks possessed a stock of Treasury bills or other government securities easily realizable in the market, the loss of cash would be avoided by the sale of such securities by A banks to B banks. In all probability, no deposit multiplier would operate. This process is even simpler if a country is served by a branch- rather than a unit-banking system. In this case, the \$25 switch from A to B would tend to be largely, if not wholly, a mere transfer within the books of individual banks, with no effect on either reserves or total deposits.

It is important to note the two important assumptions on which this conclusion rests. First, in the case of unit-banking systems, it is assumed that commercial banks possess a significant portfolio of nationally marketable assets with which to settle interregional clearing balances without affecting their basic reserve position. In some countries and at certain stages of growth, this may not be the case, for it is largely a function of the state of transport and communications and the degree of integration in financial markets. The early history of the United States, for example, shows how a deficit on capital account developed at the frontier because the assets available there (i.e., mortgages) were not readily marketable in the capital surplus areas of the East; Eastern bankers were understandably reluctant to familiarize themselves too closely with the rigors of frontier

realities.* Hence a gap existed in the credit system which had to be filled, first by professional mortgage brokers and later by the development of the middle and far West. Development of the frontiers could certainly have been impeded by credit stringency. There may be countries--and not only underdeveloped countries--in which a comparable situation still exists.

In the case of a branch-banking situation, an additional assumption underlies the conclusion: in the geographic disposition of its assets a bank is indifferent to the geographic origin of its liabilities. In particular, this means that a switch from A-region to B-region deposits will not instigate a bank to run down assets in A and build up assets in B. If this assumption does not hold, then a secondary credit multiplier would in fact operate. Historically, the assumption has usually been valid. Indeed, the emergence of the British branch-banking system was due precisely to the need to break the geographic link between assets and liabilities and to channel resources from capital surplus rural areas to capital deficit industrial areas. But again, it is not safe to regard the efficient operation of such a mechanism as a truism for all countries and all times.

For present purposes, however, the assumptions can be accepted as fairly realistic for highly developed countries--the first for unit-banking systems similar to that of the United States and the second for branch-banking systems more like that of the United Kingdom. In other words, the regional aspect has little operational significance for banking policy in regulating the overall volume of deposits. To the extent that this element of the market equilibrating mechanism is not operating, the regional problem may be made more intractable rather than less so.

* The matter was, apparently, one of considerable concern to President Andrew Jackson.

The geographic disposition of assets

Even given this lack of a regional credit multiplier, problems of distressed regions may be aggravated by two kinds of defects in the credit system. Such defects may be in the commercial banking network itself or in the credit system as a whole which a commercial bank with a regional "conscience" could remedy. Both involve possible imperfections in the national capital market.

The first defect in the banking system may be called geographic imperfection. It is a practically universal assumption of economic theory that capital is the most mobile factor of production, moving freely from areas where yields are low to areas where they are high. In his theoretical model of a regional economy, for example, J. Thomas Romans specifically assumes that while labor may move in the wrong way, such behavior is inconceivable for capital.

Capital is an economic factor of production and presumably decisions affecting its location are dominated by purely economic criteria. Labor, however, is more than just an economic factor of production. Embodied in labor are consumers and political and social human beings, who react to non-economic stimuli. . .

Reflection on this traditional assumption prompts two questions. First, if people are irrational (i.e., if they react to noneconomic stimuli) in allocating labor, why should this irrationality be assumed to disappear when they are making decisions involving capital? Second, if capital is so responsible to economic differentials, why has the experience of regional investment inducements referred to in preceding sections been so disappointing? Nor is this evidence of capital immobility a particularly recent phenomenon. As has just been remarked, the history of the United States in the nineteenth and early twentieth centuries provides considerable evidence of wide differences

in the average yield on bank assets between various regions which the movement of funds eliminated only slowly. Admittedly, this sluggishness appears to have been partly due to widespread legal restrictions on the ability of banks to lend beyond the boundaries of their home states, but it is clear that these restrictions were by no means the only factor. Unfamiliarity with the environment in which credit is to be used in effect raises the element of risk to the potential lender; more precisely, it adds to the costs of search necessary to assess that risk fully.

If the regions of the United States are defined fairly broadly--by state boundaries or as groups of adjacent states, for example--these rate differentials have virtually disappeared as the communications of the country have developed. This fact is consistent, nevertheless, with pockets of credit stringency. If relatively backward regions exist within these statutory boundaries, such stringency would not necessarily be revealed in the conventionally classified statistics because any credit starvation to such areas would by definition result in a low weight in the average yield for the area in which they were included for statistical purposes. (This is the familiar average-tariff problem: the higher the tariff, the smaller the volume of imports and hence the smaller the weight given to high tariffs in calculating an average.) More to the point, perhaps, is the fact that in recent times credit rationing has frequently resulted in an unsatisfied fringe of borrowers rather than high interest rates; regional imperfections in the credit flow would thus show up as an unduly small magnitude of lending rather than as above-average rates.

Other types of imperfection need to be considered in this context. Differing rates of return on capital in different regions may reflect not corresponding differences in the productivity of capital but merely variations

in the ability of local consumers to borrow. It has been pointed out by Scott that among municipal borrowers in Canada the highest interest rates are often paid by municipalities in the poorest regions--precisely because the pressures on them to borrow are strongest. Further, noninstitutional suppliers of capital may well be more localized in their investment habits than banks are. Workers immigrating to an area and bringing capital assets with them are likely to invest in that area; the consequent tendency for interest rates to fall would thus reflect the higher productivity of labor rather than of capital.

It must be emphasized that to acknowledge such possibilities does not create the presumption that they actually exist. The existence and extent of such imperfections are matters for empirical investigation. Published statistics are not in general given at a level of disaggregation sufficiently great to make such testing easy, but in principle it could certainly be done. Meanwhile, one should not accept mere vague and general assertions as a substitute for empirical evidence. Potential borrowers, whatever their size, shape or nationality, will always assert that credit is too scarce and/or too expensive. In an inquiry into the adequacy of banking facilities for new industrial development in Scotland, Gaskin reported that businessmen in Scotland roundly condemned the Scottish banks as being too conservative and more rigid in attitude than their English counterparts. Nevertheless he found no evidence whatever to support this indictment.

It is interesting that the most extensive attempt to measure the interregional mobility of capital in the United States at the present time--the study by Dr. J. Thomas Romans--rests heavily on the assumption that all equilibrating tendencies in the economy are embodied in capital

movements only. With the aid of a simple but ingenious model, Romans concludes that interregional movements of capital do in fact tend to occur in the right direction, away from relatively high wage regions and toward low wage regions, and therefore that interregional capital movements reduce interregional income differentials in the long run. This deduction rests heavily on the assumption of capital mobility, but if labor is assumed to be the equilibrating factor, the model can be made to conclude that regional capital movements are in fact perverse--i.e., tending to widen interregional differentials. It is not being suggested here that the latter version is more realistic than the former, of course. What is clear, however, is that the assumption of completely rational, mobile capital allocation is of crucial importance to the result.

The second type of possible defect in the capital market might be called functional or vertical imperfection, a constricted flow of capital to borrowers of a certain size or functional category irrespective of their geographical location. The complaint is the old one that farmers, small firms, or rapidly growing firms are at a disadvantage in obtaining capital compared with large, well-established enterprises. Scarcely a single developed country has been able to resist pressure to create special public or semipublic institutions in response to allegations of this kind.

While this type of imperfection does not at first sight raise any special regional issues, it could have significant implications for relatively distressed regions. The prosperous region necessarily has a momentum of growth based on successful enterprises which enjoy economies of scale and attractive profit records. Such firms generally fall into the category of the credit-favored sector, and restricted credit flows

to the underprivileged enterprises within such regions -- while they may be regrettable on grounds of general economic efficiency and may even have some moderating effect on the region's rate of growth -- will not fundamentally affect the general economic character of the region. The distressed region, on the other hand, characteristically lacks such a central growth core. Its basic industries are growing only slowly or even declining, so that their advantage of easy access to the credit market has rather less operational value. (If the basic industry is agriculture, of course, it may be alleged to lack even this rather hollow advantage.) When the whole growth potential of such a region depends significantly on the type of enterprises against which these imperfections allegedly militate--the relatively small, new, and rapidly growing enterprises--a regional credit problem may be said to have emerged. Therefore, what is a relatively marginal problem in a prosperous region can be a major obstacle to survival in a depressed one. Complaints have been expressed in Canada, for example, that periodic credit squeezes affect depressed regions disproportionately because the relatively small enterprises on which they depend are more reliant on bank credit than are the larger, established corporations and because the banks are alleged to favor the large corporations when credit restraint has to be enforced.

Once again it is necessary to emphasize that to assert that these things may happen is quite different from saying that they do in fact happen. These matters of empirical reality must be tested against the evidence:

- (1) For any given class of borrower, does the evidence support the proposition that capital can be obtained only with more difficulty and/or expense

than is typical for the economy as a whole, despite the existence of special credit agencies dedicated to meeting the needs of such borrowers?

(2) Where such agencies exist, is there any evidence to support the belief that they operate more intensively in prosperous regions?

(3) Is there any evidence to support the view that the reliance on such special classes of borrowers for future growth is in fact proportionately greater in distressed regions than elsewhere?

The case for special institutions

As has been argued, the existence and degree of the two major types of imperfection in the capital market are matters for empirical inquiry and cannot be merely assumed or asserted. Even if these imperfections were observed, one would still have to ask: Do they call for relatively minor reform in the structure and practice of existing institutions, or do they require a new and specialized institution? There is often a compulsive urge in these semipolitical matters to propose new agencies, but this tendency should be regarded with some suspicion: not only can it lead to administrative waste and unnecessary dispersion of scarce talents, but it may serve to give the appearance of energetic and original action when in fact nothing is happening.

As might be expected, the question really is: Do the gaps in the regional market arise from a lack of knowledge of the profitable outlets which exist, or is it that these outlets, while known, do not conform to the requirements of sound banking practices? If lack of knowledge is the dominant element, the creation of a separate regional credit institution does not seem at all necessary. The problem is primarily one of information

gathering, promotion and project appraisal, none of which are necessarily linked with the provision of credit at all.

The case for a separate regional agency is quite a bit stronger, however, when the return on regional development projects is high by some standard but not by the ordinary commercial criteria which a private financial intermediary must observe if it is to retain its deposits. One such case would be where social, as opposed to private, gains were relatively high; it could always be argued, however, that whatever the merits of such a case it is no part of the function of commercial institutions to bear the responsibility for it. However lofty the motivation of its managers, the mundane insistence of its depositors (to say nothing of its shareholders) on obtaining a competitive return on their funds would make this clear fairly rapidly.

A more important case arises when the return on regional development projects, while high by ordinary commercial standards, must confront the following difficulties: (1) the return must be calculated over a period of years too long to be consistent with the operation of existing credit institutions (or the competence of their management); (2) the return involves investment in enterprises unable to provide the type of security customarily required; and/or (3) (perhaps most important) the return becomes attainable only when a group of enterprises, rather than any individual component, is viewed in its entirety. Referring this sort of business to a special section or branch of an existing institution has seldom proved wholly successful. Not many institutions can long continue a schizophrenic adoption of two quite different sets of procedures and criteria for different parts of their activity. Perhaps more important, it is difficult to maintain public confidence in the competitive power of any institution which seeks to do so.

The difficulty with using existing agencies increases with the emergence of the modern concept of regional development by concentrated attack in a limited number of locations aimed at creating an integrated and interdependent industrial complex. Both medium- and long-term finance are essential to such an operation, and the participating enterprises can only be considered in a joint relationship, not as separate and isolated projects. In such a situation there may be a case for a joint financing agency which treats the project as a whole, rather than one which acts with exclusive regard to individual borrowers as in ordinary commercial practice.

Such an institutional framework might be achieved through government grants or loans, of course. But government funding would have the fundamental drawbacks referred to earlier. The operation would be subjected to the destructive pressures of political considerations. Conversely, the development project could be transformed into a state **handout**, probably alienating potential developers. Moreover, the possibility of long-term dependence on public subsidy is likely to erode the determination to achieve long-run commercial viability. A stronger case could perhaps be made for a loan guarantee system operated by a regional development agency. The system could be associated with an organized and officially supported market in such long-term guaranteed loans, along the lines of the Federal National Mortgage Association in the United States which in effect provides a market for approved mortgage loans. There are at least two disadvantages to such a system: (1) the scrutiny necessary before a guarantee can be given may have all the objections associated with a system of direct grants, and (2) the system does nothing to meet the situation in which the commercial

lending agencies of a region either do not have credit resources available or else do not have the disposition or expertise to advance equity capital. In fact, as will now be seen, nearly all regional financial agencies have been exclusively public.

SECTION 7: EXISTING DEVELOPMENT BANKS

In the last two decades the number of development finance institutions, whatever their exact titles, has risen at a rate equaled only by that of the world's population itself. Some 13 years ago, William Diamond in his well-known study, Development Banks, included in his selected list of development banks some 30 such institutions operating in Latin America. Seven years later a conference of development banking institutions attracted representatives of no less than 150 institutions by then operating in Latin America. For present purposes such institutions can be grouped into three categories:

- (1) International agencies whose primary function is to channel funds from relatively rich countries to relatively poor ones in the cause of the latter's economic development--e.g., IBRD, IFC, IDA, etc.
- (2) Regional agencies in the international sense; those concerned with raising and reallocating capital funds within a particular area--e.g., the European Investment Bank, the Inter-American Development Bank, and the African and Asian Development Banks.
- (3) National development banks--financial institutions designed to influence the internal flow of capital funds and in many cases to also act as a central distributing agency for funds received from overseas.

For this study only the third category is of direct interest; the first two are essentially concerned with the rather special problem of financing development across political and financial boundaries. The European Investment Bank, however, is to some extent an exception to this generalization and will be discussed briefly below. Unfortunately, even most institutions in the third category are also of very limited interest to the present study. They are especially prominent in the developing countries precisely because such countries are seriously, or even totally, lacking in a sophisticated capital market of the kind taken for granted in the United States or the United Kingdom. They tend to be official agencies through which the financial flows corresponding to formal or informal development plans are channeled. In addition, they are often charged with such responsibilities considerably beyond this direct function as the fostering of local capital markets, the administration of foreign aid of a capital nature, and the execution of feasibility studies. Although many are nominally private enterprises, all tend to depend heavily on official support (domestic or international) in the form of equity participation, loans, guarantees to support public borrowing or moral backing. Whatever internal regional dimension they have emerges as a by-product of their sectoral financing activities, rather than as a primary objective.

Viewed commercially, the general record of these institutions is not particularly impressive, although the record itself is still, of course, a relatively short one. The return on their equity and the quality of their portfolios have generally been low. They have rarely integrated successfully with existing financial institutions, nor have their promotional activities been particularly vigorous. On the other hand, they have usually

been operating in environments and with aims which make purely commercial criteria less than fully relevant. Many can claim to have channeled capital to a wide range of worthwhile borrowers whose individual projects would have been far too costly for the conventional banking system to handle, particularly in the agricultural and small-enterprise field.

Much the same sort of motivation has stimulated the establishment of the special development agencies created in most advanced countries. In the United States and the United Kingdom, where open capital markets have been long established, a complex network of financial institutions has evolved more or less naturally; special institutions have been created only for those limited areas where gaps in the credit flow were believed to be both chronic and socially unacceptable. The main examples have of course always been agriculture and small business. Here again, any regional dimension was largely accidental. One conspicuous and important exception to this last statement is provided by the development credit corporations or industrial foundations which emerged in the United States during World War I and have spread, if somewhat erratically, ever since, especially in the New England states. Privately financed, mostly nonprofit organizations established to counteract unemployment within individual communities or to encourage industrial diversification, they undertake the purchase or construction of plants for lease or sale, make loans of maturities longer than would be acceptable to commercial banks, and provide some technical and managerial advisory services. They are manifestations of local patriotism and necessarily operate on a small scale.

There are also Development Credit Corporations (DCCs) established by the state authorities in New England, and these approach the scale of regional development banks, although they also confine their activities to small and medium-sized enterprises. While they do not handle only state

funds, they nevertheless depend on loans up to set limits provided by financial institutions within the states under special enabling legislation of each state. As with the community development credit corporations, they occasionally build plants for lease or sale and they undertake business surveys. Their main purpose is to make loans in the interests of job creation within the state or to secure participation in such loans from commercial or saving banks. Unfortunately, no systematic analysis of the policies, performance, and effectiveness of these New England development credit agencies seems to have been made recently. Such an analysis would appear to be essential for an assessment of the possible role of commercial banking in regional development policy. A survey by the Federal Reserve Bank of Boston in 1958 concluded, however, that the DCCs of New England had achieved modest success, given their limitations of relatively small reserves and consequent vulnerability to any significant degree of recession.

It is worth noting that banking institutions of various sorts have played a significant role in the development projects sponsored by the Area Redevelopment Administration (ARA) in the United States. Between its formation in 1961 and mid-1965, the ARA approved over 380 projects involving an approximate total of \$170 million in loans, of which private banks and local development companies contributed about 14 and 11 percent, respectively. The projects' 280 banking institutions in 44 states and territories contributed around \$43 million, while local development companies provided about \$31 million. These are by no means negligible contributions.

The financial institutions of continental Europe have evolved very differently from the Anglo-American tradition; in particular, they have been slow to develop open capital markets with active new issue markets and security exchanges. Hence, the special institution for the finance

of industry in general has long been a feature of the European scene, although their ordinary commercial banks were much more involved in medium-term industrial finance than would have been considered proper in the United States or Britain. The Crédit Mobilier, founded in Paris in 1852, became an archetype for similar private investment banks in Germany, Austria, Italy and elsewhere before it disappeared after an eventful life of 15 years. Only recently, however, institutions have emerged that are concerned specifically with regional financing, but only to a very limited degree. In Belgium, for example, the state agency, the SNI (National Investment Company), has been concerned primarily with reorganizing existing enterprises at a sectoral level rather than with establishing new enterprises. Although provision was made for creating regional investment companies in which the SNI would participate, none has been formed. The official view seems to be that while such regional companies might meet some psychological need, they could not satisfy any real need in so small a country: in effect, any operations would be those of one and the same body through regional branches.

It may be worthwhile now to turn to the experiences of two European countries which are among the most active in the regional planning business: France and Italy. Although the French planning system is probably more ambitious and older than that of any other Western country, its emphasis has tended to fall on physical rather than financial aspects. Beginning in 1955, 15 Regional Development Societies were established (for the 21 planning regions); they were created by joint participation between the great national banks and local savings banks, most with about \$15 million capital. Their primary function is to provide loans to industrial enterprises expanding in accordance with the current national development plan;

in a sense, therefore, their role is relatively passive. The provision of the necessary basic infrastructure for industrial and urban growth zones is the responsibility of semipublic Societes d' Equipement, while a special Treasury fund, the Fond de Developpement Economique et Social, provides the main incentive for industrial development in the form of equipment grants and long-term loans.

The major instruments of Italian regional development policy have also been real rather than financial. The two state holding companies, the IRI and ENI, have been required to devote a high proportion of their investment program to the underdeveloped South, although neither was conceived of originally as in any sense a specifically regional agency. The Autostrada del Sole, the responsibility of the IRI, has already been mentioned; other conspicuous examples of "trigger" investment projects by the IRI are the integrated complex in the Brindisi-Taranto area and an Alfa-Romeo works at Campania. The ENI has invested considerable sums in the exploitation of oil resources in Sicily.

Nevertheless, some specifically regional financial agencies have been created in Italy, apart from the Cassa per il Mezzogiorno, a public body created in 1950 for the administration of State resources in the development of southern Italy. One of these is ISVEIMER (Istituto per lo Sviluppo Economico dell' Italia Meridionale), a public credit institution set up to provide medium-term loans (i.e., generally of ten-year maturity) for industrial projects in the mainland of the South. Most of its funds come equally from the Cassa and the Bank of Naples; the remaining 20 percent, from financial institutions in the South itself. By the end of 1967 ISVEIMER had undertaken more than 4,000 operations for a total of just over \$1 billion; the total investment stimulated by these operations is claimed to amount to more than \$2 billion.

A second regional financing agency in Italy, the IRFIS (Istituto Regionale per il Finanziamento alle industrie in Sicilia), was set up in 1953 with the object of encouraging industrial development in Sicily. Like ISVEIMER, its initial resources were provided jointly by the Cassa, the Bank of Sicily and other Sicilian credit institutions, and it has much the same lending policy. By the end of 1967 it had undertaken some 1,100 operations for a total of around \$500 million; total investment arising from these operations was estimated at just under \$1 billion.

The third Italian agency for regional finance, the CIS (Credito Industriale Sardo), was created to do for Sardinia what ISVEIMER and IRFIS were to do for the mainland Mezzogiorno and Sicily, respectively. By the end of 1967, it had completed about 800 operations for a total of \$340 million, generating investment amounting to over \$610 million.

To examine regional development in Europe as a whole, attention now turns to the European Economic Community (EEC). The main EEC agencies financing regional development are the European Investment Bank (EIB) and the European Social Fund. The Fund is concerned with financing the retraining and resettlement of redundant workers, rather than with encouraging new development, and therefore need not be considered further here. The EIB is responsible for granting loans and making guarantees on projects associated with the development of the Common Market; its capital comes from the EEC governments and from direct borrowing in the capital market. It undertakes part-financing only--in 1966, the average participation in the projects it helped to finance amounted to only 22 percent--and is expected to charge interest rates high enough to meet its own obligations and to build up a reserve of ten percent of its capital. Although the EIB is not theoretically an agency for regional development, in practice the majority of its loans

have gone to projects in distressed regions, especially southern Italy. By the end of 1966, 67 percent of its lending had been in Italy, and nearly 40 percent of this was loaned through the Cassa per il Mezzogiorno to benefit the South. Most of its loans to other countries (the overall total at the end of 1966 amounted to about \$750 million) were also to assist projects in problem areas.

What conclusions can be drawn from the record of the existing development banks? It is not easy to summarize the experience of this distinctly heterogeneous collection of institutions varying so greatly in age, environment and purpose, particularly since there is so little systematic analysis of their performance. Most information tends to describe their powers and intended functions rather than to quantitatively assess their performance; given the strongly political associations that frequently attended their creation, this lack is not too surprising.

Nevertheless, certain broad conclusions do emerge. First, the main inspiration behind the creation of most of these institutions has been a significant degree of real or alleged imperfection in normal capital markets. Hence they have tended to proliferate in economies that lack a comprehensive and sophisticated credit system. Conversely, their role has been relatively small in the United States and the United Kingdom, which now possess a long tradition of established and efficient deposit and investment banks, specialized financial intermediaries, and open credit and capital markets. This reinforces the point made in the preceding section that the need for new credit institutions is never self-evident; it has to be shown that existing institutions are incapable of meeting, or are unwilling to meet, some demonstrable gap in the credit flow.

Second, only recently have such institutions been characterized by a specifically regional purpose; the majority of development finance institutions have been aimed at sectoral rather than geographic flows. Given the relatively recent emergence of concern with regional policy as such, this is only to be expected. It does, however, suggest a cautious approach to these new channels of credit. Credit agencies have customarily specialized in particular types of borrowers or lending in seeking the advantages of division of labor. A regional agency thus tends to break new ground, since by definition it is concerned not with narrowly defined sectors or specialized types of credit instruments but with the whole range of sectoral activities and forms of lending which are likely to be involved or desired in a particular geographic area. This replacement of functional speciality with geographic speciality is not a self-evident loss, but certainly it represents a considerable break from much financial tradition.

Third, whenever regional agencies have been required to adhere to a rigidly commercial basis (as with the EIB), the growth in their activities has been conspicuously less than that of agencies more oriented toward the use of public funds and charged more explicitly with the pursuit of social rather than economic ends. The almost universal experience of agencies concerned with agricultural credit or finance for small businesses, for example, is that their overall rate of return is so low that their activities would be crippled if they had to compete for funds in the open market. Insofar as the regional problem involves this sort of low-return credit activity, securing funds exclusively from private sources on the open market is likely to be exceedingly difficult, at least in the early stages. This does not necessarily imply that such agencies should rely exclusively on public

funds, for this reliance would have all the disadvantages noted earlier in connection with conventional regional incentive policies. But it does seem to imply that any such agency needs a capital structure in which a substantial core of its resources is obtained on concessional terms. A delicate and difficult balance must be achieved.

SECTION 8: PROSPECTS FOR REGIONAL DEVELOPMENT

It is now time to bring together some of these partial insights and scattered evidence to discover what conclusions, if any, may be drawn concerning the role of special banking or credit agencies in future regional development policy. The case for such a policy, it was argued earlier, is essentially a pragmatic matter to be resolved on the basis of empirical evidence. At this stage it can only be assumed to be valid.

The evidence, such as it is, suggests that while some modest success might be claimed for the regional policy measures most widely adopted to date, their achievements are generally somewhat disappointing in relation to both the resources they have absorbed and the magnitude of the problem they are addressing. The causes of this incomplete success are not difficult to identify. Heavily reliant as they have been on fiscal and other incentives normally related to capital stock, their scale of operations in relation to total operating costs (especially after allowance for tax) has often been too low to overcome the natural inertia of most manufacturing industry. (Exceptions are the highly capitalistic industries whose mobility is frequently limited by technical factors and whose employment potential is in any case rather low.) The efficacy of such measures has been further reduced by the tendency of regional policy to proceed on an ex post facto basis--that is, to introduce measures only after the symptoms of regional decline have been manifest for some time and the cumulative forces of decline have gathered some momentum.

As long as regional policy continues to have a rather passive inducement character, it seems distinctly questionable whether any major

role can be played by special banking institutions (as opposed to purely promotional agencies). Since capital concessions of one type or another form the major weapon of policy, a banking institution, dealing primarily in the provision of capital, would have a proportionately smaller role to play in these distressed areas than in others where capital needs are not partly met by special inducement measures.

A special regional bank could have some role in such a situation if it could be shown that existing capital sources are unable or unwilling to support the development which would otherwise occur. The proliferation of the New England Development Credit Corporations, for example, suggests that such a role is viable. However, the extension of relatively cheap credit to local enterprises does not ipso facto imply the disappearance of such enterprises if credit were to become available only at somewhat higher, competitive terms. The case for a regional bank would therefore need to be argued persuasively since the mere provision of subsidized capital resources is by no means necessarily in the best long-run interests either of the enterprises borrowing them or of the local community.

If the ordinary credit system fails to meet the needs of new and small enterprises, on which regional development depends to a special degree, it remains to be established that a regional institution is a suitable solution. In some instances the answer may be to design national facilities especially to meet the needs of such enterprises or to improve existing facilities. Furthermore, it is by no means obvious that a regional inducement policy can ever hope to stimulate a major part of regional development through a reliance on such enterprises. Such policies have usually been effective in influencing the locational decisions of established enterprises unwilling or unable to expand at their existing locations, and enterprises of this sort are a priori likely to find the normal credit channels accessible.

Therefore, special financial institutions seemingly make only marginal contributions to regional development; they probably do no harm, but it would take a major act of faith to assert that they could make a fundamental difference. Yet weakness of regional policy has usually been due to characteristics far more fundamental than the mere absence of relatively peripheral credit facilities. An increasingly popular opinion is that regional policy has failed largely because it has sought to compensate for, or subsidize against, the weaknesses of declining areas rather than to eliminate them. The practice of offering various forms of inducement to prospective entrepreneurs and then hoping for the best is now felt to be essentially a passive and ineffectual technique.

The far-reaching implications of this shift in opinion could significantly change the role of regional development finance agencies. Instead of operating through inducements to entrepreneurs, regional policy would concentrate on identifying a relatively limited number of growth centers in any given region. Of course, the crucial issue is not whether there should be growth centers but the criteria by which they should be identified and how many should be created. As Galbraith has remarked, "Although there is wide agreement on a policy of selective economic growth, there is very little agreement on what should be selected." At this stage of the discussion, this question is being quite simply tucked away under the arbitrary assumption that the designated centers are determined by their assessed capacity for viable economic growth over a defined and foreseeable future rather than by the "worst-first" criterion of their loss of past prosperity. It is unlikely that the feasibility studies by which such centers are identified would conclude that their potentialities were totally

independent of the type of activity to be developed in them as the basic core of their future growth. The infrastructure, including the human capital element, in which public resources would be concentrated could thus be designed and provided only with fairly specific purposes in view.

At this stage, the role of a regional development agency begins to emerge. It could conduct the basic feasibility studies which form the starting point of the process, just as the preparation of overall economic development programs is currently required from each area by the EDA in the United States. But perhaps this work would be done more realistically by an agency which, while still locally oriented, was professionally and continuously involved in the development business.

Whoever does the feasibility studies, the provision of finance for the development program itself clearly requires a specialized agency. On the one hand, if the emphasis in the use of public resources were shifted from individual handouts to the provision of the basic social and economic infrastructure, it could no longer be argued (as it can under the inducement approach) that the capital needs of prospective developers were already receiving adequate attention. Further, the needs for capital are the usual mixture of working capital, medium-and long-term capital and equity capital and would normally require the support of several different institutions of the conventional type, each specializing in particular forms of credit. But no single one of these could be concerned with the entire regional complex involving a fairly large number of mutually interdependent enterprises. It is at this point that the case for a regional, as opposed to a functional, development agency becomes somewhat stronger.

On the other hand, this concept of consciously planned, integrated growth complexes implies that encouragement has to be directed to rather specific types of enterprises in order to give coherence to development. This again implies the existence of a competent promotional agency with the power to offer such encouragement where it appears necessary and desirable, encouragement which may need to extend to the initiation of critical enterprises in order to complete a viable jigsaw. This is manifestly not a job for government or enthusiastic but amateur local patriots. Nor is it likely to be well done if the development function is divided between several agencies, official or private. Experience with disparate agencies suggests that (like the competitive advertisement expenditure of textbook oligopolists) much of their effort is dissipated in activities which cancel one another out, if indeed they do not cause net harm overall through sheer confusion.

The case for an effective regional credit agency, in other words, rests essentially on two propositions. First, it must be much more active than would a conventional financial intermediary which provides capital for projects submitted to it but in no sense "beats the bushes" for such projects. Second, it should exploit the principle that in a well-conceived regional development program the whole is greater than the sum of the parts. It is here that the rationale of the regional dimension has to be found; it is in this regard (to the extent, of course, that it is true) that a regional financial agency can claim to be dealing with economically worthwhile investment projects neglected by conventional institutions precisely because such projects cannot exist on the single-enterprise, atomistic basis on which conventional financing institutions must of necessity work.

At the risk of monotony, it must be repeated that all this remains hypothetical; to say that a regional agency may be able to create and benefit from the scale and externalities characteristic of efficient regional development policy is not the same as saying that it will do so. Nothing is easier, or more futile, than to create new institutions with high-sounding titles and grandiose charters and then retire triumphantly from the field, giving the impression that something has been achieved when in fact something has only begun to be attempted. Institutions are merely arrangements whereby human beings are brought together into a special relationship with one another and with the rest of society and perhaps provided with certain resources for action. And in the last resort the quality of the ensuing action totally depends on the quality of the people involved and on their ability to discover and exploit worthwhile opportunities. Like all human institutions, a regional development bank is merely a means to an end.

Regrettably, all this is generalization. In the particular context of the United States, a good deal of hard empirical research needs to be done on the costs and benefits of existing and projected geographic distributions before the need for regional policy measures can be demonstrated or their scope and nature defined. Several worthwhile areas for such research have been indicated in the foregoing sections. Even with abundant regional information, the exact role of the Federal Reserve System in implementation of regional policy would obviously call for very careful thought. That role, broadly speaking, could be as either of the following:

- (1) A convenient research or consultative agency for
the formulation of an overall strategy for the
areas within the jurisdiction of each district.

The interposition between the Federal level (which

is too big) and the State level (which is probably too small) lends credibility to this possibility.

- (2) An active participant, through one of its agencies, in the actual business of regional development by providing investment banking facilities.

These are very large issues on which the present study could scarcely be expected to pronounce. On the contrary, its author, in a belated fit of modesty, recalls the familiar words of John Henry Newman:

I do not ask to see
The distant scene: one step enough for me.

APPENDIX A

CRITERIA FOR "DEVELOPMENT" AREAS

	Unemployment rates	Income level	Migration	Other
Austria	25% + above national average	Per capita taxes below 50% Federal average		Rateable values below national average
Belgium	'Considerable' or 'persistent'		'Heavy'-endangering the viability of public services	Communing under 'unfavorable conditions'; stagnation in important segments
Canada	Labor 'surplus' and employment rising by less than 50% of national average for 8 years.	Significantly below national average		
Denmark	'Higher than average'		Net emigration movement	Low degree of industrialization
France	'Exceptionally high' actual or expected	Indices of per capita income; levels of wages and savings	Continuing excess of rural manpower	
Germany (F.R.)		Per capita product below 50% of national average	Exceeding 1% per annum	Industrial employment one-third national average
Italy				'Economically and socially backward areas'
Netherlands	'Acute' structural unemployment		Solution by this cannot 'reasonably' be found	Development costs 'with-in reasonable limits'
Norway	"High"	"Low"	Excessive from rural areas	
Sweden				Support for regions where costs 'tend to be a minimum'
United Kingdom	Above 4.5% or likely to reach this level			Special measures for selected areas
United States	Above 6%	Median below 40% of national average		Other forms of 'distress' including Indian territories

APPENDIX B: THE INSTRUMENTS OF REGIONAL POLICY

	BELGIUM	CANADA	DENMARK	FRANCE	GERMANY (F.R.)	ITALY	NETHERLANDS	NORWAY	UNITED KINGDOM	UNITED STATES
<u>1. Direct government action</u>										
a. Improvement of infrastructure	X	X	X	X	X	X	X	X	X	X
b. Advance factories, industrial estates			X					X	X	X
c. Differential public spending		X			X	X				
d. New towns									X	
e. Decentralization of public institutions				X						
f. Participation in industrial development				X		X		X		
<u>2. The carrots</u>										
a. Subsidies on land and/or buildings	X	X		X		X	X	X	X	
b. Subsidies on industrial equipment	X	X	X	X	X	X		X	X	
c. Low-interest loans	X			X	X	X	X	X	X	X
d. State guarantees	X		X	X	X	X	X	X		
e. Subsidized transport					X	X				
f. Subsidized training or retraining	X			X	X	X	X	X	X	X
g. Subsidized labor									X	
h. Subsidized moving costs	X			X	X	X	X	X	X	
i. Tax concessions	X	X		X	X	X		X	X	
3. The sticks: Restriction on development									X	
4. Local development agencies	X	X		X	X	X	X	X		X

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