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regional disparities and devolution?

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Abstract

This paper presents an examination of the possible correlation between rising income inequalities at the regional level and widespread devolutionary initiatives worldwide. When the responsibility- and resource-based facets of decentralization are taken together, a marked congruency is evident between the two trends. While various spatial economic forces promote the emergence of core and peripheral regions, devolution, by establishing their autonomy, allows these forces a greater impact. We argue that this is because decentralization initiatives carry with them implicit fiscal, political and administrative costs, which fall more heavily upon those regions with limited adjustment capacities, resulting in differential rates at which regions can capitalize upon the opportunities offered by devolution. The global tendency towards devolution therefore reflects a subtle, but profound, renunciation of the traditional equalization role of national government, in favour of conditions fostering economic and public competition, and leading to greater development of initially rich and powerful regions to the detriment of poorer areas.

Keywords

Devolution, divergence, regional disparities, Brazil, China, India, Mexico, Spain, US.

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Introduction

Is there a global link between increasing regional disparities and the drive towards devolution? Many proponents of devolution assume a connection between the transfer of powers to regional tiers of government and economic development. For them, devolution yields an economic dividend in terms of more efficient, better targeted public policies and, eventually, of a reduction in spatial disparities (see Morgan, 2002, 801 and ss. and Tomaney, 2002, for a debate on the issue). This position is, however, at odds with the majority of the literature on fiscal decentralization, which emphasises the spatially regressive effects devolution can have (Prud'homme, 1995: 202-5).

In light of these contrasting positions, it is surprising that the empirical analysis of the connection between devolution and regional disparities has attracted such little attention, especially in a period when increasing regional disparities and devolution have both become firmly established trends. On the one hand, divergence, or at least a discontinuity in the converging trend, between the regions of a large array of countries has been recognised by numerous commentators. The trend is widespread, encompassing China (Yao and Zhang, 2001; Lu and Wang, 2002), India (Bandyopadhyay, 2002), the USA (Bernat, 2001), Mexico (Sánchez-Reaza and Rodríguez-Pose, 2002), Brazil (Azzoni, 2001) and most of Europe (Petrakos, 2001; Puga, 2002), among others. On the other hand, devolution initiatives have become commonplace throughout these countries and beyond. The increasing legitimacy of regional actors, alongside the decentralization of resources and authority, which have become highly politically expedient for both central and subnational governments alike, has shifted attention towards the consideration of which forms devolution will assume, rather than whether or not it will take place (Rodríguez-Pose and Gill, 2002). Hence, since the late 1970s, many countries with centralised systems of governance have implemented plans to devolve powers to regions, while more vertically dispersed countries have tended to decentralise yet more powers to the subnational level (Keating, 1998; Loughlin, 2000; Agnew, 2000).

Following two preliminary sections that establish these trends, this paper explores the possible connections between these two phenomena. Taking a group of representative countries, the coincidence of increasing economic polarization and decentralization initiatives is charted, for each country, in the third section. Although

increasing spatial disparities are driven by many forces, not least the slowdown in economic growth rates in numerous countries in our analysis, and the opening up of many to international trade (see for example Hanson and Harrison, 1999; Amiti, 1999), there is clearly a marked congruency between the timing of devolution initiatives and rising regional disparities. Given these descriptive data characteristics, the fourth section presents a discussion of the possible mechanisms linking the two trends. Explanations drawing upon the development capacity of subnational regions, the regressiveness of devolutionary initiatives and the competitive nature of modern intragovernmental relations expose the plausibility of such a connection. The final section concludes that there is a general association between devolutionary initiatives and rising inequalities.

1. The Trend Towards Regional Inequalities

Regional inequalities in most countries of the world are stable or increasing. Following an extended period of convergence after the Second World War (Barro and Sala-i-Martín, 1995; Brülhart, 1995), since the 1980s the trend has been for a large number of countries to witness either a slowdown in convergence or a reversal to divergence (Amiti, 1999). Table 1, which depicts the variance of the natural logarithm of regional GDP per capita in a series of developing and developed countries between 1980 and 2000, documents this phenomenon.

The table shows that in the last twenty years of the 20th century there has been an overall tendency towards an increase in intranational disparities around the world. Ten out of the eleven countries included in Table 1, as well as the entire EU, witnessed increasing regional disparities over the period of analysis. Brazil, the only exception, experienced strong convergence in the 1980s, but this trend was reversed after 1990. The magnitude of the trend varies substantially, with the developing countries undergoing the boldest changes. Mexico and India display the strongest divergence, with increases in the log variance of regional GDP of 12.11% and 25.28% respectively, while China, due to a significant reduction of disparities during the 1980s, shows the weakest increase at 0.6%. This figure, however, hides a rise of regional disparities of more than 20% during the 1990s. The developed countries are less extreme, but disparity increases are again evident, especially in the US and

France, with an 8.82% and 8.36% rise respectively in the log variance of regional GDP – albeit starting from a much lower level of initial disparities than developing countries. And for the EU as a whole, the period between 1990 and 2000 saw regional inequalities increase by 11.24%.

Table 1

Variance of the Log of regional GDP per capita

	Year			**% Change**		
	1980	**1990**	**2000**	**1980-90**	**1990-00**	**1980-00**
Developing Countries						
China	0.578	0.483	0.581	-16.31	20.20	0.60
India	0.352	0.377	0.441	7.10	16.98	25.28
Mexico	0.388	0.383	0.435	-1.29	13.58	12.11
Brazil	0.588	0.488	0.494	-17.01	1.23	-15.99
Developed countries						
US	0.136	0.152	0.148	11.76	-2.63	8.82
Germany	0.184	0.188	0.186	2.17	-1.06	1.09
Italy	0.265	0.269	0.277	1.51	2.97	4.53
Spain	0.207	0.199	0.222	-3.86	11.56	7.25
France	0.151	0.164	0.163	8.67	-0.29	8.36
Greece	0.156	0.158	0.158	1.21	0.16	1.37
Portugal		0.231	0.236		1.85	
EU		0.247	0.275		11.24	

*Data for Europe: EU 1980-99; Greece 1981 – 1999; France 1982 – 1999. All others as shown. Regional data from EUROSTAT and national statistical offices.

Brazil remains the notable exception. Its initial level of disparities exceeded, in 1980, any spatial inequalities evidenced by any other country in the sample over the entire period charted. While rising inequalities in China relieved Brazil of this distinction after 1990, China has yet to reach the level of inequity evidenced under the Brazilian military regime in the early 1980s. The fact that Brazil experienced a 17% decline in spatial inequalities must therefore be seen in the light of this unusually high starting point, and the meaning of 'convergence' under such conditions should be carefully considered. In short, allowing for the Brazilian case, every country in the sample has seen some sort of regional divergence since 1980, and this provides us with our first stylised fact.

There are two further features of interest concerning the data in Table 1. First, the inequalities evident in the set of developing countries are far in excess of those in

the developed subset. Indeed, in our sample of countries there is not a single case of overlap – the developing world remains regionally more inequitable than the developed for every possible pairwise country comparison and every possible sample year. The lowest log variance figure of the developing countries was registered in India in 1980, at 0.352, fully 27% higher than the highest developed figure of 0.277, registered in Italy in 1999. As a result, discussion of disparities in the context of countries such as Brazil and Mexico takes on even greater importance. If, for example, devolution is contributing to a rise in inequalities, this has greater and graver implications for those developing countries whose poorest regions are less able to adjust to new spatial income and wage dynamics.

The second point of interest concerns the more pronounced, post-1990 regional divergence evidenced both in those countries with greater *ex ante* levels of devolution and in those countries where devolution initiatives took place later. Brazil, China, Mexico, and Spain have experienced a pattern of falling disparities in the 1980s followed by increases in the 1990s. India and Italy have seen an acceleration in the growth of regional disparities over the two decades. In contrast, France, Greece, Germany, and the US saw a reduction in the growth of disparities after 1990. In each of these cases except Greece, the reduction was enough to reverse the trend and give rise to a slight degree of convergence. The emerging general distinction is linked to the intensity and the timing of devolutionary and decentralizing trends. Greece, the only unitary state in our sample, experienced only a very moderate increase in regional disparities. In contrast, and with the exception of Brazil, countries with greater levels of devolution witnessed a greater increase in their regional gap. In addition, countries in which the drive towards devolution took place earlier also tend to experience a growth in intranational disparities at an earlier stage. The revival of federalism in the US during the Reagan presidency or the passing of the French regionalization laws (Deferre laws) during the 1980s were accompanied by increases in territorial imbalances. The vigour of the decentralization process in Brazil, India, Mexico, and the transfer of resources to Spanish regions and Chinese provinces during the 1990s were associated with a rise in disparities during this decade. While various forces obviously shape the evolution of disparities, there also seems to be a connection between the timing of devolutionary and decentralization initiatives and the growth in disparities. This connection will be analysed in greater detail in section 3.

In short, there is a common and general trend towards divergence or a discontinuity in intranational convergence across the world. It is not our intention here to address the complexities of this area of research, but merely to establish this fact. Furthermore, it is certainly not our intention to suggest that devolution is the only driver of these trends. It may, perhaps, be one of many drivers, and discussions surrounding European and North American economic integration (Amiti, 1999; Hanson and Harrison, 1999; Scott, 1999), global trading and capital markets, economic slowdown and the race to the bottom underscore the plethora of different influences impacting upon the spatial disparity of incomes. Nevertheless, the possibility that institutional factors may also have a large bearing on spatial economic patterns and activity should not be ruled out (Storper, 1995; Rodríguez-Pose, 1998; Scott, 1999).

2. The Trend Towards Devolution

Alongside the trend towards regional inequalities, there has been an equally pervasive tendency for countries to devolve resources and authority from national to subnational government tiers. This trend can be conceptualised as two simultaneous movements since the mid 1970s: the introduction of devolution in those countries that previously employed highly centralist government structures, and an even greater decentralization in those countries whose regions already enjoyed some degree of autonomy. With reference to the first group, in Europe the centralist tendencies prevalent in the continent up until the 1970s have been reversed. Belgium became a federal state in the early 1990s, Italy is currently moving in that direction, and regions in Spain enjoy in some cases greater powers than states in federations. The UK and Poland have taken significant steps to devolve authority and resources to their respective regions. And even the traditionally centralist France has introduced limited measures toward greater regionalization, with Corsica at the centre of an almost perennial debate about the granting of enhanced regional autonomy (Loughlin, 2001). If we consider the populations of those countries implementing moves towards devolution, 87% of the total European population has experienced some sort of decentralization since the late 1970s, covering eight out of the fifteen member countries.

Outside the EU this trend has been, if anything, even more marked. The extremity of devolutionary forces in some areas has given rise to the emergence of separate nation-states, no bigger in size than many regions. For example, the collapse of the Soviet Union resulted in the emergence of fifteen new nation states. The Czech Republic and Slovakia were created without conflict out of former Czechoslovakia; and five states have so far emerged out of war-torn Yugoslavia. Outside Europe a similar tendency is evident. Following a drawn-out guerrilla war, Eritrea achieved independence from Ethiopia and Indonesia's occupation of East Timor has also come to an end.

In other cases, although the process has not resulted in outright independence, it is clearly in evidence through the constitutional and policy-based alterations that have occurred. Indonesia again is representative of this trend, having passed laws in 1999 designed to bolster the autonomy of subnational governmental tiers after sustained separatist pressure from constituent regions (Aspinall and Berger, 2001). In China, where the central government has traditionally kept a tight rein on regional governmental autonomy, moves towards marketization and liberalization have provided the rationale, and central government deficits the incentive, for widespread fiscal decentralization which has endowed considerable new tax raising and expenditure powers on the provinces (Ma, 1996: 5).

The trend is also not confined to previously centralised states. In Latin America, in Mexico and Brazil – which have long been federalist countries on paper – the revival of democracy has led to significant political and fiscal changes involving subnational governments. In Mexico, recent political changes that have resulted in far greater democratic representation for regional interests, have also underpinned substantial moves towards increasing the flexibility, autonomy and financial independence of the Mexican states (Ward and Rodríguez, 1999: 28). In Brazil, following the passing of the 1988 Brazilian Constitution, the political influence of the states was greatly increased (Coutinho, 1996: 7).

A similar evolution can be discerned in India and the US, both federal democracies but both now favouring a greater redistribution of authority and/or resources to their respective states. In India, the reaction to accusations of national governmental elitism and the existence of a controlling class during the 1970s gave rise to progressive moves towards bolstering the authority and responsibilities of regional and local governments (Sharma, 1999). More recently, the realisation that

central government has struggled to control its own expenditure and deficits has brought about subtle but continuous devolution of responsibilities to the states, associated with the drive towards greater marketization and liberalism (Rao, 1997). In America, disillusionment with central politics in the 1970s, following the Vietnam war and successive oil crises, coincided during the 1980s and early 1990s with rising central deficits, setting the stage for a politically popular increase in the legitimacy and authority of the states that suited the central government well (Donahue, 1997).

In brief, the devolutionary trend is a widespread phenomenon. There is evidence of some form of decentralisation in a large number of developed and developing countries, across both unitary and federal states, and in both rich and poor nations. The depth and breath of the trend allows us to establish the global tendency towards devolution as our second stylised fact.

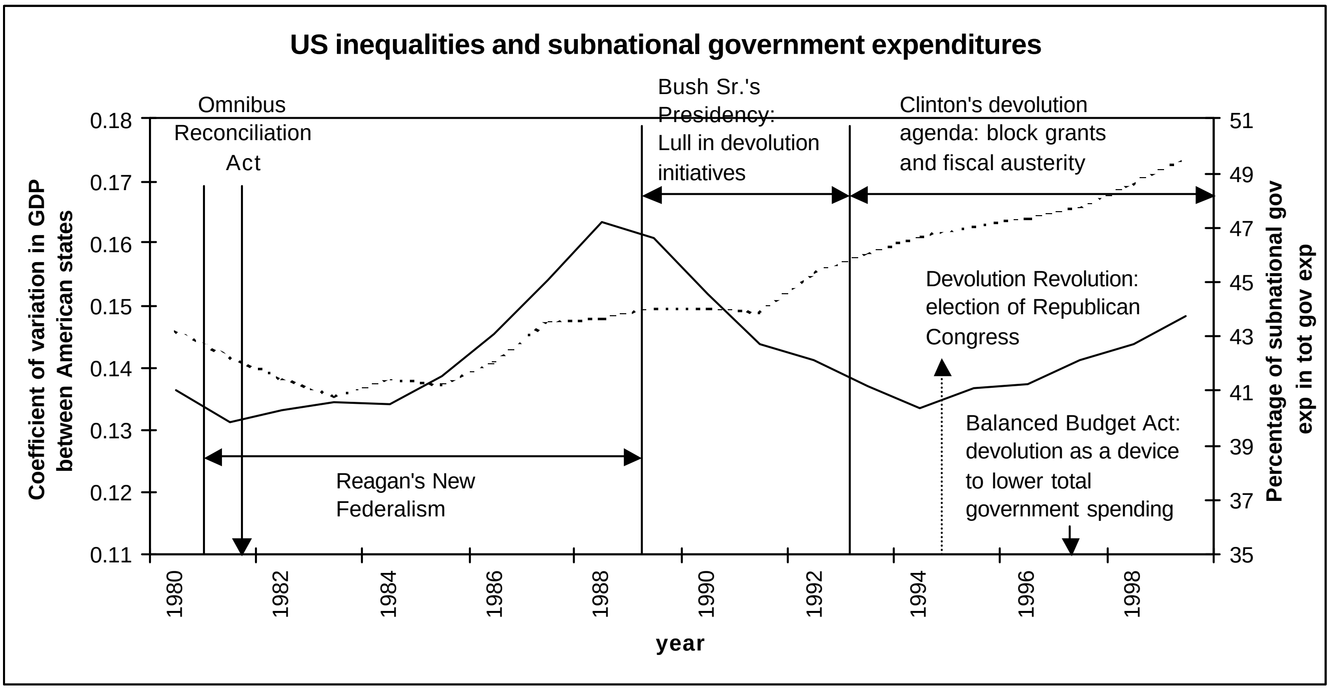
3. The Link Between Regional Divergence and Devolution

In the following section, we bring both facts together, by presenting a descriptive analysis of the apparent coincidence between rising inequalities and moves towards devolution, with reference to six case countries: Brazil, China, India, Mexico, Spain, and the US. As mentioned, it is important to bear in mind that devolutionary initiatives often assume legislative and administrative characteristics and are not necessarily fully reflected in quantifiable fiscal resource decentralization. The following Figures, therefore, illustrate both the numeric increase in subnational influence in a selection of countries, through the rise in their expenditure as a proportion of national government expenditure, as well as important political and legislative developments that have served to lend more authority to subnational units. In each Figure, the dotted line represents the share of subnational government in total national public expenditure (this includes local, as well as regional, government expenditure in the cases of America, Brazil, Mexico, and Spain)[1], while the

[1] IMF public expenditure data have been criticised on the basis that they do not convey the degree of local spending autonomy of subnational governments, do not distinguish between sources of tax and non-tax revenues, intergovernmental grants and other grants, and do not disclose what proportion of intergovernmental transfers are conditional or discretionary (Ebel and Yilmaz, 2002, pp 6-7). However, no reliable alternative exists for conducting comparative analyses of subnational public expenditure.

continuous line represents the log variance of regional GDP in the country in question.

Figure 1. The US



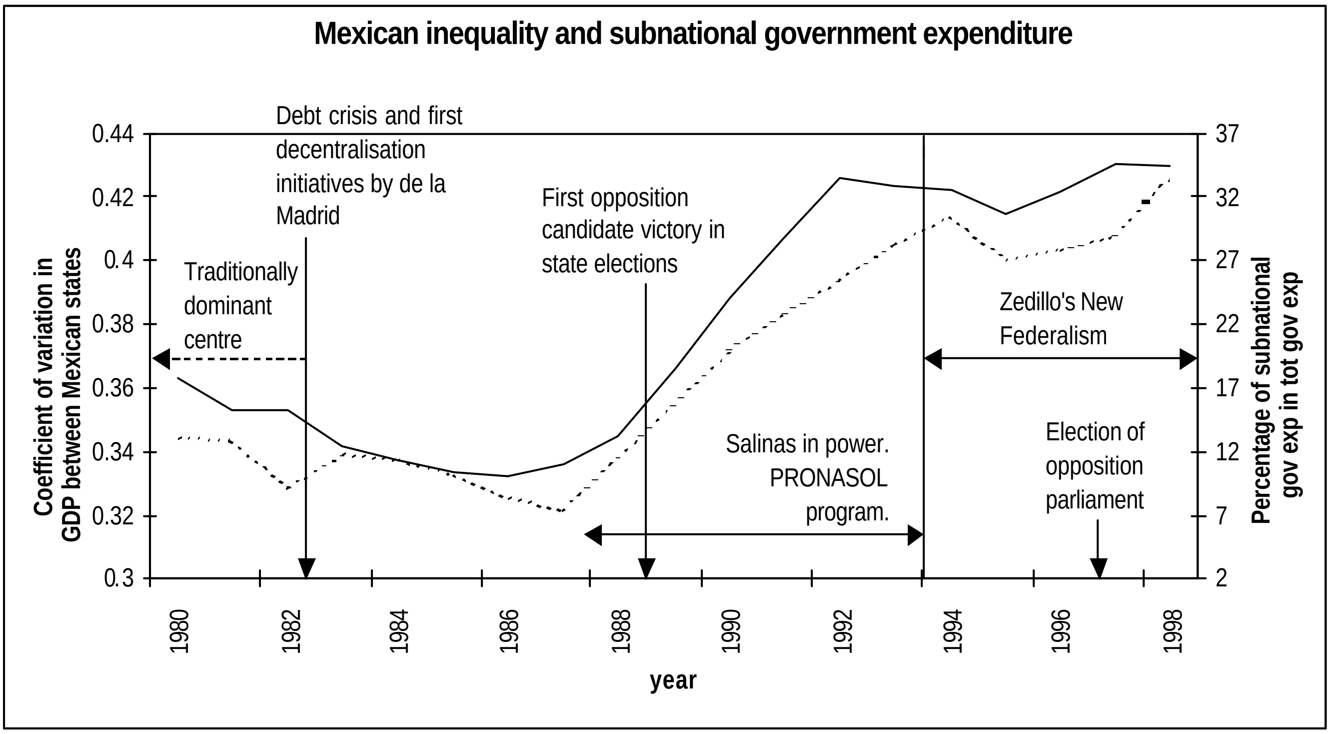
As figure 1 shows, the evolution of inequalities among US states has been highly cyclical. From 1980 to 1999, however, an increase in the level of inequality is evident (see also Table 1) and this rise has coincided with both fiscal and qualitative devolutionary developments. The era has been one of substantial decentralization of central governmental authority, illustrated by several important legislative alterations. Building from Nixon's New Federalism initiatives, Reagan's interpretation of the federal government as 'part of the problem' led to an agenda of measures aimed at scaling down federal programmes in Social Security, Medicare, and Medicaid. The opposition of a Democratic-controlled Congress prevented a widespread transfer of Medicare and Medicaid to the States at this stage. However, Reagan's federalist revolution included the transformation of 534 existing categorical grants, which were sensitive to the financial positions of the states, into 9 block grants in 1981, which were fixed and included very few progressive components (Omnibus Reconciliation Act see Donahue, 1997: 29). As a result, the states were given a freer rein over their own finances, and the subsequent divergence of state domestic products might well

reflect, among other things, the relative advantage of the richer states under this new arrangement, as well as the high economic growth of the last years of Reagan's presidency. The economic crisis that dominated George Bush Snr.'s presidency, however, was to check the emergent inequalities between the states. Bush's senior term in office was also a period of relative lull in devolutionary initiatives. A return to economic dynamism, coupled with further moves towards decentralization under the Clinton administration, and especially since the election in 1994 of a Republican-dominated Congress, was followed by a revival of regional disparities. This period, sometimes known as the 'devolution revolution' (Cho and Wright, 2001; Soss *et al.*, 2001), was dominated by the aim to return authority, responsibility, and financial resources to the states through the introduction of block grants for welfare, child care, and other social services. The introduction of legislation in this direction, which culminated with the passing of the Balanced Budget Act in 1997, took its toll on the poorer states, especially as a result of the progressive reduction of fiscally equalizing federal intergovernmental aid. Hence, the positive correlation between rising inequalities and increasing regional autonomy and financing of this period may be a side effect of the devolution revolution.

The renewal of the Mexican decentralization process begins with the debt crises of 1982. The economic and political upheaval that followed inspired an emerging political disillusionment of the country with the incumbent PRI (Partido Revolucionario Institucional). Since the crisis, successive PRI presidents tried to reform the system from the inside in order to restore presidential legitimacy (Shirk, 1999), by responding to demands for greater political and fiscal decentralization. President de la Madrid (1982-8) made the first steps by transferring powers to local authorities. Due to the lack of accompanying resources at this level, however, these powers, were often subsumed by the jurisdictions of higher level regional governments (Nickson, 1995). President Salinas de Gortari's (1988-94) period in office saw a dramatic increase in subnational expenditure. Programmes such as the National Solidarity Programme (PRONASOL) – an attempt to appease widespread calls for closer political involvement at the state and municipal levels (Ward and Rodríguez, 1999) – played an important part in the process. But perhaps the most important contribution to devolution of Salinas' presidency took place in the political arena, with the recognition for the first time of the victory of an opposition candidate in a state election. Ernesto Ruffo's 1989 election as Baja California governor was

quickly followed by other opposition victories in Chihuahua and elsewhere, making opposition governors champions of decentralization (Shirk, 1999).

Figure 2. Mexico

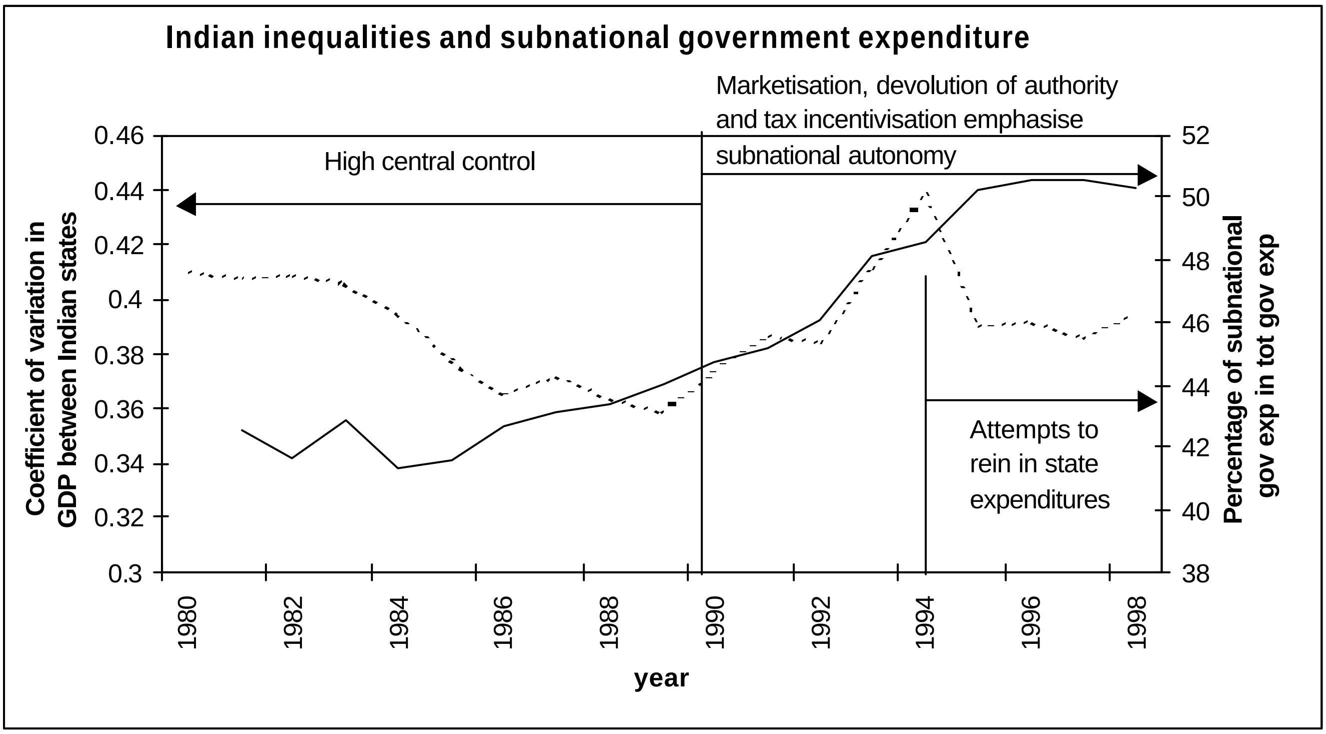


The final year of Salinas' presidency represented a momentary halt in the devolution process, which ended with the arrival of Ernesto Zedillo to power in December 1994. Following what was defined as a new federalist agenda, a cross party forum on interstate relations was called in Guadalajara in 1995 (Ward and Rodríguez, 1999). This forum proposed widespread devolution of funds as well as responsibilities, in areas as diverse as the judiciary, corruption, and income inequality, and was followed by a resumption of the trend towards greater subnational government expenditure, especially after the 1997 election of an opposition-dominated Parliament. The election in 2000 of Vicente Fox as President – a former governor of Guanajuato and the first non-PRI president since the 1920s – has only accentuated the decentralization trend.

As Figure 2 highlights, this drive towards devolution has coincided with an increase in the magnitude of regional disparities in Mexico. Only four years after the debt crisis and two after the first hesitant steps towards decentralization were taken, regional inequalities – which in 1986 reached the lowest level since records began – started to increase. The growth of regional inequalities has since paralleled that of

subnational government expenditure. The turmoil at the end of Salinas', and the beginning of Zedillo's, presidencies was also reflected in a momentary halt in the rise in subnational expenditure and inequalities. The rise in regional disparities may be related to factors that have little to do with the devolutionary trend, such as the liberalization of the Mexican economy and economic integration in the North American Free Trade Agreement (Sánchez-Reaza and Rodríguez-Pose, 2002). But, taking into account the fact that Mexican decentralization has been characterized by the inadequacy of the devolved funds to cover the additional responsibilities falling to the states and municipalities (Ward and Rodríguez, 1999), it perhaps comes as no surprise to find regional inequalities also increasing dramatically over the period as a result, as richer states have tended to fare better under the tightening budget constraints.

Figure 3. India



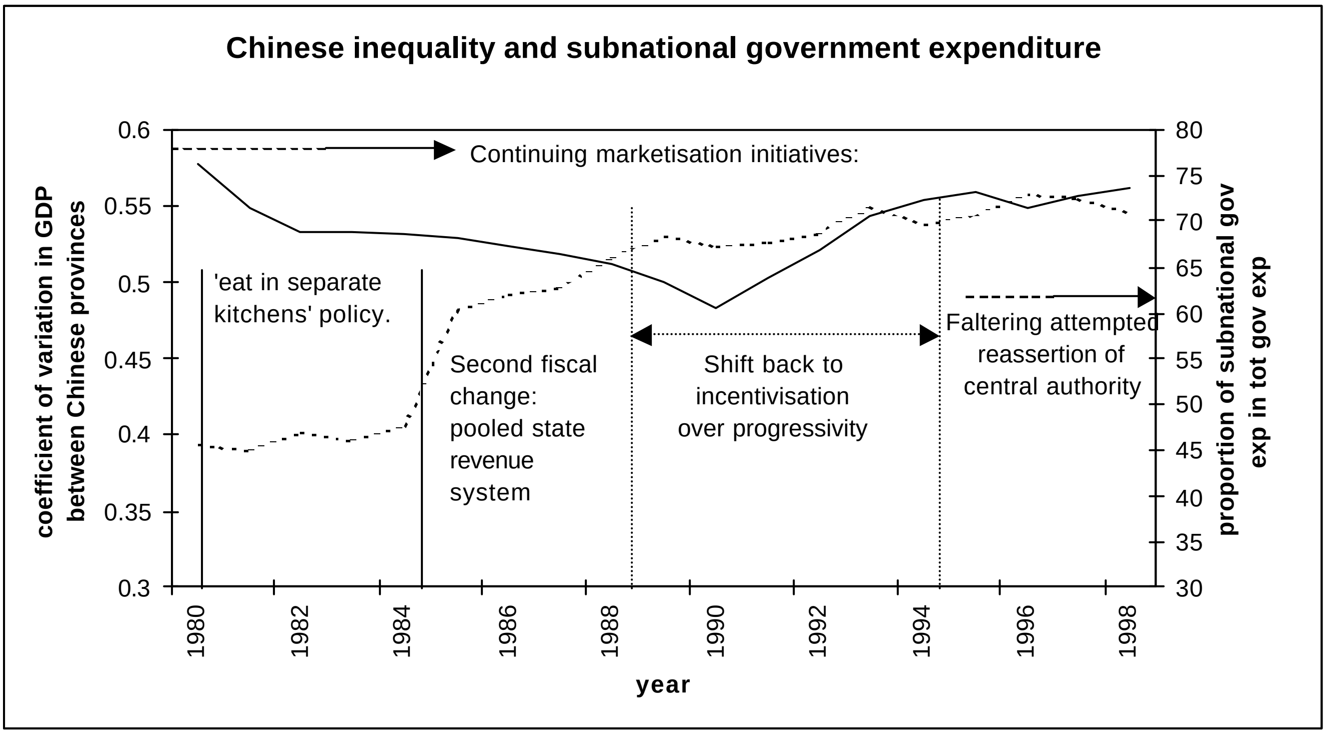
Despite having the lowest variation range in subnational government expenditure in any of the countries included in the sample, the evolution of regional and local expenditure and the growth of regional disparities in India also show a marked temporal coincidence (Figure 3). From 1980 to 1988, subnational expenditure fell

slightly, and regional inequalities remained roughly stable. In 1991 the Indian tax and fiscal financing system underwent wide-ranging reforms. Efforts to improve the rate of tax collection in the states through incentivizing principles and by allowing the states to retain a greater share of their own taxes, as well as shifts away from sales taxes and excise duties towards VAT, led to a marked rise in subnational expenditure. Moreover, the freeing up of local governments from national and regional state influences has encouraged decentralised governance to develop. The rise in subnational expenditure coincided with an increase in regional inequalities. Such a change may be related to the increasing tendency of Indian administrations to resort to marketization initiatives designed to promote competition for industry across its states, rather than just to fiscal and administrative decentralization (Bandyopadhyay, 2002). However, given that these latter changes emphasise subnational autonomy over any central redistributive role, and given the huge differences in economic development among Indian states, some authors have argued that the process of decentralization has hampered the ability of the poorer and smaller states to compete in terms of public administration or development strategies (see Rao and Singh, 2001) and that this contributed to the surge in regional disparities across India in the late 1980s and early 1990s. This argument is reinforced by the fact that regional disparities in India became more stable once subnational levels of expenditure were cut in the second half of the 1990s (Figure 3).

The trend in Chinese subnational expenditure has been marked by a consistent increase since 1980. This rise was driven by marketization initiatives which stress a reduced role for central government alongside tax incentivization schemes designed to promote innovative taxation policies at the local and provincial levels. At the same time, inequalities in China have varied significantly, falling from 1980 until 1990 and then rising again to similar levels during the following decade (Figure 4). Various changes in the fiscal system across the period may go some way to explaining this fluctuation. In 1980 a system known as 'eat in separate kitchens' was introduced, making provincial expenditures partially reliant on their own revenue collections for the first time. Under the new system the richer provinces fared well, as these were able to increase their tax efforts more substantially. At this time, however, fully 80% of all tax collections were allocated by the central government, so the regressive effect was marginal (Bahl, 1999). In 1985 the system was reviewed, with a greater role for the provinces but under a more progressive system. This time, the provinces would

pool their revenues and then redistribute them, with richer regions being net contributors and poorer ones net beneficiaries (Ma, 1996). Alongside these changes the role of the central government was steadily reduced.

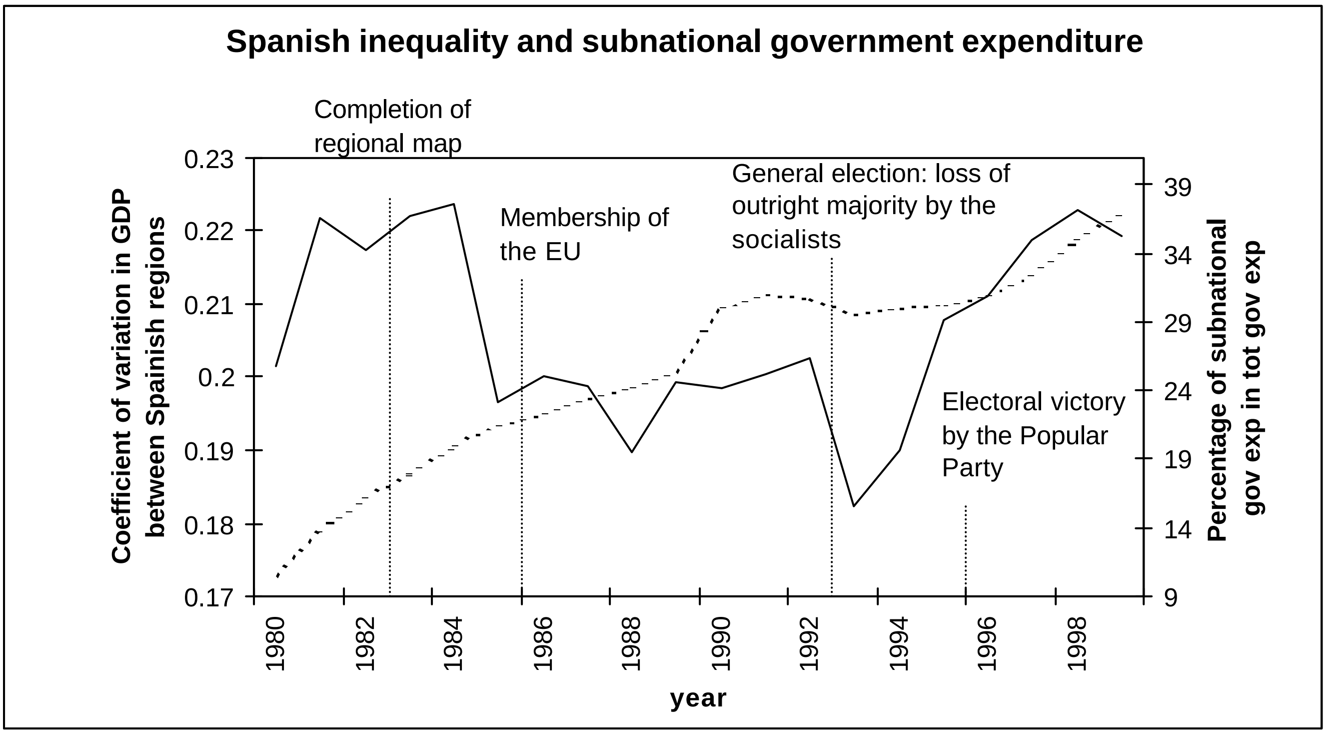
Figure 4. China



By 1988, however, the provinces had become disillusioned with the new system. The richer provinces lost their incentive to collect taxes and the poorer ones overspent in the knowledge that they would be underwritten by the central pool. The period from 1988 to 1994 therefore saw some important changes occur. First, the progressive effect of transfers was reduced, in favour of incentivization principles, much like at the start of the 1980s, but this time with a far greater absolute role for the regions. Second, the traditional formula-based central-to-province fiscal transfers dissolved, giving way gradually to negotiation based contracting that tended to favour the richer regions which had more to offer to the increasingly indebted centre (see Ping, 2000). And third, the role of the central government in many aspects of public administration receded significantly. The ratio of government spending to GDP fell from over 30% in 1978 to under 15% by 1991, the proportion of central government revenue in total government revenue fell from over 40% in 1984 to around 23% in 1993 and, as Figure 4 shows, central expenditure as a proportion of total government expenditure

was also at an all time low. These factors, taken together, provided perfect conditions for unfettered competition between provinces. The rise in regional inequalities from 1990 onwards probably reflects the channelling of FDI to certain designated areas, as well as the internal, negotiation-based battles for public funds. Both these struggles favour the richer, coastal provinces whose administrative and financial capacity to compete far outweighs that of the poorer, interior provinces (Lu and Wang, 2002). The Chinese story illustrated in Figure 4 conveys most importantly, therefore, the declining administrative, financial, and legal leverage of the centre over the regions through the period. As soon as competitive conditions were able to take root between the provinces, as the centre's authority was devolved, the inequalities evident throughout the 1990s began to emerge.

Figure 5. Spain



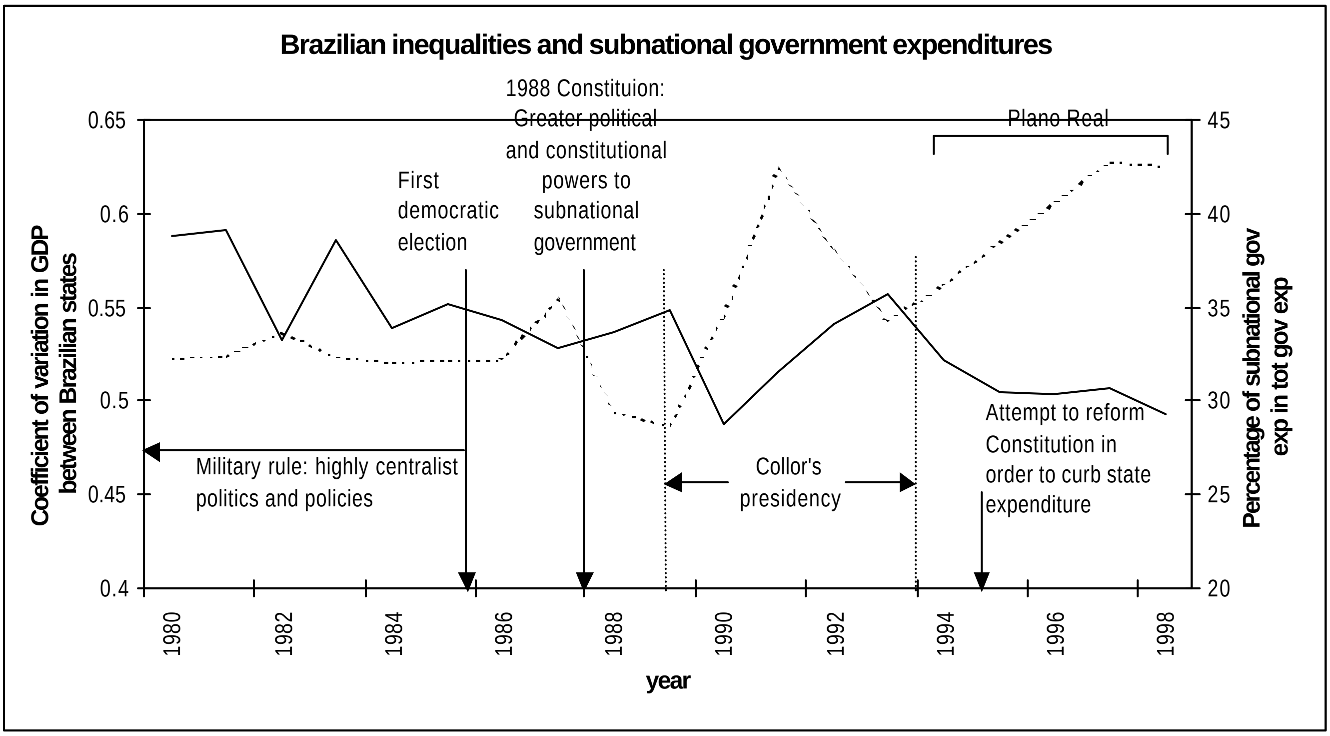
The Spanish regionalization process took off with the restoration of democracy after the death of General Franco and even before the approval of the 1978 Constitution. In September 1978, the Generalitat – the regional government of Catalonia, which had enjoyed a brief spell of regional autonomy during the second Spanish Republic in the 1930s – was re-established. Regional institutions were successively restored or

created in the Basque Country, Galicia, and Andalusia between 1978 and 1981. However, the process really took off in 1982, in the period around the collapse of the Unión de Centro Democrático (UCD) government and the election of the first Socialist government with absolute majority (Hopkin, 1999). In this year, autonomy laws were passed in most of the remaining Spanish regions and by early 1983 the first stage of devolution, which included the definition of regions and the approval of regional autonomy, was concluded. Between 1983 and 1985 the devolution process continued with a significant transfer of powers and authority to the regions. The number of transfers to the regions approved by the central government jumped from a total of 7 and 19 in 1978 and 1979 respectively to 253 in 1983 and 204 in 1984 (MAP, 2002). At this stage and with the exception of the regions of Navarre and the Basque Country – which, in contrast to the remaining Spanish regions, have their own independent fiscal institutions – most transfers were transfers of authority rather than of resources. As seen in Figure 5, the transfers of resources took on a much more gradual trajectory during the second half of the 1980s, a factor that may have contributed to the relative stability of regional disparities over this period.

The stamina of the devolutionary process waned at the turn of the decade, with few transfers of powers and/or resources to the regions. Only 6 transfers of powers were approved in 1988 and 1991, the lowest number since the beginning of the devolutionary process (MAP, 2002). Subnational government expenditure growth also stagnated and the combination of this factor with the effects of the downturn in the economic cycle was reflected in a short-lived reduction in regional disparities (Figure 5). The 1993 elections represented a new watershed in the devolutionary process in Spain. The loss of an absolute majority in Parliament meant that the Socialist party had to govern with the implicit support of the moderate Catalan nationalists. The 'price' for this support was a sharp renewal of the autonomizing and devolutionary process in the following years. Transfers to the regions rose to 169 in 1995 and Spanish regions secured the administration of 15% of the income tax collected in their territory (Castells, 2001). The failure of the right-wing Popular Party to win an overall majority in the 1996 election meant that the support of the Catalan moderate nationalists became once again essential. Further transfers to the regions ensued as a result, including a transfer of 33% of the income tax collected in each region. The process has culminated at the beginning of 2002 with the transfer of education and health to all those Spanish regions which did not previously control those sectors,

making Spain the most decentralised state in terms of regional government expenditure in Western Europe. The rapid transfer of resources to the regions – and especially the transfer of larger shares of income tax revenues collected in the regions – in the second half of the 1990s has coincided with a rapid rise in regional disparities (Figure 5).

Figure 6. Brazil



Brazil represents the main exception in the link between regional devolution and the evolution of regional disparities. Traditionally a fairly decentralised country, during the military regime Brazil experienced a process of political and fiscal centralization (Shah, 1991). The return to democracy in 1985 marked a reversal in the trend and the 1988 Constitution was passed in a climate of reaction to 20 years of centralization (Mora and Varsano, 2001: 2). The high fiscal autonomy enshrined in the Constitution, the lack of coordination among different tiers of government and the lack of a clearly defined set of responsibilities concerning public expenditure resulted in a dramatic rise in subnational expenditure (Teixeira Lemgruber, 1997) (Figure 6). After a delay of approximately a year, inequalities between Brazilian states also began to rise, as the more influential states lobbied the central government for funds more effectively,

were able to take on more debts and were bailed out by the federal government (Mora and Varsano, 2001). In these increasingly volatile conditions, the election of Fernando Henrique Cardoso as president led to efforts aimed at reining in the expenditures of the states. These efforts were twofold. On the one hand, the macroeconomic package known as the Plano Real brought about a few years of economic stability. On the other, in 1995 a Constitutional amendment was proposed aimed at reversing some of the decentralization promoted by the Constitution and at increasing fiscal revenues across the country. These measures, however, have been unable to curb the growth of subnational spending, which has risen sharply since the mid-1990s (Figure 6). The rise in state expenditure is directly related to the dependence of government stability on a myriad of parties with often highly entrenched local interests and on the intensification of bidding wars among Brazilian states in order to attract foreign direct investment to their territories, especially in the automobile sector (Rodríguez-Pose and Arbix, 2001). The effect of these bidding or fiscal wars has been a sharp growth in expenditure, a reduction in tax revenues, and, consequently, the spiralling of state debt. Less developed states have been most affected by these developments, as they "become unable to provide services and public works necessary to attract private investment" (Mora and Varsano, 2001: 13). This process has not been, as in other national cases, accompanied by an increase in regional disparities. Regional inequalities in Brazil in the second half of the 1990s have remained relatively stable and even declined slightly (Figure 6). This factor may be explained by the existence in Brazil of a fairly developed fiscal transfer system, which guarantees poorer states in the North, North East and West of the country a larger percentage of income and industry tax (Teixeira Lemburger, 2002).

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This section has examined the coincidence between the devolutionary trend and rising spatial inequalities in our case countries. In five out of six cases the correlation is quite strong. For example, the coincidence between Mexican rising subnational expenditure and rising inequalities, or the correlation between China's responsibility devolutionary initiatives during the 1990s and its subsequent increasing disparities, exemplify the apparent temporal relationship between the two factors of the analysis. It is on the strength of such observations that we proceed, in the following section, to examine the possible reasons behind such a temporal relationship.

4. The Role of Devolution in the Emerging Geography of Disparities

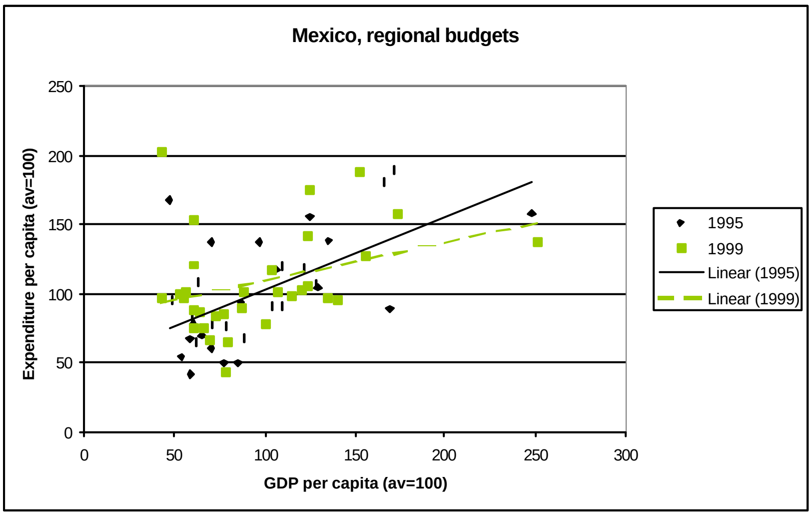
Widespread economic and geographical research has tended to underline the basic trend of agglomeration at various spatial levels and among various actors. From Marshall and Lösch, through Myrdal and Perroux, to Krugman and Storper, regional and local agglomerations have become well-recognised drivers of uneven economic and social landscapes. The reasons for spatial economic differentiation are varied, spanning diverse concepts such as the 'something in the air' hypothesis, the cumulative causation model, the concept of socially embedded networks and the new economic geography variables of transport costs and economic integration. Given these collected reasons for the emergence of stronger and weaker regions and localities, the role of devolution in determining spatial disparities is necessarily auxiliary. Nevertheless, it is our contention that devolution can play a part in allowing inequalities to develop. To the extent that any public sector policies hold influence over the operation of market forces, the vertical power-structure of governance within a country has an equally pervasive effect. Moreover, as is the case with all public policies, implicit choices and priorities underlie moves towards and away from devolution. In this section we expose the nature of these choices and priorities. By devolving power it is our contention that the redistributive role of government is compromised, in favour of the operation of the market which, in a spatial context, is likely to be inequitable.

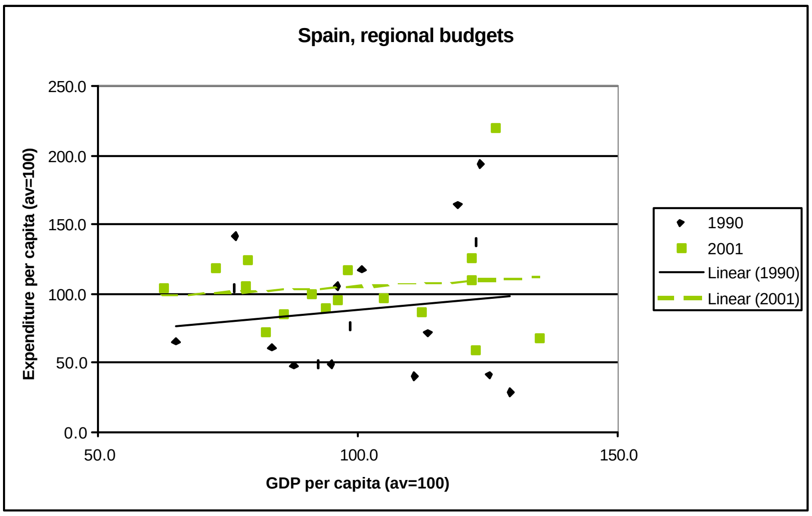
This section is structured around two ways in which devolution provides the conditions for, and encourages, the emergence and persistence of regional inequalities. The first discusses the fiscal contribution of devolution to the latent inequity often evidenced by subnational units, as well as the systemic inequitable fiscal effects that devolution, through the empowerment of highly heterogeneous regions, has in promoting further interregional disparities. The second focuses on the efficiency implications of devolution for highly diverse regions. Given a decentralization of power and resources, richer regions have both an institutional and economic capacity advantage with which to capitalise on the autonomy that devolution brings.

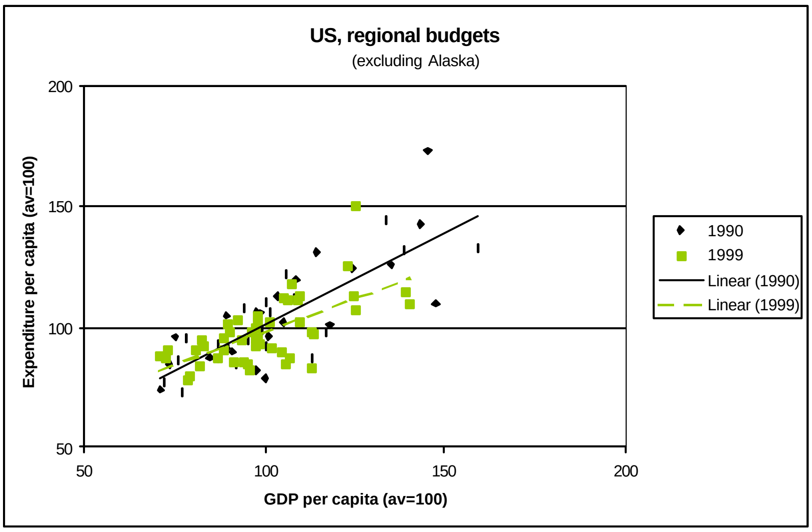
4.1. The Fiscal Impact of Devolution

The fiscal inequalities engendered by devolutionary initiatives take on both static and dynamic forms. In a static context, devolution accentuates the autonomy of regions, and given the diversity of different regions' tax bases and welfare responsibilities, a contraction of transfers is likely to make actual government spending at subnational levels less progressive. By reducing the equalising role of the central government across regions, the latent inequalities between them take on more importance in the determination of regional budgets. Arguments in favour of devolution point to the incentivising effect of tax appropriation at regional levels. Where regions are able to spend more of the taxes they collect, then tax efficiency will increase and, moreover, lagging regions will have a stronger incentive to tax effectively so as not to fall further behind other regions. Hence, a contraction in governmental transfers may be progressive for the nation as a whole. But this argument is flawed on two counts. Most obviously, mechanical limitations associated with poorer regions limit their tax bases and the extent to which they can increase tax effort without engendering migration. More subtly, in reference to achieving a high tax effort, 'transfers that are properly designed can achieve this goal even if they finance 90% of local expenditures. Poorly designed transfers will not, even if they finance only 10% of expenditures' (Bird and Smart, 2002: 899). The implication is that the absolute level of central government financing at the local level is less important than achieving, through carefully designed incentivization schemes, an equality between marginal effort and marginal expenditure at the local level. However, the absolute level *is* important in determining the level of absolute spending, given the tighter automatic constraints evident in poorer localities (Prud'homme, 1995: 203). We can conclude, therefore, that the contraction of central financing and the accompanying emphasis on regional government autonomy is likely to promote spatial inequalities. Where regressiveness between regions already exists this will be amplified, and where progressive spending has been achieved through transfer assignments, this distribution is likely to be diluted. Moreover, any justifications for the withdrawal of central government support to increase tax effort are likely to be misplaced since such goals can be more readily achieved through incentive manipulation than through absolute reductions in financing. Indeed, such justifications may simply be hiding central governments' desire to reduce outlays and responsibilities.

Figure 7. Regional per capita government expenditure in relation to regional per capita GDP







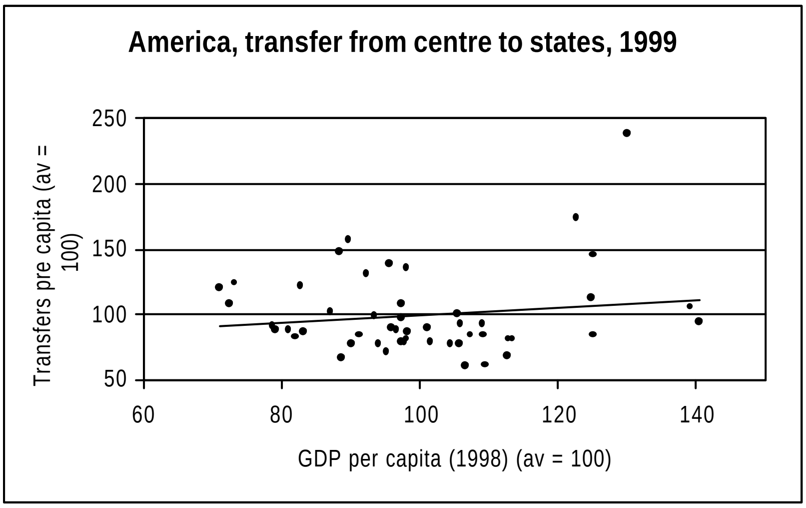
These theoretical considerations are reflected empirically. Figure 7 plots regional per capita government expenditure against regional per capita GDP and illustrates that after ten years of meaningful devolution in Mexico, at least twenty in Spain, and more than two centuries in the US, poorer regions and states in these countries seem to be losing out in terms of regional government expenditure. Regressive trends in the actual expenditure of subnational governments in each of these countries are apparent at the beginning and the end of the 1990s (or the latest year for which data is available). This regressiveness is even more striking in countries like Mexico or Spain where a considerable percentage of regional expenditure is still dependent on government grants. While some cyclical variation in the regressiveness of government spending is only to be expected, the consistency of the direction of the correlation between spending and regional GDP is clearly evident across the 1990s. Moreover, we can only expect the robustness of this relationship to increase in the coming years as the spatial forces acting to differentiate governmental spending at the regional level become progressively less diluted by central government transfers, grants and loans.

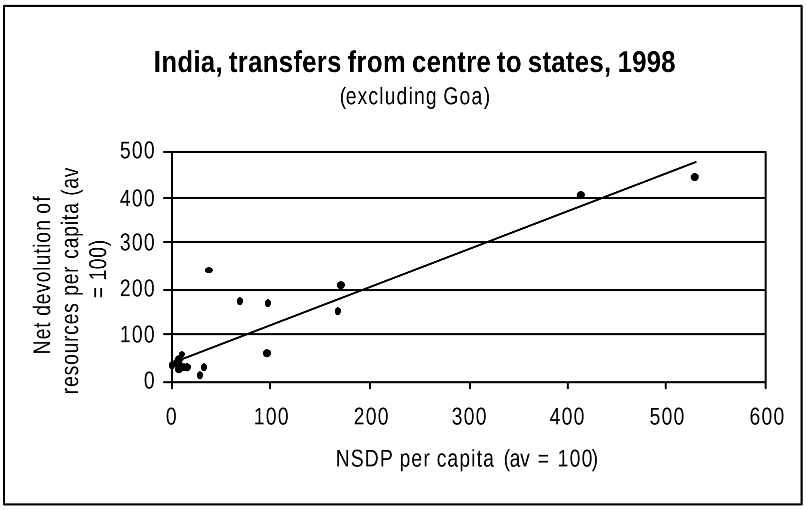
A further, dynamic, effect of devolution that carries with it profound implications for the regressiveness of state government expenditures, involves the derivation of transfers from central to regional governments. During devolution states often gain more influence over the distribution of transfers, promoting a more regressive system (Prud'homme, 1995). This is because the empowerment of the states gives a disproportionate negotiating strength to the richer states, whose support is more important to the central government. The relevance of this political aspect should not be underestimated. Rao and Singh (2001) find that variables such as the proportion of central government representatives originating from a particular state, state domestic product per capita and whether or not the same party was in power at the state and central levels were, in the context of India, consistent and robust determinants of grant aid to the states. While they acknowledge room for further empirical research, they are driven to conclude that, 'political factors, whether captured through straight political variables, or through measures of demographic and economic importance, do matter for the actual pattern of transfers in India' (Rao and Singh, 2001: 13). Moreover, this hypothesis is confirmed in a number of our case countries. In Brazil, as Dillinger and Webb (1999) point out, the disproportionate threat of default on government debts that larger, and richer, states held over the central government during the late 1990s afforded them favourable conditions during

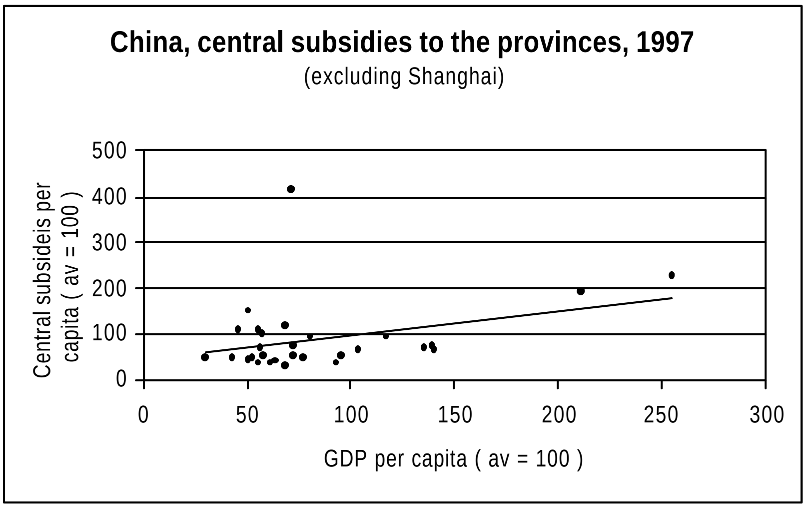
the negotiation of repayment contracts that began in 1997. In Spain, the relatively affluent regions of Navarre and the Basque Country managed to secure a very favourable tax arrangement, known as Concierto Económico (Castells, 2001). In China, Lee (2000) stresses the compromised position of the Chinese government in the context of centre/state negotiations during the 1990s, largely resulting in inequitable outcomes that tended to favour the politically dominant states. And in Mexico the World Bank, in investigating the equity of centre to state transfers under the newly adapted participaciones scheme, was forced to question the disproportionate benefits accruing to the then President's home state (Ward and Rodríguez, 1999). The graphs in Figure 8 indicate the regressiveness of centre to state transfers in three of our case countries – China, India, and the USA – a regressiveness largely based on the political clout of richer states.

While Indian commentators give explanations in terms of the incentives richer states have to tax effectively under preferential treatment, thereby justifying the regressiveness of the central pool of transferred resources through its increased size (Rao, 1997), such incentivization arguments are dubious, as Bird and Smart (2002) highlight. The more likely explanation is that central governments have, through the devolution of power, become increasingly subject to the demands of the states. And richer states can shout louder. One of the common features of the fiscal transfer mechanisms in our case countries is the trend towards discretionary transfers. China's extra-budgetary transfers, the introduction of the flexible 'aportaciones federales' fund in Mexico, the discretionary loan and debt conditions decided upon by the Brazilian government, the 'exemptions' from various terms of the block grants for welfare programme for some states in the US, and the special tax system of the Basque Country and Navarre in Spain, all indicate the same pattern. The regressiveness of transfers shown above runs counter to any notion of equity, but through devolution and the political endowment it affords richer states, such patterns are, if anything, likely to intensify. The rise in discretional transfers is a symptom of this trend, opening the way for central capitulation to the states. Moreover, 'once a political settlement is reached in intergovernment finance, it often proves exceptional hard to alter thereafter' (Bird and Smart, 2002: 908), a fact the benefiting states are doubtless gleefully aware of.

Figure 8. Centre to states transfers in relation to regional per capita GDP.







4.2. The Efficiency Impact of Devolution

Devolution holds further implications for differentiated, subnational governments if we consider the hidden, or subtle, costs that devolution entails. The differing abilities of individual states or regions to handle these costs become an important consideration. In each case discussed, the cost incidence falls more heavily upon poorer states, while, at the same time, the efficiency with which to deal with these extra costs is concentrated more heavily in richer regions. This is because the latter enjoy deeper resources, access to more skilled workers, have or are located near to the largest markets, and, as we have seen, often have access to larger financial and fiscal resources. As devolution progresses, therefore, and costs arise and fall to the states, the differential efficiencies and capacities across them are likely to manifest themselves in more, or less, effective public management. As a result, devolutionary attempts may promote regressiveness at the subnational level.

The first of these costs involves the simple administrative strain that a devolution of resources and responsibilities presents. Within the context of relatively poor, subnational governments in developing countries, the most basic assumptions underlying devolutionary initiatives are called into question. Crucially, policies advocating the decentralization of resources and responsibilities assume, first, that decentralised resources will be spent at least as effectively as the central government may have spent them, and, second, that responsibilities will be managed at least as competently. Indeed, devolutionists argue that the greater knowledge of local markets and social conditions that subnational governmental units possess, affords them the opportunity to target policy spending more effectively than the central government and hence increase overall public expenditure efficiency (Oates, 1972). But there is little evidence to support the claim that local policy makers are automatically more knowledgeable. Information collection and application is a costly exercise at any level of government, making the effective targeting of expenditure an expensive and time-consuming act, made costlier, of course, by deficiencies in information technology, research staff and skills and capital such as information and communication technologies. Given that such deficiencies tend to predominate in poorer states and localities, these considerations, especially in the context of developing countries, present a trade off between centrally directed and locally directed expenditures that is often overlooked. Moreover, with reference to responsibilities, poorer states which

employ smaller and less departmentalised public systems have less opportunities to exploit economies of scale and scope in public management, implying a further, opportunity, cost to small states as responsibilities are devolved (Prud'homme, 1995: 209). In short, the successfulness of devolution rests in part upon the abilities of subnational governments to convert the opportunities decentralization presents into more effective policies. To the extent that this conversion implies costs to participating units, this represents a regressive influence of devolution since the efficiency and capacities of poorer states to meet these costs are inferior to that of richer states.

Further costs are implied by the economic competition that devolution engenders at the regional and local levels. As Cheshire and Gordon (1996, 1998) have pointed out, territorial competition for economic activity at the regional level has become commonplace as capital has become more mobile and therefore has been presented with a vast array of locational choices. The intensity of competition increases as more regions from more countries compete for the same mobile industry. Cheshire and Gordon (1998) note, however, that such competition can be inefficient. This is especially true when competition for mobile assets involves tax concessions and incentives or is designed to attract industry that is already interested in the market potential of a region or country. In these cases, the competitive efforts represent a deadweight loss to the nation as a whole in the absence of strong regulatory bodies.

Two points related to this process arise in the context of devolution. First, devolution represents an effective endorsement of this process. For good or ill, the contraction of central government's role in attracting and allocating industry, at a time when territorial competition is becoming more intense, can only be taken as a recommendation for this competitive process. Given that this process is endorsed, it is surely the prerogative of central government to protect the interests of those states attempting to compete from a weaker financial and administrative platform. Second, however, while on the one hand devolution imposes the cost of competition upon all subnational units, on the other, it makes little provision for the differing abilities of regional and local governments to meet those cost requirements. In contrast to the argument that responsibility decentralization will bring about innovative ways to stimulate and attract industry, the reality is that in most cases the attraction of industry is still very much incentive based. Once again the higher costs of giving incentives to industry tend to fall on relatively less developed states that are often forced to offer

greater tax concessions, larger loans and grants, and a plethora of subtle enticements in order to attract industry. Richer regions, in contrast, can rely on plentiful resources, shared ideas and abundant, skilled and entrepreneurial workers, providing them with yet another systematic advantage under a devolved framework. The outcomes of this process are readily apparent. In the US and Brazil, it is the less developed states that tend to bear the greatest cost per employment created of attracting large multinational companies. This is the case in Alabama or South Carolina in the US (Florida, 1996; Donahue, 1997) or Bahia in Brazil (Rodríguez-Pose and Arbix, 2001). And in China, the spiralling decline in the quality of working conditions in many of the multiple special economic zones that have emerged throughout the country in an attempt to attract industry belies the implicit solution that poorer states are forced to adopt (McKenney, 1993). The second cost of devolution, therefore, alongside the administrative strain it imposes, concerns the cost of competitive industrial attraction. The efficiency of states in meeting such costs are diverse, and the extent to which states can consequently capitalise upon the opportunities presented by devolution are therefore skewed and regressive. Again, then, the imposition of a cost through devolution is accompanied by fundamental tendencies towards the divergence of regional incomes.

Conclusion

In a world in which increasing regional disparities and transfers to subnational levels of government have become common trends, this paper has sought to chart the link between both facts. It is by no means a paper against devolution. We acknowledge that the widespread decentralization of powers to regional governments across the world has proved popular and seems to be associated with significant social and political benefits. Insofar as devolution has awakened local consciousness and spurred local economic potential, it may also have delivered greater economic efficiency. Yet, the scrutiny of the evolution of regional disparities and decentralization processes in Brazil, China, India, Mexico, Spain, and the US has highlighted that claims of a supposed economic dividend in terms of territorial equity should be greeted with caution, if not with outright skepticism. While some correlation between rising subnational expenditures and increases in regional inequalities is immediately evident,

once qualitative aspects of the devolution initiatives in the various countries are also taken in consideration, the relationship takes on more authority. In each of the countries examined, the explanation of rising inequity across regions could be traced to the political and policy-making events that had surrounded evolving centre-state relations since 1980. Some cases are more clear-cut than others – such as the Mexican and Chinese cases – and this indicates the importance of separate factors engendering regional inequalities in the other countries in the analysis. But in every case – with perhaps the exception of Brazil – there is sufficient evidence to suspect a relationship between devolutionary initiatives and rising inequalities.

The development of devolution around the world represents a profound shift in the nature of governance. Concern for equality across regions is implicitly compromised through policies that emphasise regional autonomy, and the equity role of government gives way to the objective of securing free market conditions to allow competition to proceed. This is only a problem if respective nations and populations believe it to be so. What is clear, however, is that although devolution may bring about many political, social, and even economic benefits, it also has in our case studies unleashed forces that seem to be contributing to perpetuate and, in some cases, aggravate, existing economic disparities. This process, as conveyed by the new economic geography literature, may also have happened as a result of the interplay of economic forces and regardless of the institutional setting of every space. Our concern is, however, that these economic forces towards greater concentration of economic activity in dynamic centres seem to be both encouraged and facilitated by devolutionary initiatives, giving rise to the emergent inequalities documented. Moreover, as these inequalities widen, the economic rationale of agglomeration implies a strengthening of the motivations towards concentration, as resources, capacities, and competitive abilities progressively gravitate towards more successful regions and their administrations. Devolution *per se* will thus not deliver greater territorial equity. This objective would require the establishment of substantial inter-territorial fiscal equalization systems at the national or supranational level if the persistence, recurrence, and permanence of economic disparities is not to become one of the hallmarks of future geographies.

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