Economic Premise

Competitiveness and Connectivity: Integrating Lagging Regions in Global Markets

Thomas Farole

Twenty years ago, virtually all of the world’s poor people could be found in poor countries. Today, the picture has changed dramatically. Nearly three-quarters of those living in poverty—close to 1 billion people—are in middle-income countries (Sumner 2010). This reversal reflects the complex effects of the globalization of trade and investment on development outcomes. On one hand, the rapid integration of many developing countries into global markets has contributed to a convergence of incomes across countries, pulling large economies like China, India, and Indonesia into the middle-income ranks. On the other hand, these same factors have contributed to widening income disparities within countries.

One of the principal manifestations of these within-country disparities is spatial, with growth accelerating in well-located, typically metropolitan regions, while more peripheral regions fall further behind. The resulting pattern of leading and lagging regions matters not just for social and political cohesion, but also because the failure to integrate lagging regions may have a dampening effect on national growth, and contributes to the massive rural-urban shifts that are overwhelming the infrastructural, environmental, and institutional capacities of metropolitan regions in many developing countries. The World Development Report 2009 (WDR; World Bank 2009) brought this issue of economic geography to the fore of the mainstream development agenda, arguing that structural issues of location and geography play an important role in shaping the uneven spatial patterns of development, but that these are often compounded by policy. A recent report, The Internal Geography of Trade Competitiveness: Lagging Regions and Global Markets (World Bank 2012), draws on the WDR 2009 framework to explore more specifically the nexus between trade and location to inform policies to address the challenge of lagging regions.

Trade and the Challenge of Lagging Regions

Trade plays a crucial role in the interaction between location, growth, and inequality. Expanded market access can have a transformational impact on regional growth. For example, in the five years following the implementation of the North American Free Trade Agreement (NAFTA), Mexico’s border
regions grew more than three times faster than the rest of the country (Baylis, Garduno-Rivera, and Piras 2009). But for regions that are already lagging—particularly those affected both by distance (remote) and density (sparsely populated)—the trends of global and regional trade integration can result in further isolation, as firms and consumers in the core increasingly engage outward at the expense of the domestic hinterland. Meanwhile, firms in remote regions may struggle to take advantage of the opportunities available from integration in global markets due to higher transport costs and lack of scale, among other factors. For example, while overall poverty declined significantly in Mexico following NAFTA, the gap between rural and urban regions grew due to declining relative returns in agriculture and lower skills in rural regions (Nicita 2004). Thus, while trade brings opportunities, it has the potential to accentuate regional disparities.

Indeed, drawing on evidence from 28 countries over the period 1975–2005, Rodriguez-Pose (2010) shows that trade openness often leads to spatial divergence, and that it is much more likely to do so in developing countries. This is not because trade inherently leads to regional inequality, but because developing countries tend to have structural features that potentiate the polarizing effect of trade openness, including existing inequalities, lower government social expenditures, higher variations in regional sector structures, and high internal trade costs.

Using Enterprise Surveys data across more than 100 developing countries, Farole and Winkler (2011) show that firms located in core regions trade substantially more than those located outside the core. Conversely, firms in the core also perceive a significantly worse investment environment, particularly with respect to regulation, bureaucracy, and governance, indicating the presence of large congestion costs in the core. Given such congestion costs, what is it that makes the core so much more attractive than the periphery to exporters and importers?

Benefits of the Core: Agglomeration, Connectivity, and Institutions

Core regions are more likely to allow firms to exploit several types of agglomeration economies. Firms in regional economies, where there is substantial diversity across sectors (urbanization economies) as well as a concentration of firms and exporters in specific sectors (localization economies and export spillovers), are more likely to become exporters. As a result of agglomeration, firms in core regions benefit over time from technology and knowledge spillovers. They can also leverage scale economies through access to deep and specialized labor and suppliers. This raises productivity and helps overcome the fixed cost barriers to exporting. In contrast, firms and farms in peripheral regions must contend with thin input markets and have few opportunities to share resources with industry partners, making it impossible to generate scale economies.

The scale-related challenges of lagging regions are compounded by problems of location and connectivity. The structures imposed by physical networks and poor virtual networks for management of information and payments make it difficult for firms in peripheral regions to compete in the context of modern supply chains organized around the demands of shared production networks (Kunaka 2011). Such barriers may result in export-capable firms in peripheral regions trading through intermediaries. Firms in core regions, meanwhile benefit from easier access to trade gateway infrastructure, the opportunity to benefit from logistics consolidation, and informational benefits from the opportunities for face-to-face contact.

Finally, institutional factors can also favor core regions. This is less an issue of governance quality, which as noted earlier is often perceived as worse in the core. Instead, it is a function of the capabilities of institutions, which are highly dependent on the availability and quality of human capital, and the depth of local markets. For example, while many traditional measures of the investment climate appear to be rated worse by exporters in the core, access to finance is a critical area in which firms in the core benefit more than those in the periphery.

What Does It Mean for Lagging Region Policy?

These dynamics suggest that interventions focused on boosting the competitiveness of existing agglomerations in core regions may have a bigger impact on aggregate competitiveness than interventions targeting peripheral ones. On the other hand, focusing exclusively on the core is likely to exacerbate existing inequalities and may ultimately constrain growth in the long run. Therefore, it remains critical to balance aggregate national competitiveness with building the endogenous capacity for improved competitiveness in peripheral regions.

To this end, lagging regions have long been subject to targeted interventions designed expressly to reduce spatial disparities, including infrastructure investments, wage policies, deregulation, promotion of clusters, development of industrial parks and special economic zones (SEZs), and, most commonly, fiscal incentives to encourage investment. Such spatially targeted policies have largely failed. In some cases, for example, Italy’s Mezzogiorno policies, this has led to perverse development outcomes, subsidizing inefficient investment, aggravating leakage of the best firms and most talented workers, and contributing to an unfavorable institutional environment. More commonly, the impact of such policies has been minimal relative to their cost. For example, targeted interest rate subsidies in Brazil did succeed in attracting firms into lagging regions, but at a cost of several billion dollars annually.
While fiscal incentives may be effective at the margin, evidence shows that the level of incentives that most countries offer falls far short of what it would take to overcome competitiveness gaps in lagging regions—and the level that would be required to do so would, in most cases, be simply unaffordable (World Bank 2012).

Overall, there is now widespread recognition that past attempts to use blunt instruments to raise investment in lagging regions have failed, and more nuanced—yet comprehensive—approaches to building regional competitiveness are needed. In this context, it is worth noting that integrating lagging regions into the global trading system has not yet been at the forefront of regional development policies.

Targeting Interventions and Focusing on Competitiveness and Connectivity

Not all lagging regions are the same. Some have greater potential to support agglomeration, others may benefit from cross-border integration, while others may have fewer realistic opportunities to integrate directly into global production networks, but can effectively serve domestic markets. Table 1 provides a basic framework for the regional policies that may be most effective in enhancing trade integration and competitiveness in different types of lagging regions.

At the heart of these policies is a focus on interventions targeted at two objectives: building the competitiveness of the region and its firms and improving its connectivity with domestic and international markets. With these objectives in mind, following is a brief summary of some of the important policy recommendations derived from research outlined by the World Bank (2012):

- Aligning trade and growth strategies with regional comparative advantage: Opportunities emerging from industrial and regional lifecycles—that is, the process by which industrial activities shift from those locations that offer advanced technological inputs and urbanization economies to those that offer low-cost production, scale, and possibly clusters of specialized inputs—offer scope for development and integration of some lagging regions. These opportunities are likely to fall first to the urban fringe, then to intermediate regions. While lagging, peripheral regions should seek opportunities to benefit from these developments, and should do so in the context of strategies that are defined tightly aligned with the regional comparative advantage. Given the challenges of achieving scale in peripheral regions, effective strategies may focus on linking into established production chains anchored in the core or focusing on niche production.

- Attracting and linking foreign and domestic capital: Foreign investors in industrial and services sectors are strongly biased to locating in the core. Therefore, efforts to attract foreign direct investment (FDI) should consume a limited share of resources devoted to lagging regions and be targeted to those sectors in which a region has clear comparative advantage. FDI attraction policies should target sectors and firms with reasonable prospects for integration with the regional economy, particularly if fiscal incentives are being offered.

- Firm-level interventions for skills and access to technology and finance: Efforts to improve the export competitiveness of lagging regions must go beyond the external environment to address firm-level competitiveness. This means introducing new tools and instruments into regional policy, including vocational development and training, access to technology and finance, and addressing management skills and capacity.

### Table 1. Policies for Trade Integration and Competitiveness in Different Types of Lagging Regions

<table>
<thead>
<tr>
<th>Region type</th>
<th>Nature of policies</th>
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<tbody>
<tr>
<td>Near the core</td>
<td>Many of the traditional regional policies may be effective, including investment incentives and export-oriented incentives Promotion and facilitation of agglomeration, including industrial parks/SEZs and cluster policies Investment climate reforms</td>
</tr>
<tr>
<td>Peripheral but with economic mass</td>
<td>Targeted foreign direct investment attraction (following comparative advantage and industry lifecycles) Support to existing industry clusters Transport connectivity and infrastructure Investment climate reforms Firm-level competitiveness interventions (training, finance, and others) Critical importance of governance</td>
</tr>
<tr>
<td>Peripheral and without density</td>
<td>Limited prospects for export-oriented investment—focus on endowment-based opportunities (mining, agriculture, tourism) Focus on social infrastructure and connectivity Firm-level competitiveness interventions</td>
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• **Developing and empowering labor:** Too little attention has been paid to the local labor force in lagging region policies. As recommended in the WDR 2009 (World Bank 2009), policies to promote labor mobility are important, but it is also important for regional policy to focus on education and training to build local skills. Targeting investment incentives toward training and skills development rather than broad tax reductions may be a more effective long-term approach for lagging regions.

• **Leveraging agglomeration—a balancing act:** While agglomerations have a powerful impact on export competitiveness, policy makers should avoid the temptation to build agglomerations where they have not developed organically. Instead, both core and noncore regions should eliminate barriers to natural agglomeration, ensuring appropriate trade and social infrastructure, but also removing regulatory barriers that distort land markets and fragment goods and factor markets. Policies to support the competitiveness of existing clusters may also have a positive impact. In this context, SEZs should be used to accelerate existing agglomerations rather than to catalyze “latent” ones.

• **Exploiting nontraditional channels:** Integrating small producers from remote regions into global markets also requires finding solutions outside established channels. In terms of infrastructure, beyond traditional roads, ports, and airports, investment in information and communication technology networks can allow firms in remote regions to take advantage of electronic platforms to deliver goods and services to international markets. Recent research, for example, finds that the effect of distance on trade is 65 percent lower via eBay than in offline markets (Lendle et al. 2012). Similarly, using existing distribution networks that penetrate peripheral regions can open connectivity opportunities. Brazil and Peru both had notable successes in using their postal networks to facilitate simplified exporting for small firms in rural regions.

• **Connecting and integrating with domestic and regional markets:** Facilitating exports relies on improved connectivity of peripheral regions not only with global markets, but also with national markets. This is important because firms in lagging regions are more likely to be competitive participants in global markets by providing inputs to firms in the core that ultimately export, or by trading indirectly, through agents and distributors based in the core. It also gives firms in lagging regions the chance to leverage scale economies and opens up opportunities for investment from the core. Beyond domestic connectivity, addressing trade policy barriers that prevent integration with regional markets is also critical, particularly for border regions that may be located much closer to large markets in neighboring countries than their own domestic core.

Connectivity policies are, however, particularly difficult when it comes to lagging regions. Indeed, one of the main lessons learned from the failed Mezzogiorno policies in Italy in the 1950s and 1960s is the problem of the “two-way road,” and the risks of subsequent brain drain and hollowing out of local production. While recognizing these challenges, improving domestic connectivity must be central to the policy agenda to raise a region’s competitiveness. This requires investment in hard infrastructure, but also improvements in trade facilitation and, critically, efforts to address regulatory and competition barriers that hinder market access. Domestic trade in India, for example, has long been hampered by a range of interstate barriers, including standards and licensing requirements. And barriers to competition in the transport sector raise the cost of domestic connectivity in many countries—like everything else, this hits peripheral regions hardest because they already suffer from lower levels of competition and lack of scale in transport markets.

### Concluding Remarks

The concentration of the world’s poor in lagging regions of increasingly rich countries presents serious challenges to the growth and stability of emerging economies. However, the opportunity for integrating firms and households in these regions into national and global trade networks is substantially greater than it was only a decade ago. Clearly growth will always be unevenly distributed. And it is unrealistic to expect a sparsely populated, remote, and mountainous region to become the next Shenzhen. But even marginal improvements in integrating lagging regions effectively into global markets have potential for significant impacts on global poverty.

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### Notes

1. Based on the US$1.25 international poverty line, as defined by the World Bank.
2. This research also finds striking differences in a number of firm-related factors that have previously been associated with...
exporting. Relative to firms in noncore regions, firms in the core are on average larger, have a greater share of foreign ownership, have a top manager with more experience, make greater use of technology, and are more likely to have an international quality certification and provide formal training for their workers. What is not clear is whether these firm characteristics are endogenous to the core, or it is a case of spatial sorting—that is, do core regions breed export-ready firms or do export-ready firms seek out core regions?

References

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