Regional Institutions and Competitiveness in a World Recession

ANDREW HARRISON
Teesside University
Middlesbrough, TS1 3BA
United Kingdom
a.harrison@tees.ac.uk

Abstract

Regional competitiveness is determined by a combination of firm-specific and location-specific factors. Location-specific factors may be expressed in terms of the comparative advantages offered by a particular region. One of these comparative advantages is comparative institutional advantage. This paper explores the role of the institutional environment in influencing regional competitiveness in relation to international trade and investment at a time of world recession. In particular, it focuses on the ability of institutions to facilitate adaptive economic efficiency.

Keywords: adaptive, competitiveness, institutions, location, recession

JEL Classification: R11

Introduction

This paper starts from the proposition that regional competitiveness is about the ability of a region to create an environment which is conducive to business growth and is therefore attractive to domestic and international firms and contributes towards a region's economic development. In an open global economy, businesses make location decisions on the basis of firm-specific and location-specific factors, a model of internationalisation encapsulated in Dunning's eclectic paradigm[1]. The main focus of this paper is on location-specific factors at the regional level. Most of the world's sub-national regions are exposed either to the full rigours of international trade and investment in the global economy, to more limited international economic activity within regional trading arrangements, or both. It is therefore important that the regional environment offers comparative advantages to prospective exporters and inward investors. Regional competitiveness is especially tested during a downturn in economic activity such as the 2008-09 world recession. It is the contention of this paper that comparative institutional advantage is of particular importance at a time of economic difficulty, not only to create stability during a period of uncertainty, but also to facilitate adaptive efficiency.

In order to develop the above thesis, the paper draws on developments in the debate on regional competitiveness, especially in the context of an open regional economy, and ideas from the developing field of comparative institutional advantage. Examples are used from a number of countries to illustrate the way in which trade and investment are influenced by comparative institutional advantages. The paper then outlines the course of the 2008-09 world recession and analyses some of the implications of the economic downturn and potential recovery path for particular industrial sectors. Finally, the paper evaluates the extent to which different institutional arrangements are likely to affect a region's ability to withstand economic turbulence, especially during the recovery stage of the economic cycle.

The Concept of Regional Competitiveness

The issue of territorial competitiveness has been the subject of much debate. The use of the term 'competitiveness' in a territorial context came increasingly into use during the 1990s, but the debate was fuelled by Paul Krugman in a 1996 paper, in which he argued that comparative advantage was the appropriate concept to apply to a country rather than international competitiveness [2]. Others have argued that absolute rather than comparative advantage is the core feature of territorial competitiveness, especially at the regional level, implying that regions have to be competitive in a similar way to businesses [3]. In this author's view, Krugman's argument is valid as a basis for international trade specialisation, but not necessarily in relation to the meaning of competitiveness used in this paper, or for that matter by organisations such as the World Economic Forum in its annual Global Competitiveness Report. However, the view that regional competitiveness relates to absolute rather than comparative advantage seems to be misguided. Whilst, as Camagni argues, there is no guarantee that any particular region will prosper, it is surely better for a region to specialise in what it does comparatively well (relatively productively) than to rely on being the best (with an absolute productivity advantage). What is important is that regions are able to offer an environment that enables businesses to be competitive rather than for regions to become competitors themselves.

In this sense, regional competitiveness may involve encouraging knowledge creation and the development of social capital, creating a supportive institutional environment or allowing the market to operate unimpeded. Depending on empirical evidence, or perhaps ideological convictions, these policies may help in various ways to promote creativity, the development of supportive networks, the establishment of property rights or the generation of entrepreneurial activity, among other things. Either individually or in combination, such policies may help to create comparative advantages at the regional level. As illustrated by the above examples, these comparative advantages are of many different kinds, not purely cost advantages as generally assumed in conventional trade theory. However, it is important that regions are able to create conditions that encourage 'trade', both with other regions and internationally, support home-grown businesses and attract inward investors.

Regional Competitiveness in the Global Economy

Given the importance of regional competitiveness for regional development, the more open a region is to the global economy the more important regional competitiveness becomes. In some cases, regional specialisation is determined more by comparative advantages within the global economy than at the sub-national intra-regional level. Where economic activity takes place predominantly within a regional grouping such as the European Union, regional specialisation will also to be influenced by the dynamics of this grouping. This issue is explored further when considering comparative institutional advantage below, with some surprising ideas on the extent to which international openness leads to greater or less pressure for regional convergence.

In the context of open regional economies, there is a growing amount of theoretical and empirical support for the view that regions benefit from regional clusters [4], knowledge spillovers [5], international connectivity through networked multinational operations [6], and reputation building stemming from the creation of an innovative milieu [7], among other things. However, in this paper, we focus especially on the importance of the institutional environment in influencing regional competitiveness and in particular the role of regional institutions in enabling a region to cope with an economic downturn.

Comparative Institutional Advantage

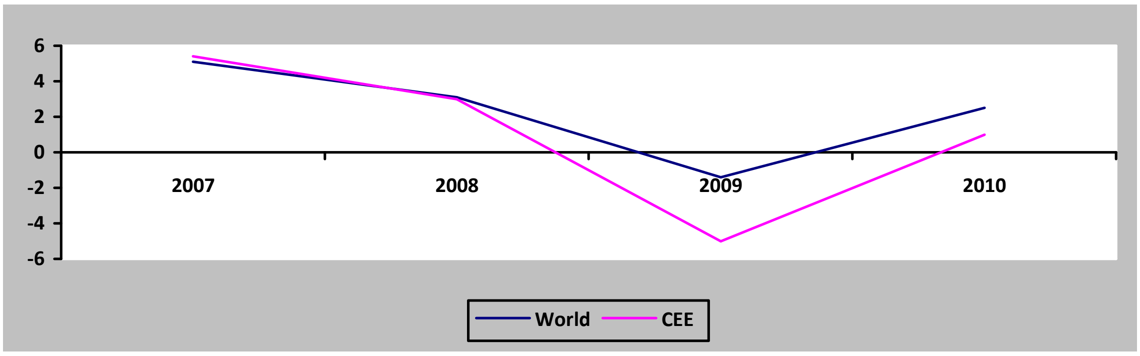
Building on the work of scholars such as Douglass North [8] and Oliver Williamson [9], institutions are now regarded as being increasingly important in establishing the rules by which a market or economy operates and the system of incentives that influences the decisions of consumers, producers and other economic agents. In a regional context, institutions include the system and policies of local authorities, the local taxation regime, the availability and quality of education and training, the nature and extent of inter-firm networks and relationships, the way in which property rights operate, the climate of industrial relations and attitudes towards work, enterprise and internationalisation. Whilst many of these examples represent formal institutions established through legislation or cooperative effort, some of them are based on informal customs and practices. In both cases, cultural influences are likely to have played a significant role in the development of the institutional environment over a period of time.

The importance of the cultural and institutional environment is encapsulated in the literature on varieties of capitalism [10]. Hall and Soskice distinguish between coordinated market economies and liberal market economies, but sometimes a number of further sub-divisions are identified, such as Anglo-Saxon capitalism, Asian capitalism, continental European capitalism or the Rhine model of capitalism [11,12]. Although these varieties of capitalism operate primarily at the national level, they are likely to apply equally at the regional level and may even exhibit regional variations. Whilst there is a tendency to assume that Anglo-Saxon characteristics such as market efficiency and flexibility are necessary for competitiveness in an open global economy, the evidence in practice suggests the picture is more subtle. Franzese and Mosher argue that, whilst there may be welfare losses from trade in countries with apparently inflexible institutional environments, there may also be compensating benefits from such environments [13]; for example, whereas the United Kingdom's free-market institutions may have facilitated the development of an innovative financial sector, Germany's more regulated institutional environment may have encouraged the manufacture of precision-engineered motor vehicles.

In a world of perfect competition, the more flexible institutions would create a more efficient allocation of resources by minimising transaction costs, but in a world of imperfect competition, where competition is based on product differentiation as much as on price, the more inflexible institutions may create a comparative institutional advantage. This accords with the ideas of new trade theory [14]. There may also be some resistance to institutional change in a particular country or region, resulting either from ideological preferences, accepted social norms or path dependence. In such cases, the social and economic transaction costs involved in carrying out institutional change may outweigh the economic benefits from removing obstacles to a more efficient trading environment. Similar arguments have been used to explain Sweden's generally positive economic performance over a number of years, despite high taxes and social protection [15]. An additional factor to consider is that increasing exposure to trade within a regional grouping such as the European Union may even encourage the maintenance of local cultural and institutional diversity 'by reinforcing locally dominant modes of production and by freeing domestic consumption to pursue its distinct preferences even more intensively' [16]. It should also be noted that institutions evolve over a period of time, a point to which we will return when considering the interaction between institutions and creativity below [17].

The Impact of World Recession

Graph 1: Output Projections for the World and CEE Countries, 2007-10 (annual % growth rates)



Source: IMF World Economic Outlook Update, July 2009

Much of the world has experienced severe recession during the latter part of 2008 and throughout most of 2009. For some countries the fall in output has been particularly sharp in 2009, including the United States, Japan, Germany, the United Kingdom and many of the countries of Central and Eastern Europe, whereas for China, India and some of the high-performing economies of Southeast Asia there has been a economic slowdown rather than a full recession. Most forecasts suggest world output will return to growth by 2010, though in much of the world the recovery is expected to be gradual rather than dramatic. The question this paper seeks to address is the extent to which the institutional environment is a help or hindrance, not only during the worst of the recession but more especially during the early stages of the recovery.

Institutions in an Evolutionary Environment

As indicated above, it is now increasingly recognised that institutions have an important role to play in economic growth [18]. Recent research has focused particularly on the role of institutions in creating adaptive efficiency in an evolutionary context. From this perspective, 'Good institutions are those that both develop rules to create economic opportunities and develop rules to grow knowledge, and therefore create new value' [19]. This prescription leaves a number of unanswered questions in practice and clearly a good deal of research is needed to establish precisely what these rules should involve. It is also important to remember that institutions are likely to have different effects in different national and regional environments. However, in order to shed some light on these questions, let us consider an example of how the institutional environment may help to create opportunities and increase knowledge.

How, for example, can the institutional environment support creativity, particularly in a region where it has not previously been evident? Such an example is provided by the author's university town of Middlesbrough in north-east England. Like a number of towns which have experienced industrial decline, Middlesbrough has introduced a variety of regeneration initiatives in recent years. One of its more ambitious initiatives is the DigitalCity project [20]. This project is jointly sponsored by Teesside University, Middlesbrough Borough Council, the north-east regional development agency (One NorthEast), and a number of local business organisations. The DigitalCity project builds on the existing expertise of the University in media technology and digital animation, and aims to combine this expertise with new and growing businesses by providing business units with close access to academic researchers. It will also serve as a vehicle for the commercialisation of academic projects. However, the project organisers are keen to establish a creative community rather than simply technical specialists. To this end, they have set up an area for fine artists and other creative professionals to work alongside the technical specialists, together with live-work accommodation to create a community rather than simply a working environment. These activities take place in purpose-built or adapted premises in close proximity in a previously run-down area of the town.

A number of researchers have been investigating the way in which creative communities evolve [21,22]. In particular, they have focused on factors such as technology and the innovative milieu but also on characteristics such as tolerance and openness. But how can the institutional environment promote creativity? The above example in Middlesbrough suggests that the physical environment is important, but the director of the DigitalCity project recently claimed that the single factor which allowed the project to progress, even at the depth of the recession, was the support of the local council. In fact, the project would not have gone ahead without the political will to make it happen and a willingness to take risks (something which is not always associated with local government). The project also represents a partnership between the University and the town, and its director has been given the freedom to pursue his vision with considerable autonomy. These appear to be some of the institutional characteristics that help to promote a create environment in this case.

Conclusion

Drawing on the concept of regional competitiveness and the theory of comparative institutional advantage in a global context, together with an example of how the institutional environment can promote creativity, the paper attempts to demonstrate the importance of institutions in creating adaptive efficiency at a time of economic turbulence. While the principles apply equally at all points in the economic cycle, the right institutional environment is particularly important when other factors have a more negative influence. It should be noted, however, that there is unlikely to be any single institutional environment that is right for all regions, as this will depend on the existing overarching institutional framework in the region concerned. This should not, however, deter us from the search for appropriate institutions.

References

[1] DUNNING, J. H.: Explaining changing patterns of international production. In *Oxford Bulletin of Economics and Statistics*, vol. 41 (1979), pp. 269–95.

[2] KRUGMAN, P. R.: Making sense of the competitiveness debate. In *Oxford Review of Economic Policy*, vol. 12, no. 3 (1996), pp. 17–25.

[3] CAMAGNI, R.: On the concept of territorial competitiveness: sound or misleading? In *Urban Studies*, vol. 39, no. 13 (2002), 2395-2411.

[4] PORTER, M. E.: The economic performance of regions. In *Regional Studies*, vol. 37, nos 6-7 (2003), pp. 549–78.

[5] DÖRING, T., SCHNELLENBACH, J.: What do we know about geographical knowledge spillovers and regional growth? A survey of the literature. In *Regional Studies*, vol. 40, no. 3 (2006), p. 375-395.

[6] FRENZ, M., LETTO-GILLIES, G.: Does multinationality affect the propensity to innovate? An analysis of the third UK Community Innovation Survey. In *International Review of Applied Economics*, vol. 21, issue 1 (2007), p. 99-117.
[7] AULA, P., HARMAAKORPI, V.: An innovative milieu – a view on regional reputation building: case study of the Lahti urban region. In *Regional Studies*, vol. 42, no. 4 (2008), p. 525.
[8] NORTH D. C.: *Institutions, Institutional Change and Economic Performance*. Cambridge: Cambridge University Press, 1990. ISBN 0521397340.
[9] WILLIAMSON, O. E.: *The Economic Institutions of Capitalism*. New York: Free Press, 1998, ISBN 068486374X.
[10] HALL, P. A., SOSKICE, D.: *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage,* Oxford: Oxford University Press, 2001. ISBN 0199247757.
[11] AMABLE, B.: *The Diversity of Modern Capitalism*. Oxford: Oxford University Press, 2003. ISBN 0199261148.
[12] ALBERT, M.: *Capitalism Against Capitalism*. London: Whurr, 1993, translated from the original French edition (Editions du Seuil, 1991). ISBN 2020132079.
[13] FRANZESE, R. J., MOSHER, J. M.: *Comparative institutional and policy advantage: The scope for divergence within European economic integration*. In European Union Politics, vol. 3, no. 2, pp. 177-203. London: Sage Publications, 2002. ISBN 177-203: 023432.
[14] KRUGMAN, P. R.: *Increasing returns, monopolistic competition, and international Trade*. In Journal of International Economics, vol. 9, issue 4 (1979), pp. 469–79.
[15] SCHNEIDER, G. E.: *Sweden's economic recovery and the theory of comparative institutional advantage*. In Journal of Economic Issues, vol. 41, no. 2 (June 2007), pp. 417-26.
[16] FRANZESE, R. J., MOSHER, J. M., op. cit., p. 197.
[17] POTTS, J.: *Evolutionary institutional economics*. In Journal of Economic Issues, vol. 41, no. 2 (June 2007), pp. 341-50.
[18] NELSON, R. R.: *Institutions and economic growth: Sharpening the research agenda*. In Journal of Economic Issues, vol. 41, no. 2 (June 2007), pp. 313-23.
[19] POTTS, J., op. cit., p.349.
[20] DigitalCity website (www.dcbusiness.eu).
[21] FLORIDA, R.: *The Rise of the Creative Class: And How It's Transforming Work, Leisure, Community and Everyday Life*, New York: Basic Books, 2002.
[22] ACS, Z. J., MEGYESI, M. I.: *Creativity and industrial cities; A case study of Baltimore*. In Entrepreneurship and Regional Development, vol. 21, no. 4 (July 2009), pp. 421-39.