Economic Development Strategies: Diversification or Specialisation?

Which strategy should economic development practitioners follow as they pursue growth: should they seek to diversify the economic base of their region, city or community, or would they generate better outcomes if they were to specialise into one or two sectors that are already established? This is a question that has occupied the minds of practitioners and researchers alike for many years. And it is a question that has been asked for very large cities and regions, but also for quite small communities in both the developed and developing world.

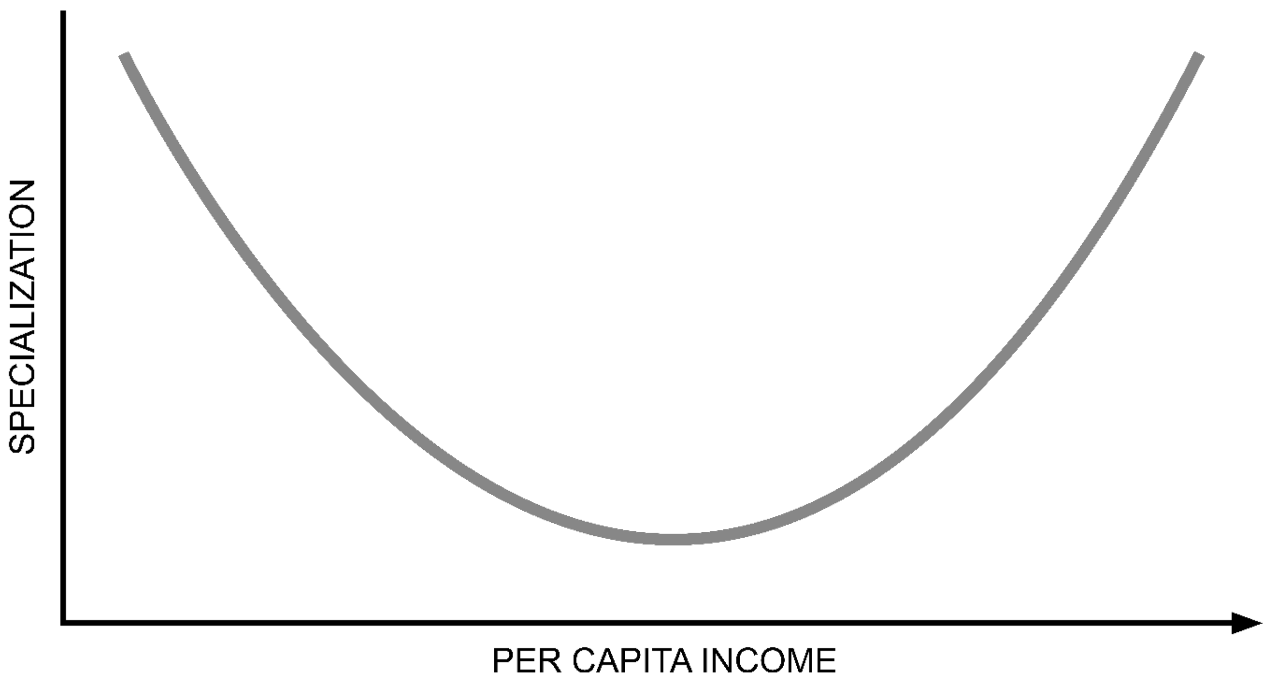
The world is a big place, and there are many, many economists and other commentators who have written on this topic. In the nineteenth century the English economist David Ricardo was the first to argue that places (specifically nations) need to specialise their economies in order to drive productivity growth and the efficient use of resources. His work, which established the idea that places can have a **comparative advantage** in one industry or sphere, looked at trade between Portugal and England, and concluded that the English should continue to focus on manufactured goods, while the Portuguese should concentrate on wine exports. Ricardo, clearly, was an advocate for specialisation.

But others have held different views. American economist Simon Kuznets argued in his 1971 Nobel Prize acceptance speech that

> **'a country's economic growth may be defined as a long term rise in the capacity to supply increasingly diverse economic goods to its population.'**

With Kuznets clearly arguing for the diversification of an economy as it develops, both Kuznets and Ricardo focussed on national economies, not city or regional economies. More recently, both perspectives have been challenged with research showing there is a 'U' shaped relationship between

Figure 1: the relationship between specialisation and income at the national level



the degree of economic specialisation and per capita income at the national level. That is, in nations and regions with lower incomes, the economy is highly diversified, but as income grows production systems become more specialised as markets mature (Ims and Wacziarg 2003). This narrowing of the economy slows and then reverses, as the now-wealthy regions and nations re-specialise in higher order goods and services while also maintaining the basic components of their economic structure (see Figure 1).

However, it is important to acknowledge that cities, towns and regions aren't nations and different dynamics might apply because of governmental system, market structures, or other demographic factors. A great deal has been written about the advantages and disadvantages of specialisation and diversification for individual communities and regions, and some of these themes will be covered off below:

Resilience

It is often argued that places need diversified economies in order to be resilient. That is, cities, regions and communities with diversified economies are less affected – and more resilient – when they experience a major shock, such as the closure of a substantial manufacturing plant or the depletion of resources that previously supported jobs. These diversified economies, it is argued, result in places that are not 'locked in' to one industry or employer, though it is worth noting that larger regions and urban settlements may have an advantage as they are naturally more diversified than their smaller counterparts.

Productivity

It is argued that places that specialise in one or a few industries become more productive as they become very, very good at that one or small number of activities. They are more likely to remain at the cutting edge of technological innovation and have the capacity to develop supporting industries and infrastructure that support their success in the long term. This was the core of Ricardo's suggestion around comparative advantage, but the same insight also applies to the work by Michael Porter and others around competitive advantage. The maxim would appear to be: do one thing and do it well, and you will grow.

Sustainability

Diversified local economies are seen to be more sustainable, as more goods and services can be obtained locally, reducing the carbon footprint of both inputs and outputs. Similarly, diversification can be seen to add to social sustainability by creating the opportunity for existing businesses, including farms, to have a portfolio of activities. These businesses can then make use of multiple income streams, thereby offsetting the risks associated with their primary activity.

Dynamism

Some researchers have argued that diversified economies are more likely to encourage new business ideas and entrepreneurs as there is a broader range of opportunities for those looking to innovate. A great deal of entrepreneurialism involves the transfer of knowledge from one industry to another as individuals move from one sector to the next, or learn about developments and ideas in an unrelated business and apply them to their start-up. Localities with diversified economies are more likely to witness this transfer of ideas and the associated creation of new, viable enterprises.

Inequality

There is a body of literature that argues highly specialised economies are more unequal or unfair. Those who miss out on employment in the prime industry – for whatever reason – suffer economically. The mining sector is often cited as a prime example of this inequality. Those employed in mining are often well paid, but other members of the community outside this sector may struggle to find alternative employment and therefore struggle to make ends meet within a local economy affected by price inflation.

When we examine the published literature on specialisation vs diversification at the level of regions and communities, a number of clear messages emerge:

- the performance of urban centres and regions varies over time in line with broader economic conditions (national and global), including – in the case of the mining industry – global demand for mineral resources (Chapman et al 2015);
- urban centres are more likely to experience strong growth if their economy is specialised, and becomes more specialised over time;
- diversification of the economy may be more important in smaller centres (those with a population of fewer than 10,000 persons) as it may reduce the risks associated with limited population size;
- a more specialised economy is likely to generate stronger economic growth and higher per capita incomes for larger communities, but is likely to generate fewer jobs than a diversified economic base; and,
- the industries or sectors on which a city or region is focused have a large impact on growth rates. Put simply, places with fast growing industries grow more quickly, and those reliant on slow-growing industries are likely to experience more sluggish growth.

In some recent work we examined growth across 180 urban centres in Australia with populations between 5,000 and 50,000 at the 2016 Census, and we looked at:

- population change;
- labour force change; and,
- change in wages and income.

We found that places that became more specialised over the period 2006 to 16 experienced population and labour force growth, but:

- there was a negative impact on wages;
- places were more likely to grow if they were close to a metropolitan area;
- places that pursued completely new industries (i.e. industries that were not present previously) saw wages and incomes fall;
- places that looked to grow in industries already present in their region or community experienced both population and labour force growth.

So what is the answer? Are regions, cities and communities better placed in following a strategy of economic diversification or of further specialisation? The answer seems to be dependent on the size and maturity of that community or city:

- Smaller, less developed places should diversify.
- Larger, more developed places should specialise.

There is a second layer of complexity though: a city, region or community is more likely to see workforce growth and population growth if it specialises, but may be more likely to see wages grow if it diversifies. Ultimately, it becomes a question of what does a community seek to achieve? Which of these worthy goals do they prioritise?

Finally, it is important to consider what types of activities and investments communities and regions should look to for future growth. The available evidence shows that a community is more likely to grow if it is able to further develop and expand the profitability of its existing industries, rather than launch itself into completely new industries. Academics label this 'related variety' but we can more probably think of this as just good sense.

Stepping forwards from existing industry and firm capacity:

- carries less risk;
- takes place with a better awareness of markets and opportunities;
- makes use of existing labour force abilities and infrastructure; and,
- results in productivity improvements as new technologies – new knowledges - are used to make production, marketing and distribution more efficient.

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