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EUROPEAN POLICYBRIEF

Policy options for the development of peripheral regions and countries of Europe

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INTRODUCTION

Objectives of the research

The current financial and economic crisis has drawn renewed attention to the national and regional disequilibria in the European Monetary Union (EMU). After a bumpy catch-up by the periphery countries over the last few decades, several southern European countries suffered severe setbacks, culminating in twin deficits in the public sector and the current account, and – since the beginning of the consolidation period – negative growth and rising unemployment. Disequilibria across European countries push down stability and growth in Europe and challenge both European cohesion and the monetary union.

This policy brief uses the experience of low income regions to investigate which strategies led to the sucessful catch-up in these regions over the last two decades, and which did not. This approach allows an assessment of the options available to peripheral countries in a monetary union, since – like regions within a country – they cannot promote growth or correct policy failures by devaluing the currency. Based on these regional experiences as well as on the results from the literature on growth drivers, we draw policy conclusions on the regional, national and EU-wide strategies needed to successfully restart growth in the southern European periphery.

We focus on Greece, Portugal and Spain (the "southern" peripheral countries which we refer to as the P3 countries), but a number of recommendations are also relevant for Ireland, southern Italy and other peripheral regions of the European Union. Of course no size fits for all and differences across countries are large.

KEY OBSERVATIONS

Problems in the P3 countries before the crisis

The P3 countries did not develop smoothly even before the crisis. Rather, they experienced recurrent problems in competitiveness that were often temporarily alleviated by simply devaluing the currency. However, over the last fifty years the P3 managed, in general, to catch-up remarkably well. Starting from a per capita GDP of only 54% of the EU 15 in 1960, they reached 82% on average in 2008, with Spain coming nearest to the EU average (with 94%), and with Portugal lagging behind by about 30%. The P3 were also quite successful in attracting foreign direct investment and greatly benefited from EU funds after they joined the EEC. On average the share of inward FDI stocks increased from 7% of GDP in 1980 to 22% up to 2000.

Problems started to emerge, however, in the nineties and the first eight years of this century with the emergence of new low cost competitors, and after entering the monetary union. The mounting problems prior to the financial crisis period were:

- A loss in price competitiveness at least since 2000. Wages increased faster than in the other European countries (which is typical for catch-up economies), but productivity did not. In other words, catching-up took place in wages but not in productivity. This resulted in higher unit labour costs in the P3, relative to their major European trading partners.
- An increase in current account deficits in all P3 countries, reaching double digit percentages of GDP. Although such current account problems had happened in the P3 before, they were previously corrected by devaluations.
- A dramatic decline in the manufacturing base in all P3 countries. On average the share of manufacturing declined from 20% of GDP in the eighties to 10% in 2010, relative to a decline from 20% to 13% in the EU 15 in the same time period. A considerable share of this decline occurred between 2000 and 2008.
- A merely modest increase in tourism revenues resulting in a loss of market shares, relative to other major competitors (such as Turkey and North-Eastern Europe).
- A levelling-off of FDI inflows which had helped to close the productivity gap and to promote structural change towards capital intensive and marketing driven industries during a period in which labour intensive industry shifted to low cost competitors.

Closer to the deeper roots of the downward trend is the limited capability for change in the southern periphery and the "rent-seeking" bias of their economic models. Innovation is low, the education system does not provide the skills demanded by firms, labour and output markets are highly regulated, business start-ups are relatively rare and small firms do not grow rapidly. Exports (to some extent also investment shares in GDP) are low, while imports are high and rising. Globalisation tends to be seen as a threat rather than as an opportunity. The share of exports to fast growing and distant markets is low and has not kept up with the dynamics of these markets.

Emergency responses

These imbalances proved to be explosive when the financial and economic crisis of 2008-2009 began. Bailing out banks and efforts to contain the upsurge in unemployment quickly aggravated states' fiscal balance. Parallel public and private deleveraging brought the economy to a standstill. P3 countries tried to solve their budget problems on their own at first, but were subsequently forced to call for help as a result of the extremely high interest rates for their sovereign debt on the financial markets. The conditions for low interest loans were formulated jointly by the European Commission, the ECB and the IMF. They were discussed with individual national governments, but they are rather similar across countries. They combine budgetary measures with elements of internal devaluation (the cutting of wages, pensions, and social expenditure) and some measures for structural reforms.

Blind spots

As a consequence the negotiated strategies summarised in the reform programmes ("memoranda of understanding") between the governments and the European Commission contain the following blind spots:

- There is no call for a new industrial policy or investment to be shifted from infrastructure to production (e.g. creation of firms).
- No emphasis is put on SME clusters, innovation, education and lifelong learning.
- Strategies to boost exports specifically to dynamic global markets are lacking.
- Policy measures to boost alternative energy and import substitution of oil and gas are missing, as are measures to reduce imports and expenditures for military equipment.

Distributional questions such as high levels of unemployment or rising poverty are not addressed even though they risk damaging human capital in the long run; neither is the reintegration of young people in the employment process or gender inequality.

In contrast to successful consolidation events (such as in Sweden and Finland in the nineties), the efforts of the P3 countries are made in an environment where all of the main European trading partners are going for consolidation themselves. Consolidation in such an environment combined with the lack of an active strategy component limited the chances of success from the start.

The results so far

Four years after the financial crisis budget deficits on average still amount to 6% of GDP in the P3 average, and public debt has increased from 75% of GDP to 118%. GDP growth rates have become negative and unemployment rates – in particular youth unemployment rates – have soared.

On the positive side unit labour costs declined due to wage restraints and there was a moderate acceleration in productivity growth. The P3 are now back in the position they were in 2000 relative to their European partners excluding Germany. Relative to Germany, however, unit labour costs have risen ten percentage points faster since 2000.

A relative success is also seen in the halving of the double digit current account deficits over the last four years. This success may, however, prove to be short lived given that half of this improvement is due to a reduction in import shares – which will increase again once the P3 countries resume growth.

The lack of more pro-active policies is understandable given the large public deficits. It is, however, problematic given that the P3 countries – like regions within a country – cannot devalue their currency. The experience of both regional economics as well as the empirical growth literature suggest that pro-active policies (such as policies aiming to attract foreign investments, improve educational attainment, foster R&D expenditures and the support of business start ups and growth) are a necessary precondition for lagging regions to catch up.

Catching-up in a currency union is difficult

The literature on regional development shows that a) the sustained catch-up of regions towards the national average is extremely difficult and is usually associated with repeated setbacks, b) there is less regional convergence within countries than there is convergence between countries, c) regional convergence within countries was slightly slower in the 2000s than in the 1990s. The second point suggests that catching-up in a common currency area (if one likens this to a region within a nation state) is more difficult than for countries which can devalue currencies. The third point indicates that globalisation increasingly challenges the comparative advantages of poorer regions.

In addition this literature shows that convergence has been particularly difficult for the poorest regions in the EU. During the last two decades convergence was limited primarily to middle income regions while for the poorest regions in most EU countries progress was modest. The differences between the richest and the poorest regions actually increased in the majority of the EU countries during the last two decades. In particular we found that:

- Regional disparities in labour productivity – despite reducing in the EU aggregate – increased in 16 of 21 EU countries with more than one region in the last decade.
- Of 133 European regions that had productivity levels below the country median in 1991 only 31 managed to move to above country average levels by 2009. Big leaps forward are even rarer: only 7 regions made their way from the lowest quartile within their country to an above average productivity during the same period of time.
- Catch-up is also quite bumpy: Between 1991 and 2009 only 16 regions experienced at least one five year period of takeoff (in which they outperformed the country average in productivity growth each year and managed to grow by more than 2% annually).
- Chances of catching-up both in terms of productivity and GDP per capita are particularly low when policies primarily provide income support and/or stimulate consumption since this leads to an increase in the demand of products produced in the more

competitive centre. The same holds true if policies are directed at investments that do not fit existing production structures (as in the Mezzogiorno or Eastern Germany). Strategies built on competitive advantages, on deepening inter-firm cooperation, and on fostering clusters are more successful.

Catch-up processes in peripheral regions are thus rather bumpy and characterised by repeated set-backs and the same can be expected for the catch-up process in periphery countries.

Success factors for regional development strategies

According to regional studies as well as macroeconomic growth literature, strategies for successful catching-up in GDP per capita and productivity are characterized by:

- A strong commitment to (i.e. ownership of) a strategy shared by regional actors that is based on a vision of the long run position and the desired specialisation goal. The strategy should build on region specific strengths and institutional culture, focusing on a limited number of priority projects and applying methods of evidence based governance.
- Prudent institutions like development agencies, social partners, knowledge-transfer boards: These are important for the take off of poorer regions as well as for regional convergence in general.
- A high and increasing share of employment in manufacturing and high value-added services (and a lower share of employment in agriculture), as well as sector policies that support structural change and focus on clusters which expand regional strengths.
- Higher shares of (i) educated workers (with secondary and tertiary education), (ii) FDI and specifically (iii) employment in high technology industries
- A long term view of regional development emphasising the need for investment, education, and technology and efforts to attract FDI as well as increasing the openness of the region to trade and migration.
- Adequate financial and institutional support from the centre and higher tier government levels taking the form of fiscal transfers (automatic stabilizers) and investment support, to avoid vicious circles in growth and underdevelopment traps.

Thus, pro-active strategies based on investment and industrial policy are at the core of any successful catching-up process. Accommodating strategies (i.e. strategies based on transfers from the centre) contribute to success when they complement active strategies in the periphery or low income regions. There is only limited evidence for passive strategies (such as declining wages or labour shares) promoting a catch-up: wage levels per employee were relatively higher on average in successful regions.

RECOMMENDATIONS

Success needs a driver and supporting partners

The failure to reduce deficits and debts in the P3 calls for augmenting the current consolidation strategy with a more pro-active policy as suggested by previous regional experiences and predictions from growth theory. Since the erosion of the manufacturing base is at the centre of the current problems of competitiveness, and since higher investment is at the core of a successful strategy to regain growth, industrial and investment policies are specifically needed to complement the current passive strategy of cutting public deficits and labour costs.

Even then the process may be bumpy and periods of success and temporary set-backs may potentially alternate with each other. Also, the reform process will have substantial upfront costs, while the benefits will be reaped much later. P3 countries are, therefore, unlikely to be able to finance such a strategy on their own and this strategy needs to be supported by appropriate policies on the Community level and in the centre.

We therefore structure our recommendations by first detailing the strategy to be followed by the periphery countries and the regions themselves. Then we describe elements of a complementary policy at the European Community level to monitor and support the periphery countries to regain growth and employment and finally we describe supportive policies from high income countries (which could take up the role of the "central regions" in regional catching-up processes).

The driver: a national strategy based on a vision

A vision for the period after consolidation

A successful consolidation strategy has to be based on a vision of where the country (region) wants to be after consolidation. Even if the financial means available for active strategies are limited, the vision needs to guide the structure of expenditure and investment as well as budget cuts and should point out which impediments to structural change have to be abolished. It should be developed in and by the country itself, preferably be elaborated jointly with experts (economists and managers) including expatriates. It should be communicated to the citizens and should be optimistic about the very long run. Taking social partners and youth representatives from both genders on board, as well as creating reform bodies would help to formulate such a vision. Such a broad based nationally governed strategy does not exist currently in the P3.

Rebuilding the production base

Boosting productivity is the priority

Some form of wage restraint, as well as institutional labour market reforms are necessary. This is especially necessary to eliminate the unfair privileges of "insiders", a particularly prevalent problem in the public sector. The main problem causing the loss of competitiveness in the P3, however, is that productivity growth was extremely slow. This increased unit labour cost not only relative to the rest of Europe, but also relative to the increasing number of other competitors.

Remedying this situation needs more private investment, including FDI, more innovation and better cooperation between firms, as well as better schools and universities. Vocational training should be promoted, and secondary and tertiary education should become more technology oriented.

An industrial policy is needed

Given the disappearing industrial base a new systemic industrial policy strategy is called for. In contrast to old style industrial policies which subsidized ailing large firms and prevented necessary market exits, this industrial policy should be based on competition, innovation, business start-ups and closer links between the education system and firms. A new industrial policy for periphery countries requires four pillars:

(i) promoting the entry and growth of firms and increasing competition,
(ii) attracting FDI to accelerate technology transfer and boost productivity while ensuring its adequate use,
(iii) the creation of fiscal transfer institutions to close the gap between education, universities and firms,
(iv) increasing exports specifically to fast growing global markets, using ocean locations and the existence of ports (and providing industrial zones in these ports).

Entry and creation of firms

Providing incentives for growth to newly created firms is one of the main corner stones of such a policy. Micro firms should get incentives (e.g. lower tax burden for additional employees) to grow into small and medium sized firms or gazelles and SMEs should be supported in their growth strategies through export promotion encouraging private sector R&D and facilitating university-enterprise linkages in innovation. Promoting university spinoffs, closing gaps between firms and education, one stop shops and less regulation will also help new firm creation, as will cheap finance and shared risk taking, technology transfer institutions and assistance with administrative issues.

Attracting FDI and embedding it into an industrial strategy

FDI should be made more attractive. While it is not easy to attract investors in general and probably even harder to attract them to southern Europe, FDI is the fastest way to bridge productivity gaps and to import technology. Low property prices, well developed logistics, industrial parks or software centres near universities and near to the ports can be supportive. Fast track administrative procedures and low property prices, good infrastructure, a strategy for reindustrialisation as well as adequate legal institutions are necessary. Some highly visible success stories – maybe by expatriate managers, maybe by non European investors – would help to jump start the inflow of foreign capital. In addition, state assets should not necessarily be sold to the highest bidder, but to the bidder that provides the concept with the highest growth potential. A combination of international investors and a domestic partner holding a strategic minority share (e.g. 25% remaining in the hands of the state, the region, or an institutional investor) could provide highly visible "core enterprises" attracting further FDI as well as domestic firms, so as to create industrial clusters.

Changing structures

Reforming education, promoting innovation, regulation
The education system should be more closely oriented to labour market needs and in particular providing vocational and technical skills. These reforms should also be coordinated with industrial and innovation policy. University spinoffs can be fostered using industrial and software parks. The cooperation with SMEs and research contracts with manufacturing firms should be an integral part of university strategies and be supported by financial incentives from the government, to increase growth perspectives of SMEs. The strict regulation of product markets should be abandoned. Transfer institutions between the educational system and the industrial sector should also be created and the currently low R&D rates should be increased.

Improving the employment impact of expenditure and tax
Without renouncing budgetary discipline, employment and growth can be stimulated by shifting expenditure from old tasks to those promoting tomorrow's competitiveness. Expenditure on administration, high pensions for specific groups and the military could be cut, and partly be used for education, innovation and investment. Investments in capital intensive activities could be reduced to finance employment intensive projects (from intangible infrastructure to the creation and growth of firms).

Shift taxation and boost tax compliance
Tax revenues could be shifted from taxing labour to taxing property or financial transactions. Above all tax compliance should be increased, and the escape of capital to tax havens halted. Administration is rather inefficient, often not based on best practice and readily available electronic standards. Hierarchies and decision processes should be changed in the direction of lean and efficient government adhering to the principles of modern budgeting.

Role of gender and youth in a new reform alliance
Gender gaps should be reduced in existing and in newly built institutions, gender neutrality and promotion according to qualification should be established. Young people should play an important role in the reform processes, hierarchies should allow for more vertical and horizontal mobility, job changes between the public and private sector should be facilitated.

Defining competitive advantages

Making use of globalisation, location and ports
The southern peripheral countries have low and slowly growing exports to dynamic economies in the Mediterranean and worldwide. Given their history in previous periods of globalisation, the ports could be used to boost exports. Industrial zones and logistics centres with special rules and less administrative red tape could provide the basis for this. In addition focusing export promotion policies on fast growing markets could encourage firm growth and improve export performance.

Centre of alternative energy
Peripheral southern countries have large imports of energy, specifically oil and gas and a high share of coal in generating electricity. As shown by some initiatives for alternative energies in Portugal and Spain, southern countries could become a laboratory for the development of alternative energies (such as wind and solar power).

Upgrading tourism
The common comparative advantages of the P3 also suggest substantial strength in tourism. The quality of tourism should therefore be upgraded. The central goal of tourism policy should be shifted from supporting low value added mass tourism to developing high value added tourism forms including health and wellness tourism or cultural tourism. In addition efforts should be made to lengthen seasons, by diversifying visitor structures and attracting new customers from other regions of the world than the EU.

Support: EU-wide policies

Even the best national reform strategies in the southern periphery countries will, however, need the support (and some monitoring) of the higher tier unit of government (i.e. the European Commission). Existing financial resources on the Community level should be targeted and better used. More money needs to be made available for long-run growth components in the consolidation process, knowledge transfer should improve administration in the P3, and a supportive monetary policy is needed.

Better targeting of existing funds
A larger share of the structural funds should be used for periphery countries. Periphery countries should speed up the application for funds and manage the projects more efficiently so as to maximize the impact of any investments as early as possible. The improvement of administrative capacity, either through inter-governmental cooperation or monitoring by the European Commission, is key to optimising the use of money available at EU level. In this perspective, the idea of contracts between the Commission and the periphery countries should be experimented.

The funds should also be used to more strongly support new and small firms, technology parks and service centres (where business start-ups share resources) and focus in general on the growth drivers in medium skill sectors. The funds should foster convergence among EU countries by mobilizing the growth potentials in all regions of the P3 countries to contribute to this goal.

Coordination between funds and policies
Funds for agricultural policy and regional policy will be coordinated in the new programming period in a better way than in the past as foreseen in the current legislative proposal for cohesion policy. The emphasis of agricultural policy and the allocation of funds should be furthermore shifted away from the support of agricultural holdings towards the broader aim of sustainable rural and regional development (i.e. by promoting structural change and new enterprise formation in rural regions). Fewer funds should be used to subsidize

large scale farming; more should be devoted to make farms more productive, to enhance the production of high value products and to establish strong value chains in food processing and local services. The major goal should be to promote structural change and more funds should be allocated to measures on facilitating it.

Increasing the level of support

The newly planned growth enhancing measures of the EU (€ 120 bn announced after the June summit) should be speeded up and a large part should be used to boost employment and the creation of new firms in the southern periphery. Measures to increase the credit facility of the European Investment Bank should be accelerated and the strategy of the EIB should be coordinated with regional and agricultural funds.

A stabilisation fund for investment and employment creation in periphery countries should also be established. This fund could be initially financed from part of the proceeds of a financial transaction tax and could subsequently be replenished through repayments or by issuing bonds.

Providing fiscal transfers as automatic stabilizers of shocks

In the long run a fiscal transfer system that acts as an automatic stabilizer for regions affected by region specific shocks must also be part of the governance structure in the European monetary union. Such a transfer regime could be based on a common European unemployment insurance system or other social transfers on the expenditure side of the EU's budget or on business cycle sensitive taxes such as financial transaction taxes on the revenue side. Such automatic stabilizers accommodate about one third of an asymmetric shock in the US.

Reducing disequilibrium including income distribution

The Macroeconomic Imbalance Procedure (MIP; which should detect imbalances threatening the future development of countries) should be made more symmetrical with respect to countries with deficits and surpluses in the current account balance.
Distributional concerns (e.g. measures of wage dispersion and wage shares relative to GDP) should be included in the current Imbalance procedures.

Supportive monetary policy

The ECB should continue to stabilize the interest rates in the periphery countries provided they comply with agreed programmes (to take into account moral hazard problems) while the ESM should be used to recapitalize banks in periphery countries and to thus lower the burden on governments from banking recapitalisation.

Debt mutualisation in the Eurozone is necessary, at least to some extent. It makes no sense for Eurozone members to pay higher interest rates on average than the US, the UK and Japan, which are all regions where debt is higher relative to GDP. A redemption fund, in which countries pay back their debt slowly and at very low interest rates is one possibility. Eurobonds are another. A one-time cut in debt will be indispensable for one, or all, southern periphery countries.

Improving knowledge transfer
The European Commission should also encourage inter-governmental support and knowledge transfer when it comes to designing active labour market policies in particular those aiming at improving employment chances of youth and increasing female labour force participation.

Reducing tax evasion
The European Commission should foster tax compliance, administer structural funds as well as monitor restructuring policies in other areas of national and regional policies (e.g. an active labour market policy providing an own public sector adjustment facility) and should co-operate with the periphery countries in trying to restrict illegal capital exports and support strategies which transfer money back to the P3. When money is transferred abroad there should be strict investigations as to whether taxes were paid (thus reversing the current burden of proof).

Support: Spillovers from the centre

Finally, policies should also take into account the interaction between the centre (i.e. the leading countries) and the periphery of the monetary union, since the empirical evidence shows that catch-up works best when spillovers from the centre facilitate adjustment in the periphery:

Aligning wages with productivity growth
Wage shares in income have fallen drastically in several European high-income countries and firms have become net creditors in the last decade. Boosting domestic demand in "successful" Euro-countries by increasing wages at least as fast as productivity and by stimulating private investment to create positive spillovers would contribute to facilitating adjustment in the periphery.

Increasing consumption by reducing income spreads
Similarly, reducing or at least preventing a further increase in wage differentials among workers and increasing the income of the young as well as women would also foster increased consumption in the European core, as low income groups tend to spend more of an additional Euro in income on consumption than the more affluent part of society.

Going for excellence in energy saving and sustainability
Finally, fostering investments with double dividends like investment into environmental and energy saving technologies and pursuing the strategic goals of Europe 2020 could provide another source of expansionary policies in the centre, which could facilitate adjustment in the periphery.

All these measures, in principle, increase economic welfare in the leading countries. They create positive spillovers for periphery countries and help to limit transfers made necessary in long consolidation periods.

Summary

Periphery countries do not only need more time for budget consolidation, but they need a strategy shift. A new strategy for the periphery is necessary. It is also feasible, if.

- Reforms primarily build on efforts of the periphery to develop a nationally owned strategy, focusing on productivity increases, technology imports, restructuring the industrial base and boosting exports to dynamic countries. An active growth component during fiscal consolidation, a vision of where to go and a new industrial policy are absolutely necessary during the period of consolidation.
- The efforts of the periphery countries are supported at the community level by providing additional funds for investments concentrated on the creation of new firms and jobs. The community can also help in reforming institutions according to the European best practice. More time could be given to achieve the consolidation targets, however only if the proactive component is strengthened. The European Central Bank together with stability enhancing institutions (ESM, structural funds) should support a long period of stable and low interest rates. The stability of the financial markets is increased by the creation of a banking union. Investment and employment are created by Structural Funds, the European Investment Bank and a new Stabilisation Fund.
- Indirect support by creditor countries is provided e.g. by increasing domestic demand and maximizing spillovers from the "centre" to the "periphery". Countries with external surpluses and budgetary leverage stimulate consumption in their own countries by wages following productivity, by reducing wage differentials and by promoting excellence in education, innovation and new environmental technologies and by supporting overall European growth in line with the Europe 2020 strategy.

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RESEARCH PARAMETERS

Objective of the research

In the face of the financial and economic crisis and long-term challenges from globalisation, demographic shifts, climate change and new technologies, Europe needs to redefine its development strategy. The objective of WWWforEurope – Welfare, Wealth and Work for Europe – is to strengthen the analytical foundation of this strategy. It goes beyond the Europe 2020 targets of smart, sustainable and inclusive growth and lays the basis for a socio-ecologic transition. The new development strategy aims at high levels of employment, social inclusion, gender equity and environmental sustainability.

The research programme

WWWforEurope will address essential questions in areas of research that reflect vital fields for policy action to implement a socio-ecological transition:

- It will deal with challenges for the European welfare state, exploring the influence of globalisation, demography, new technologies and post-industrialisation on welfare state structures.
- It will analyse the impact of striving towards environmental sustainability on growth and employment and provide evidence for designing policies aimed at minimising the conflict between employment, equity and sustainability. This involves using welfare indicators beyond traditional GDP measures.
- It will investigate the role that research and innovation as well as industrial and innovation policies can play as drivers for change by shaping the innovation system and the production structure.
- It will focus on governance structures and institutions at the European level and the need for adjustments to be consistent with a new path of smart, sustainable and inclusive growth.
- It will explore the role of the regions in the socio-ecological transition taking into account institutional preconditions, regional labour markets and cultural diversity and examining the transitional dynamics of European regional policy.

This research will be conducted within a coherent framework which from the outset considers linkages between research topics and highlights how different policy instruments work together. The results of all research areas will be bound together to identify potential synergies, conflicts and trade-offs, as a starting-point for the development of a coherent strategy for a socio-ecological transition.

Methodology

The project builds on interdisciplinary and methodological variety, comprising qualitative and quantitative methods, surveys and econometrics, models and case studies.

PROJECT IDENTITY

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