

Europe's Regions: Engines of Millstones?

March 1995

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Networking Scotland in Europe

SCOTLAND EUROPA ★

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Paper No. 1
March 1995

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THE SCOTLAND EUROPA CENTRE PAPERS

This is the first of the Scotland Europa Centre Papers; a series of occasional papers which have two objectives:

- to make a Scottish contribution to key issues that will effect the development of the European Union;
- to promote a wider understanding of European issues in Scotland.

The Scotland Europa Centre Papers are intended to provide a forum for interested parties in Scotland to promote ideas and perspectives on issues that are of importance to the development of Scotland and the EU. The papers will be given wide circulation in Europe and Scotland. Contributions to the series are invited.

The views expressed in the Scotland Europa Centre Papers are those of the authors and do not necessarily represent the views of Scotland Europa or its members and partners.

We would be very pleased to have your views on any of the ideas raised in the papers or for you to arrange to receive further papers in the series. Please contact:

AN INTRODUCTION TO THE SCOTLAND EUROPA CENTRE, BRUSSELS

The Scotland Europa Centre works as an umbrella organisation promoting Scottish interests with the institutions of the European Union. It was opened in May 1992. Eight separate and independent Scottish organisations share the premises. It has become well-known as the Scottish centre in Brussels and aims to create a higher profile and coherent image for Scotland as a whole across the EU institutions.

As well as representing Scottish interests to the EU, the organisations within the Scotland Europa Centre share two other aims. Firstly we wish to contribute to the development of the EU by sharing our experiences of how its policies have operated in the diversity of situations in Scotland. We aim to do this by developing a regular, open dialogue with the European Commission, European Parliament, the Committee of the Regions, the Economic and Social Committee, other regional offices and others, across a range of issues. We believe that exchanges of this type are fundamental to determining the best policies for the future of the EU.

Secondly we hope to stimulate interest in and awareness of the EU and its policies amongst Scottish companies, institutions, local government and people. We aim to do this by building upon the established information service we provide to our member organisations in Scotland to stimulate thinking about the role of Scotland in Europe.

EUROPE'S REGIONS: ENGINES OR MILLSTONES?

Charlie Woods; Chief Executive, Scotland Europa

Inaugural Lecture, Centre for Public Policy and Management, The Robert Gordon University, Aberdeen, Scotland. March 7th 1995.

Introduction

Regional policy has become an increasingly important part of the European Union's (EU) work. The current programme of action, which is budgeted to cost 142bn ECU (113bn) between 1994 and 1999, will involve twice as much EU investment in the regions as took place between 1989 and 1993. Economic and Monetary Union (EMU) and the further expansion of the EU to include the former communist states of eastern and central Europe will significantly change the environment in which regional policy operates. This will put increased pressure on the EU budget and will require a fundamental review of the objectives and operation of EU regional policy. The European Commission has already indicated that this work will begin in 1995. For countries like Scotland, which currently receives around £170m a year in regional investment from the EU, this the results of this work will have important implications. This paper considers the role that regional policy currently plays in the development of the European Union and the way in which it may develop in the future.

One of the major challenges faced by Europe is to increase its international competitiveness, its growth rate and its ability to generate employment opportunities. Looked at from a traditional perspective the economies of regions that benefit from European Union regional policy measures are often seen as something of a drag on the overall performance of Europe as a whole. This paper looks at some of the factors underlying the development of strong regional economies and argues that to see Europe's under performing regions simply as millstones on the rest of Europe is to miss a chance to realise new economic development opportunities for Europe as a whole. Properly used, regional policy could help fire some new engines of growth across Europe. To fail to do this would not just be a missed opportunity, it could also result in increased pressure for greater financial transfers in the future to prevent lagging regions from becoming further detached from the mainstream of European development.

Regional Problems and Potential in Europe

The economic problems faced by different regions in Europe vary greatly. This is recognised to a great extent by the different objectives in the current structural policies (see below). The nature of the problems faced include underdevelopment, industrial decline, agricultural decline, urban deprivation, peripherality and sparsity of population. In some areas the problems are deep seated structural problems which have built up over years of decline or backwardness. In these instances the process of cumulative causation identified by Myrdal¹ in the 1950's (a vicious cycle of decline which feeds on itself and which is not self correcting) often continues to exacerbate the problems. In other regions the problem may be more one of fragility caused by distance from key markets or over dependence on one industry, when a regional economy can be unduly susceptible to

¹"Economic Theory and Underdeveloped Regions", Gunnar Myrdal, Duckworth (1957)

changes in external factors. This fragility can often result in deeper structural problems if a vicious spiral of decline sets in following an external shock to the economy. The degree to which all or part of the country in which the region is located suffers from economic problems is also an important factor in both the nature of the regional problem and the member state's ability to deal with it.

The varied nature of regional problems manifest themselves in a number of ways - high unemployment, underemployment, low activity rates, low productivity, out migration and low incomes. The underdeveloped rural regions in the south of Europe tend to suffer low incomes and low productivity, while declining industrial areas tend to suffer from above average male unemployment. The range of economic performance across Europe's regions is wide. From income per head of a third to half the European average in Greece, Portugal and eastern Germany (and correspondingly low productivity) to income per head of nearly twice the European average in Hamburg and Brussels. Unemployment ranges from over 20% in parts of Spain to below 5% in Luxembourg. On most indicators Scotland is around the European average, although there are significant differences within Scotland (such as relatively low incomes in the Highland and Islands and above average unemployment in parts of Strathclyde). The relative prosperity of Scotland and most other regions currently in receipt of EU regional investment will increase as the countries of eastern Europe (with incomes per head of less than a third of the EU12 average) enter the EU.

The unrealised economic potential of different regions also varies depending on the nature of the problems faced and the amount of economic development that the region has already undergone. The skills, experience, expertise and infrastructure that a declining industrial region may possess are a valuable asset on which future development can be built. The assets of a undeveloped area or one that has been subject to decades of a different economic system will be completely different as will its unrealised potential. This is an extremely important factor when shaping the broad principles of regional policy and the specific programmes that are appropriate to a particular area. Policies and programmes must build on the realistic economic development potential of an area if they are to benefit the region in any sustainable way and make a wider contribution to the economic strength of Europe.

Current European Regional Policy

EU policy to stimulate the economic development of Europe's regions is aimed at: achieving economic and social convergence in the EU to ensure that the benefits of a single market are felt across the EU, maintaining widespread support for the European project and allowing the development of closer economic and monetary union in the EU. Action to stimulate regional development is embodied in the Structural Policies aimed at the following types of regions:

- Objective 1 regions are areas where development is considered to have significantly lagged behind the rest of Europe, such regions include all of Ireland, Portugal and Greece, much of Spain, Eastern Germany and Southern Italy and the Highlands and Islands of Scotland. The main indicator of development used is GDP per head and all regions where GDP per head is less than 75% of the European average are Objective 1 regions. Objective 1 regions will receive around three quarters of the EU's Structural Funds over the period 1994-99. In addition the four poorest countries (Spain, Portugal,

Ireland and Greece) also benefit from a special Cohesion Fund agreed at the time of the Maastricht Treaty (see below). 27% of the EU12's population live in Objective 1 regions.

- Objective 2 areas are areas that are suffering from industrial decline with high levels of unemployment and below average income. They include areas such as West Central Scotland, South Wales, the North-East of England, North-East France and Catalonia. These regions will receive around 9% of the Structural Funds. 17% of the EU12's population live in Objective 2 areas.
- Objective 5b regions are rural areas suffering structural decline linked to the decline of agriculture and fishing. These areas will receive around 4% of Structural Funds. Regions covered include large parts of southern France, northern Spain, Dumfries and Galloway, Borders and parts of Tayside, Grampian and Central Regions. 8% of the EU12's population live in Objective 5b areas.

A new type of region, Objective 6, has been added to coincide with the accession of the Nordic countries to the EU. This provides support for sparsely populated areas with a population density of less than eight people per sq. km. No Scottish regions are covered by this objective although the Highlands and Islands almost qualifies with a population density of nine people per sq. km.

In addition to the structural objectives set out above the period 1994-99 will also see over 13bn ECU being spent on 'Community Initiatives' focused on specific issues, e.g. cross border co-operation, urban problems, decline in specific industries and ultra-peripheral areas.

Also included in Structural actions is the Cohesion Fund which aims to assist those countries (rather than just regions of countries) which will have difficulty in achieving the economic convergence criteria needed to enter EMU. In many respects this is a variant of regional policy. It allows countries to continue investing in their economic fabric, without putting undue pressure on their public finances and hence their ability to enter EMU. It is targeted at whole countries with GDP per head of less than 90% of the EU average (Spain, Greece, Portugal, Ireland). 15bn ECU is budgeted to be spent on the Cohesion Fund up to 1999.

In 1995 around 26bn ECU will be spent on Structural Policies, this is budgeted to rise to 36bn by 1999. Over this period the structural actions will take around a third of the EU budget. The amount spent by the EU on Structural actions has increased significantly over the years from 58bn ECU in 1958-88 and 64bn ECU in 1989-93, to a planned total of 142bn ECU in 1994-99 (1989 prices). Over the 1994-99 period the majority of the Structural Funds (around 75%, up from 62% in 1989) will be targeted at the Objective 1 regions. This 'concentration' on the poorest areas is a deliberate act of policy to try to have maximum impact in these areas and break the spiral of underdevelopment which afflicts them.

As well as increasing in size over the years there has also been a changing emphasis in regional policy actions away from support for individual projects to a focus on more coherent programmes of projects to benefit particular regions, with the programmes being

planned and implemented by partnerships at a local level. Increasing emphasis has also been given to business development and other 'softer' actions over upgrading the basic infrastructure of regions.

Industrial Location and Competitive Advantage

Before looking at the changes that may take place in the environment in which regional policy operates it would be helpful to consider some recent analysis which looks at the process by which successful industries develop and the role that location plays in this process. This has important implications for the role that regional policy could play in Europe.

The Competitive Advantage of Nations² was a major study by Michael Porter, of the Harvard Business School, of ten countries (Denmark, Germany, Italy, UK, Sweden, Switzerland, USA, Japan, Singapore and Korea) and over 100 industries. The essence of the study was to understand why internationally competitive industries develop where they do. The study highlighted the role of innovation in developing and sustaining competitiveness, putting it at the centre of the process by which firms develop and maintain competitive advantage. The study also emphasised that no country is competitive in everything. For example Japan is considered to be a very internationally competitive country, yet it is only competitive in 100 out of 4000 industries.

One of the study's most interesting conclusions was that despite increasing globalisation, leading internationally competitive companies in specific industries are often found in clusters in one country or more often in one region. The most widely quoted examples are from the US; Computers in Silicon Valley, Entertainment in Southern California, Automobiles in Michigan. Similar clusters are also found in Europe; Printing Presses in central Germany, Food Machinery in Bologna, Ski Boots in Montebelluna, Cut Flowers in Holland, Cars in Southern Germany, Super cars in Modena, Machine Tools in Stuttgart, etc.

Much of Porter's analysis builds on Alfred Marshall's observations about the location of industry in Britain at the end of last century.³ Marshall emphasised the importance of industry clustering for the supply of skilled labour, for the development of specialised support services and for the exchange of information and the dissemination of new ideas to improve products and processes. In many ways the Porter analysis confirms that what Marshall said about the development of competitive industries in Victorian Britain (with its centres of cutlery in Sheffield, lace in Nottingham, cotton textiles in Lancashire etc.) is as relevant to modern globally competitive industries as it ever was.

There is a school of thought that suggests that new communications technology will weaken the tendency of industries to cluster as operations become less location dependent. However, it is also possible that such technology could have the opposite effect with key players and organisations still choosing to remain in close physical proximity to facilitate effective human interaction. While at the same time more people have access to this hub and pour information into it, in the expectation of getting something out of it, thus

² "The Competitive Advantage of Nations", Michael Porter, Macmillan, New York (1990)

³ "Principles of Economics", Alfred Marshall (1890)

intensifying the importance of the cluster and its ability to innovate and remain competitive.

Porter's work stressed that this clustering in particular locations is a key part of what makes industries innovate and become competitive. He identified four main elements at work in establishing and developing a cluster:

1). Factor Conditions - The factors that are traditionally considered to influence location decisions, such as skills, raw materials, infrastructure etc. available in a particular area. Over and above these basic factors there are also advanced factors that are more important the more sophisticated the cluster. An important stimulus for the development and maintenance of a competitive cluster can often be a major scientific research facility or higher educational establishment. For example, while there were many mutually reinforcing factors at work in the growth of Silicon Valley, the role played by Stanford University in providing the seed for much of this development can't be underestimated.

An important implication of this is that decisions on the location of research institutions and contracts can have a significant impact on regional development. However, recent research⁴ has shown that 75% of public research contracts in Europe are currently concentrated in 'Islands of Innovation' that are located in the heart of Europe, between south-east England and northern Italy. Similarly much commercial R&D is also carried out in the heart of Europe. This has important implications for regional development and is a reminder that it is not just the traditional regional policy measures that can be important in stimulating regional development.

2). Demand Conditions - the importance of demanding local customers and a demanding local environment acting as a spur to company innovation, e.g. the fact that two of the world's three leading suppliers of mobile phones come from Scandinavia is not unrelated to the sparsity of population in the area.

3). Related and supporting industries - finance, suppliers etc. which understand and are geared up to support the specific requirements of local industries. The role of the venture capital industry (which has built up a close understanding of the specific needs and risks involved in supporting new, fast growth, high tech firms) in promoting the growth of the electronics based industry in Silicon Valley is often cited in this regard.

4). Firm strategy, structure and rivalry - in particular the role that intense local rivalry and good local communication networks can play as a spur to innovation. Rivalry is important not just in terms of 'normal' competition between firms, it is more akin to a personal rivalry where the motivation is as much pride in technological success as commercial interest. Such local rivalries are usually played out against the background of a very good local communications network (professional and social) which can quickly spread innovative thinking.

These four factors mixed together and spiced with the influence of Government actions and chance operate to form a mutually reinforcing process with innovation at its core. Geographical concentration focuses the four elements, all of which are necessary but not

⁴ "Islands of Innovation", Ulrich Hilpert, FAST, Prospective Dossier No.1 Science and Technology and Social and Economic Cohesion in the Community (1992)

sufficient conditions for competitiveness, into a coherent system which forces companies to continually innovate to stay competitive. The intensity of the competition at a local level means that firms that succeed locally are also likely to succeed internationally. As Porter says: "The process of creating skills and the important influences on the rate of improvement and innovation are intensely local".

Implications for Regional Development

Porter's work has important implications for regional economic development in Europe. Some are positive. Depending on the balance of the four elements set out above some regions may offer great potential for the development or growth of certain clusters that will become internationally competitive. If this can be encouraged it will have a positive effect on Europe's overall competitive position and ability to generate income and jobs. Economic development policies can play a key role in kick-starting the development of a sustainable competitive cluster and a virtuous cycle of development.

Some of the implications are negative. If regions lack most of the key attributes of a competitive cluster the mutually reinforcing nature of the process may make it difficult to initiate development. Public sector action can help overcome some shortcomings, but an attempt to overcome too many would be expensive and likely to fail. It is therefore vital that any attempt to initiate the development of a competitive cluster should build on the potential for success that already exists in the local economy.

The most important lesson to be drawn from Porter's work in the context of this paper is that the localised nature of the process by which internationally competitive clusters develop means that regional policy has a potentially significant role to play in building a more competitive and dynamic European economy.

Future influences on the European Regional Policy

The two major new influences on European regional policy in the years ahead are further expansion into eastern and central Europe and Economic and Monetary Union.

Economic and Monetary Union is likely to put increased demands on the structural funds budget if countries enter a currency union before their economies are able to be tied into the stronger currencies of Europe. This was the reason for the convergence criteria (covering relative inflation and interest rates, public sector indebtedness and currency stability) set out in the Maastricht Treaty to which were aimed at assessing the ability of countries to enter EMU.

At the moment the economically weakest countries do not meet the Maastricht criteria and show little chance of doing so in the near future. However, if political considerations get the upper hand over economic and financial considerations and countries do enter before they are ready this will give them difficulties. If their economies are having trouble competing with the stronger economies they will have no room for manoeuvre on exchange rates and interest rates and they will have limited options as far as fiscal policy is concerned. If wage levels and other costs are inflexible downwards this will put upward pressure on unemployment and/or increase out migration. This will lead to increased demands for financial transfers to support the economies of these countries.

Expansion to the east (probably to include the Visegrad countries of the Czech and Slovak Republics, Hungary and Poland in the first instance) will also place new demands on the structural funds. Expansion will add significantly to the range and scale of regional problems in Europe combining underdevelopment, industrial decline, low productivity and low incomes with the legacy of decades of operating under a completely different economic system and significant environmental problems. Under the present regime of regional policy all the countries that might enter from the east would qualify as Objective 1 areas. Estimates range from 50 to 100% increases in the budget being needed to accommodate them if no changes are made. This type of increase is unlikely to be financed by the richer members of the EU. A senior Government spokesman in Germany⁵ has already indicated that Germany sees the need for fundamental changes to be made to regional policy and funding once the present programmes are completed in 1999. So changes will be required in the type of regional policies adopted and the eligibility of regions to benefit from them to accommodate the entry of countries from eastern and central Europe. It is difficult to see many regions that currently benefit from the EU's regional policies continue to benefit from such policies in the future if current priorities remain the same and funding levels remain unchanged or fall.

With both EMU and expansion to the east the balance between the political desire to strengthen European integration and encourage the new democracies to strengthen their ties to the west will have to be balanced against its economic and financial feasibility. The judgements involved in moving towards both will be critical to Europe's future in the twenty-first century. Premature expansion or entry into EMU may have certain political attractions to some member states but the impact of this could be ultimately counterproductive to European development if the budget pressures are too high or the economic consequences are not sustainable. Indeed the dangers of expanding to the east too quickly were highlighted by the new Regional Commissioner, Monika Wulf-Mathies, at her hearing with the European Parliament in January.

A Missed Opportunity?

There is a danger is that the budget pressures from these new influences will lead to what remains of regional policies in the next century being focused only on alleviating the plight of the poorest underdeveloped regions while the potential of other regions such as the traditional industrial centres, peripheral areas and sparsely populated regions is ignored. Indeed this would be the logical extension of current policy of the 'concentration' of structural funds. If this was to happen it could not only store up problems for the future in declining and fragile regions, it would also be a missed opportunity to make a contribution to Europe's overall development.

If we accept the Porter analysis that innovation is at the heart of economic development and that the proximity of key economic agents plays an important part in releasing innovative forces, then the people, companies, universities and other players in many of Europe's under performing or economically fragile regions offer significant potential to develop new products, processes, companies and ultimately industries that can compete in international markets. This will enhance the competitiveness of Europe, improve its

⁵ Jurgen Stark, State Secretary Finance Ministry, (Chancellor Kohl's representative in preparations for the 1996 Inter Governmental Conference). Reported by Reuters 23 Feb. 1995.

balance of payments, create new jobs and diversify Europe's trading base. There is therefore a strong case for the putting investment to help realise this potential at the heart of the EU's regional economic development policies.

The right type of investment by the EU (in concert with national and regional partners) in the right place at the right time can help make the difference between stimulating a virtuous upward spiral of development and allowing a potentially successful region to slip into a vicious downward spiral of decline. Investment at the right point in this process offers the chance of overall benefits to Europe and will help avoid having to invest even more to break a deeper spiral of decline in the future. It may also be that the right type of investment need not only come from traditional sources of regional policy investment, with more attention being paid to the regional implications of other forms of EU investment particularly those focused on increasing research and development improving cross European transport links.

A Scottish Perspective

Scotland has a system of economic development which recognises the need to respond to the urgent and severe problems of economic decline in certain areas while at the same time investing in other areas to help them realise their economic potential. If the distribution of resources to the Local Enterprise Companies (LEC) in Scotland was driven totally by reference to such indicators as relative unemployment rates and income per head Grampian Enterprise would receive little to invest compared to the other LECs in the Scottish Enterprise area. However, the potential that Grampian offers for the overall development of Scotland, as it builds on its traditional industries and strengths while taking advantage of North Sea oil and gas developments, is well recognised. So economic development resources in Scotland are not allocated simply according to an analysis of relative economic performance, attention is also paid to the plans that have been drawn up locally to realise the area's potential. The principles that lie behind these policies in Scotland perhaps have something to offer Europe as it wrestles with the diverse calls on the structural funds in the future.

Conclusion

It is short-sighted to look at all the regions of Europe that are currently suffering from some form of economic problem at the moment as simply being millstones round the neck of the rest of Europe. With the right sort of EU policies complementing the actions taken by national and local governments many of these regions offer the potential to make a significant positive contribution to Europe's future economic development. However if this economic potential is overlooked as pressure builds on regional and other structural funds they could indeed become millstones in the future.

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