Gruppo di Discussione
Crescita Investimenti Territorio

A.I.S.Re

edited by
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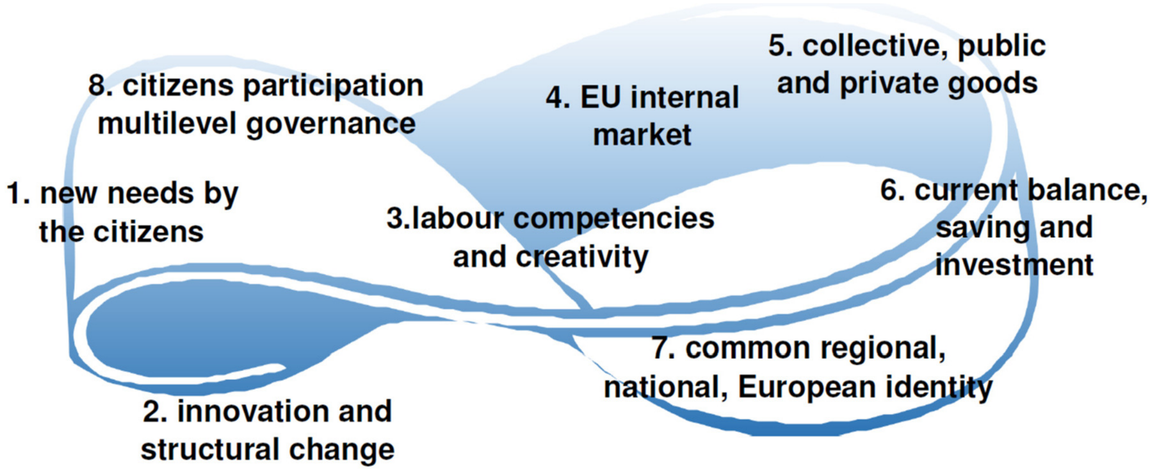
The guidelines of a "New European Industrial Strategy" oriented to the citizens and the territory:

policy proposals for the European economic growth



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Unbalanced structural change in Europe: implications for regional and industrial policies [1]

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Position paper

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Unbalanced structural change in Europe: Implications for regional and industrial policies[1]

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ABSTRACT

Uneven development, both across countries and within countries, is one of the most relevant economic challenges for the overall stability of Europe, together with the main political threats related to security, migration, and the mounting of Euroscepticism. However, the discussion on these phenomena and the future of the European Union is not always based on objective data, as it should be in an open, free and informed democracy.

The debt crisis, with all its facets, disclosed the relevance of various real and structural asymmetries among countries in an incomplete and still fragile European Monetary Union. During the crisis, fiscal stabilization and the management of macroeconomic imbalances has become the main concern, in a context of low growth and deleveraging. But the long recession has significantly disrupted wealth and employment with heterogeneous effects across countries and regions. On this background, this contribution provides an overall picture of the evolving regional disparities and the related changing geography of industrial and service activities. It derives some basic policy implications for industrial and regional policies.

[1] Part of this contribution is extracted from: Eleonora Cutrini (2019). Economic integration, structural change, and uneven development in the European Union, *Structural Change and Economic Dynamics*, forthcoming.

1. Introduction

A significant share of the available EU budget is allocated to the Cohesion Policy, with the aim to augment the wealth-creating capabilities of Europe's regions and of the people who live in them, paying most attention to areas that are lagging in their development. In a period characterized by deindustrialization and structural change into a service based economy, defining appropriate policies for a stable and widespread recovery –and in the spirit of the principle of solidarity- requires a deep understanding on the territorial organization of production and wealth across Europe.

Some scholars warned against an excessive spatial agglomeration, since, as integration was proceeding, the fiercer competition among companies that seek to exploit differences among places could have led to the hollowing out of the production structure in several European areas (Hudson, 2003). A major issue in the empirical literature, partly related to these concerns, is whether structural change drives economic growth. In this respect, it is important to remember that earlier studies proved that per capita income and regional productivity are closely linked to sectoral compositon.

The attention to regional income inequality in Europe rebounded after the global financial crisis and focused on the different capacity of regions to overcome the Great recession. The characteristics ensuring regional resilience were deeply investigated and the emphasis was put on regional vulnerability in the absence of a common automatic fiscal stabilization mechanism and with limited geographical mobility of factors in a single currency area. Again, at the heart of the current debate is the question whether heterogeneous structural change is a driving force of the divergence among European regions, an issue in which scholars have shown renewed interest.

On this background, we investigate the relationship between uneven development and structural change in the European Union with the aim to shed lights on the evolution of spatial inequalities after the common shock of the global financial crisis and the successive debt crisis.

Main results: growing regional disparities and heterogeneous structural changes

It is widely agreed that the distribution dynamics of income per capita and productivity were displaying polarization properties in Europe well before the crisis. More recent empirical evidence is quite controversial, and it appears that results may vary according to the spatial scale at which convergence is assessed. For example, some scholars suggest that across-countries income inequality was declining whereas within-countries inequality was increasing before the global financial crisis (See, e.g., Marelli and Signorelli, 2010).

A look at the data confirms that convergence took place before the Great Recession, particularly across countries (Figure 1). Thereafter, the convergence process halted and disparities across the NUTS2 regions started to rise again. Instead inequalities across countries remain stable until 2013. The rise in the subsequent period is largely due to the sovereign debt crisis when a clear divide emerged between the 'core' Eurozone countries and the peripheral ones (in particular, Greece, Italy, Spain, Portugal, and Ireland).

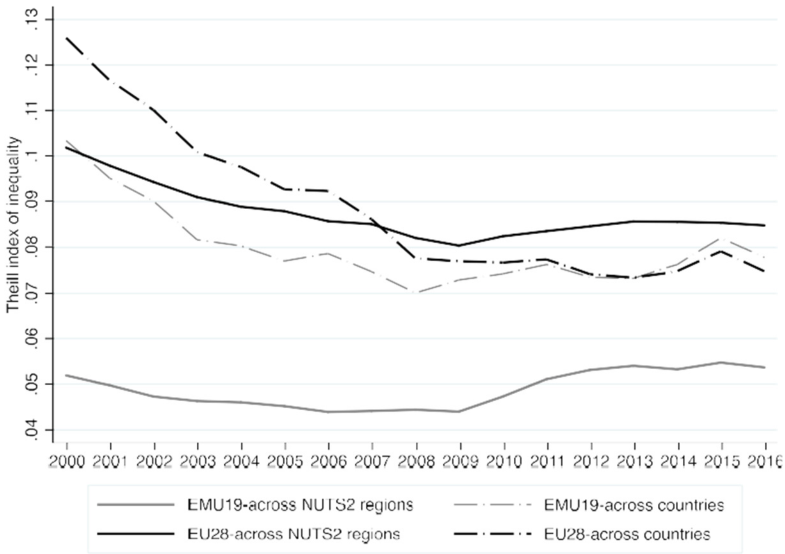

Figure 1 – Regional inequality in GDP per head, pps

After the 2008's financial crisis, the European economy experienced a significant drop of employment and an overall shift away from manufacturing and towards a service-based economy. Job losses have been highly uneven, both across regions and sectors and structural change followed heterogeneous paths within the European Union (Figure 2).

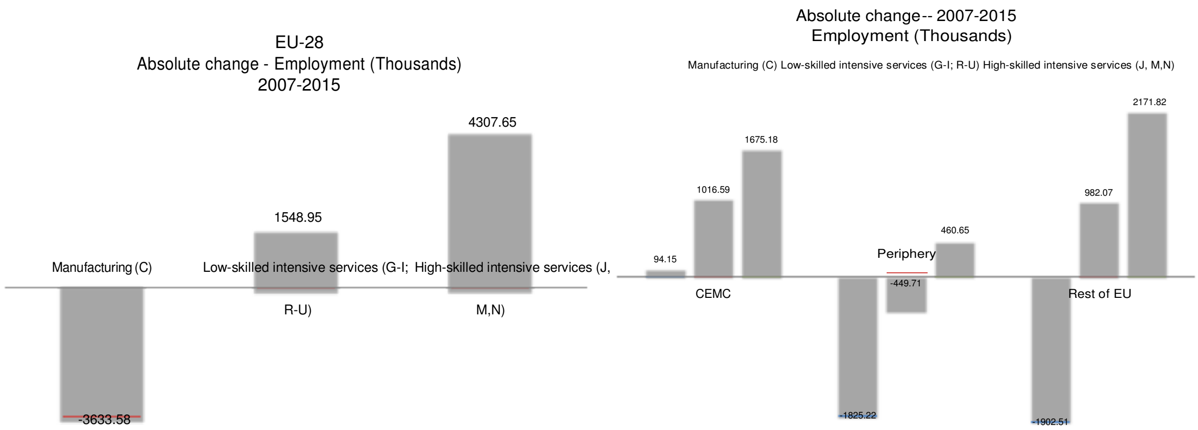

Figure 2- Structural change 2007-2015; EU-28 (left-panel); Macroareas (right-panel)
Note: CEMC: Austria, Germany, Slovakia, Czech Republic, Hungary and Poland
Periphery: Greece, Italy, Portugal, Spain
Rest of EU: Belgium, Denmark, Estonia, Finland, France, Cyprus, Bulgaria, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Romania, Sweden, Slovenia, Slovakia, UK

It is worth stressing that different paths of structural change are closely related to macroeconomic asymmetries and the emergence of the so-called 'Central European Manufacturing Core' (CE) (Landesmann and Stöllinger. 2018). Recent empirical studies with international trade data and the World Input-Output Database (WIOD) have highlighted that Germany plays a pivotal role in the organisation of the region's production networks. The CE Manufacturing Core comprises Austria and the four Visegrád countries, i.e. the Czech Republic, Slovakia, Hungary and Poland. Stehrer and Stöllinger (2014) analyzed the CE manufacturing core and explored in detail the structure and development of the regional supply chains over the period 1995-2011. Moreover, they suggest that the integration into supply chains has contributed to the spatial agglomeration of manufacturing activities in the CE core, and it was mirrored by a significant decline in the share of the other EU

Member States, in particular high-income countries, such as Nordic and Benelux countries, and above all France and the United Kingdom. It is worth noting that the organization of transnational production networks in the wider Europe not simply follow the traditional economic principle of minimizing transport and logistic costs, since it is driven even more by trade-offs between wages and coordination costs. Moreover, other factors related to geography, culture, institutions, and quality of infrastructure surely come into play in the decisions by companies to intensify outsourcing abroad.

At a lower spatial scale, in our analysis we identify clusters of EU regions with different sectoral composition, we can thus confirm that different paces and trajectories of regional structural change from manufacturing to services are at the root of the deepening uneven development in Europe. Particularly, a sizeable manufacturing sector and well-developed knowledge-intensive services both enhance growth, while services that use intensively low skills are less relevant or even deteriorate growth prospects. The results clearly support our view that both manufacturing and KIBS are the main determinants of economic growth, once controlled for physical capital and human capital.

The map in Figure 3 illustrates the spatial distribution of the identified clubs that can be ordered by the average level of per capita GDP and the respective growth rate over the period 2003-2016.

Figure 3 – Economic clubs in the EU-28 panel (2003-2016)

Club 1, Club 2 and Club 3 are higher income clusters with favorable structural change while Club 4 and 5 are lagging behind in income, because of substantial de-industrialization and an adverse structural change towards low productivity/low wage service activities.

Beside considering their geographical location, in order to further characterize the identified clubs, it is useful, as a first step, to rely on a simple descriptive analysis of key variables capturing the initial sectoral composition as well as the structural change that are deemed to be responsible for the divergence among clubs. Table 1 shows, for each club, the descriptive statistics of the variables of interest that are discussed in what follows. The characteristics of the five clubs suggests that they may be categorized as 'Metropolitan areas and capital regions' (Club 1), The

'Central European Manufacturing Core' (Club 2) 'Resilient regions with intermediate average per capita income levels' (Club 3), 'Deindustrializing regions with adverse structural change' (Club 4), and 'South-East falling behind' (Club 5).

	Whole sample (270)	**CLUB 1 (20)**	**CLUB 2 (39)**	**CLUB 3 (83)**	**CLUB 4 (106)**	**CLUB 5 (24)**
Initial conditions (in 2003)						
Per capita GDP, pps	20626	33900	25790	21388	17275	13333
Manufacturing, share	0.162	0.121	0.183	0.176	0.159	0.121
Knowledge-intensive services, share	0.109	0.181	0.132	0.114	0.095	0.058
Routine services (Trade, transport, accommodation & food services), share	0.244	0.256	0.251	0.236	0.242	0.253
Finance and insurance, share	0.023	0.046	0.028	0.023	0.020	0.013
Real estate activities, share	0.009	0.015	0.009	0.010	0.008	0.003
Other services, share	0.052	0.055	0.055	0.055	0.050	0.049
GFCF (Millions euro)	7876	17569	10722	8202	5238	3606
Population aged 25-64 with level 3-8 (%)	66.89	78.55	76.49	69.93	61.89	53.20
Employment rate of 20-34, level 3-8 (%)	80.83	84.49	85.48	83.48	79.42	67.36
Population with tertiary education and/or employed in S&T (%)	22.71	32.17	27.43	24.83	19.55	14.21
Geographic controls						
Metropolitan region	0.40	0.84	0.50	0.38	0.36	0.13
Per capita GDP, pps (annual average growth rate 2003-2016)	0.022	0.026	0.025	0.023	0.020	0.012
Per capita GDP, pps (annual average growth rate 2010-2016)	0.022	0.027	0.029	0.025	0.021	0.002
Structural change variables (average rate of change 2010-2016)						
Manufacturing	-0.011	-0.012	-0.001	-0.008	-0.013	-0.031
Knowledge-intensive services	0.018	0.020	0.025	0.019	0.017	0.007
Routine services	0.003	0.009	0.006	0.004	0.002	-0.008
Finance and insurance	-0.015	-0.008	-0.004	-0.012	-0.019	-0.031
Real estate activities	-0.003	0.012	0.007	-0.005	-0.007	0.000
Other services	0.006	0.008	0.004	0.007	0.007	0.004
GFCF	0.011	0.044	0.031	0.020	0.010	-0.074

Table 1- Average values, by clubs

Club 1 is associated with the highest steady state and it is mainly made up of metropolitan and capital cities of Northern and Central Europe, such as Vienna, Brussels, Prague, Paris, Dublin, Bratislava, Stockholm, London, Amsterdam, Hamburg, Stuttgart, Bucarest, Warsaw. Given the composition of the first group, it is not surprising that it is characterized by a substantial

specialization in knowledge-intensive business services (KIBS) and a small proportion of employment in manufacturing.
Club 2 spans different EU countries, but regions belonging to the so-called Central European manufacturing core are highly represented in this cluster. Latvia (LT), Yogozapaden (BG) where the capital city is located, Dolnoslaskie (PL), Wielkopolskie (PL) are the catching-up Eastern European regions. It also includes other capital regions, such are Berlin, part of London (Outer London-West and North West), Helsinki, and wealthier areas of North European countries. Similarly, Club 3 encompasses affluent regions too, but in this case they are scattered in a more heterogeneous set of countries. Larger cities and capital regions in Mediterranean countries (e.g. Madrid, Rome, Portugal, Bilbao) belong to this cluster. As for their economic structure, Club 3 has almost the same initial share of manufacturing employment compared to preceding Club 2 (18%) but it experienced a higher decrease of manufacturing employment (-4.8%) in the post-crisis period (2010-2016) compared to Club 2 where manufacturing employment shrank by only 0.6%.
Clubs 3 and 4 are the largest groups, each with almost one third of the sample's regions. What distinguishes the two clubs is both the initial sectoral composition and the structural change experienced over time. At the beginning of our convergence analysis, Club 3 was more specialized both in manufacturing (17.6%) and in KIBS services (11.4%), than was the case in Club 4 (15.9% and 9.4%, respectively). On the contrary, the employment share in routine services was higher in Club 4 (24.2%) compared to Club 3 (23.6%).
During the period 2010-2016, the distance between the two intermediate clubs widened, possibly due to a divergent structural change. In Club 3, the decline in manufacturing employment (-4.8%) was less dramatic than in Club 4 (-7.8%) and it was offset by slightly higher growth of knowledge-intensive services (+11.4% and +10.2%, respectively). Most of the regions belonging to Club 4 are British and French, but there are also some Italian, Czech and Polish regions. This club includes all Portuguese regions, 2/3 of Spanish regions, and four Belgium regions, while neither Austrian nor German regions are included in this club, the latter ones being scattered among the first three clusters.
Finally, the fifth club is the other small subgroup, with regions mainly belonging to Mediterranean and South Eastern countries and characterized by sluggish economic growth. 85% of all Greek regions end up in this cluster. It also includes southern Italy, and the remaining regions of Spain, Hungary and Bulgaria not included in the previous clubs.
Club 5 experienced a significant deindustrialization (-18.6%) accompanied by a feeble structural change toward high-skilled/highly-paid services (4.2%) during the post-crisis period (See Table 1).
To summarize, our analysis confirms that the initial economic structure of regions matters for the subsequent club convergence. The three highest income clubs share a growth-enhancing path based on a resilient manufacturing sector and vibrant knowledge intensive service activities.
The counterpart of divergent structural changes is the substantially different capacity of absorbing young and well-educated active population. Hence, agglomeration processes are cumulative and may lead to drainage of skilled personal and purchasing power from less-developed and marginal regions, thus further widening regional disparities and the deepening urban-rural divide.

Policy implications

A people-centered discourse for industrial and regional policies (Discussion group "Growth, Investment and Territory", 2018) requires that the contribution of all individuals to value creation should be recognized. The relevant question is: where value is created and by whom, in a well-being perspective? On this view, workers currently engaged in less qualified services (e.g. care of the elderly, tourism, leisure ...) should benefit from an increase of their income if and to the extent that they make an important contribution to the well-being of the society. Training policies for the entire spectrum of functions of the value chains are all equally important: from craft skills (tacit knowledge) to digital skills and humanities, and critical thinking.
If we turn to the demand side, how do the regional differences that we have documented are relevant in a policy oriented towards people and territories? Even though there are needs that are becoming increasingly important for all European citizens - mobility, leisure, culture, tourism, care - , there may be specific needs and constraints that are differentiated in space, both along the urban-rural divide and, more generally, in the core with respect to the peripheries.

In our study, we have seen that a successful structural change toward high-value added and high-wage services in the higher-income clubs enhanced their resilience, helping them to counter the adverse effects of the crisis. Instead, a substantial de-industrialization coupled with a slow transition toward low-value added services can be at the root of the 'peripherisation' of regions that are drifting apart from the core dynamics.

We suggest some implications of our study for designing appropriate policies aimed at promoting a more balanced European economy.

First, on the basis of our results, there is a need to develop policy interventions more sensitive to the different paths of recovery and structural transformation, as already suggested in the place-based approach (Barca, 2009), and, more recently, in the 'place-sensitive distributed development policy' (Iammarino et al., 2017) and in the place-based industrial policies to address the challenges of industry 4.0, "Industrial Policies 4.0" (Bellandi et al., 2019). This is particularly relevant since the manufacturing sector represents a source of innovation and productivity growth, and its dramatic decline, experienced in some territories, can have important spillovers' effects on the whole economic system, due to the depressing effects on the demand for services. Industrial policy should not follow the 'same size fits all' approach, due to the different absorbing capacities of regions. In other words, Industry 4.0 cannot be the one-way recipe for different regional economic structures and Smart Specialization Strategies should take into account the need of small firms and focus on those conditions required to unleash the potential of sectoral complementarities.

Second, as for the issue of multilevel governance, it is important to find the right balance between the implementation of the European regional and competition policy, and a sufficient leeway to countries and regions to define their regional and industrial policy according to their specific development challenges and opportunities.

Third, regional policy makers should devote a particular attention to satisfy the training and educational requirements that are needed to accompany their specific regional structural change. Moreover, according to our study, skill upgrading and wage growth, especially for low-skilled services, may also contribute to attenuate regional disparities. They could support household incomes and spending in peripheral areas that are usually more specialized in low-skilled services.

Forth, given that the financial crisis and the Eurozone debt crisis –involving excessive accumulation of both public and private debts- have had asymmetric effects within Europe, it is important to devise financial instruments for stabilization purposes, to shelter economic and social cohesion.

Finally, the private sector and private investment, at least in Italy, will certainly benefit from a more efficient public sector. Whereas it is a priority to improve public investment - especially in the quality of infrastructure, prevention of land and seismic instability - it is equally important to proceed with a decisive institutional and cultural change towards accountability and transparency in the public administration. This change will certainly create a more favorable environment for new business formation and improved the overall productivity of the private sector, especially in some countries.

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