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Regional Policy and European Economic Integration

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Introduction

Progress towards Economic and Monetary Union (EMU) in Europe is usually discussed in terms of achieving the objective of the internal market by the end of 1992 and, beyond that, the closer coordination of policies, leading ultimately to irreversibly fixed exchange rates. The regional dimension receives much less emphasis and is less well defined than other aspects of the process of economic and monetary integration. This paper attempts to introduce more balance. In Section 1, emphasis is placed on the importance of regional policy as an essential part of the integration process. The failure of the market mechanism to guarantee an even distribution of the gains from economic integration and the consequent need for regional policy is elaborated upon in Section 2. A description of what should be viewed as the most desirable features of an effective regional policy is given in Section 3. The final section emphasises that regional policy must make a real contribution if the peripheral economies are to participate in the benefits of EMU, thereby ensuring that the Europe of the future will have an optimum output and welfare level and the cohesiveness necessary to compete effectively on a global basis.

In the light of the experience of both an economic and monetary union for one hundred years and a monetary union for some fifty years with Britain, there are definite views in Ireland on the nature of a viable union, on the principles on which a successful regional policy should be based and, of course, on the pitfalls that should be avoided. In addition, Ireland is in a unique position being a peripheral economy fully participating in the exchange-rate mechanism of the EMS.

Section 1: Economic and Monetary Union: Requirements and Potential Problems

The main elements of EMU are:

- freedom of movement of goods and services, capital and labour
- a high degree of policy coordination
- the elimination of regional disparities
- irreversibly fixed exchange rates

Clearly, these requirements go far beyond those of the internal market programme, which does not require the close coordination of fiscal and other economic policies or the fixed exchange rates demanded under economic and monetary union.

It is crucial that the important preconditions of EMU be recognised at the outset. The process of economic integration requires a number of distinct stages, with monetary union, involving irreversibly fixed exchange rates, being the final stage. Before this can be achieved, all Community countries will need to have reached a broadly similar stage of economic development and be committed to broadly similar economic policies. If this is not the situation, disparities within the Community would cause persistent capital and labour flows from the less prosperous to the richer regions, creating both economic and political tensions that could put the whole process in jeopardy.

The economic union phase of integration requires the removal of restrictions, the elimination of regional disparities and close policy coordination. While member States would retain the possibility of exchange-rate adjustment as a response to external shocks and differences in the evolution of competitiveness, a policy of exchange-rate adjustment should be avoided. This is because, firstly, such adjustment would be inconsistent with the degree of exchange-rate discipline required for moving towards the ultimate objective of monetary union and, secondly, because any benefits to problem countries would be merely temporary, being quickly reflected in higher inflation and a loss of credibility and would not promote the narrowing of divergences between the richer and poorer countries. Moreover there is increasing agreement that this principle of avoiding realignments in order to increase credibility and to achieve price stability is appropriate not only for small open economies; other larger ERM participants, through their words and actions, have shown their support for this principle.

Economic union is not something which will suddenly begin after 1992 but, rather, is a process already under way which will continue after 1992 for quite some time before the final state of EMU is reached. One important element in this process is that, as integration proceeds, member States will experience an increasing loss of autonomy with increasing coordination of economic and other policies. Without complete political union, member States will, of course, continue to exist, but there will be growing constraints on their freedom of economic action to deal with their own national regional problems. At the level of the European Community, it is the theory of regional economics, and not the theory of international trade, which will become increasingly relevant in the future. Regional economic theory, confirmed by Ireland's historical experience, suggests that in the absence of appropriate accompanying policies, market forces will not of themselves be sufficient to eliminate divergences and bring about the required degree of economic cohesion within the Community, but rather the reverse. This is because factors such as better infrastructure, lower transport and distribution costs and proximity to bigger markets would almost certainly favour the growth of the stronger regions and the stagnation, or even contraction, of the weaker. The process already exists in the existing nation-States of Europe. Areas of France south of Lyons, the Mezzogiorno in Italy, and some northern regions of Germany clearly exhibit, although at different absolute levels of income, the process of relative impoverishment - relative, that is, to the richer regions in these countries - even while the national economy as a whole grows richer. According as the barriers to trade, capital and labour movements come down and the freedom for member States to have independent monetary, fiscal and exchange-rate policies diminishes, exactly the same process will take hold throughout the European Community, since economies will no longer be definable simply by reference to national boundaries. The Community as a whole can be expected to fare better in the aggregate from moves towards EMU, but there is a need, already urgent, to tackle the issue of regional imbalances directly; otherwise, the weaker peripheral regions of Europe such as Ireland could suffer, rather than benefit, from the process of economic integration. This can only be achieved through the development of a comprehensive Community regional policy with adequate resources for the task.

While a convincing case can be made for significant regional support in a more integrated Europe, it tends nevertheless to be viewed as a national demand based on national self-interest, rather than a requirement of a sound regional policy framed in the interests of the Community as a whole. The history of the European Regional Development Fund since 1975, with its rigid adherence to national quotas to which each member State was 'entitled', bears this out. The Fund was viewed not so much as a means of dealing with Community regional problems but rather as Community assistance to member States to deal with their own, internal, regional problems. The fact that Ireland was recognised as a single region for the purposes of the Fund was more a reflection of the political process than an acknowledgement that Community problems had to be dealt with on a Community scale. There are signs that these attitudes are changing - the doubling of the Structural Funds by 1992 and the institution of a 'quota free' component of the Regional Fund are obvious examples - but there is some way to go yet before it is fully accepted that the backward regions of Europe, whether they are so because of geography, trade patterns or the decline of once-prosperous industries, must get special assistance if they are to remain attractive places in which to live and areas which have an economic future. Regional policy needs to be seen as an essential element in the policy mix necessary to achieve EMU, but equally all members must recognise that regional policy is not simply a question of financial grants for specific projects, or even for programmes, still less does it comprise subsidies to prop up non-viable ways of life; rather it is the continuing application of a regional dimension to every European policy.

Section 2: Costs and benefits of economic integration

The establishment of the European Regional Development Fund (ERDF) in 1975 was the first major recognition of the need for an active regional policy at Community level. When outlining the Community decision the Commission noted that:

'"... not only do the less developed regions fail to integrate fully within the Community, but the problems to which they give rise become an increasingly heavy burden on national economies and thus increase the pressure on the public authorities concerned to refuse the constraints inherent in the mechanism of Community integration. It is, moreover, an illusion to hope for the convergence of Member States' economies so long as regional problems continue to weigh so heavily on certain economies... It follows from this situation that Community regional policy must be strengthened and its field of application expanded. This is not only desirable; it is now one of the conditions of continuing European economic integration." (Community Regional Policy - New Guidelines: Bulletin of the European Communities, Supplement 2, 1977)

These considerations are even more relevant today than they were in 1975. There is still no guarantee that the benefits of market integration will be evenly distributed among all member States. Indeed, these concerns increase as economic integration proceeds towards EMU in that the availability of policy instruments to deal with the problems arising from further integration are reduced and thus regional disparities could become more permanent. For these reasons there is urgent need to establish a strong regional policy before proceeding to EMU. Before outlining in more detail the particular factors likely to give rise to problems, it is worth looking at the case for the complete freeing of trade and the furthering of market integration.

The case for free trade is usually based on the principle that there are efficiency gains from the removal of trade restrictions which are welfare-increasing for the Community as a whole. These gains are generally seen as being of two types. Firstly, there are those resulting from comparative advantage which, in turn, can be classified into gains from increased specialisation and gains from an increased volume of trade. These gains increase the welfare of all parties engaged in trade and arise primarily from trade involving the output of different industries in the trading countries (that is, inter-industry trade). Secondly, there are gains arising from the existence of economies of scale in some industries whereby as a result of the removal of trade restrictions, firms can expand and thus produce more efficiently. This trade involves the output of similar industries in different countries (that is, intra-industry trade). Many of the gains from freer trade within the Community have been of the latter type though, in this case, only some parties may gain.

One must take a number of considerations into account, however, when considering the likely distribution of both types of gains in the context of increasing market integration in the Community. Firstly, while the principle of comparative advantage is generally seen as providing a compelling justification for a policy of opening up markets, there are a number of qualifications which need to be considered. These relate to the fact that the basic assumptions underlying the comparative advantage model, i.e. free competition, full employment of factors of production, full mobility of capital and labour and zero transportation costs, are unlikely to be fulfilled in reality. Thus one of the predictions of the model, that trade liberalisation leads to the equalisation of factor prices and hence to a convergence of incomes and living standards is not borne out in practice, largely because of incomplete factor mobility. Moreover, the forces which give rise to the second type of gains, that is, those arising from the phenomenon of intra-industry trade, that is from the operation of economies of scale in production, suggest that the convergence of incomes and living standards is even less likely. Other considerations such as the non-uniformity of transport costs, the effect of demand factors and the existence of external economies would, in fact, reinforce this conclusion.

The existence of economies of scale in production has been the most important factor giving rise to intra-industry trade in the Community. This provided important efficiency gains in the early days of the Community of Six when economic structures were relatively similar. However, in the present enlarged Community there are much greater differences in economic structures and thus the effect of economies of scale will most likely be to favour the further development of the stronger central regions. This arises because the existence of these economies of scale will create market structures that are oligopolistic, being dominated by a few firms located, for the most part, in the stronger central regions. The effect of other factors will also tend to work in this direction. The level of transport costs will tend to be higher in the peripheral regions of the Community than in the central regions reflecting the rather obvious fact that it costs more to bring goods to a distant market than to a neighbouring one. This will tend to attract firms to central rather than peripheral regions. The effect of demand factors is likely to be similar - because central regions tend to be densely populated and peripheral regions do not, the largest and most dynamic markets will be found at the centre of the Community and not at the periphery. The central regions will also tend to benefit to a greater extent from external economies, such as a highly developed infrastructure, closer contact with suppliers and access to a larger labour market.

The combination of all these considerations strongly suggests that the attraction of central regions is much stronger than peripheral regions for both the location and growth of new firms. Moreover, the strength of a region is of itself likely to create further external economies and thus one faces the possibility of creating a spiral effect, whereby the relative strength of the central region is an important factor in ensuring its continued growth. This growth, however, is to some extent achieved at the expense of the peripheral regions which find it increasingly difficult to catch up on the more developed regions.

In sum, therefore, while economic theory suggests that the Community as a whole should gain from the integration process, the considerations just outlined strongly indicate that this gain will be concentrated in the stronger regions and will be achieved at the cost of major adjustment on the part of the weaker economies. As a result, the efficiency gap between the weaker and the stronger regions may actually be widened. This suggests that if left to itself the market process would increase divergences between regions rather than lead to convergence.

Another important point which must be borne in mind is that the movement of factors of production from the periphery to the centre may be determined by private rather than social cost considerations. For instance, significant movements of labour into already densely-populated areas may lead to some problems of congestion while, from the point of view of the less-densely populated region, the outflow of labour will mean that the cost of maintaining the economic and social infrastructure will increase. This latter problem is likely to be compounded because, as Irish experience indicates, the migration of labour tends to come from the younger, more skilled and more enterprising sections of the population; thus, those remaining behind are reduced not only in numbers but also in competitive ability, thereby exacerbating the initial disadvantage.

The above reasons indicate not only why there is a need for a regional policy within the Community <u>but also why, as integration proceeds, there is a need for that policy to play a</u>

greater role. The requirements of EMU go a considerable distance beyond the 1992 programme in terms of the constraints which they place on policy autonomy in individual countries. For EMU to be sustainable, the economies of the countries forming the union must be similarly competitive or else some countries would be faced with the equivalent of a constant balance-of-payments deficit which, in EMU, would be reflected in terms of stagnation and unemployment. Obviously, the only way in which countries in such a union can compete on similar terms is for the burden of problem regions to be tackled. Otherwise, pressures on national governments would be likely to force them to abandon the commitment to EMU and to take autonomous action to solve their regional problems. This danger, presented by regional imbalances, is the greatest threat to the realisation of economic and monetary union.

Section 3: Principles of regional policy in context of moving towards EMU

Regional policy, which refers not simply to regional fund expenditure but rather to all policies affecting the development of the regions, must be an essential element in the policy mix necessary to achieve economic and monetary union. In its absence, the Community may well fare better on aggregate than before embarking on the process, but it would have created problems associated with highly concentrated industry and populations.

3.1 The Role of Regional Policy in Reducing Disparities

The objective of Community regional policy should be to correct imbalances by contributing to the development and the structural adjustment of the regions. Eliminating regional disparities should not be confused with equalising income per head between regions. Differences in income could, of course, be greatly reduced by some transfer mechanism, but a mechanism based primarily on income subsidies would not contribute to the achievement of sustainable growth. Rather, it could act as a disincentive to effort in the region receiving the transfers, while possibly damaging the dynamism of the stronger regions. It would, at best, merely subsidise the continuation of the problem; it would not help to solve it.

Instead, it is more constructive to think in terms of equalising the conditions needed for the production of goods and services. Here, the main difficulty faced by problem regions is a lack of adequate infrastructure. This is true both of peripheral regions and declining regions. Peripheral regions have inferior infrastructure largely because they are both poorer and less densely populated and the per capita cost of providing the infrastructure becomes prohibitive. Declining regions, on the other hand, tend to suffer because decaying infrastructure is not being replaced. The lack of good infrastructure discourages new firms from locating in either type of region and results in higher costs for existing firms. In order to overcome this problem, peripheral regions need assistance to bring their infrastructure up to a similar level as that obtaining in the stronger regions of the Community.

Here, one of the key areas is transport. For example, in Ireland, it is estimated that industry spends approximately £1 billion annually in transporting materials and distributing finished products. Though geography and a lack of producer goods industries will always mean that transport costs in Ireland will represent a significant proportion of total manufacturing costs, it has been calculated that these costs could be reduced by almost half through significant improvements in the road network. The recent decision to expand the Community regional programme to include infrastructural projects undertaken by the private sector is, therefore, welcome.

Even if physical disparities were considerably reduced, however, there remain other locational disadvantages - not merely the demand factors mentioned earlier, but also the existence of economies of scale in the central regions arising from, for example, proximity to research institutes, major financial centres and other services and an abundant supply of skilled labour. The importance of these disadvantages could, however, be reduced as more firms locate in the periphery and as the problems of communication over long distances are reduced by new technology.

3.2 Regional Policy and Labour Mobility

Economic theory tells us that in an economic and monetary union, disparities between regions will produce movements of labour and capital. While such mobility is obviously a requirement of any dynamic economy, large-scale mobility, particularly in the case of labour, would hardly be politically acceptable as a major adjustment factor in an integrated Europe. Indeed, from an Irish point of view, the extent of labour mobility might well be regarded as a measure of regional disparities and of the lack of success in overcoming them. While disparities cannot be totally eliminated, they must be reduced to a level where labour mobility, in particular, is largely voluntary. It is recognised that migration and emigration today are complex issues and it can be misleading to classify emigration in simple terms such as voluntary or involuntary, but Ireland has long experience of the effects of large-scale involuntary emigration and it has very few positive features. In a more integrated Europe, it is essential that the weaker regions do not become mere suppliers of labour. Regional policy must be structured in such a way as to induce enterprises to locate and labour to stay in the peripheral regions. It is worth bearing in mind that the education and training of individuals who, in the event, emigrate to take up employment elsewhere in the Community represents an outright benefit for the receiving region while, for the region of emigration, it is an investment from which it obtains little or no return. This is a non-trivial example of the way in which the richer regions may benefit from integration at the expense of the weaker areas.

Another aspect of the impact of regional policy on labour is that there should be a move away from providing labour-intensive low-pay projects for peripheral regions. With rapid changes in technology, such projects tend to be short-lived as competition increases from some of the newly industrialised countries with even lower wage levels. Such a policy would not seem likely to bring about the objective of reducing disparities in living standards in the EC.

3.3 Structure of Regional Policy

The difficulties posed by the "national quotas" approach to the Regional Fund were mentioned earlier. In the context of European integration, a basic principle must be that aid should be determined on the basis of regions and not of countries. The adoption of this principle should help to reduce the political friction in regional policy, with aid being allocated to approved programmes within the designated regions, regardless of the country in which they happen to be located. This implies a major increase in funding for programmes with specific objectives in mind, a process already under way. It means a shift of emphasis towards setting overall objectives for infrastructure at Community level and providing funds to achieve them, rather than engaging in piecemeal project financing. The recent Council Regulation on the use of the Structural Funds commits the Community increasingly to concentrate on programme funding, which by end-1987 was targetted to account for only 20 per cent. of regional policy expenditure. This development clearly has much further to go.

A truly European regional policy in the context of EMU should not become another open-ended drain on Community resources and should eventually become self-sustaining. As some regions become self-supporting and able to compete without assistance, there could be greater concentration of resources on the remaining problem areas. A point would eventually be reached where the amount of Community resources needed would decline. A properly-framed regional policy would not become an ever-expanding part of the Community budget; a policy that did so would contain the seeds of its own destruction.

The corollary of a policy for the less-favoured regions is a policy for the more advanced regions. The other side of the coin of a policy that encourages growth where it now lags is a conscious discouragement of growth where it is not merely unnecessary, but brings great social and economic costs in terms of congestion, pollution, social problems and even destruction of the environment. If transfers of much-needed resources to the peripheral areas are acknowledged as necessary for the cohesion of European integration, then it is surely beyond argument that the case for subsidies to industries operating in the richest and most polluted areas in Europe is open to serious question. A subsidy given to industry to locate in developed Europe has an inevitable and negative effect on underdeveloped Europe. Indeed, the external costs imposed on society by locating an industry in an already overcrowded and polluted environment would justify the imposition of a tax rather than the granting of a subsidy. It is not only the peripheral regions that need to justify subventions for their development.

3.4 Financing and Composition of Expenditure

There should be a move away from a policy of widely dispersing regional aid towards one of concentrating that aid on programmes, projects and activities in regions. This would ensure the maximum return for a given transfer expenditure. Moreover, in designing regional programmes it is important to guard against the problem of "fatigue" on the part of the richer countries. This tends to arise in the context of debates on annual allocations of national contributions to a central budget and reflects an unduly static analysis of the costs/benefits of regional policy. By focussing mainly on the costs of providing transfers to the poorer regions and taking insufficient account of the less quantifiable opportunities provided by the opening up of these countries' markets, an unbalanced picture of the integration process emerges. One way of overcoming the problem of fatigue is by ensuring that a major portion of Community financing is on an "own resource" basis; that is, that it accrues to the Community budget automatically. From the point of view of the recipient regions, there is a need to ensure that funding would continue to be available for programmes until divergences between the objectives and actual achievements of a regional plan are either eliminated or reduced to acceptable levels.

An essential aspect of a Community regional policy must be that regional transfers should be earmarked for specific purposes rather than taking the form of general purpose funding which, due to fungibility with other uses, can be used to maintain public consumption at unrealistic levels. Thus, the use of specific-purpose transfers would be geared directly towards reducing the impact of locational disadvantages and towards mitigating the adverse effects in the disadvantaged regions of economies of scale arising elsewhere. It would also be desirable that such grants be flexible in their time-frame of application so as to provide an incentive for a country or region to reduce regional disparities in infrastructural facilities at a rapid rate. If Community spending cannot be expanded to match accelerated investment by a national government, it effectively means that national quotas in terms of regional transfers operate in practice; these would not provide any incentive for member States to undertake ambitious development programmes.

There must also be full appreciation and acceptance of the fact that the Community budgetary funds must be large enough to be effective in reducing regional disparities. In this regard, it is instructive to compare the allocation of structural funds amounting to ECU 8 billion in 1988 (not all of which is earmarked for the least favoured regions) to the gains expected from the single market. The Cecchini Report estimated the direct gains from the move to the single market to be of the order of ECU 216 billion in 1988 prices. Even on this basis, there is clearly a need for a greater volume of transfers to the least favoured regions; otherwise they are likely to contribute more to the gains from the single market than they would receive. An examination of existing federal states demonstrates that the amount of funds as a proportion of GDP devoted to the elimination of regional disparities within these states is considerably greater than it is as between the member States of the Community. It is not unrealistic to suppose that this may explain why the extent of disparities within existing federal states (at least in the industrial world) is much less than it is within the Community.

3.5 Administration

The Community budgetary system should be as democratic and efficient as possible. It is clear from experiences of highly centralised administrations that, in the interests of both democracy and efficiency, the principle of decentralisation should be espoused. As much planning and execution as possible should be made and carried out in the regions. There is, however, also a need for much more coordination of policies at a Community level to ensure that there is not a wasteful duplication of projects in the Community. These two opposing needs could be satisfied by the regions' developing medium-term plans of say 3-5 years which they would submit to the Council for discussion, negotiation and approval or, as the case may be, rejection. It is encouraging to note that this type of approach is advocated in the Council Regulation on the use of the Structural Funds. Once the medium-term plan and funds (or means of raising the funds) to carry it out is approved and synchronised with other Community plans, administration should be carried out in the region. A Community authority should be empowered to carry out regular audits to ensure that the conditions of the plans were being adhered to.

Section 4: Contribution of regional policy to a stronger Europe

Conclusions

In an economic and monetary union, there would be no national policy instruments available to offset the tendency for poorer regions to suffer from the effects of market integration. It is essential, therefore, to be clear on the basic principles that should inform a European regional policy. Among the more important principles on which regional policy should be based are:

- the need to eliminate the locational disadvantages of the poorer regions in the production of goods and services,

- large-scale movements of labour must not become a major adjustment factor,

- regional transfers should be sufficiently large to effect the necessary reduction in disparities between member States,

- the need for aid should be determined on the basis of regions, not of countries, and aid should be concentrated in the poorer regions,

- the composition of regional transfers should be weighted in favour of programme financing rather than project financing; moreover, it should be designed, as far as possible, to catalyse private-sector investment in the regions so that they become self-sustaining,

- Community regional transfers should be financed from the own resources of the Community and be complemented by macroeconomic policies directed towards financial stability in the medium term,

- a sizeable Community budget.

Regional policy must be directed at enabling the peripheral areas to compete, not at subsidising them in continued deprivation; it must be far more than financial transfers, and those transfers should be directed towards reducing costs and raising productivity; it should mean a regional dimension to every European policy, and not simply a fund, however well-spent; and it must encompass the richer regions too - both to discourage undesirable development and to acknowledge that the losses of the poor are often the gains of the rich. EMU involves surrendering a high degree of national autonomy in economic policy-making. This should take place in an environment in which the interests of the peripheral regions are protected. Central economies should not gain the benefits of integration at the expense of the peripheral economies. Rather, EMU should mean that all share in the decision-making process and in the benefits that accrue. Commitment to EMU must involve a corresponding commitment to ensuring that the integration process is beneficial to all. In particular, the stronger economies in the Community cannot pick and choose the elements of EMU that are favourable and disregard the rest. EMU must be a package representing a sharing of costs and benefits that is equitable and acceptable to all member countries. The achievement of economic and monetary union on these terms would result in a much more cohesive Europe than is the case at present. This would guarantee not only the sustainability of EMU but also a Europe that would have a more decisive influence in its dealings with the other major economic blocs.