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## Regional policies in times of austerity

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The responsibility for the accuracy of the analysis and for the judgments expressed lies with the authors alone; this document does not constitute a policy position of the EU Commission.

Policy decision makers and their advisers working in regional development have been seriously challenged by the current crisis. Not only because of the need to do more with less in the face of a severe fiscal squeeze. They have also been questioned by both society and academia on their achievements in terms of the resilience they were able to provide to regional economies.

Has regional policy helped in promoting towards a more diversified and knowledge-based economy? Or has it contributed only to “buy time” and slow down the necessary process of adjustment in tackling globalisation and external shocks of all kinds, from financial infection and rising oil and food prices to climate change pressures?

The answer is not straightforward, not least because of the absence of a counterfactual we could compare with. On the one hand, empirical evidence and recent statistics as presented in the recently published 5<sup>th</sup> Cohesion report<sup>1</sup> seem to suggest that for many regions policy interventions have made a difference, thus arguing for a positive response to the first question. On the other hand, it is a fact that many of the less favoured regions in the Union, which have traditionally concentrated the bulk of regional policy investments, are suffering most in the current crisis. Is this a reason which confirms the need for renewed – or perhaps better reviewed and revised – regional policy efforts or a clear symptom of policy failure?

In a way, it all boils down to a basic question: can regional policy be a form of efficient public intervention in the economy? Is it one which without substituting for the market can channel its powerful energies towards accelerated change and development, in particular for those that need it most, including by smoothing troughs in business cycles? Or is it simply crowding-out private investments and slowing or even preventing swift, painful but necessary, market adjustments?

To respond to these questions, we first need to better identify and understand the shortcomings of current policy practices, so that we are able to explain what can and can not be realistically expected from regional policy in the face of a crisis.

Except for those who can calm their feeling of uneasiness with standard recipes, which they tend to apply indiscriminately everywhere at any period of time, the majority of us emphasize this or that aspect of the economic development process around which we advise our political masters on policy options and priorities. Our

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<sup>1</sup> EU Commission, “Fifth report on economic, social and territorial cohesion: investing in Europe’s future”, Brussels November 2011.

advice tends to be tentative in nature and varies substantially from one region to the other. Most of the times we are aware of the limitations of our efforts and we feel somehow frustrated by our inability to apprehend the problem in its wholeness and provide a satisfactory response, which will “solve it”.

This is why some of us have always secretly wondered when listening to orthodox recipes, if exclusively calling for more labour market flexibility, deregulation, lower salaries and tax rebates to attract foreign direct investment, in regions with high levels of unemployment, low levels of education and little or no influence over macroeconomic policy tools, was the best we could do in terms of policy options. Fortunately more and more economists have now entered the debate beyond diagnosis and safe recipes into the slippery ground of what role public policy must play in all of it<sup>2</sup>.

At the centre of the debate on regional policy as efficient public intervention in the economy lies the concept of agglomeration and its natural and/or necessary character to speed up development, as well as the extent to which it can be (or is desirable to be) influenced by public policy. We would argue that what is in question is not the benefits of agglomeration processes themselves (economies of scale, concentration of the “brains of industry” in globally connected high-tech hubs, etc.) but its scale, pace and connectedness to the wider geography, including its limits in terms of environmental (pollution), economic (inflationary pressures), social (security) and accessibility considerations, not to speak about “beyond GDP” issues in terms of human dimension and shared community values.

In this sense, one might think out of developmental considerations that a more geographically balanced and connected distribution of economic activity throughout the territory might militate in favour of overall economic competitiveness and, among others, more social cohesion by helping people work where they choose to live. This way we can also contribute to preserving communities and a rich regional diversity that counts positively in an economy driven more and more by innovation, in particular in emerging new markets such as the “green economy” (e.g. decentralised production of renewable energy) and societal challenges such as the “silver economy” (e.g. advanced services for senior citizens, including health and longlife learning) where geography does matter. Such an approach may eventually help liberate latent energies and unblock economic potential where they are currently most underutilized and needed, not to speak of diminishing environmental problems and external diseconomies in central regions and urban centers (e.g. price of housing, traffic congestion).

In terms of policies, one could argue that in the earlier stages of development (e.g. some of the new EU members from south-eastern Europe and the Union’s periphery) public policies should accompany the process of agglomeration while ensuring that “trickle down” effects in its wider hinterlands do take place in order to optimise growth country-wide. In more advanced stages, public policies should turn their efforts to develop a balanced multipolar growth structure and ensuring connectivity both amongst these poles and between them and the global economy in order to develop a harmonious development process which does not leave any

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<sup>2</sup> (Paul Romer, 1994) “... the most important job for economic policy is to create an institutional environment that supports technological change.”

region behind and exploits overall economic capacities to their full, wherever they are to be found. In no case regional development policy should take the form of charitable fiscal transfers if it is to have a truly lasting development impact. We believe that regional policy is about sharing growth efforts and helping regions help themselves, not about redistribution per se.

In terms of agglomeration processes, no one can deny the advantages of more flexibility and therefore mobility in the labour market, in particular in those advanced economies which work with the safety nets of low unemployment and solid social security systems. In these economies people may be able to choose to emigrate in search for better job opportunities, enrich themselves by exposure to multicultural experiences or take chances with their present jobs by trying more promising avenues. Moreover, the economic adaptation to an ever changing market demand fuelled by an accelerated process of “creative destruction” will be facilitated by this flexibility and, in the long run, it will probably help limit and minimize its social costs. Nevertheless, as policy advisers we have also to be concerned by the deserted underdeveloped regions left behind and deprived of their younger and more entrepreneurial people or of those latent economic capacities left unexploited.

So, what are the policy options? In our view, neither macroeconomic policies nor inward investment policies on their own can be very effective in creating sustained (lasting) and sustainable regional development trajectories. On the one hand, to try to solve the problem of microeconomic competitiveness with an overdose of macroeconomic policies is highly inefficient and therefore self-defeating. Of course, a healthy macro-economic framework is a necessary pre-condition for any regional and industrial policy to succeed in a sustainable way, even if the latter can, in turn, contribute to achieving the former objectives. On the other hand, direct foreign investment from outside is less and less available to less favoured regions in the EU, and footloose branch plants tend to come for a while as long as the subsidies or tax savings are interesting and then go elsewhere, as recent history shows.

The real issue here is about the ‘else’ part: what else to do once the macroeconomic picture is reasonably right? Is there anything else that can be done through public intervention in the promotion of economic development? The issue is not to oppose macro-economic policies and meso-economic policies (regional policy) as excluding alternatives. The problem arises when all public economic policy and governmental role is constrained exclusively to the first type of policies and the second are discarded on the grounds of orthodoxy. In this way, many of their possible synergetic effects through coordinated and complementary effort are, at best, not maximized, and at worst, simply lost.

In our opinion, regional policy is better placed to tackle the challenge of competitiveness, including by helping rooting direct investment from outside the region in the regional economy. A regional policy which stimulates development efforts will necessarily have to change and evolve over time, beyond investment in physical infrastructures (e.g. road and rail, waste and water, etc.) to become more effective. It will eventually have to focus more and more on intangibles linked to regional innovation capacities, including the institutional framework and public-private interaction which underpin this capacity. To say it in more imaginative terms: as the regional economy and society progress, the accent has to shift from opening

roads (with big budgets) to opening minds (with smaller budgets but much more difficult to design and implement). This is not always easy to explain.

Thus multi-level governance, both horizontal across traditional institutional boundaries amongst ministries, as well as vertical through intelligent subsidiarity amongst local, regional, national and – in the EU – European authorities, together with making good use of professional intermediaries (e.g. regional development agencies), addressing “functional” regions, becomes of paramount strategic importance as we move forward in the developmental path. That is institutions and the way in which regional key players learn to interact among themselves matter. We believe that this can largely explain why some territories shoot ahead through innovation while others lag behind in their development, even in the presence of similar endowments of those factors that have been traditionally considered by economists as key to economic development efforts.

Moreover, the progressively interdependent economy we work in is not a zero sum game: there is room for generating win-win situations between driving and lagging regions. As European regional policy has demonstrated, those that engage in a solidarity effort to help others stand on their (economic) feet through enlightened self interest do get value for their money. In time, their economies will benefit through increased, more stable and diversified demand for equipment, know how and a market for higher value added products for which they have consolidated competitive advantage. Moreover, it is not only a question of economic prosperity. It is also a question of social and political stability.

The regional development policies that we propose are about empowerment by helping regions help themselves, not compensation or charity, and creating additional overall value so that there is altogether more to share. They are also helping regions reach their full potential whatever their developmental level rather than establishing a standard goal for all or creating rankings within a single narrow developmental path. They are much more about levelling the playing field at the start than equalising the outcomes at the end.

In conclusion, while regional policy can make in our view a difference in the pace and direction of regional development, current policy practice needs profound revision in terms of objectives, instruments and policy delivery systems.

In terms of objectives, regional policy has to continue its move from a narrow interpretation of cohesion in terms of redistribution and disparities into supporting latent growth capabilities wherever these are to be found.

Micro and mesoeconomic competitiveness problems can not be efficiently tackled by overdoses of macroeconomic or sector based policies but by integrated, “place-based” policies. Regional development policies are such “place-based” policies. To be clear, in our concept of regional policy, “place-based” does not mean parochial or inward looking. Place-based means understanding contexts beyond a few narrowly defined economic variables across the board and identifying distinct developmental assets in each case. That is, understanding institutions, history and business culture, which are precisely the key features that define a region. Regions are neither artificial administrative constructs nor independent institutional frameworks but links in a governance chain where public policy can sometimes be more effectively developed because of its closeness to understand economic needs

and mobilize capabilities. Thus, regional policy is neither national policy at smaller scale nor public policy applied to a territory which has been artificially identified as a region. The objectives of these policies, with their feet solidly rooted in their territories should be to have regional heads above the clouds or nearby valleys and into the global economy, where they should aspire to become competitive players in their own terms.

Regarding instruments, public policy effectiveness is about the right policy mix adapted to each regional context: there are no “one-fits-all” recipes and good practice only exists for those willing to learn from others and experiment themselves. The capacity of key regional players to interact, share a vision and jointly commit efforts and resources is an integral part of any public policy trying to promote regional development. Regions which are able to develop the institutions and policies promoting these interactions through partnerships (be they public-public, public-private or private-private) and across the governance ladder are likely to be successful in developing a process of sustained and sustainable growth, no matter their current development level, natural endowments or inherited comparative advantage. In short, regional policy is relevant for all types of regions as a means to liberate latent developmental capacities through appropriate policy mixes.

Public policy to promote regional development can not be left solely in the hands of the national or regional ministries of the economy. It requires horizontal and vertical governance structures cutting across administrative boundaries and power structures. Budgetary, audit and accounting considerations should only be at the service of strategic planning capabilities and not the other way round: ideas, concepts and cooperation first, public money after.

In terms of policy delivery systems, regional policy can not continue to be treated as simply a funding strand. It is a public investment framework with specific requirements. It requires strong conditionality and a healthy degree of competition of the best project ideas to access scarce public funds.

The best thing one could probably say about regional policy is that it can make economic development a non zero-sum game where all stand to gain, and it is possibly the most effective means to ensure cohesion through the “overall harmonious development” established in Article 174 of the Lisbon Treaty.