

Economic convergence across and within EU countries : is there a puzzle?

by **Paolo Sestito**

Ministry of Labour and Social Policies, Italy

Spatial income inequality across EU countries and (country) regions

- Increasing role of within countries (across regions of each given country) inequality in total EU15 spatial inequality:
 - Within countries share of total variance of GDP per inhabitant across EU15 NUTS2 regions rose from $\frac{2}{3}$ to $\frac{3}{4}$ between 1996 and 2001
- Jump of the total spatial inequality and of its between countries share (to around $\frac{1}{2}$) when considering the EU25 aggregate – over time (albeit over a very short period) it is confirmed the increasing role of the within countries component
- Quite different national cases:
 - In EU15, mild reduction of spatial inequality in IT, small rise in ES and DE
 - Apparently, succesful catching-up countries are among those experiencing increasing regional disparities.

Spatial Inequality versus β -convergence

- **BSM (and many others) → 2% convergence speed as almost universal rule**
 - It refers to the conditional β -convergence in a CRTS with exogenous technical progress frame
 - It is compatible with a widely reinterpreted notion of K (including human capital, upon which post MRW literature has specifically focused)
- **Later refinements:**
 - Discontinuity (and heterogeneity) in convergence and emergence of clubs
 - Speedier convergence when fully taking account (in panel data applications of MRW specification) of heterogeneity → emptiness of convergence concept?
- **EU results:**
 - Evidence of convergence across EU regions and within most countries
 - Post mid'70s decline in convergence speed: apparently linked to subdued intraEU migrations and rather at odds with the timing of EU (not national) regional policies
 - Some hints of a revival in convergence since mid'80s, particularly in Ob. 1 regions covered by EU regional policies.

How to interpret the convergence/lack of convergence results

- **What drives convergence?**
 - Diminishing returns to reproducible assets
 - Technological catching-up (transferring of best practices and learning)
 - Economic integration and “gains from trade” (capital, labor and trade flows favouring structural shifts towards more productive uses of the existing resources, particularly in formerly rural areas)
- **What drives divergence?**
 - (locally) increasing returns
 - Cumulative R&D prospects and first mover advantages
- **Conclusions**
 - the heterogeneity of outcomes across time and space is not so puzzling (the BSM 2% rule is at most an average)
 - There may be systematic differences among the within-countries and the between-countries dimensions

Differences in the within-between countries processes

- The geographical dimension: at a very detailed level locally increasing returns and cumulative processes prevail → no convergence across narrowly defined regions is possible (and efficient)
- Heterogeneity in initial conditions during a catching-up phase leads to diffusion processes with a complex dynamics → Williamson hypothesis of an inverse U-shaped relationship between (spatial) inequality and economic growth
- Taking account of (equilibrium) unemployment: downward real wage rigidity and excess unemployment (of relatively immobile people) in less productive regions may reinforce within countries divergence

Some stylised facts about employment and productivity

- **Decomposing the yearly log variance of GDP per inhabitant into an employment and a productivity components (plus a double covariance term) it appears:**
 - Across EU15 regions employment “explains” slightly less than 1/3 of total variance, its relevance having been declining.
 - Across EU25 regions the importance of employment shrinks to about 1/5 of a larger total.
 - The covariance of employment and productivity is small. Its between countries component is negative, while its within countries component is (predominantly) positive.
- **In terms of (unconditional) convergence:**
 - GDP per inhab: the unconditional- β is slightly negative across regions and countries, but not so within countries
 - Notice that the convergence is stronger (and for EU15 it does not fade out when considering its within countries component) for the productivity term.
 - The lack of convergence within countries is due to the positive (within countries) covariance between productivity and employment

Equilibrium employment and productivity are positively correlated across regions of each country

- Focusing upon multiyears averages (in order to purge from business cycle factors possibly leading to a positive covariance), it appears that within countries employment and productivity are positively correlated, particularly when removing the poles where wait-unemployment phenomena à la Harris-Todaro may confound the picture.

	EU15	EU25
total	-.0222	-.0827
Within countries	.1023	.1169
Within countries (excluding capitals)	.1895	.2128

Unconditional- β coeff(t-stat)

	GDP	Employment	Productivity
Within countries EU15	.2 (.51)	-6.7 (11.41)	-1.7 (2.96)
Total EU15	-1.2 (3.46)	-5.9 (9.23)	-2.6 (4.85)
Within countries EU25	.6 (1.55)	-2.7 (2.78)	1.9 (1.91)
Total EU25	-.7 (2.25)	-4.0 (4.38)	-2.2 (3.72)

The goal of regional policies – some reflections

- Regional policy is not (only) a relief (redistributive) policy. Overall efficiency may be increased by furthering the use of unused (relatively immobile) resources in laggard regions.
- Regional policy and labour market flexibility are parts of a two handed approach, one aims at shifting productivity and labour demand, the other at shifting effective labour supply.
- Too narrowly defined regions (in terms of population/physical/economic size) are not a meaningful target for regional developmental policies
 - Some widening of spatial inequality across microareas may allow to reap the overall efficiency gains from locally increasing returns. Actually, the effectiveness of regional developmental policies may be increased by appliance of a “concentration” principle
 - Mobility across microareas of a broad region (for instance through commuting) may be less costly than long distance mobility
 - The risks of induced microeconomic distortions are increased when policy aims at targeting microareas.
 - Income maintenance goals in stressed regions may be more efficiently pursued through direct programs than through developmental policies, while other goals (for instance environmentally related ones) have to be assessed per se.

The balance between EU and national competencies

- The between countries dimension, particularly after the enlargement, is the one predominantly relevant at the EU level
- The subsidiarity principle, the differentiated shape of the subnational levels of government across MS, the fact that much of the policies implying redistribution of resources at regional level (and to be coordinated in a two handed approach) are defined at national level all would suggest to leave the within countries dimension to the national level.
- Yet, the non redistributive role of regional developmental policies suggests the presence of EU level gains.
- Moreover, a policy easing the development of (across national borders) regional interactions within the EU is part of the overall EU economic integration process.
- Finally, there are possible gains to be reaped from a common EU frame for regional development policies

A common EU frame

- Respect of internal market and competition rules
- Avoidance of “national champions” (sustained through narrowly chosen regional targets implicitly picking up a bunch of firms)
- Avoidance of “dumping” risks through competition of national tax authorities
- Channelling the resources towards “appropriately large” regions with unused resources
- Gains from the “open method of coordination” frame:
 - the advantages (and some bureaucratic drawbacks) of the 4 guiding principles of EU regional policy and the emergence of a community of policy makers;
 - the boost to local governance capability as prerequisite for economic development;
 - promotion of the two handed approach
- More flexibility to the national level and more outcome orientation in the common OMC game
- Possible new ideas:
 - Non-wage labour cost rebates
 - Microareas versus broad regions
 - The links between regions targeted at national and EU level