European Commission

THE FUTURE OF COHESION POLICY

DEVELOPMENT: A CONCEPTUAL FRAMEWORK FOR COHESION POLICY

Michael Storper

Professor of Regional and International Development, UCLA (Los Angeles, USA)

Professor of Economic Geography, London School of Economics (UK)

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First meeting – Developing the European Growth Model

Regional and Urban Policy

My purpose

- **Two main questions:**

1. What is a viable development model for high-income countries in today's world? What is the European model, and how does it compare to this viable development model?
2. How can we situate the needs of lagging or less-dynamic regions within the context of an updated European development model?

What is “development?”

- Per capita income (PCI), in cross-sectional and panel studies of international development, has an extremely high correlation to most of the good things (such as health, longevity, quality of life, housing, environment) that we want to achieve from economic development.
- Development can be said to be taking place when per capita personal income (PCI) is increasing. When absolute levels of PCI are stagnant or declining, development is not occurring.
- In addition, PCI’s impact on the welfare of the “average” inhabitant of a region is conditioned by the interpersonal income distribution of the region.
- Substantial social science research converges on the idea that the “goldilocks zone” for income distribution – the one that favors political stability, problem-solving, happiness and social welfare, while maintaining high incentives for innovation and dynamism -- is a Gini coefficient on income in the neighborhood of 0.30-0.35, whether before or after social transfers.
- The term ”development” as I am going to use refers to PCI in this socially inclusive sense.
- **My argument today is that cohesion policy should use socially inclusive PCI growth in all regions as an operational guideline for policy design and policy monitoring and evaluation**

What is Europe's growth model?

- In recent decades, Europe's PCI growth sources are principally:
  - Scale increases due to European integration
  - Comparative advantage effects from globalization – sectoral succession
  - Labor –*substituting automation* in consumer services and in manufacturing and other trade-able sectors – high hourly labor productivity
- Europe's PCI growth *limitations* come from:
  - Sluggish demographics
  - Low working time and short working years by world comparative standards
  - Low labor force participation in certain regions
  - Weak first-mover labor-augmenting innovation sector: Europe's big companies are too much in legacy activities and industries
- Let's compare Europe's growth model to the other developed world growth model, the USA. The USA's differences are:
  - More demographic increase than EU (labor force growth)
  - Longer working hours and working years than EU (less leisure)
  - Higher labor force participation across the life cycle;
  - Similar *labor-substituting automation* in trade-ables and standardized consumer services
  - A bigger innovation-driven sector (finance, high-tech, entertainment) with more labor-intensive "frontier work" and "new occupations" -- this is *labor augmenting innovation*
  - A bigger *labor-intensive personal services* sector driven by high incomes
  - Much higher income inequality than most of the EU

Non-growth or de-growth are not options

- PCI must rise over time in real terms if Europe is to finance increasing dependency ratios; longer life spans; higher quality of life; and competition with other world regions for influence and mastery of Europe's own destiny in economic, social, cultural and military terms.
- PCI rises through increasing labor force participation and increasing wages

The “narrow corridor” for PCI growth

- All developed economies face similar technological constraints and possibilities that affect the potential for PCI growth.
- Overall, technological change has polarized labor demand between high-skill and low-skill occupations, and tended to hollow out of the middle (with growing wage-income inequality the result).
- However, innovation can also *create* new forms of relatively labor-intensive employment. This comprises work that is in “new” occupations and industries that have not yet been routinized and offshored; “frontier” work that is highly tacit and involved in the work of creation and innovation itself; and older work that is “augmented” with new technology tools to become more productive.
- Innovation-driven, labor-augmenting employment growth is the main way that developed economies can dynamically compensate employment losses from labor substitution, offshoring and importing.
- It must occur, as we shall see, in all regions.

The EU work model further narrows the corridor

- The European corridor is especially narrow, because it is unlikely to augment the quantity of work through labor force growth
- Europe is not about to abandon its social model, which impacts PCI by reducing working hours, protecting leisure and high quality of life for those who work
- Demographics are probably not going to change– can't raise PCI this way in the short-run by increasing pop-based output.
- Labor-substituting automation is unlikely to slow down
- Thus, the corridor to raising PCI is especially narrow for the EU: a a European pathway to labor augmenting high-wage growth

The EU social model further narrows the corridor

- If we compare the American and European growth pathways, the American pathway has done better on PCI growth but has experienced much greater inequality growth than Europe
- There are two big sources of this difference:
  - Europe's taxation, labor market, and financialization policies have done some of the work of limiting certain kinds of inequalities; combined with more a redistributive model of robust public services
  - But part of the difference is that the USA has had more growth of the best jobs – those that are linked to its first-mover innovation system – the same one that is labor augmenting with high wages
- Therefore, if Europe is to find a European growth model with more high-skill labor augmenting innovation, it must do so in a way that avoids the collateral American inequality effects and is compatible with our social model
- This will require close attention and *policy originality*

All regions must contribute to the overall PCI growth of Europe

- *PCI must rise over time in all regions.*
- This is because the overall level of PCI is the population-weighted average of the PCIs for the patchwork of territories respectively, for each member state (MS) and for the EU as a whole. Think of this as water flowing into a bathtub or reservoir, where the level of the water is determined by what flows in from different faucets or tributaries.
- For example, think of two equal-sized regions: Region A's productivity/PCI index is 150 and region B's is 80, the average is 115. Each territory is contributing to the average.
- If we modestly raise Region B's index to 90, and Region A's to 160, notice that the baseline equilibrium income potential of the national (or EU) economy increases to 125. Assume, for the purpose of the argument, that we can do so while maintaining the inter-personal income distribution of both regions in the desired range. This is a balanced positive-sum growth pathway.

Inter-regional redistribution has limits

- Inter-regional redistribution occurs in many ways, whether deliberately through regional policy, or implicitly through health, education, pensions, that attach to people, including mobile people across the life cycle.
- Superstar metropolitan regions already trickle-down considerable income to other regions: through fiscal redistribution that attaches to people-based and place-based formulas; through de-agglomeration of routine functions from value chains; through residential income/spending and the local multipliers from that. In some Member States, this is a very big part of the income of non-Superstar regions.
- But redistribution is limited because maintaining or improving the 150 in the most dynamic regions is itself very costly in terms of fiscal-public resources. The highest-performing metro regions have non-linear ("cost disease") dimensions, such as for increasing education and infrastructure and abating congestion. There is thus an inevitable tension between super-leading regions and the rest in the attribution of fiscal public resources. This isn't inherently a zero-sum game to non-Superstar regions, unless it gets too extreme.
- The point: regions must be made to grow their PCI from widely spread own productivity and employment changes, not just from redistribution or trickle down.
- In this light, convergence is not the goal, growth is.

The tasks (4 types of regional problem)

- Research demonstrates that the two main channels by which changing the employment base of a region can increase PCI are upward occupation-industry switching, and increased labor force participation. These are the channels for labor-augmenting employment growth.
- Territorially, this is already occurring in a tier of dynamic middle-sized cities in Europe. They benefit from high interaction with one another as well as with superstar regions. They manifest systematic urban productivity (and hence, income) surpluses. Though they are relatively well-off, they should receive additional attention as particularly feasible locations for raising employment and productivity in the EU. They are a huge target of opportunity for dynamizing the European city system.
- Let's consider three rather more problematic cases: lagging industrial regions; catch-up regions; and middling "average" regions

Lagging or older industrial regions

- Many of these are the less dynamic middle-sized cities/metro regions
- They are not attractive to the skilled and the young
- They are not particularly innovative
- There are not very many examples in EU or USA of reconverted old industrial regions: Rochester and Pittsburgh are cases, where anchor institutions, firms and networks kept innovators in place or attracted new ones. This is the key.
- Contrast the stagnant such regions to the up-and-coming places. In the USA, they are young and multicultural (Austin, the area around Denver). We need to think more about how these conditions could be generated in older industrial regions
- Some of it is lifestyle
- Some of it is perceived social openness – less conservative and closed local society
- Some of it is objective concentration of innovation organizational tissue (firms, labs, start up conditions, higher education)
- There is an insider-outsider dynamic here that must be faced by policy. It will not be easy.

Catch-up regions: how to keep them moving upward?

- Catch-up regions, mostly in accession countries, have done relatively well in PCI change
- This is because the first stage of European integration has had immediate benefits
- But then, many of them have hit or will hit, a middle-income development trap (similar to many Sunbelt American regions)
- That is a much more difficult stage, because it requires order-of-magnitude changes in skills, innovation, and agglomeration economies
- The larger of these regions have more potential than the smaller ones: this is what the US evidence clearly shows.
- But even the larger ones will hit a middle-income trap unless they focus on education, innovation, immigration-open-ness and social open-ness; and good governance -- the "high road"

Middling (or "average") regions

- Any continent has a lot of regions that are are not marked by high levels of urbanization or distinctive high-skill regional specializations, but nonetheless offer decent PCI and standards of living
- With good infrastructure, good living conditions, and a productive and available labor supply they can become attractive for secondary positions in continental value chains….more routine functions that need to leave the areas in which they are created.
- Right now, the main blockage is their rigid labor markets, with low LFP and the fear by companies that they will suffer labor shortages in these places

Conclusion: an EU-wide growth model for all regions

- My main point is that the different “problem” regions must be seen in the context of a reconsidered *EU-wide growth model*
- That model needs to emphasize labor-augmenting innovation from from the top all the way to the bottom
- Convergence per se is not the goal: making all territories grow their PCI so that it contributes to the European “pooled” PCI is the most urgent task
- **Growing PCI (in an inclusive way) is a simple and clear benchmark to use for policy design, monitoring and evaluation. It can serve as a guidepost.**