

Policy Brief

1 - JUNE 2008

This Policy Brief has been elaborated under the EU-funded project **PLATON+** (www.platonplus.net) which aims to:

- a) **communicate** socio-economic research results to policy makers, Civil Society Organisations and business communities across Europe, and
- b) **show ways** of collaboration and bring into contact socio-economic researchers and researchers from other disciplines.

PLATON+ Policy Briefs communicate socio-economic relevant research results and key policy recommendations in a concise and non-technical format to policy-decision makers, Civil Society Organisations (CSOs) at European, national and regional level.

This Policy Brief discusses key findings and policy implications provided by the EU-funded project "The Impact of European Integration and Enlargement on Regional Structural Change and Cohesion"- **EURECO**.

The Impact of European Integration and Enlargement on Regional Structural Change and Cohesion

Research Context

Over the past two decades there has been a growing interest in the analysis of spatial implications of economic integration via trade and foreign direct investment (FDI). The explanation for this increased interest is twofold:

- First, because of the policy relevance of such analysis;
- Second, because of insights from new theoretical trade and growth models

Although several empirical studies already exist, most of them cross-country analyses, the changes of production structures at regional level in the context of economic integration have been little investigated so far.

In particular, in the case of the enlarged [European Union \(EU-27\)](#) the following research questions are interesting and policy relevant:

- To what extent does [economic integration](#) affect regional production structures?
- How do changes in [regional production structures](#) affect regional economic performance?
- What role does [FDI](#) play in regional structural change?
- Which [types of regions](#) are more affected by structural change?
- What [policy implications](#) are there for cohesion in the enlarged EU?

These research questions are [policy relevant](#) for at least three reasons:

- First, [economic integration](#) is essentially a reallocation of resources across sectors and space expected to result in changes of production structures. While these changes bring aggregate efficiency gains these gains may not be evenly distributed across space and sectors and, moreover, short - term adjustment costs may be important. This structural change [has thus an impact on welfare](#).
- Second, to the extent that there are [industry-specific shocks](#), changes in patterns of specialization at regional level have an impact on the probability of asymmetric shocks which in turn [has an impact on the net benefits of the European Economic and Monetary Union](#).
- Third, to the extent that [changes in production structures](#) affect regional economic performance, these changes [affect the economic cohesion at the EU and national levels](#).

Research context

What effects has the economic integration had on regional production structures and convergence in the EU-15?

What effects has the economic integration had on regional production structures and convergence in the new EU member states?

What role has foreign direct investment played on regional structural change and development?

Key policy implications for cohesion in the enlarged EU

Further reading

What effects has the economic integration had on regional production structures and convergence in the EU-15?

- Over the past two decades, changes in regional production structures have taken place at a slow pace. The regional production structures are converging to the EU-15 average level, so that more specialised regions are becoming more diverse and less specialised regions are becoming more specialised. In terms of the regional performance, those regions that are highly specialised in resource dependent industries, such as iron and steel industries, are not performing well, and one might consider these regions as 'losers' from the integration process. On the other hand, central regions tend to perform above average, while remote regions appear to be catching-up. Semi-central and semi-remote regions show a very mixed picture.
- Overall, it appears to be some convergence among EU-15 regions when compared to the EU-15 average. This however does not rule out that there is divergence among regions in the same country, especially in countries that are growing fast such as Ireland, where the degree of convergence is negatively related to the national growth rate, which was also found to be the case for Greece. Furthermore, despite EU-wide convergence, substantial disparities persist, so that a role for regional policies remains in the EU-15.
- In terms of their output performance, the highly industrialized regions in the EU-15 appear to be falling behind over the observation period of the 1980s and 1990s. An initial high specialisation at the regional level had a negative impact on employment growth. This negative relation can be observed, in particular, in regions specialized in resource intensive and increasing returns to scale industries. The significantly negative industry-specific specialization-growth nexus did, however, generally not translate into a negative aggregate specialization-growth nexus. There is little evidence from the descriptive analysis of a high initial specialization onto single industries, or a comparatively high aggregate specialization generally shaping aggregate regional employment growth to a notable extent.
- Slightly higher degrees of concentration prevailed in agriculture and related food-processing industries, which are more closely associated with more rural regions rather than urban agglomerations. Similarly resource-based industries such as mining and steel industries are more concentrated since natural resources are only found in certain locations. Finally, manufacturing industries, which are subject to localization economies are also more concentrated (e.g. Mining, Iron and Steel). By contrast, several of the manufacturing industries that are usually regarded as being subject to firm-specific increasing returns to scale are not found being systematically higher concentrated than other industries.

What effects has the economic integration had on regional production structures and convergence in the new EU member states?

- Regions that have a high proportion of employment in the secondary and tertiary sectors, that are less specialised, tend to have the highest per capita GDP levels. These regions tend to be internal regions, capital city regions or regions with a direct border to the EU-15, suggesting that agglomeration and location are important determinants for the performance of the regions of the NMS.
- There has also been a distinct divergence among NMS regions. Indeed this finding is not dependent on the spatial scale of the countries. This suggests

that the integration process has not benefited all regions equally, and that there are 'loosing' regions.

- Internal regions (those that do not border other countries) and the capital city attract the majority of economic activities. Furthermore, 'capital-intensive' sectors are only concentrated in capital cities, internal regions and regions that border the EU-15. As a general rule among the manufacturing industries the regions of the NMS tend to be more specialised in labour intensive activities, which reflects comparative advantage since labour costs are considerably lower in NMS. These patterns are also apparent in a dynamic analysis of the specialisation patterns.

What role has Foreign Direct Investment played on regional structural change and development?

- FDI is concentrated at the country and region level. In general, FDI is most heavily concentrated in Hungary and the Czech Republic, while Poland, Romania and Bulgaria still lag behind. From a sectoral perspective, it is noticeable that high-tech foreign firms are less numerous than low tech ones, representing no more than 30% of the whole sample. An interesting feature of the sectoral distribution of firms across space is that high-tech foreign firms prefer to locate in Hungary or the Czech Republic, while low tech foreign firms concentrate in Romania.
- The economic factors that are important in attracting FDI are good macro-economic fundamentals, good infrastructures, skilled labour force, large domestic markets and a sound legal system. While high tech foreign firms seem to be attracted by market potential, degree of connectivity with neighbouring markets, and agglomeration economies emanating from other foreign firms, low-tech foreign firms, instead, look for a more complex set of location advantages. Apart from those mentioned in the case of high-tech foreign firms, it also includes the cost and the availability of skilled labour force and the possibility of interacting with domestic firms. Quite surprisingly, country risk does not decrease the probability of a location to be chosen by a multinational enterprise. This confirms that markets compensate high risks with high profits.
- It appears that national boundaries do not exert any significant effect on FDI location choice. The choice of foreign firms is not between Poland and Romania, for examples, but between groups of similar regions. High tech and low-tech foreign firms perceive this "similarity" differently. The former, in choosing a location for their production plants, consider three different types of regions: the capital cities, the regions bordering with the EU, and all other regions; the latter, instead, simply consider whether a region is member of the EU or not.

Key policy implications for cohesion in the enlarged EU

- Given the slow speed of diversification it is reasonable to consider that policies be introduced that speed up the convergence of industrial structures since this could benefit the speed of convergence. This conclusion also corresponds with the observation that those regions that are more focused on the primary sector, which implies a significant difference from the average industrial structure, have performed poorly. Thus, rather than focusing substantial funds on the support of the agricultural sector, a reorientation of these resources towards more advanced sectors could help reduce regional disparities. Similarly, regions that are specialised in resource intensive industries appear to be performing poorly, and instead of supporting these indus-

tries, policies that deal with the transition costs for the reorientation of regions towards more sustainable industries, should be pursued. An important focus of this reorientation should be placed on training and other labour market initiatives.

- Linkages between domestic and foreign owned firms should be further stimulated by appropriate policy interventions. In order to increase their effectiveness, linkages should however be targeted to domestic firms rather than foreign firms. Stronger local firms not only attract FDI but are also able to exploit benefits emanating from them.
- Policy interventions aiming at improving market access, infrastructures and labour market conditions, appear more efficient in attracting FDI rather than granting fiscal and financial incentives. In addition new EU member states might consider more pro-active measures to help maximize long-term dynamic FDI benefits. This implies to strengthen domestic firms so that they can compete with foreign enterprises or become more active partners in upstream and downstream operations, improve innovation system and the absorptive capacity of domestic firms. These policies are likely to improve the attraction of high-quality foreign firms and avoid the emergence of FDI enclaves.

Further reading

- Boden-Krieger, C., E. Morgenroth, G. Petrakos (2008), The Impact of European Integration on Regional Structural Change and Cohesion, London: Routledge (www.routledgeeconomics.com), ISBN: 978-0-415-40024-4
- European Commission (2007), The Impact of European Integration and Enlargement on Regional Structural Change and Cohesion, Final Report, Luxembourg: Office for Official Publications of the European Communities. www.esri.ie/UserFiles/publications/20070627174716/BKMNEXT098.pdf

EURECO at a glance

Title	The Impact of European Integration and Enlargement on Regional Structural Change and Cohesion
Research Objectives	<p>The EURECO research project has provided empirical evidence on the impact of economic integration on changing regional production structures and cohesion in the enlarged European Union (EU-27). Specifically, this research has contributed the following:</p> <ul style="list-style-type: none"> • an empirical analysis of patterns and changes of regional production structures and economic performance in the EU-27; • an analysis of the role of foreign direct investment (FDI) in fostering changes in regional production structures and regional development; and • key policy implications for cohesion in the enlarged EU.
Duration	1 January 2002 – 30 October 2005
Website	http://www.zei.de/zei_alt/eurec/frameeureco.htm
Scientific Co-ordinator	Dr Iulia Siedschlag Tel. +353-1-863-2116; e-mail: iulia.siedschlag@esri.ie
Research Consortium	<ul style="list-style-type: none"> • Center for European Integration Studies, University of Bonn (ZEI), Germany (co-ordinator) • Institute for World Economics, University of Kiel (IfW), Germany • University "Luigi Bocconi" (UNIBOC), Milan, Italy • Economic and Social Research Institute (ESRI), Dublin, Ireland • University of Thessaly, Volos (UTH), Greece • Institute for World Economics - Hungarian Academy of Sciences IWE), Budapest Hungary • Institute of Economics - Bulgarian Academy of Sciences (BAS), Sofia, Bulgaria
Funding Scheme	5th Framework Programme, Key Action: Improving the Socio-Economic Knowledge Base
EU Financial Contribution	800, 000 €