EU REGIONAL POLICY AND LOCATION EFFECT: CONTRADICTIONS AND COSTS

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Is there a dissonance between the objective of the European Union and the effect of its policy? Jamie Wilson takes a closer look at the process of location and agglomeration, whereby the production of goods and services locates itself where comparative advantage arises. The paper will then examine the costs of the EU regional policy, and outline the imbedded contradiction.

Introduction

The 1957 Treaty of Rome set out the famous 'Four Freedoms' for citizens of the European Economic Community (European Commission, 1957). However, only in recent times have the free movement of goods, people, services and capital actually, by in large, been properly implemented. What these fully enforced freedoms give us, is not only an extra set of lovely sounding rights for EU citizens, but also, it frees up the movement of economic activity within Europe. What the EU and economists alike are interested in, regarding this free movement, is where this economic activity occurs. What this essay will explore, is the role that regional policy plays with regard to location effects and how the policy costs the EU and contradicts its objections. In dealing with this we must begin with the facts of economic location within the union. Next, in order to gain a better understanding of location effect itself, we will need to examine the economic process of 'Agglomeration'. We will then look at what regional policy actually entails. With this covered, we will be able to critically assess regional policy in terms of the location of economic activity in Europe and what the policy means for the EU itself.

The Facts

When looking at the facts of location effect in the EU we concentrate on two key aspects: national differences and regional differences of economic activity. Beginning with national differences, in 2011, member states ranged from 45% to 274% of the 'EU27' GDP per capita average, with Bulgaria being the low extreme and Luxembourg being the high extreme (Eurostat, 2012). Taking out the extremes, there are still huge disparities between member states incomes. There has however, been some narrowing of national differences, most notably amongst the 'EU15' whose incomes have converged to their own 'EU15' average. The aforementioned Luxembourg, is the only member state that is diverging quite sharply from member state averages, as it over doubles next in line Netherland's 131% of EU average income.

Interestingly, when we look at the differences between incomes in terms of regions within states and regions within the EU as a whole, we actually see income disparity becoming more pronounced. Take the North West of Europe – West Germany, North-East France, South-East England and the Benelux countries. This area takes up around 1/7 of EU land mass but now houses a third of its population and half of its economic activity (Baldwin and Wyplosz 2012). It follows that out of the fifteen countries below the EU average GDP per capita in 2011, all were in the southern and eastern regions of the EU. There are also wide regional income differences within member states, with the United Kingdom being a good example of this. The only areas above the national income average are greater London and the area just south of London. The increased economic activity in these areas seems to be somewhat 'balanced' by significant reduction of incomes in regions such as Scotland and North-East England who have both fallen below national average. This leaves 10 out of 12 regions within the UK actually being below national average income.

Having looked at the figures, averages and percentages we have some clear facts about location effect in the EU: Income differences between EU states are vast with some member states being significantly richer than others. These differences are however narrowing slightly, particularly within the 'EU15'. With regards to regions, economic activity is becoming more and more concentrated, both in the EU as a whole and within individual member states. With these facts dealt with, we can now delve into the 'behind the scenes' of location effect in the EU by looking at Agglomeration.

Agglomeration

The key process we need to examine when looking at location effect in the EU is agglomeration. This is best explained with a simple example. Let's take an economy with two regions: 'The North' and 'The South'. The southern region experiences, for whatever reason an injection of economic activity while the North receives none. With increased activity in the South, more jobs become available there, increasing the purchasing power of the region and enticing people from the North to work in the South. With an increased population, more services are required, further jobs are created and more wealth is accumulated in the there. Firms are attracted to the south because locating there means they are closely located to other suppliers and firms and more importantly, closer to a bigger population. There are a large number of these knock on effects that could be explained but what is important to understand is that the increased activity in one region, be it a new firm or an expansion of a particular sector means that people, firms and money are attracted to the area, and once attracted there, it makes the region even more appealing, this is agglomoration (O'Flahety, 2005). In a European context the area which experiences the increased economic activity could be considered to be the north east. This, at least partly explains why it contains so much of the EU population.

Regional Policy

Now we can begin to discuss regional policy. Over a third of the EU budget between 2007 and 2013 was spent on regional policy, a total of 347 billion (European Commission, 2012). Some of the goals of the policy include: 'Reducing regional inequalities …due to many things, including: longstanding handicaps imposed by geographic remoteness, more recent social economic change and the legacy of formerly centrally-planned economic systems' (European Commission 2007) .The funding comes through from three different sources; The European Regional Development Fund (ERDF), The European Social Fund (ESF) and the Cohesion Fund. The specific objectives of these funds are 'European Territorial Co-Operation', 'Regional Competitiveness and Employment' and 'Convergence', respectively. Over 80% of total regional policy is spent on the 'Convergence' objective and in order to attain particular levels of funding, a region must have a particular level of income compared to the EU average (European Commission, 2007a, 2009). What's key to understanding the regional policy is that with the use of terms such as 'cohesion' 'longstanding handicaps' and 'Territorial Co-operation' it's quite clear that there is a huge amount of politics going on behind the scenes. From the bigger picture of what direction the Policy is moving, to why Luton received funding over 'equally depressed' Torbay, Regional Policy is tied to the hip with the battles in power that go on between EU member states (The Economist 1999; Financial Times 2010). If we take out the political terms of regional policy, it's pretty easily explained. Essentially the policy is a redistribution of wealth in the effort to make poorer regions in the EU become more prosperous. The simple explanation makes it clear why politics is so entrenched in regional policy, as due to the scale of the funds (a third of the total EU budget), regions which receive a significant chunk of money could potentially see their area go from bust to boom. This makes receiving funds become extremely significant for politicians whose regions are potential recipients.

It is important that the separate aspects that have been discussed; 'the facts', the ins-and-outs of agglomeration and EU regional policy be dealt with separately. Once there is an understanding of these alone, we can bring them together in order to help us look more closely at the role regional policy plays.

Contradictions

Firstly, we must take a step back from regional policy and take a look at the fundamentals of the EU. We were recently reminded of the actual aim of the Treaty of Rome, when the EU won the 2012 Nobel Peace Prize and Europe turned from 'the Continent of War' to 'the Continent of Peace'(The Guardian, 2012). It is often easy to forget that the main motivation behind the EU was in fact to foster better relationships between member states and to avoid further armed conflict. What is interesting is how European leaders believed they could achieve peace. It was perceived that the best way for Europe to improve relations between its states was essentially through a fairly simple economic process: deregulation. What the treaty of Rome created was a single market for member states and all that the 'Four Freedoms' were, was deregulations in the goods, worker, service and capital markets. The idea was, that by freeing up the market and removing restraints on economic activity between states trade would be encouraged and this would lead to increased prosperity which in turn would hopefully would ease tensions (particularly between France and Germany). The 'Common Market' today is still the foundation of the EU; without it, it is be hard to imagine that the other political links tying the union together would remain. The role that regional policy plays compared to the common market is particularly interesting. The whole premise of the common market is to try to take away as many instruments that interfere with the marketplace as possible. What regional policy does is go back into the market with money raised from taxes and attempts to promote economic activity in particular regions within the EU. Interestingly, what it essentially does is actually interfere with economic activity in the common market. Regional policy, which takes up a third of the EU budget, actually contradicts the whole basis of the common market, which attempts to reduce institutional interference in economic activity. We can further expand on this contradiction by looking at regional policy and agglomeration.

Let's go back to our simple example on agglomeration with the two region economy of the 'north' and the 'south'. By looking at regional policy we could say that by encouraging economic activity in the poorer regions of the EU, the policy is actually discouraging agglomeration, that is, we are encouraging people and business to go or stay in the 'north' instead of moving to the 'south'. Here, we can bring back the four freedoms which were part of the deregulations for the common market. What these freedoms did was essentially free up where economic activity decided to locate itself. If we think about this a little more, we can see that by fully implementing these freedoms, agglomeration can now take place not only within individual member states, but on an EU wide level. This means that the 'north' and 'south' regions now become regions of the EU as a whole. The common market amplifies the process of agglomeration and it is as if regional policy actually attempts to undo some of the work which is created by the very foundation of the EU. Not only can people move around in their own countries but now people from areas such as Southern Italy, Eastern Germany and the CEEC's can get up and go to the prosperous north- east and the other large EU cities. What regional policy does is by investing in these poorer regions mentioned, it tries its best to keep these people where they are. In essence, the nature of regional policy, whether intentional or not, means that EU wide agglomeration, cannot take full effect. The inconsistency here is that we once again have EU regional policy working against the deregulated Common Market. So why does the EU have such a conflicting policy?

Social Benefits

So far we have looked at regional policy and agglomeration from purely from an economic perspective. What we haven't taken into account is the social benefits which the policy brings and the potential social cost of Agglomeration. The fact of the matter is, the EU is a political organisation, so it must take into account the social challenges its member states face. This idea of the social side of the EU is exemplified by its Social Charter which outlines various freedoms and rights for citizens (Council of Europe 1996). So taking the social aspect into account our argument on how Regional Policy is inconsistent with the Common Market comes under some scrutiny. Why does it matter if regional policy interferes with the common market and works against the agglomeration process? Surely it's better to interfere with the market than have people who live in a particular areas move thousands of miles away to acquire employment? If we were to let agglomeration take further effect by letting go of regional policy we probably would face potential social costs. Regions which are seen as unfavourable could see increased levels of emigration to the richer areas of the EU. Essentially this would see these poorer areas go from bad to worse. This type of emigration has been associated with large declines in young people, the degradation of infrastructure, rising levels of crime and a demoralised atmosphere among those citizens who remain (Fesar and Sweeney, 1999). All this adds up to, unfavourable regions becoming even more unfavourable to the extent where going back to prosperity is a hugely difficult task. This is why regional policy intervenes, so as stop regions degenerating to the brink of no return and this is seen by many, as a crucial element of the EU so we can avoid these costs on our society. However, apart from the policy having a contradictory nature, what does regional policy actually cost us?

Social Costs

Big cities are the result of agglomeration and the two generally come hand in hand. According to Harvard professor and economist Ed Glaeser, cities actually make us: "Richer, Smarter, Greener, Healthier and Happier". Through data that he has collected for his book "The Triumph of the City", Glaeser points out how cities perform much better than other parts of the economy (Glaeser, 2011). This supports the idea of the Common Market and non-intervention as we need only to look as far back to our own facts on the EU to prove this right, with the North-East region homing the EU's largest cities and half of the total EU economic activity. Also it is clear to see that other high performing areas outside the region are big cities too (eg. Berlin, Madrid and the Northern Italian cities (Nordregio,2009)). As we previously discussed however, agglomeration also brings about social costs, so what do we gain in social terms from cities? Interestingly, Glaeser particularly focuses on a key social issue which the EU spends billion and billion trying to solve: the environment. For example, Glaeser found that a single family detached house uses on average 83% more electricity than urban apartments do. This is a significant figure and maybe even surprising to some as cities are usually associated with billowing smoke and traffic jams. The reduced emissions by city dwellers (which are actually 40% less than even those living in the suburbs) can be partly explained by the lower use of automobiles, as public transport and walking replacing the need for cars. Glaser also highlights other social benefits from cities which might be surprising. He found that city inhabitants are actually healthier than other parts of the population, especially with regard to younger age groups. In addition, according to Glaeser, living in cities actually increases overall happiness of individuals and it is cities that drive innovation. Although Glaeser is strictly talking about cities, we can certainly apply some of the benefits that a city brings to agglomeration as a whole, as both are inextricably linked. As regional policy fights against agglomeration, the EU actually limits the growth of its biggest cites, which although has its social motivations, costs Europe not only in economic terms but socially as well.

Conclusion

So, what can we conclude about regional policy? It would be a bit naive to completely discredit the role which Regional Policy plays. Regional policy has and will help numerous regions across the EU become attractive places for people to live and invest. There is no doubt about what we gain socially from regional policy, but are we sacrificing more than we think? From what we know about the process of agglomeration, once the single market was fully implemented in the EU it became clear that this would affect the location of economic activity in the region. The point is that regional policy attempts to stifle the location effect that is brought about by the single market. This leaves EU policies actually working against themselves which in terms of consistency and efficiency, is not desirable. By taking the point of view of Regional Policy, Agglomeration is seen as a negative, but as we have discussed, we can actually benefit from this economic process. Cities not only benefit us economically but they also have the potential to play a significant part in solving climate change and other social problems. So maybe a better conclusion to come to regarding regional policy is how we view its price tag. It turns out that the 347 billion Euro spent on the policy, a third of the EU budget, is only its face value. Hidden behind this figure, there are significant contradictions and costs which EU citizens pay for.

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