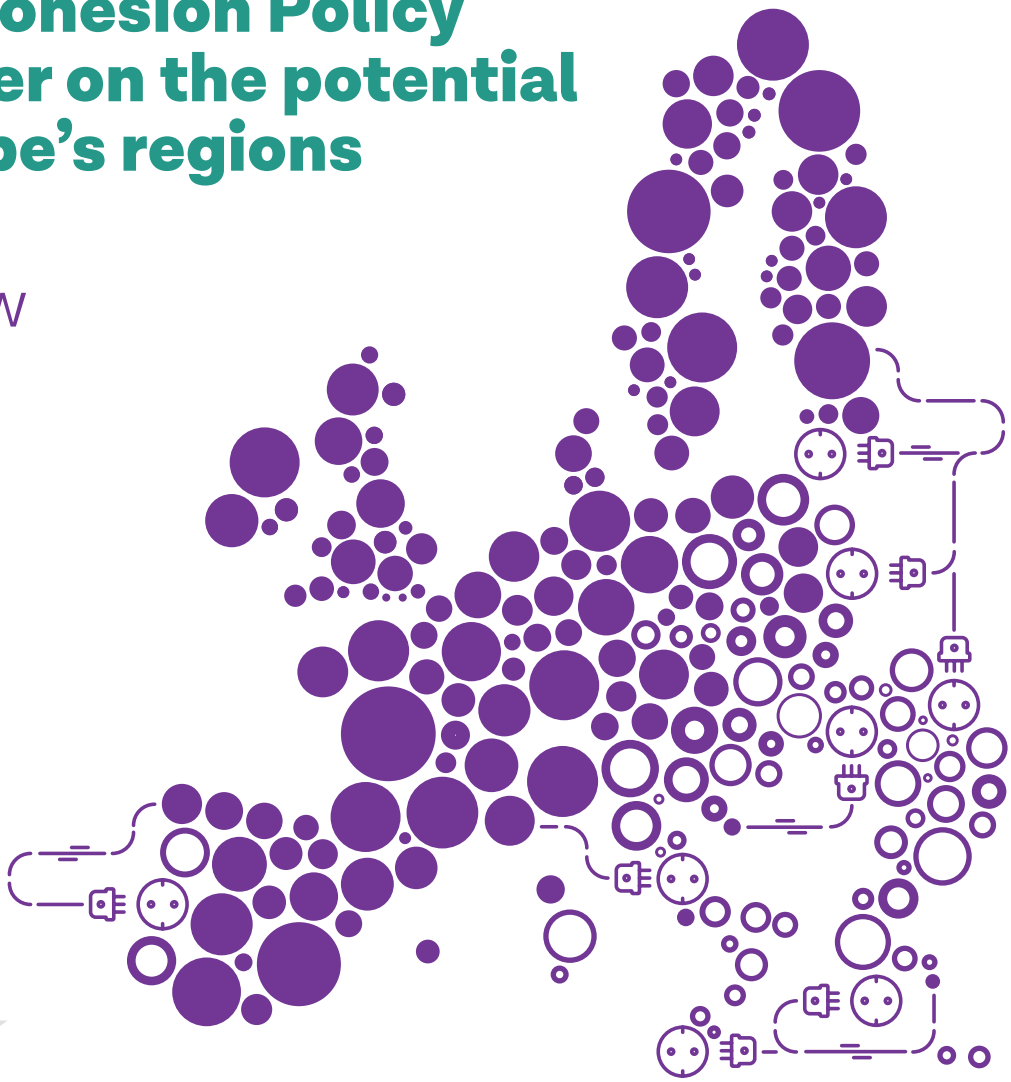
WORLD BANK REPORT
ON THE EUROPEAN UNION

Rethinking Lagging Regions

Using Cohesion Policy to deliver on the potential of Europe's regions

Overview



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Acronyms and Abbreviations

CAGR	compound annual growth rate
CEE	Central and Eastern Europe
CPR	common provision regulation
DG-REGIO	Directorate-General, Regional and Urban Policy (European Commission)
EC	European Commission
ECD	early childhood development
EPI	Economic Potential Index
EQI	European Quality of Governance Index
ERDF	European Regional Development Fund
ESI	European Structural and Investment Funds
ESF	European Social Fund
EU	European Union
ExAC	ex-ante conditionality
FDI	foreign direct investment
FUA	functional urban area
GDP	gross domestic product
GMCA	Greater Manchester Combined Authority
GNI	gross national income
GVA	gross value added
GVC	global value chain
HHI	Herfindahl-Hirschman Index
ICT	information and communication technology
ITI	Integrated Territorial Investment
JRC	Joint Research Centre
LHDI	Local Human Development Index
NEET	not in employment, education, or training
NUTS	Nomenclature of Territorial Units for Statistics (Nomenclature des Unités Territoriales Statistiques)
OECD	Organisation for Economic Co-operation and Development
PforR	Program for Results
PHARE	Poland and Hungary: Assistance for Restructuring Their Economies
PISA	Programme for International Student Assessment
PPS	purchasing power standard
RDA	regional development agency
RIS3	Research and Innovation Strategies for Smart Specialisation
ROP	regional operational plan
SMA	special management authority
SMEs	small and medium-sized enterprises
TfGM	Transport for Greater Manchester

Acknowledgments

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Paper	Contributors
Recasting Lagging Regions	Chris Hooten; Thomas Farole
Assessing the Economic Potential of Europe's Regions	World Bank: Mark Roberts; Jane Park; Chris Hooten; Keith Garrett EC (REGIO): Lewis Dijkstra; Laura De Dominicis; Blazej Gorgol; Karolina Jankowska
Enterprise Dynamics and the Regional Business Climate	Shawn Tan; Grace Cineas; Thomas Farole
Firm Performance and the Regional Business Climate	World Bank: Shawn Tan; Thomas Farole EC (JRC): Issam Hallak; Peter Harasztosi; Michela Nardo
Magnet Cities: Migration and Commuting in Romania; Poland; and South Europe (three separate volumes)	Marius Cristea and Marcel Ionescu-Heroiu with inputs from: Andreea China, Bogdan Dolean, Codruta Mare, Ciprian Moldovan, Andina Vintan, Thomas Farole, Jane Park, and Keith Garrett
Benchmarking EU Fund Absorption in Romania	Clara Volintiru, Marcel Ionescu-Heroiu, and Soraya Goga
Fiscal Transfers and Rules of the Game	Soraya Goga, David Rosenblatt, and Sangmoo Kim
Regional case studies: Central Macedonia (GR); Sardinia (IT); Podkarpackie (PL); North East (RO)	Sakis Karamoschos (Central Macedonia), Miruna Mazurencu-Marinescu (North East), Conrad Czapiewski and Tomasz Komornicki (Podkarpackie), Anna Pinna (Sardinia)

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Executive summary

Regional inequalities are high and rising around the world, and the EU is no exception.

As the World Bank's 2012 *Golden Growth* report emphasized, the European Union, since its founding, has been a "convergence machine," generating wealth and a higher quality of life for the poorest in the 28 EU member states. More recently, the *Growing United* report highlighted that while the convergence machine still works, it is not working for everyone. And among the fault lines emerging in the convergence machine, regional inequality represents a potent threat to Europe's economic well-being, and to its social and political cohesion.

In this context, *Rethinking Lagging Regions* highlights the nature and implications of regional inequalities in Europe and recommends how cohesion policy can be leveraged to maximize its impact on lagging regions, and on the businesses and people in these regions. The report has several key messages:

Regional inequalities are high and likely to rise.

Leading regions in European countries have, on average, 2.3 times the GDP per capita of the poorest region in their respective country. And while the EU has had great success integrating the new member states in Central and Eastern Europe, the 2008 economic crisis ended a decade of gains in convergence. Divergence is also growing at the local and at the household level, driven by factors such as urbanization and specialization. The impact of technology on labor markets will exacerbate these trends in the future. Moreover, demographics and migration patterns are emptying many of Europe's lagging regions. Parts of Southern Europe have fertility rates 20 percent below the EU average, while parts of Central and Eastern Europe continue to experience large-scale outmigration.

Europe's lagging regions are going in opposite directions, but face common challenges.

Europe's "lagging regions" include poor "low-income" regions in Central and Eastern Europe, many of which are converging rapidly, as well as "low-growth" regions in Southern Europe, that are experiencing stagnant productivity and job destruction. In fact, the economic hierarchy of European regions is on track to experience a sharp change within the next decade – if the trends of the past decade were to continue, by 2025 the poorest regions of Romania, Poland, Hungary, and Bulgaria will be richer, on average, than the lagging regions of Italy, Spain, Portugal, and Greece. But both sets of lagging regions face common challenges that constrain long-term growth prospects, including low levels of labor market participation, incomplete structural transformations, and large gaps in critical endowments like skills and institutions.

Cohesion policy can maximize its impact on lagging regions by explicitly targeting regional potential and equality of opportunity rather than convergence.

While economic convergence remains a political objective, it is neither realistic nor effective as a guide for cohesion policy. *Rethinking Lagging Regions* argues for a strongly region-centered cohesion policy that adopts a dual objective of: (1) *maximizing regional potential*, measured not simply by output per capita but also by the capacity to generate quality (productive) jobs; and (2) e*nsuring equality of opportunity* for individuals to achieve their potential. Such an approach helps further center cohesion policy squarely on the regions. While it is clear that not all regions can reach the same level of income, it is also true that many regions have substantial underexploited potential. This report estimates that delivering on unexploited potential alone could raise GDP per capita relative to the EU average by an average of 9 percentage points across up to 100 regions. But for many lagging regions, notably for many "low-growth" regions in Southern Europe, there are no easy answers to raising regional incomes. Rather, they must strengthen fundamental endowments to build capabilities for the future.

Cohesion policy priorities can be rebalanced to help deliver on regional potential.

Delivering on the potential of lagging regions requires a rebalancing of the policy tools that are deployed in cohesion policy, with greater attention to *distortion-removing* and *endowment-building* policies as complementary tools to support targeted sectoral and firm-level support. *Rethinking Lagging Regions* highlights five horizontal policy priorities for cohesion policy: (1) *Addressing macro-structural weaknesses that limit regional growth potential* – for example, national fiscal and external debt in countries with "low-growth" lagging regions cripples growth potential; (2) *Improving the regional business environment*: firms in lagging regions are smaller, less productive, and much more likely to be engaged in nontradables than those in "non-lagging" regions, in part as a result of weak local and regional business environments; (3) *Leveraging the productivity potential of cities*: investment in secondary cities – which generate 45 percent of EU GDP – as as sources of productivity, human capital accumulation and locations of opportunity, is central to achieving policy objectives in the EU's lagging regions; (4) *Investing in skills as a "no-regrets" policy*: addressing entrenched regional gaps in foundational skills is critical to deliver on the potential of regions and to enable individuals to reach their own potential; and (5) *Strengthening institutional endowments*: weak institutions are one of the defining features of lagging regions, and addressing them is fundamental to expanding regional potential and to delivering regional policy. These five horizontal priorities can support smart sectoral policies, which build on the unique comparative advantages of each region.

Delivery of regional policy needs to engage ever more deeply at the ground level.

Rethinking Lagging Regions calls for an even stronger orientation toward the regions as the architects and implementers of regional programs that are designed to address the unique capabilities and challenges of individual regions. Making this a reality, however, will require more intensive, on-the-ground support, including technical assistance and capacity building at the regional and the local level.

Overview

Rosica is 19 years old and living in a rural district around Montana in northwestern Bulgaria. Like 30 percent of her cohorts, she left school before receiving upper secondary qualifications. Without qualifications, she is not eligible for most positions with the government, which accounts for one in every four jobs in the region, and factory jobs are hard to come by. As a result, she is among the one in three youths in the region who is neither in work nor any form of training and education, and is at significant risk of falling into poverty (again, like one in three). Just 100 kilometers away, however, sits the capital, Sofia, where the employment rate for women is 30 percent higher and average earnings are about 40 percent higher. But the poor state of the roads means that commuting is not an option, and high housing costs make moving to the city costly. Moreover, without access to broadband in the village, doing a job search remotely is difficult. In any case, if Rosica is going to have to move from her village, why not go to Bucharest (just 300 kilometers away), where jobs are even more plentiful and wages are almost twice as high as in Sofia? Or better yet, if she can get the money together, why not join some of her former school friends and go to London while it is still open for EU citizens? There, even a low-skilled job, if she can get one, will pay almost four times more than anything she would be lucky enough to secure in or around Montana. This will allow her to send some money back to her family or save for returning home in the future, although she knows that if she goes, she is unlikely to return.

This story is obviously a caricature. Severozapaden, the region where Montana is located, is the EU's poorest, and London is its richest. Yet, the broad dynamics which the story describes—wide disparities of economic opportunity across regions, vicious circles of economic and social exclusion, and the pull of migration on youth—are repeating themselves across the EU, and across the world. They are a function of changing technologies and globalization, exacerbated by economic shocks. But they are also a function of path-dependent economic geography and of the policy choices made by governments.

As the World Bank's 2012 *Golden Growth* report emphasized, the European Union, since its founding, has been a "convergence machine," propelling poorer, and newer, member states to become high-income economies, and delivering to its citizens some of the highest living standards and lowest levels of income inequality in the world. More recently, the *Growing United* report highlighted that while the convergence machine still works, it is not working for everyone. And among the fault lines emerging in the convergence machine, regional inequality represents a potent threat to Europe's economic well-being, and to its social and political cohesion.

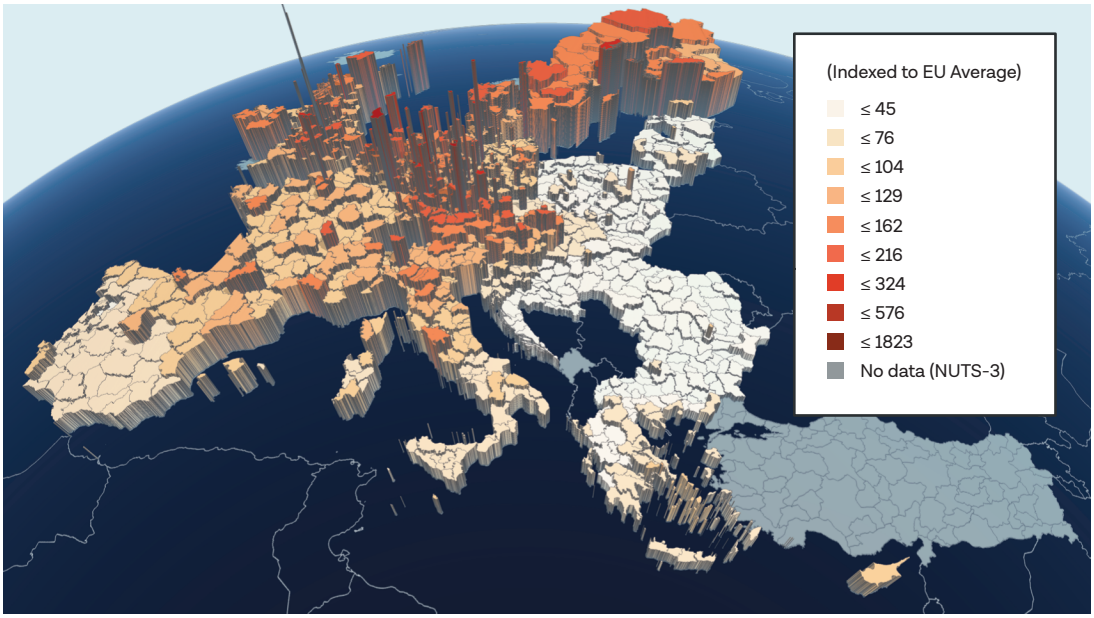
In this context, the EU's cohesion policy is more important than ever. With €50 billion invested each year to support convergence across European regions, cohesion policy has the scale to make a difference. It also has a solid track record. But as the EU looks toward the next programming cycle beginning in 2021, in a context of strengthening forces of divergence and tightening fiscal constraints, it will be critical to reconsider how cohesion policy can be most effectively designed, targeted, and delivered to maximize its impact on lagging regions, and on the businesses and people in these regions.

This report aims to contribute to the debate on the future of cohesion policy, with a specific focus on lagging regions. It calls for a further shift in the objectives of cohesion policy towards an increasingly "region-centered" approach that aims to maximize potential in all regions, while seeking convergence of opportunities for individuals, no matter where they live.

Regional inequality matters for economic growth and social cohesion

Economic activity is never spread evenly across territories. As map O.1 shows, peaks and plains are a common feature of the economic geography of Europe, as they are the world over. Leading regions of Europe have, on average, 2.3 times the GDP per capita of the poorest region in their country. In Europe's less developed countries, leading cities like Bratislava and Bucharest look a lot more like more like Rome, Madrid, or Copenhagen than they do like any other part of their own country.

Map O.1. Distribution of GDP per capita (PPS) across the EU at NUTS-3 level



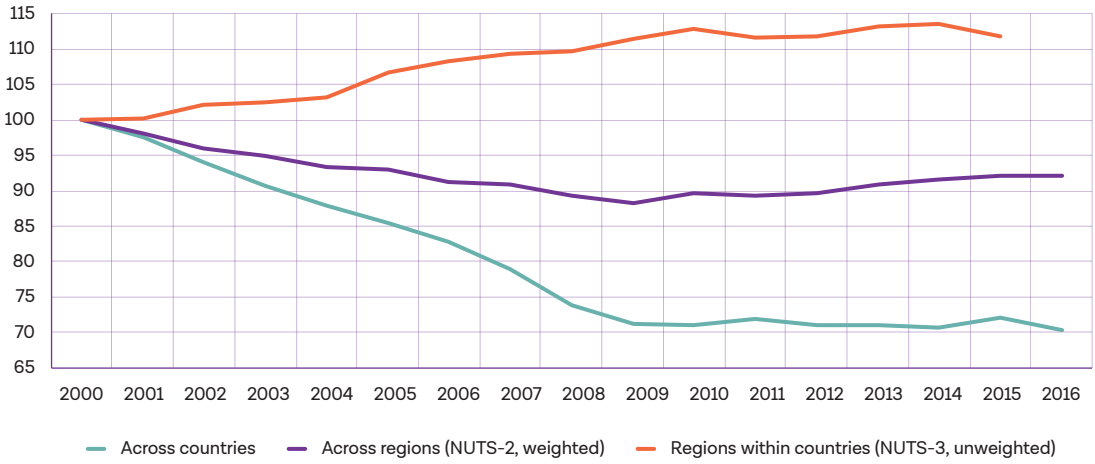
Source: Eurostat.

But while such patterns of growth are commonplace, and arguably represent the outcome of efficient economic processes, they have consequences. Persistent inequalities have a direct impact on the well-being and opportunities of residents in lagging regions, leading to higher poverty and emigration. They lead to the underutilization of potential and the emergence of "low-growth traps"; they can also act as a drag on national growth. And increasingly, regional disparities threaten social and political cohesion, as populism feeds on both real and perceived inequality of opportunity across geography.

Regional inequality in Europe has both cyclical and structural features

After a decade of strong convergence catalyzed by the integration of new EU member states in central and eastern Europe (CEE), the economic crisis halted and reversed these trends. As shown in figure O.1, GDP per capita converged across NUTS-2 regions through 2008, but then diverged, so that by 2016, inequality was at its highest level since 2005. At a more local level—comparing NUTS-3 regions within countries—the pattern is different. While nominal inequalities are lower at this level, they have risen sharply since 2000 (by more than 12 percent), and the divergence trend started well before the crisis, although it appears to have steadied since 2010. This suggests that there may well be different factors at work at different spatial levels, with cyclical patterns of growth making a top-down impact, while structural features like increasing urbanization and specialization shaping patterns from the bottom up.

Figure O.1. Coefficient of variation in GDP per capita (PPS), 2000-16 (Index 2000=100)



Source: Eurostat.

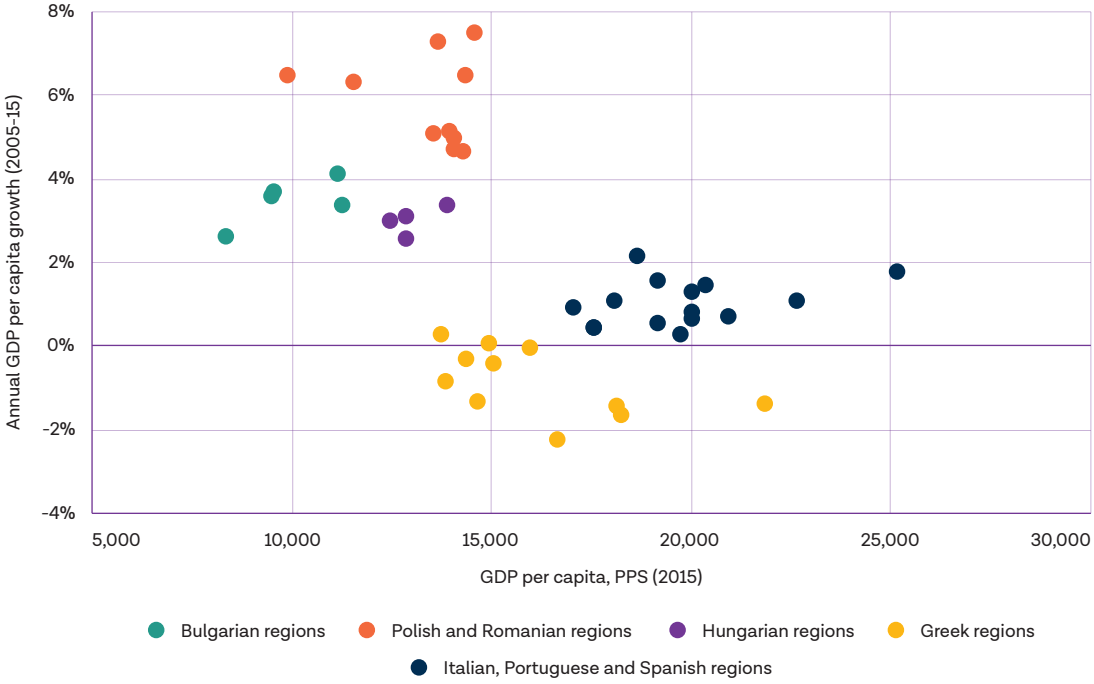
Note: Data at NUTS-3 level available only through 2015 at the time of publication.

"Low-growth" and "low-income," lagging regions are on contrasting paths, although significant heterogeneity exists

Between 2005 and 2015, "low-growth" regions (in Europe's South) experienced zero growth in GDP per capita compared with the EU average of 2.1 percent annually.[2] By contrast, annual growth in "low-income" regions (in Europe's east) averaged 4.6 percent. If these trends were to persist, there would be a radical restructuring in the economic hierarchy of European regions, with "low-income" and "low-growth" regions having traded positions by 2025. But even within these groups there is significant heterogeneity. Figure O.2 shows, for example, that Bulgarian and Hungarian regions are on a much slower

convergence path than Romanian and Polish regions, while Portuguese regions are performing slightly better than other "low-growth" regions. It also highlights the difficult situation in Greece, which displays all the characteristics of "low-growth" regions but at income levels much closer to those of "low-income" regions.

Figure O.2. Country groupings of lagging regions—income level and growth



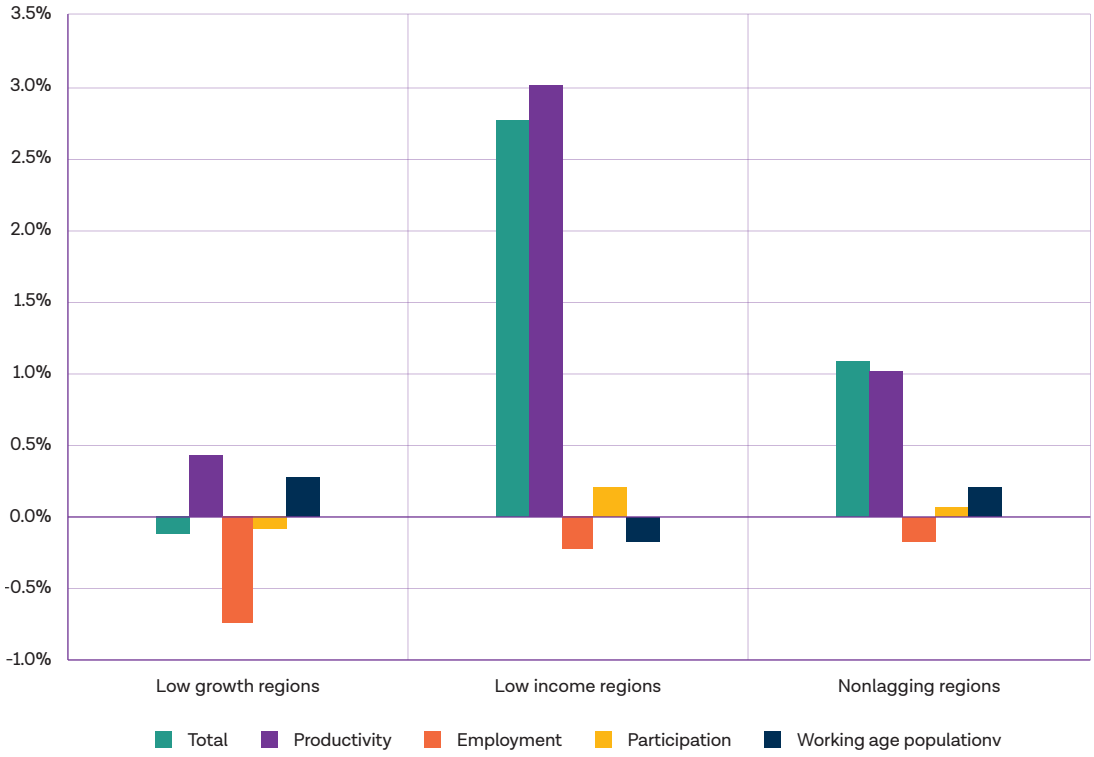
Source: Eurostat.

"Low-growth" regions are experiencing stagnant productivity and jobs destruction, while "low-income" regions also face labor market challenges

Successful regions must sustain productivity growth, while also creating jobs. Indeed, jobs and earnings are ultimately the most important measure of economic progress, as they translate to household and individual level well-being and may play a crucial role in mitigating brain drain. In this respect, "low-growth" regions are lagging badly, with annual productivity growth of just 0.4 percent between 2000 and 2014, compared with more than 3 percent in "low-income" regions and just over 1 percent in "nonlagging" regions (figure O.3). Moreover, employment is declining in "low-growth" regions (almost 0.75 percent annually, along with declining labor force participation). In fact, almost all "low-growth," lagging regions that experienced some productivity gains shed jobs at an even faster rate—that is, *productivity growth was job-destroying*.[3]

But both sets of lagging regions underperform on two key indicators of labor market outcomes. First, the overall employment rate in lagging regions trails far behind nonlagging regions. Second, and a main explanation for the first, are very low levels of female labor force participation. The average rate of female labor force participation in the EU was 66.8 percent in 2015; but in "low-income" and "low-growth" regions, it was just 59.5 and 56.4 percent, respectively. In Italy, the female labor force participation rate in lagging regions is more than 20 percentage points lower than in nonlagging regions.

Figure O.3. Growth decomposition by region type—average annual percent change, 2000–14



Source: Eurostat.

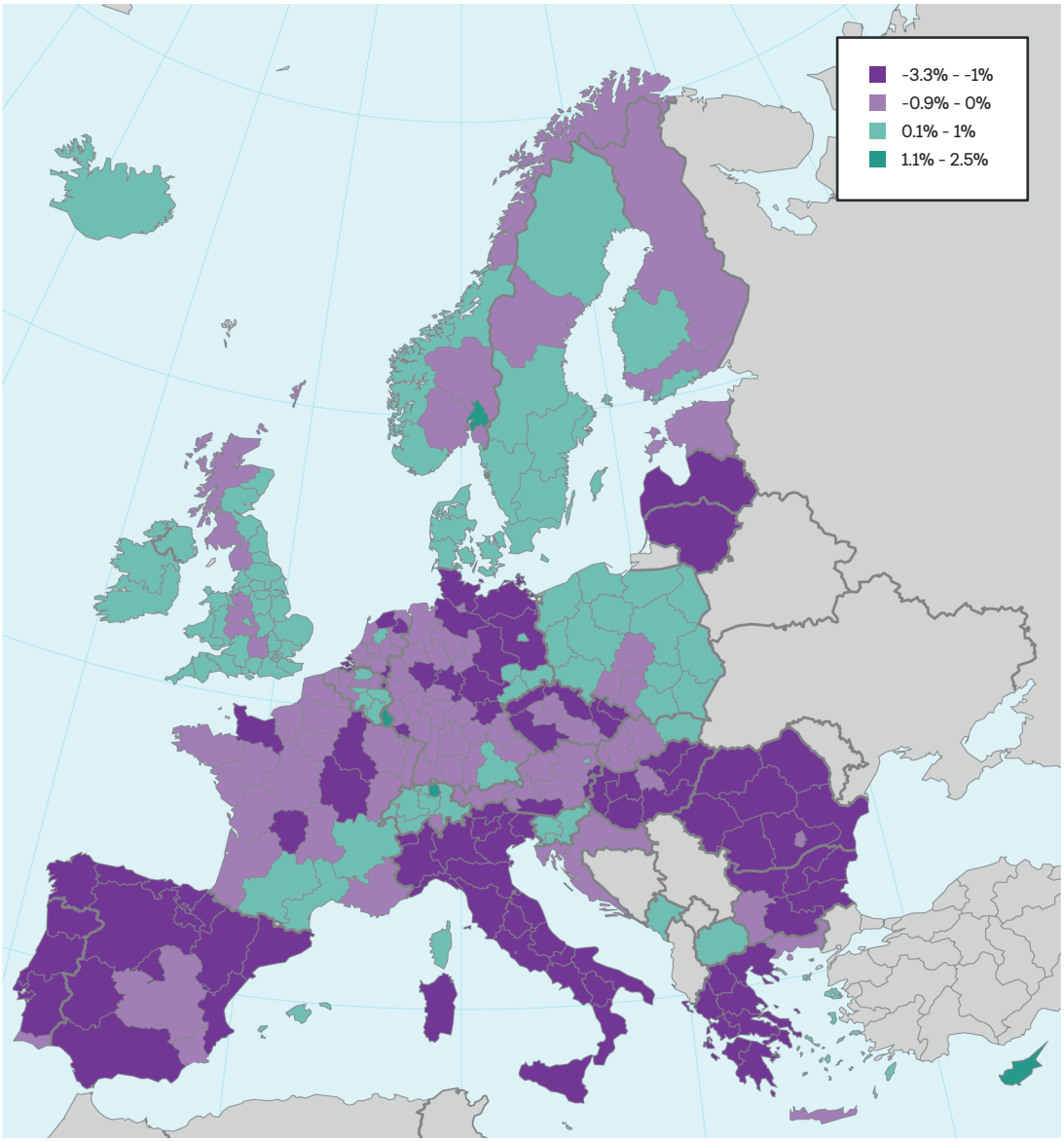
Note: Data available for only 203 NUTS-2 regions.

Demographic and technological trends heighten the risks of further divergence for lagging regions

Improved technologies—including digitization, along with major advancements in transportation and telecommunications—are contributing to significant changes in the geography of production, and in the skills demanded in labor markets. Across all parts of Europe, the share of jobs carrying out manual labor has declined sharply, while those requiring cognitive skills have increased. This is polarizing labor markets, increasing the returns to workers with skills that complement new technologies, while reducing opportunities for the least-skilled. For both workers and for enterprises, these dynamics have spatial implications. Because the highest skilled workers tend to concentrate in leading metropolitan areas, while lagging areas often have concentrations of both lower-skilled workers and lower-productivity firms, these trends can be expected to put further pressure pushing toward regional divergence.

A second force pushing further divergence is demographics. While the EU as a whole faces demographic challenges that will continue to constrain growth, the situation is more acute in lagging regions of the south and east, which have experienced net contractions in the young population of 1 percent or more each year over the past two decades (map O.3). This is driven both by low fertility rates—20 percent below the EU average in "low-growth" regions—and high levels of net out-migration, particularly in "low-income" regions. In this context, a simple accounting exercise highlights the limits of growth potential in many of the regions that are already lagging, and greater divergence with leading regions.

Map O.2. Annual growth of young population (age 20–35) across European regions, 2000-16



Source: Eurostat.

Poor social outcomes in both sets of lagging regions point to underlying weaknesses in key endowments

Arguably, economic outcomes matter less than social outcomes—good health, access to education and opportunities, access to quality infrastructure and public services, voice and participation in community and public lives. In a progressive polity, these outcomes need not be strongly correlated with the production of the economy. Across EU regions, it seems that high income is a necessary but not sufficient condition for ensuring high social outcomes—put simply, *you can be a rich region and still not have great social outcomes, but you cannot be a poor region and have good social outcomes*. Europe's richest regions, which are

its biggest metropolitan areas, have social outcomes only around the EU median level, linked to high levels of local and household-level inequality. But almost all lagging regions also fare poorly on social outcomes. The poorest of the "low-income" regions are ranked lowest in measures of social outcomes. The picture is mixed in "low-growth" regions, with social outcomes worse than economic outcomes in Italian lagging regions, the opposite in Spanish lagging regions, and varying across Greek and Portuguese lagging regions.

The poor performance of lagging regions on social outcomes, particularly the low levels of human and institutional capital revealed by measures of social progress, raises questions about the limits to future growth in these regions, and highlights the two-way causality between economic and social outcomes—that is, investments in raising income levels are also likely to be critical to improving social outcomes, but investments in raising human and institutional capital are likely to be critical to driving income growth.

Taking a region-centered approach to cohesion policy—from economic convergence to regional potential

Targeting convergence of GDP per capita across regions is unrealistic, in that it fails to take account of the huge variation in endowments across regions. It is insufficient in that it masks large and growing spatial inequalities within NUTS-2 regions. And it is also inefficient, as it ultimately risks biasing (de facto) policy responses toward redistribution rather than toward growth and competitiveness.

This report argues for a continuation of the trend to move away from targeting convergence, and toward a region-centered cohesion policy that adopts a dual objective of: (1) maximizing regional potential, measured not simply by output per capita but also by the capacity to generate quality (productive) jobs; and (2) ensuring equality of opportunity for individuals to achieve their potential. Such an approach helps further center cohesion policy squarely on the regions, as the "potential" objective necessarily requires explicit consideration of the specific context of each region.

This has important implications for the approach to regional policy. First, it acknowledges that all lagging regions have some potential for growth, and that some regions may be exploiting less of this potential than others. But it also accepts that all regions do not have the same potential for growth over the same time frame, as a result of differences in endowments and structural conditions.

While most lagging regions have low economic potential in the short term, the factors that drive growth vary significantly across regions and have implications for convergence patterns

This report defines and operationalizes the concept of "economic potential" with a model based on three sets of regional "endowments":

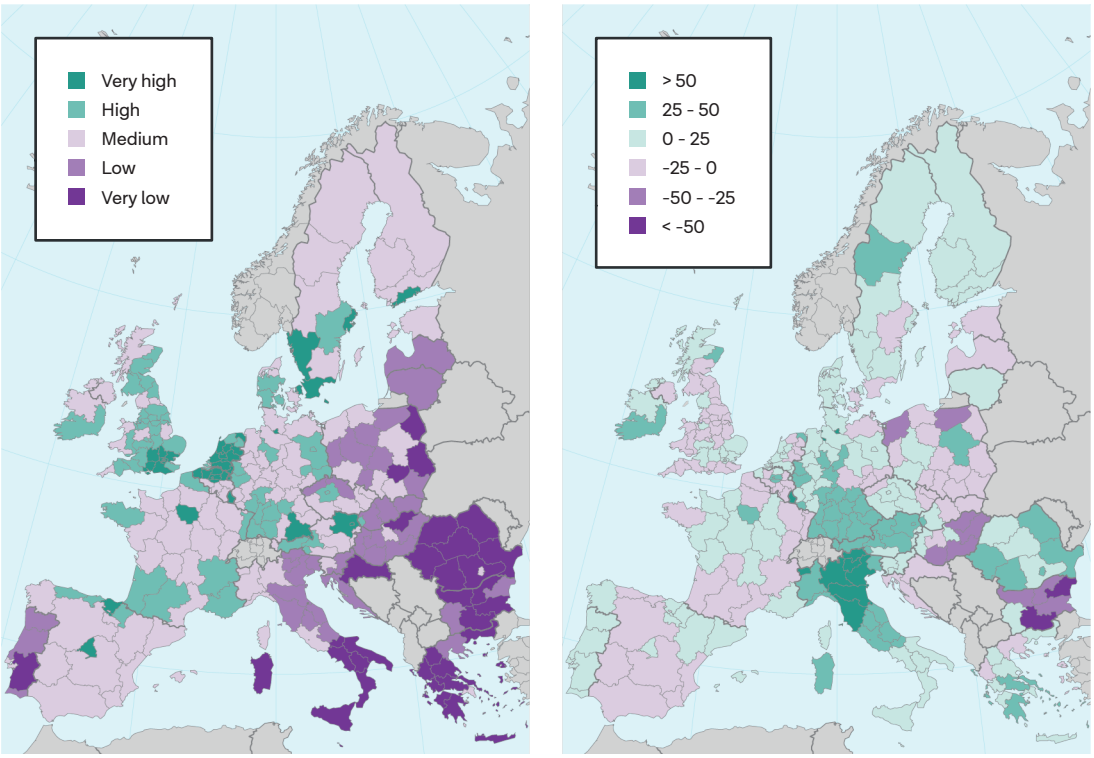
1. **Human capital endowments:** Education / skills and institutional quality, which capture the quality of human capital and of local economic and social institutions.

2. **Locational endowments**: Market access and population density, which capture the ability to exploit scale and agglomeration economies.

3. **Physical and sectoral endowments**: Sectoral structure and investment, which capture the specialization of the local economy and the scale of public and private investment.

Map O.3 (left) illustrates economic potential across regions in 2015. It shows that the regions identified as having the highest potential are concentrated in and around Europe's major metropolitan centers. Most important, for the purposes of this report, is the fact that lagging regions—including both "low-income" and "low-growth" regions—map closely to the "low" and "very low" potential regions. However, regions vary widely in terms of how closely the economic potential model maps to actual outcomes—some ("overperformers") have GDP per capita well above what is predicted based on their underlying endowments in the model; others ("underperformers") appear to not be achieving the economic outcomes that should be possible given their endowments. Most lagging regions in Poland, Hungary, and Bulgaria appear to be "underperformers." This suggests that significant growth potential remains in the short term. By contrast, most "low-growth" lagging regions (with the exception of those in Spain and some in Greece) "overperform" on their endowments. Thus, achieving significant growth in these regions is unlikely without strengthening fundamental endowments.

Map O.3. Map of European regions on economic potential (left) and actual GDP per capita relative to predicted economic potential (right)



Source: World Bank and European Commission (2017).

Such a model of potential, while it should not be the sole determinant of policy design, may be valuable in establishing the broad expectations of a region's prospects within any given (seven-year) programming period, as well the direction of policy priorities. Performance against potential may be improved over a programming period, but actually shifting a region to a higher potential (which is possible through improved connectivity, improving institutions, raising education levels, etc.) is more likely to be achieved within a longer time frame. Thus, some regions may be targeted for unlocking short-term growth, while the priority in other regions may be improving endowments to raise future potential for growth.

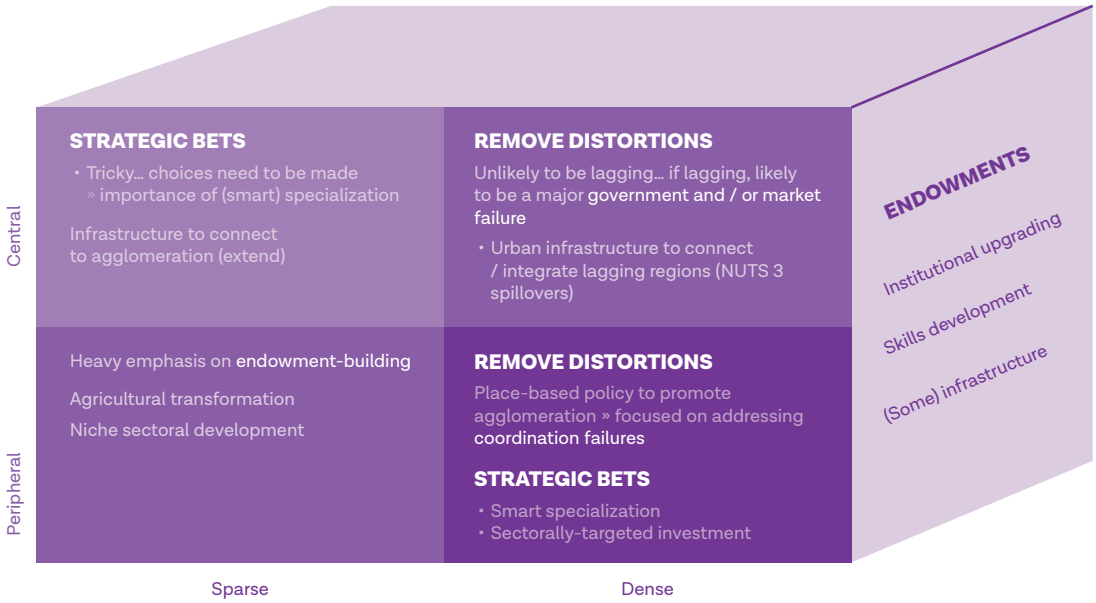
Delivering on regional potential requires a complementary approach to policy

This report argues that policy to raise the potential for growth in lagging regions needs to put greater emphasis on strengthening fundamental endowments, while complementing this with smart sectoral policies. Place-based interventions in lagging regions often focus on encouraging new investments—sectoral and spatial "strategic bets." But the expected returns to investors depend fundamentally on what investments others will make (e.g., an investment in an automotive factory will be more profitable if parts suppliers and transportation companies also decide to invest in the area; and their investments will be more profitable if universities in the area invest in training workers for the skills they need, if a new motorway is built, etc.). In the absence of existing agglomeration, coordination on such investments is difficult, and underinvestment by all parties results in a low-level trap. This is common across lagging regions—more so in regions that have lower agglomeration potential.

This report argues that overcoming these coordination problems and increasing the returns to place-based "strategic bets" starts with addressing government and market failures that raise costs and risks for investors. It therefore calls for a complementary policy approach that recognizes the priority of supporting sectoral development and targeted spatial investments with aggressive efforts to remove market distortions and build fundamental endowments in lagging regions.

Figure O.4 translates this principle into a basic framework for approaching policy in lagging regions, providing perspective on the scope of interventions that may be most appropriate in different regional contexts. It emphasizes the complementary approach—removing distortions to support "strategic bets" (sectoral and spatial investments)—in regions with sufficient density to support agglomerations. In low-density regions, "strategic bets" have higher risk, even if distortions are limited. Here, the main priority should be strengthening endowments—human capital, institutions, and, where still missing, connective infrastructure—and implementing smart sectoral policies. Indeed, across all lagging regions, endowment building should be given a leading place in the design of regional policy and allocation of resources.

Figure O.4. A framework for approaching policy in lagging regions



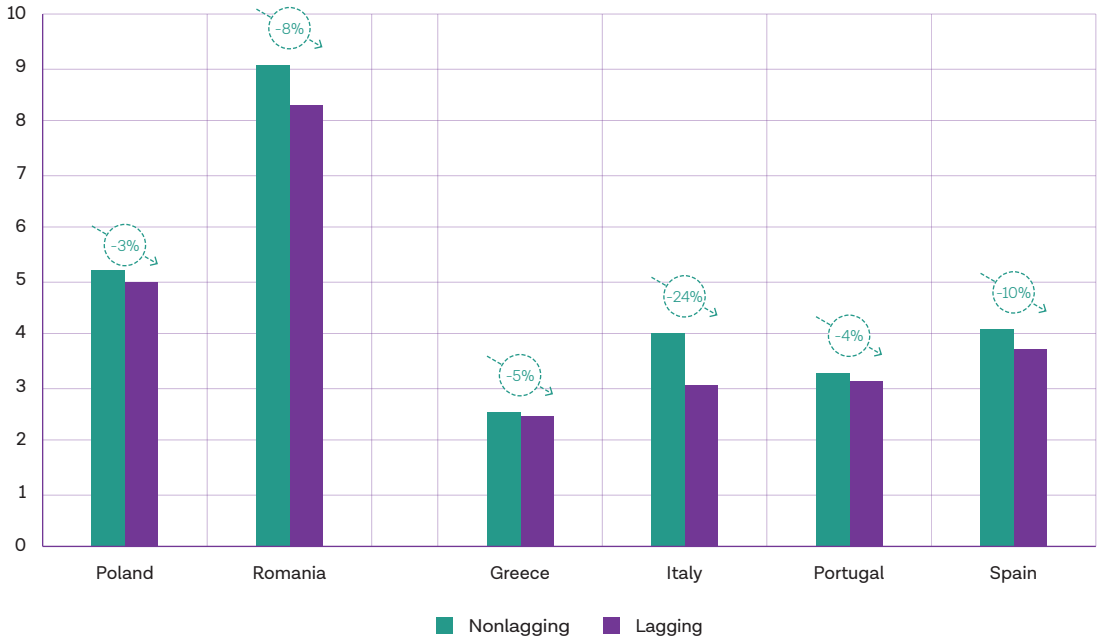
This report highlights five priority distortion-removing and endowment-building policies to complement sectoral interventions in lagging regions: (1) addressing macro-fiscal weaknesses; (2) improving the regional business environment for firms; (3) leveraging the productivity potential of cities; (4) building skills; and (5) strengthening institutions.

Remove distortions that restrict investment in high-productivity, tradable sectors

Unstable and weak macroeconomic conditions generate risk and uncertainty, which hinder the private sector from making forward-looking, productive investments. And if government fiscal conditions are such that budget austerity is required (e.g., national government debt in "low-growth" regions exploded from 79 percent of GDP in 2005 to 135 percent in 2015), growth-oriented public investments are also likely to be curtailed. This matters not only because lower public and private investment directly reduces growth potential, but also because lower investment—in infrastructure and technology, for example—limits the potential for productivity growth. These factors may be national in scope, but they matter for regional growth because they determine the bands around within which regional growth is likely to fall—where national growth is close to zero, the prospects for growth in lagging regions are limited.

In "low-growth" regions, the national conditions for growth matter even more because the private sector in these regions is dominated by family-owned microenterprises, selling nontradables in local markets. As figure O.5 shows, firms are significantly smaller in "low-growth" Southern Europe; and they are smaller still in lagging regions—in the case of Italy, the average firm size in lagging regions is 24 percent smaller than in nonlagging regions. Moreover, firms in low-growth Southern Europe export at a rate 30 percent below the EU average.[4]

Figure O.5. Average number of workers per firm in lagging and nonlagging regions, 2013



Source: Eurostat (Structural Business Statistics).

Note: Average firm size is measured as the number of employees. No data were available for Hungary and Bulgaria.

With such a private sector that relies on local consumption, depressed domestic demand resulting from national conditions reverberates and leads to a vicious circle of underinvestment. Thus, delivering on economic potential in many lagging regions, particularly in "low-growth" regions, will require a fundamental change in the nature of the private sector—shifting from microenterprises focused on nontradables to larger firms with a much stronger orientation toward external markets, increasingly through integration into regional and global value chains. This will require, among other things, establishing a business environment that is conducive to investment, employment, and growth. Results from the World Bank's Doing Business indicators show a strong correlation between a country's business environment and the size of firms—poor business environments are associated with the prevalence of microenterprises across Europe.

While many of the factors that contribute to the business environment are nationally legislated, their implementation varies substantially across regions. And, indeed, evidence from the *Subnational Doing Business* surveys shows significant differences in the business climate across regions within countries. And while patterns vary across countries, overall, lagging regions perform marginally worse—and in the case of Italy, dramatically worse. These differences matter. Analysis of a large dataset of incumbent firms across four lagging regions indicates that regional business environment factors do have an impact on firm performance in terms of sales, employment, and productivity growth, as well as investment (Farole et al. 2017).

What can be done to improve the business climate and facilitate trade in lagging regions? There are both national-level and region-specific elements to the solution. The latter require not so much policy as program- and project-level interventions to improve the administrative processes that underpin approvals and service provision. This requires substantial work to build the capacity of local institutions and actors.

Leverage the productivity-enhancing potential of cities

As regional economies seek to shift their sectoral structure into higher value-added tradables, the role of cities becomes increasingly important. This report argues that investment in cities, particularly in secondary cities, as sources of productivity growth, human capital accumulation, and ultimately as locations of opportunity, is central to delivering on the potential of lagging regions. In effect, the argument is to focus on strengthening the strongest parts of national and regional economies—to concentrate investments on competitive cities rather than spreading it across the periphery.

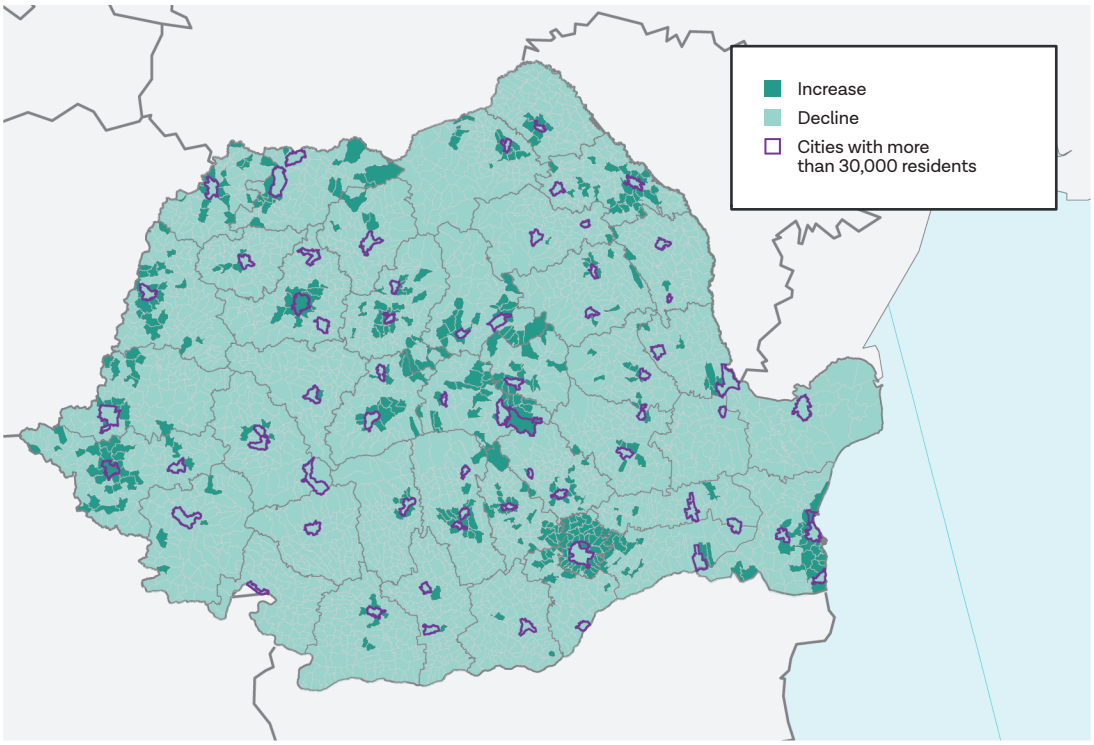
In "low-income" regions, while cities have contributed the majority to growth, large gaps remain in the productivity of primary and secondary cities. Primary cities—such as a Bucharest, Sofia, Budapest, and Warsaw—have reached the point where they compete almost on par with primary cities in Western Europe. However, the disparities between primary and secondary cities in "low-income" countries remain much higher than in other parts of Europe. In "low-growth" Europe, the problem is not so much between primary and secondary cities per se, but rather between cities in leading and lagging regions. Across "low-growth" Europe, productivity of cities in lagging regions not only trails that of leading regions, but fails even to outperform nonmetropolitan areas.

Analysis of secondary city development in Poland and Romania (map O.4)—as well as in Greece, Italy, Portugal, and Spain—shows that much of the growth is coming not so much from internal migration but rather from significantly increased commuting resulting from suburbanization. Evidence suggests that much of this suburbanization is happening because poor planning, a lack of investment in social

infrastructure, and distortions in land use contribute to rising congestion costs (high housing costs, diseconomies from crime or pollution, etc.), which undermines the productivity-enhancing potential of agglomeration.

Building competitive cities that can have strong spillovers to the regional hinterland will require addressing distortions that lead to inefficient suburbanization; strengthening the physical, social, and cultural assets of cities; and continuing to develop more effective transportation links between core cities, peri-urban areas, and the rural hinterland. Finally, it will also require raising the quality and capacity of both social and economic institutions at the city and wider regional levels. Regional policy can play an important role in unlocking the potential for urbanization to deliver positive spillovers in lagging regions. In the current programming period, EU member countries are required to allocate just 5 percent of ERDF for sustainable urban development activities. While, in practice, cities tend to capture a much larger share of resources, there is reason to consider increasing the targeted investment in cities, with an emphasis on integrated territorial planning.

Map O.4. Growth in population in and around core cities in Romania, 2002–11



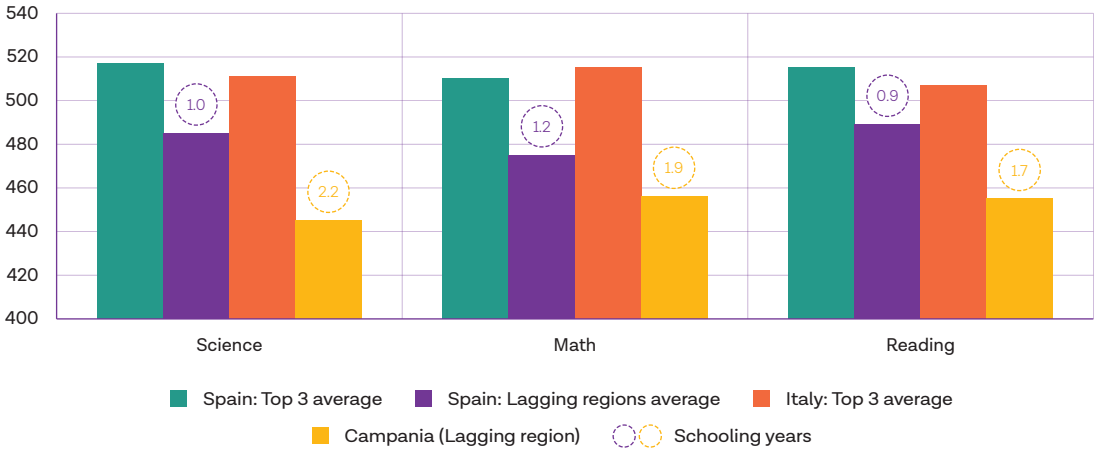
Source: Cristea et al. (2017).

Investing in skills is a "no regrets" policy for regions

Building skills and supporting mobility should be at the heart of the agenda for ensuring equality of opportunity for individuals to exploit their potential. Moreover, in an environment like the EU, where comparative advantage is increasingly defined by knowledge and innovation, and where technological capabilities will increasingly define outcomes, human capital development is also central to delivering on regional economic potential.

The problem is that the disparities in income across regions in Europe are mirrored in disparities in human capital outcomes. These disparities are not simply a function of labor markets and of the accessibility and quality of tertiary and upper-secondary institutions, but also stem in part from disparities that emerge in earlier stages of education. Data from the most recent PISA results (2015) show significant gaps in performance between schools in urban and rural areas, which generally map to leading and lagging regions. For example, in Bulgaria and Hungary, the difference in mathematics scores between urban and rural schools was over 50 points (equivalent to close to two years of schooling), while the gap was 30 points in Poland and 25 in Italy and Portugal. Data available from Spain and Italy confirm significant gaps in outcomes between lagging and leading regions. In the case of Italy, the difference is stark—students in Campania are about two years behind their peers in Bolzano, Trento, and Lombardia in science, math, and reading (figure O.6).

Figure O.6. Gaps in PISA scores between top regions and lagging regions: Spain and Italy



Source: OECD (2016a).

Strengthen institutions as the bridge from policy to delivery

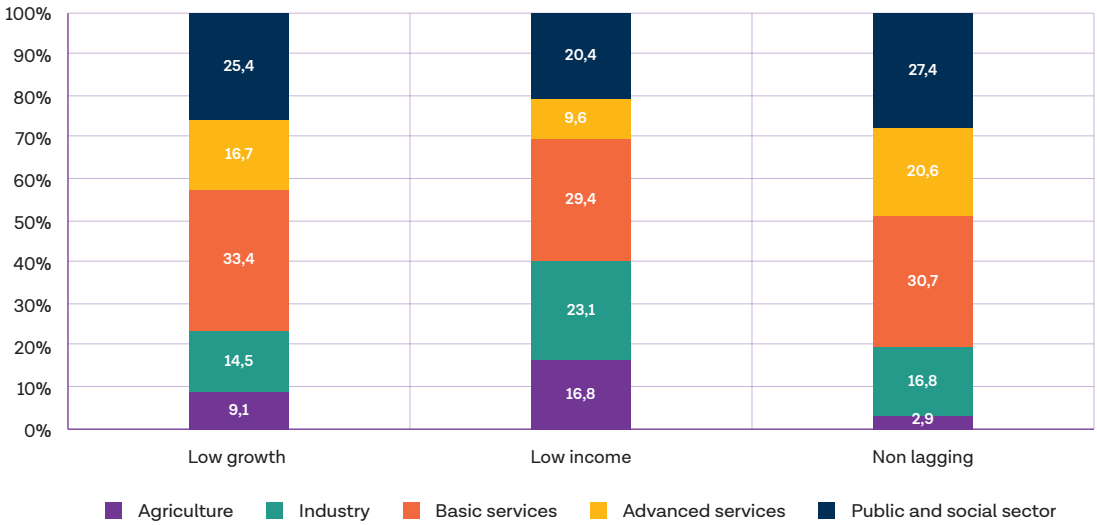
Quality institutions are critical to support regional transformation, to enable adaptive regional economies, and to ensure equitable social outcomes. They are also essential to deliver on the reforms proposed in this report. But in fact, institutional weakness, both in terms of governance and capacity, is one of the defining features of lagging regions. Institutional quality in "low-growth" regions is just 63 percent of the EU average; in "low-income" regions, it just 57 percent.[5] But it also varies significantly, from just 12 percent of the EU average in Campania (Italy) to 26 percent above the EU average in Alentejo (Portugal). And while institutions are often viewed as among the "deep determinants" of economic growth, evidence suggests that regional institutions can change over the short term. This may be particularly relevant for "low-income," lagging regions, which are still in the process of integrating with European institutions. Recent research (Rodriquez-Pose and Ketterer 2016) finds that regions that have been able to improve institutional quality have had significant economic payoffs.

Persistent efforts to modernize institutions must be a high priority to underpin all other aspects of regional policy. Delivering on this is easier said than done, although the use of institutional conditionalities, combined with substantial capacity-building efforts, are important components of the solution.

Target regional transformation by focusing on agricultural productivity and the regional innovation system

Sustainable growth in lagging regions is dependent on achieving structural transformation. Both "low-income" and "low-growth" regions have markedly higher shares of agricultural employment relative to nonlagging regions, and a lower share of high-productivity tradable activities (figure O.7). While "low-income" regions are undergoing rapid structural transformation, many of them—particularly the more peripherally located regions—still have a large share (20 percent or more in most cases) of their population engaged in low-productivity agriculture. Several "low-growth" regions, especially in Portugal and Greece, also remain heavily reliant on agriculture. For these regions, the priority is to raise productivity in the agricultural sector, while also developing the capacity to support investment in manufacturing and services. Based on policy scenarios run for this report, agricultural transformation could be expected to have a substantial impact on growth in many lagging regions—about 7 percentage points (in PPS relative to the EU average) on average in Greece and Portugal, and more than 10 percentage points in Romania and Bulgaria. Making this transition depends precisely on the type of complementary policy approach that this report advocates. Specifically, it requires, on the one hand, targeted sectoral approaches in agriculture to raise agricultural productivity and increase value addition in agricultural outputs. But in order to enable the transition, complementary interventions—through endowment-building and distortion-removing policies—are needed to establish a regional environment that can support investment in high value-added manufacturing and services.

Figure O.7. Employment structure by region type, 2015



Source: Eurostat.

Note: "Basic services" include construction, wholesale and retail trade, transportation, accommodation, and food service activities; "Advanced services" include information and communication, finance and insurance, real estate, professional, scientific and technical activities; administrative and support service activities, and arts, entertainment, and recreation.

In addition, "low-growth" regions must begin making the shift into higher-value-added tradables, while "low-income" regions must start moving quickly up the value-added ladder in the manufacturing and services sectors, in order to sustain the levels of productivity that will be needed for convergence. These shifts will require removing distortions in the business environment to attract investment, designing and implementing strategies to develop key sectors where regional compara-

tive advantage exists, and strengthening competitiveness and innovation capacity of local firms and workers. In this respect, Smart Specialization will remain an important tool of cohesion policy, because it helps ensure focus on the regional context. It will be important for regional programs to also implement Smart Specialization in a way that distinguishes between targeting innovation-intensive/high-technology *sectors* and treating innovation as a horizontal policy that is relevant in all sectors and in all places. The former approach risks setting unreasonable expectations and developing inappropriate strategies for lagging regions, while the latter offers the potential for adaptation to both sectoral and regional needs.

Yet, while Smart Specialization can support transformation in many regions, it may not be the most effective approach in all regions at all times. In lagging regions plagued by thin markets and government failures, an alternative approach may be to allow these sectors to emerge over time by establishing an environment that incentivizes experimentation and facilitates market entry and exit (Correa and Guceri 2016). This type of approach again emphasizes the horizontal agenda, including ensuring an unhindered business regulatory environment, a level playing field of competition, and transparent governance.

Finally, remembering the importance of complementarity in policy delivery and the importance of agglomeration in supporting innovation, lagging regions may benefit from integrating planning and programs for sectoral and urban policy. Specifically, regions should focus on leveraging the assets of their largest urban areas to create an environment that attracts and retains knowledge workers.

Strengthen the delivery of regional policy by localizing, intensifying capacity building, and focusing on results

Having a bigger impact on the ground in lagging regions requires not only the most appropriate set of policy domains for meeting and expanding regional potential but also sequencing and coordinating interventions to maximize their impact. This requires that regional development plans achieve an effective balance at both the policy and spatial levels. Arguably, investments in many "low-growth," lagging regions over the past two decades have been unbalanced, with intensive investments in transportation infrastructure not supported with complementary investment in other key development axes. Integrated strategies that take into account the current regional context and short- to medium-term economic potential when sequencing interventions, are critical for successful delivery of regional policy. In this context, the integrated planning and financing approach encapsulated in Integrated Territorial Investments (ITI) offers a model that might be expanded in the next programming period.

In terms of delivery, taking a "region-centered" approach to cohesion policy has several implications. First, it requires regional and local authorities to take the lead to define priorities and policy responses. Second, along with local ownership should also come capacity building, to enable local actors to plan and deliver on regional policy. The lack of local-level capacity is a major barrier both in planning and implementation. Effective delivery of regional policy also requires establishing the right incentives to ensure that strategies are well planned and operational programs are well executed. To date, the main instrument has been ex-ante conditionalities (ExAcs), which have targeted "enabling" conditions operating largely at the national level. There is a need to simplify these conditions, and shift from a reliance on stringent and bureaucratic ExAcs to an approach that establishes an agreed-on set of expected results and pays, ex-post, on reaching these results. While this will require significant changes to the current approach of cohesion policy and raises a number of political risks, it is worth considering as an innovation for delivery in the next programming period.

In summary, improving on delivery outcomes of regional policy will require a "region-centered" approach that designs and implements policy in a more context-specific way. This will require more intensive technical assistance and capacity building at the local level, including potentially rolling out the "lagging regions initiative" model much more widely in the next programming period. This will, in turn, have implications for how the European Commission organizes itself to support cohesion policy's delivery, including the scale of resources and the nature of technical expertise available.

Notes

[1] The municipality around Montana lost close to 20 percent of its population over the last decade.

[2] Even considering Greece's sharp GDP fall between 2010 and 2015 as an outlier and calculating growth in Greek regions based on the 2005–10 average, growth in "low-growth," lagging regions remains just 0.18 percent annually.

[3] Also, the only "low-growth" regions that experienced (small) relative employment growth during the period did so in the context of declining productivity.

[4] By contrast, most "low-income" countries in Europe have export shares above the EU average.

[5] This is based on the 2013 European Quality of Governance data set.

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