

Moucque, Daniel

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# A survey of socio-economic disparities between the regions of the EU



*Daniel Moucque*

## 1. Introduction

The European Union is facing challenges that have important implications for its economy as a whole and for regional cohesion in particular. The transition to the euro had already started, as had the process of enlargement towards Central and Eastern European countries. This occurs against a backdrop of increasing globalisation and a 'second industrial revolution' based on information technology.

The current essay consequently surveys the resulting social and economic trends in the regions. Section 2 finds that there is a clear distinction between a successful, prosperous and competitive EU core and regions, often in the periphery, which perform less well. Section 3 briefly surveys the factors that underlie competitiveness, and suggests that the main reasons for poor performance can be found in unfavourable sectoral structures, a lack of innovative capacity, poor accessibility and low education. The situation in Eastern Europe is discussed in Section 4. Finally, Section 5 summarises and concludes.

## 2. The situation in the regions

In previous Periodic (1981, 1984, 1987, 1991, 1994) and annual Cohesion (1995a,b to 1999) Reports, the first signs of real convergence of lagging regions were detected, but the message was mixed, with some indicators showing convergence while others were unclear. The evidence now shows that the output per head of the poorest regions has converged towards the EU average. For example, over the 10 years from 1986 to 1996:

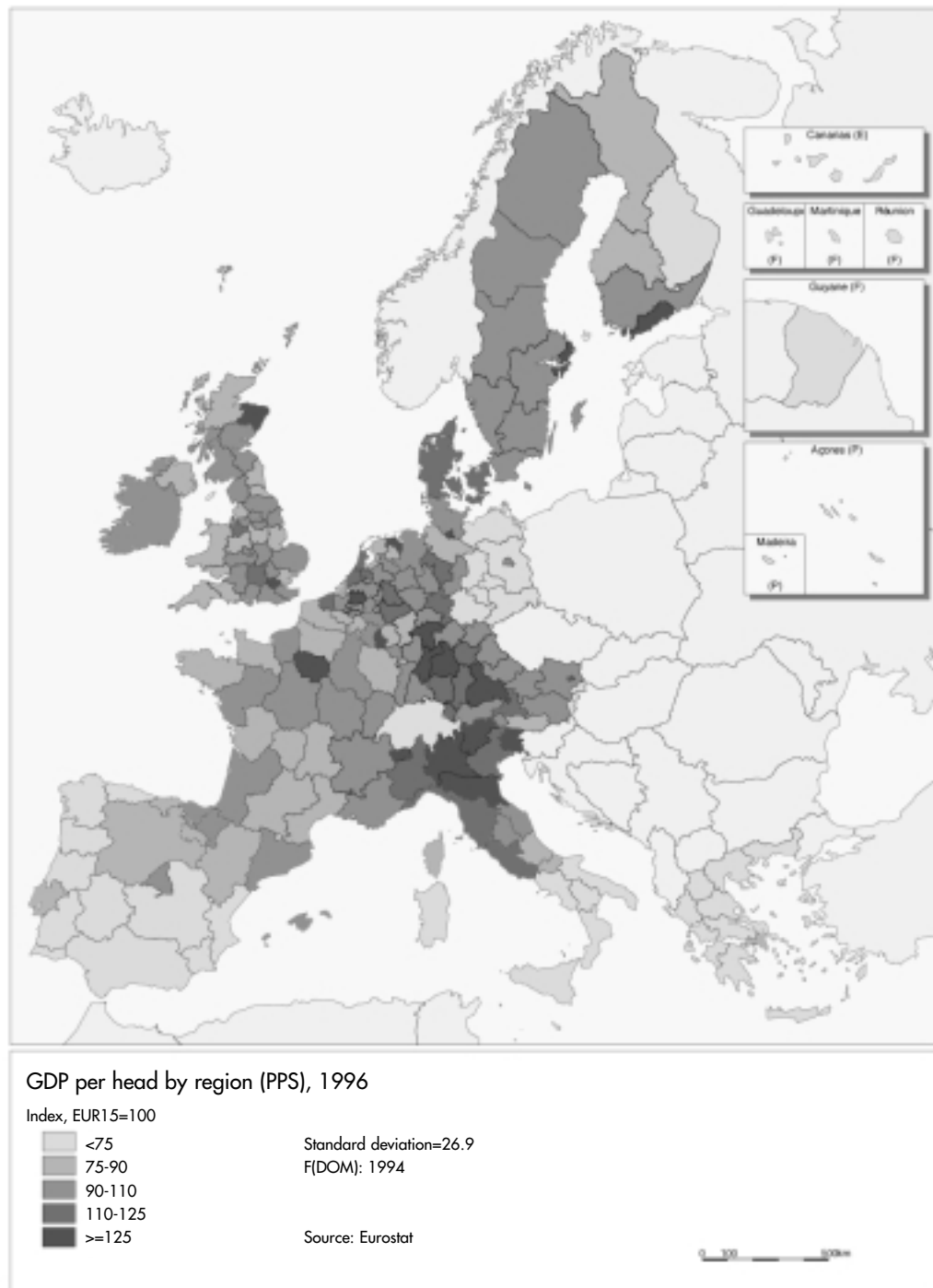
- GDP per head in the 10 regions where this was lowest, increased from 41% of the EU average to 50%. In the 25 poorest regions, it rose from 52% to 59%.
- GDP per head in the four Cohesion countries went up from 65% of the EU average to 76 $\frac{1}{2}$ %, and, according to estimates, to 78% in 1999.

This pace of convergence has been driven largely by closer European economic integration. As an example, exports and imports between the Cohesion Four and other EU Member States have doubled in real terms over the past decade and now amount in each case to around 120 billion ECU. In addition, the Structural Funds have contributed to the reduction in regional disparities across the Union. Although the precise impact is difficult to measure, the four main macroeconomic models used to assess the Funds suggest that one third of the reduction in disparities is due to the Funds. One model suggests that around  $\frac{1}{2}$  percentage point or more has been added to the growth of Objective 1 regions (cf. infra). Another suggests that, the cumulative effect of the Funds so far has increased the GDP of Greece, Ireland and Portugal by nearly 10% and that of Spain (much of which is not covered by Objective 1) by over 4%. Around half of this represents a supply side improvement and not just a boost in aggregate demand.

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*Daniel Moucque is with the Directorate General for Regional Policies at the European Commission, Brussels. He was editor of the 6<sup>th</sup> Periodic Report, and one of the co-authors of the 1<sup>st</sup> Cohesion Report. This paper summarises the main findings of the 6<sup>th</sup> Periodic Report.*

**Figure 1.** The regional distribution of GDP per head, 1996



However, significant disparities remain; even where catching up is occurring relatively fast, the full process can take a generation or more. In addition, although most regions may experience at least some convergence, their performance varies widely, as can be observed from Figure 1. The more favoured lagging regions, particularly those hosting capital cities such as Dublin or Lisbon, are catching up much more rapidly than their rural hinterlands.

The situation regarding unemployment is less positive. Despite the recent cyclical recovery, unemployment in the EU still stood at just under 10% in late 1998, equivalent to 16½ million people. The overall increase is concentrated in some regions, while others are hardly affected. The 25 regions with the lowest unemployment have hardly changed over the last decade, with rates steady at around 4%. Rates for the most affected regions have climbed from 20% to nearly 24% and are continuing to increase despite decreasing rates elsewhere in Europe. Figure 2 illustrates the regional distribution of unemployment in 1996.

One particular concern here is the high proportions of long term unemployment; 48% of the unemployed have been so for more than one year. A closely related problem is the exclusion of certain individuals and social groups – such as women and young people – from the labour market. These forms of unemployment are particularly worrying, since they are relatively resistant to general improvements in the economy. The high overall rates in the 25 most affected regions are in fact largely driven by such problems. In such regions, the long term unemployed account for 60% of total unemployment (as against 30% in the 25 regions least affected). In addition, only 30% of women of working age there have a job, and youth unemployment rates average 47%.

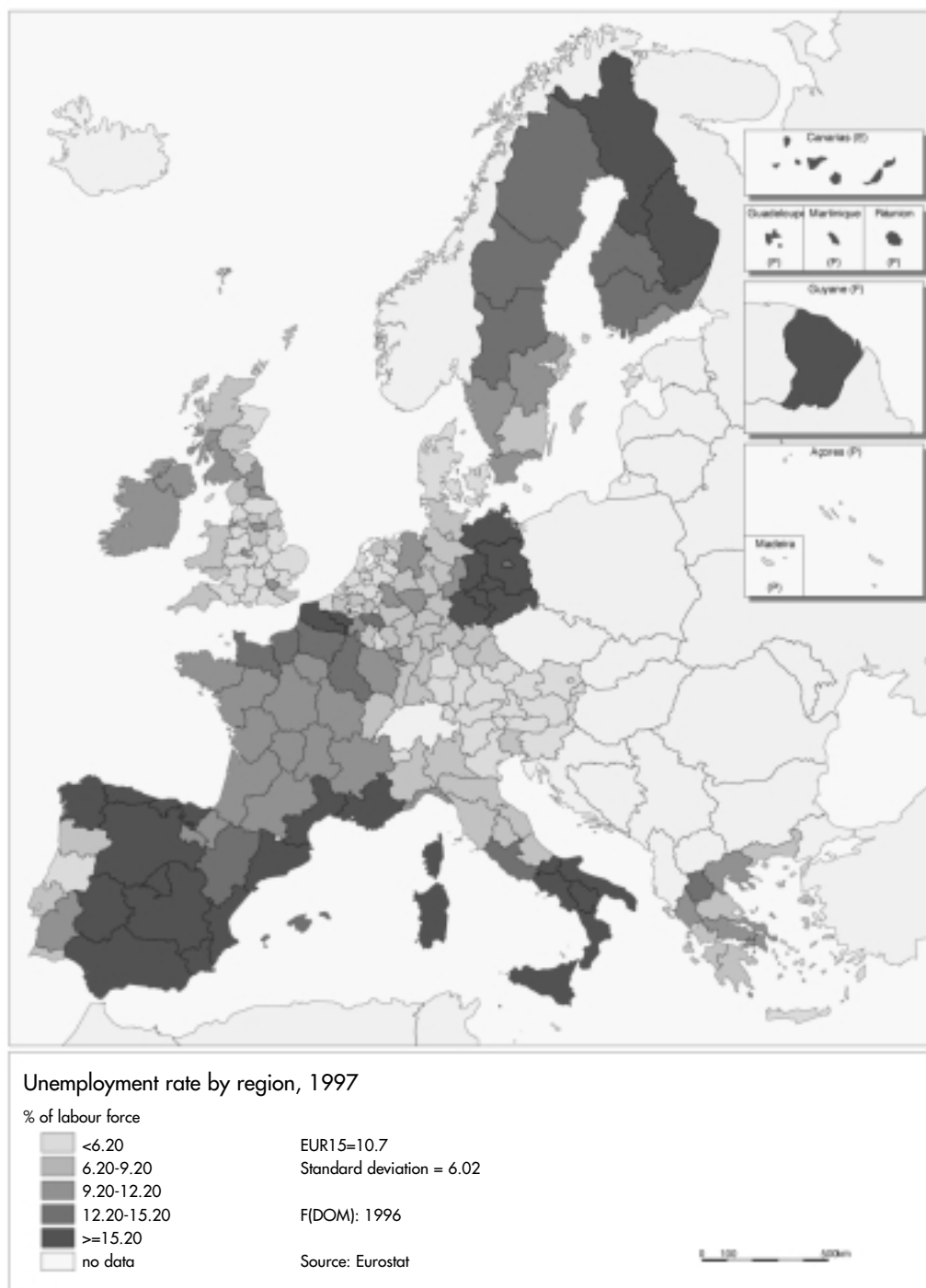
The resumption of growth alone will not tackle such problems. What is needed is an integrated approach combining improvements to the economic base in these regions with training measures aimed at reskilling those at a disadvantage in the labour market and re-inserting them into the world of work. In addition, where female and young workers are so underused, mainstreaming of policies aimed at them is not an option but a necessity.

The Commission has designated the most disadvantaged regions as “Objective 1 areas”. They are characterised by a GDP per capita that is lower than 75% of the Union’s average for the last three consecutive years. In terms of population, Objective 1 areas account for 22% of the EU population, or around 83 million people. Lower productivity and lower employment rates than in other parts of the Union have been the main causes for the differences vis-à-vis the EU-average in the standard of living in these areas. For some regions, notably Ireland and regions in Spain and Southern Italy, productivity is close to (or in the case of Ireland, above) the EU average, and the main challenge is the generation of employment. Conversely, Portugal and Eastern Germany have relatively high employment rates, but both would need to boost productivity by 50% to converge on the EU average. For Greece, significant improvements would need to be made both in productivity (by 40%) and employment (20%).

*The closing of the gap in lagging regions is predominantly due to increases in productivity rather than higher employment.*

However, the closing of the gap that has occurred since 1989 in Objective 1 regions is predominantly due to increases in productivity growth, rather than higher employment. Indeed, unemployment is a major problem in many such regions. Just over one in six of the labour force in Objective 1 regions are unemployed, compared with one in ten in the EU as whole.

**Figure 2.** The distribution of unemployment.



### 3. Drivers of competitiveness and catch-up

In fact, the regions of the EU can be roughly divided into three types (though some regions do not fit neatly into a single category):

- Large urban service centres. These regions typically perform well in terms of both GDP and employment. The 25 regions most concentrated in services have an output per head that is 27% above the EU average. Since the service sector is the main source of employment in the EU – jobs in market services in particular increasing by 12 million over the past decade – service centres generate significant employment opportunities, often extending well beyond the region concerned. Nevertheless, there can still be serious unemployment blackspots within the cities themselves.
- Industrial regions, the economy of which tends to be centred on medium-sized cities, which are often part of a network. The fortunes of these regions depend strongly on the health of the particular industries located there. Since much of the sector is performing well, manufacturing regions are often successful; the 25 regions in which employment is most concentrated in manufacturing have an output per head 8% above the EU average and unemployment of over 1½ percentage points below the average. However, a minority of industrial regions particularly affected by restructuring have high rates of unemployment, sometimes (but not always) combined with moderately low GDP per head.
- Rural regions, with relatively high employment in agriculture. These regions generally perform reasonably well in terms of unemployment, although problems may show up in other ways, e.g. in terms of high outward migration. However, some agricultural subsectors are low value-added and face significant restructuring pressures. The 25 regions with the very highest dependence on agriculture (and this can be extreme, covering anything up to 40% of the labour force) are particularly affected and have an average unemployment rate of 14.7%. This underlines the importance of facilitating diversification.

*An unfavourable sectoral structure together with a lack of innovative capacity are the most important factors underlying lagging competitiveness.*

Studies conducted for the Sixth Periodic Report found that an unfavourable sectoral structure together with a lack of innovative capacity seems to be among the most important factors underlying lagging competitiveness, suggesting that the key development challenge in the regions affected is to improve the productive base and their potential for growth.

Poor accessibility and low levels of education are often contributing factors to reduced competitiveness. Even though disparities in the education levels of the work force are tending to narrow, significant differences remain in the relative number of young people in education and initial vocational training beyond compulsory schooling. The weight of the past is reflected in the high proportion of people of working age with only a basic level of education. Three-quarters of those aged 25 to 59 in Portugal and two-thirds in Spain have no qualifications beyond basic schooling. These figures are substantially lower, however, for the 25 to 39 age group, reflecting the progress being made to raise levels.

In addition, the technology gap (measured by such indicators as patent applications and spending on research, see figure 3) between the Cohesion countries and the other Member States far exceeds the gap in GDP per head (except for Ireland, which has more or less caught up in both respects). The disparities are most significant in terms of output indicators, i.e. in terms of the innovations which stem from research and development, underlining the need to improve the efficiency of the process

by which research effort is translated into new products or more efficient ways of doing things in lagging regions. In this respect, it is important to bear in mind that companies can innovate and become more competitive through the transfer of technology, possibly by means of direct investment, without necessarily having to do their own research and development and applying for patents.

Small and medium enterprises (SMEs) play a major role in employment creation and the development of lagging regions. The number of SMEs is highest in the Southern Member States, although this is partly due to their different pattern of sectoral specialisation. In addition, SMEs tend to be concentrated in more favoured regions of these countries, particularly capital cities, while in the poorest regions there are comparatively few. Tackling such imbalances must be part of an integrated approach to regional development which also takes account of the sectoral distribution of SMEs and the extent of their presence in the more dynamic sectors. Recent research suggests that the potential contribution of SMEs to development depends on other conditions, such as the availability of support services and on their links with large firms and/or the networks between them.

Foreign direct investment (FDI) contributes to regional development, not just by increasing the capital stock but also by introducing new products and techniques. In order for lagging regions to derive the full benefits of FDI, however, it is important that the firms making the investment become integrated into the local economy. Over the past 10 years, the EU has been the world's major investor abroad, but it has also received large inflows of FDI. In relation to GDP, Ireland especially but also Portugal and Spain have benefited from above average inflows of investment from countries outside the EU as well as from other Member States.

Despite progress in recent years, significant disparities in transport infrastructure remain between regions, and the four Cohesion countries still lag behind other parts of the Union, particularly in terms of the standard of provision. More progress has been made in reducing disparities in telecommunications infrastructure. The Cohesion countries still have somewhat less extensive networks, as measured by the number of telephone lines per 100 inhabitants. However, with the notable exception of Greece, the gap in the quality of networks, as measured by the extent of digitalisation, has largely been eliminated.

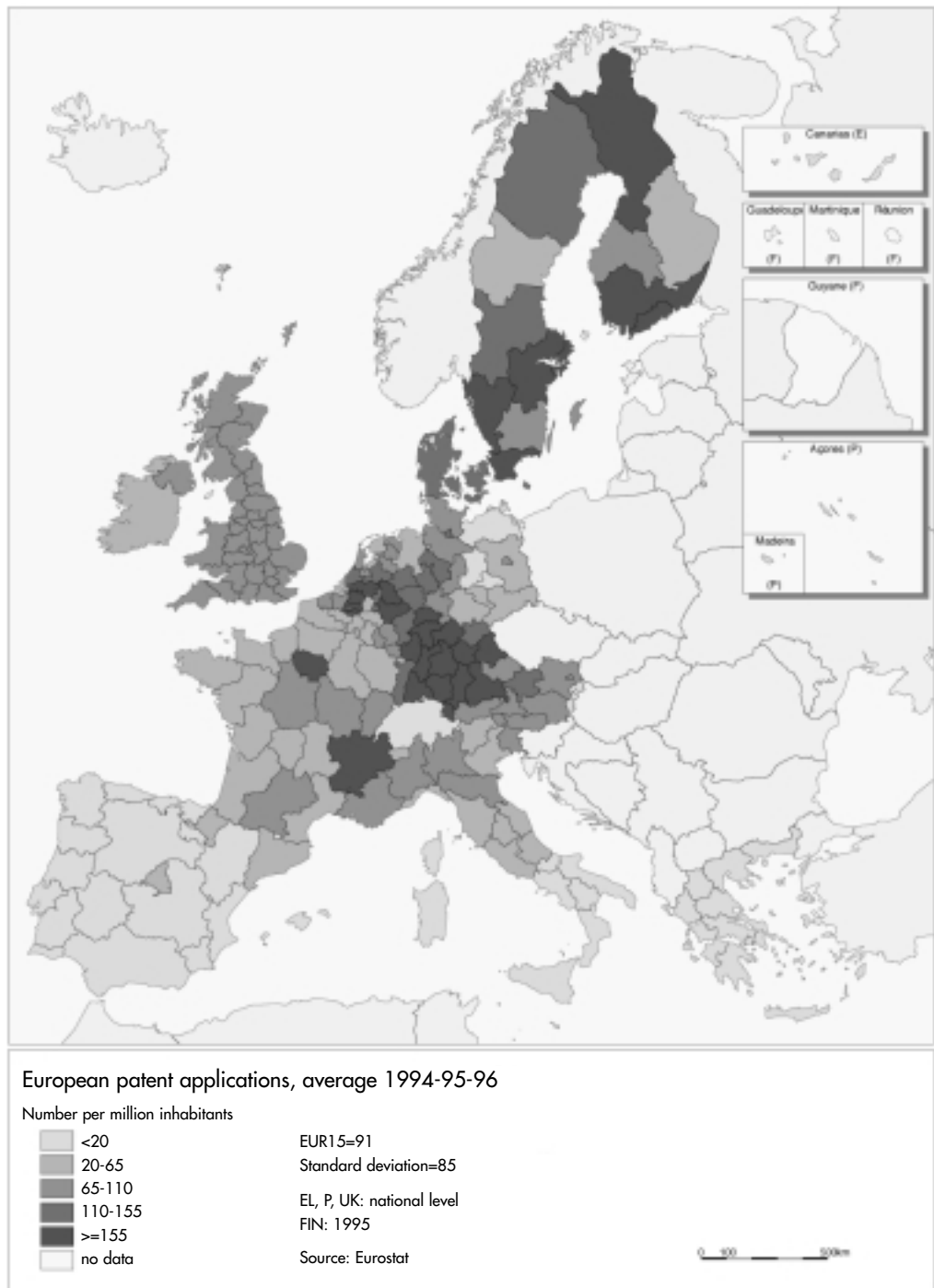
The availability of reliable sources of energy at reasonable cost is closely linked to economic growth and development. Investment in energy infrastructure is necessary to close the remaining disparities in provision between different regions. In particular, the market in natural gas is still very segmented, and certain regions continue to be at a disadvantage in terms both of market structure and of infrastructure.

*Institutional factors are increasingly seen as key elements in competitiveness.*

Institutional factors are increasingly seen as key elements in competitiveness. Such factors include the endowment of social capital, in the form of the business culture and shared social norms of behaviour which facilitate co-operation and enterprise, which is of particular importance for regional development. Networks between firms are both a product of social capital and an element of it. These combine the economies of scale normally open only to large firms with the dynamism and flexibility of small units and, as such, are especially important for innovation. The success of Northern Italy, for example, or the lagging development of many parts of the South, cannot be explained simply in terms of the structure of economic activity, accessibility and education levels.

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**Figure 3.** Number of patent applications as an indicator of innovative capacity.





The efficiency of public administration is another institutional factor of importance. In recent years, there have been significant changes in the principles governing public sector management, a key feature being emphasis on performance evaluation, so that lessons from the past can be systematically fed into decision-making to improve policy in the future (to create a 'learning organisation'). Another feature is a shift towards decentralisation and partnership, enabling different levels of government as well as the private sector to participate in the policy process and to bring their different kinds of expertise and experience to bear.

*A long-term strategy is needed, which builds up social capital parallel to physical capital, and improves the skills of the work force.*

This, therefore, argues strongly for an integrated approach to regional development that explicitly acknowledges the complexity of the process and takes due account of the interaction between factors, intangible as well as tangible. The need, in sum, is for a long-term strategy which addresses simultaneously the many aspects of the problem of a lack of competitiveness and attempts to build up the social capital of a region – its business culture, administrative structure, institutional relationships and so on – in parallel with its physical infrastructure, the skills of its work force and its productive base.

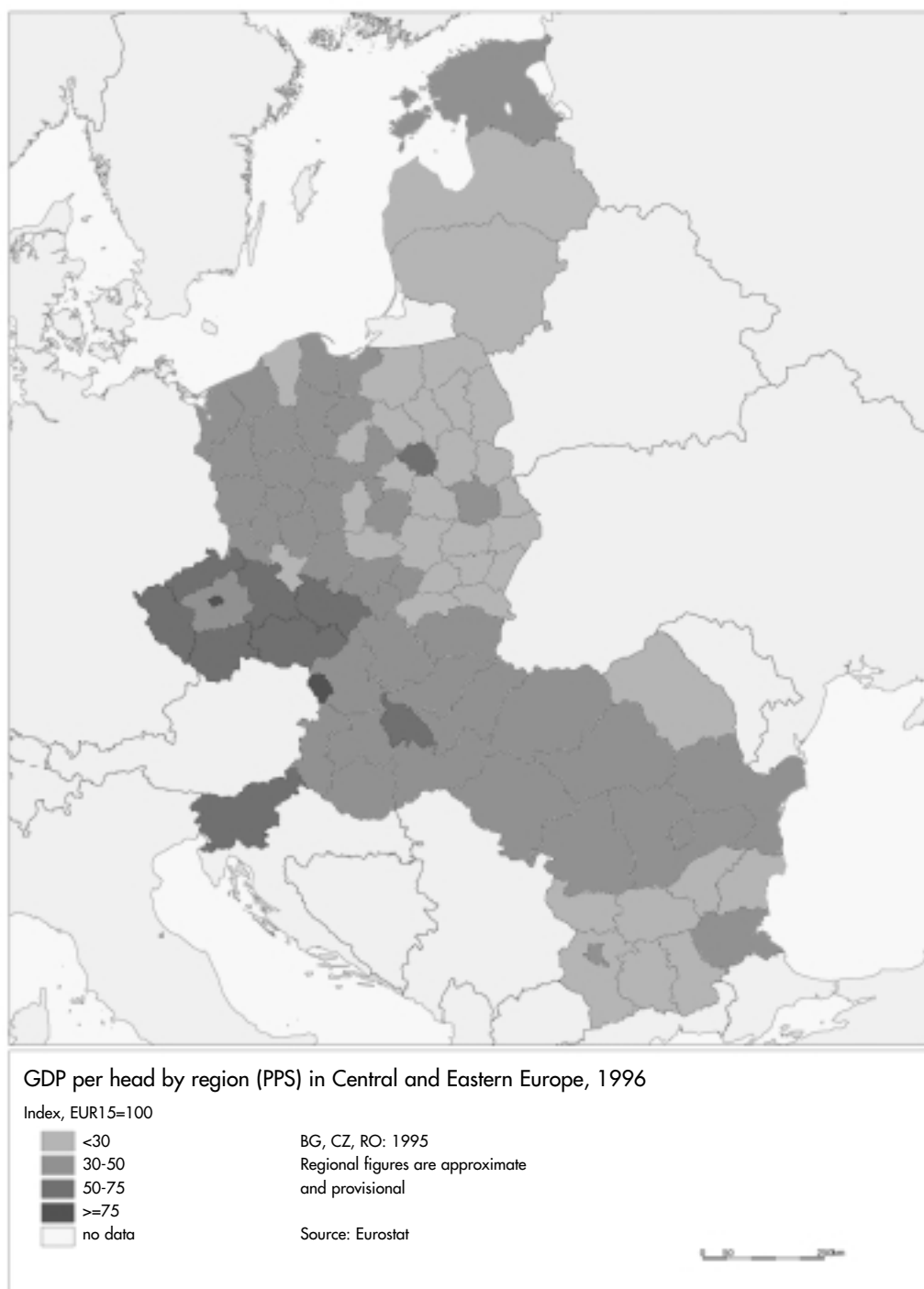
#### **4. Enlargement to Eastern Europe**

The situation in the Central and Eastern European (CEE) countries has evolved rapidly since the collapse of the previous regime about one decade ago. After initial sharp falls in income and output, most of the CEE countries have experienced growth since 1993 or 1994. The recovery has, in general, been most marked in the countries that have made the most progress in moving towards a market economy, underlining the gains to be achieved from reform. On the basis of the recovery and closer economic integration with the EU, many CEE countries have made large strides towards preparing for EU membership.

European-wide economic integration is reflected in growing trade flows. By 1995, the EU was the main trade partner of all CEE countries, and the share of the latter in total EU trade is now superior to that of Japan. This has given rise to a significant EU trade surplus with the countries and EU-CEE exchanges are increasingly dominated by intra-industry trade. The CEE countries as a group are also experiencing a significant inflow of foreign direct investment, though flows are concentrated in a few countries with well-advanced reform programmes. EU Member States are by far the main source of investment, further confirming the increasing degree of economic integration.

The economic recovery from 1993 onwards has allowed some CEE countries to narrow the gap in output per head with the Union. Figure 4 shows that in 1996, GDP per head in the countries was nonetheless barely around 40% of the EU average, thus far less than the economic performance in the Cohesion countries. In addition, this masks significant imbalances, such as Latvia, whose GDP per head is only 25% of the EU average, and Slovenia, for which this figure is closer to 67%. Only two regions, Prague and Bratislava, have a GDP per head above 75% of the EU average. Consequently, much remains to be achieved. Even if the Eastern applicants maintain a 2% point growth differential with respect to the EU, it will take about half a century before most of them approach the EU average.

**Figure 4.** Standards of living in Eastern Europe.



Regional imbalances within CEE countries are characterised by the relative prosperity of urban centres and certain Western regions bordering the EU, which have benefited from the expansion of the service sector. Conversely, employment has plummeted in other regions as a result of large-scale job losses in traditional industries and reductions in agriculture. Nevertheless, employment in agriculture and industry remains high in some regions, reflecting delayed restructuring.

*Even if the Eastern applicants keep a 2 percent point growth differential with respect to the EU, it will take about half a century before most of them approach the EU average.*

Unemployment has risen significantly in most countries, but with considerable variation in rates, ranging from 5% in the Czech Republic to 14% in Bulgaria, Latvia and Lithuania. There are also significant regional disparities with, again, large urban centres and most Western regions having lower unemployment. The labour force has declined as the availability of jobs has diminished and people have withdrawn from the work force and, in many CEE countries, participation rates are now close to the EU average. Participation is regionally differentiated, often with high rates in areas where restructuring is still incomplete.

Most governments have begun to introduce development policies in recognition of the need to address regional disparities. This has been facilitated by decentralisation of government and encouraged by the prospect of EU membership. Accordingly the legal, institutional and budgetary structure for regional policy which will be necessary to participate in EU structural policy has begun to be established. However, completing these structures and procedures is likely to be a long process. CEE regional policies are still weak, lacking a comprehensive strategy and a programming approach. Measures tend to take the form of limited projects, implemented through sectoral policies that are only loosely co-ordinated. There remains a need to strengthen the Ministries responsible for regional policy and to develop their operational capacity, as well as to formulate national strategies for regional policy on the basis of which sectoral policies can be co-ordinated. Financial procedures also need to be improved so if the support from the EU Structural Funds is to be used efficiently.

## **5. Conclusion**

Evidence now shows that GDP, or output, per head of the poorest regions has converged towards the European Union's (EU) average. To be more precise, these regions have typically closed the gap with the EU average by around 10 percentage points over the last decade, although even at this rate it will be several decades before the process is complete. The Structural Funds are making a significant contribution to closing the gap – the average result of a number of macro-economic models ascribes a third of the convergence to the Funds.

However, the situation with regard to unemployment is less positive. Disparities are high and tending to increase, driven in the worst affected regions by social exclusion, especially of young workers, and long term unemployment. The implication of output convergence and labour market divergence is a trend in Western Europe towards compact pockets of problems of economic and social restructuring (including urban problems) and away from the larger scale regional problems typified by Objective 1 (i.e. lagging development).

In addition there is the challenge of enlargement, where although regional unemployment rates fit well within Western norms, there are severe problems of lagging development, low GDP, poor quality infrastructure and environmental damage. In fact, GDP is so low that, even if the Eastern

applicants maintained a 2% point growth differential with the West, it would be of the order of half a century before most of them approached the EU average.

In sum, much progress has been made with regard to disparities in output and many of the factors, such as education and infrastructure, which underlie this. However, much work remains to be done; the economic – and particularly the technology – gap between core and periphery in Western Europe remains a challenge. This, along with labour market problems (including social exclusion) and accession, constitutes the three main challenges to cohesion over the next few years.

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