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Reshaping Economic Geography: Implications for New EU Member States

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Key Messages

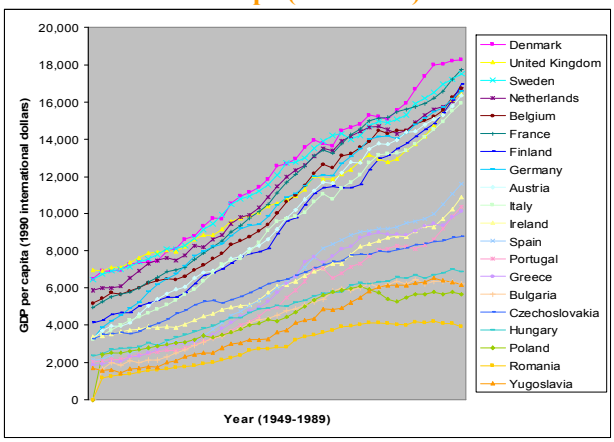
- **Make economic borders 'thinner'.** Economic divisions to the mobility of people and products remain considerable between new EU member states. Reforms to reduce these divisions should remain high on the agenda even during the financial crisis. In the EU15[2], as governments deliberate economic stimulus programs, they should resist the temptation of nationalism that would make their borders 'thicker'.
- **Welcome rising economic density.** The lesson of history is that greater international convergence is accompanied by a concentration of production in leading areas and cities. Governments should not resist domestic concentration of economic activity – the very nature of growth and competitiveness.
- **Deepen institutional convergence.** While infrastructure and place-based investments are often seen as critical, the mainstay of a strategy for economic integration is common institutions that facilitate mobility of goods, services, capital, ideas, and labor. New member states should continue their efforts to harmonize trade, financial and employment regulations.

The ongoing crisis should spur deeper European integration, rather than a return to the nationalism of the past. The World Development Report 2009, *Reshaping Economic Geography*, spotlights several issues for new EU member states.

Some Economic History

From 1950 to 1990, Eastern Europe was impermeable to the flow of goods, services and ideas from the West, and grew slowly. During the same period, GDP per capita in fourteen Western European economies grew at three times the pace of Eastern Europe (Figure 1). The drivers of West European growth were market economies, regional cooperation, and global economic integration. The European Economic Community, started by six Western European nations in 1957, continued to increase its membership with the ultimate aim of full economic and monetary integration.

Figure 1: Economic Divergence in a Politically Divided Europe (1949-1989)



Source: Data from Maddison (2008), "Statistics on World Population, GDP and Per Capita GDP, 1-2006 AD."

After the collapse of the former Soviet Union in 1991, the EU10[3] countries, along with Malta and Cyprus, joined the expanded European Union, an economic zone based on the principles of democracy, markets and the free mobility of goods, capital and labor. The 27-country European Union has a combined population of almost 500 million people[4] and accounts for over 30 percent of the world's GDP.[5] But the legacy of division has meant that the EU10 countries lag considerably behind most of the other member states. While the EU10 have brought 123 million people into the European Union, they have reduced its average level of GDP per capita by an estimated 15.6 percent.

[1] Special thanks to Siobhan Murray for her superb cartographic assistance. For questions, please contact Chor-ching Goh at cgoh@worldbank.org.

[2] EU15 countries: Belgium, France, Germany, Italy, Luxembourg, Netherlands, Greece, Portugal, Spain, Austria, Finland, Sweden, Denmark, Ireland, and UK.

[3] EU10 countries: Bulgaria, Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Romania, Slovakia, and Slovenia.

[4] *Eurostat* figures for 2008.

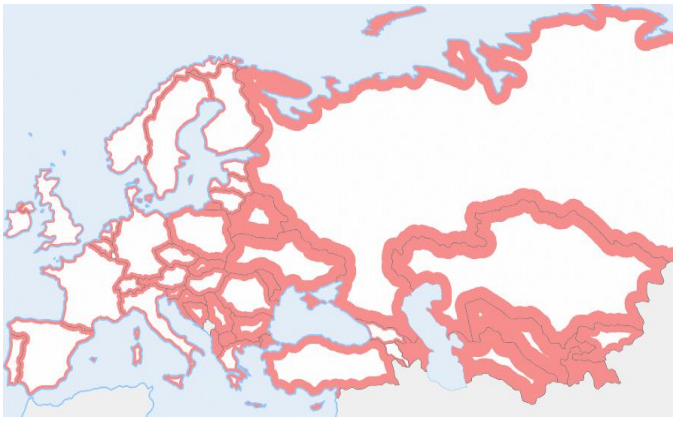
[5] International Monetary Fund, *World Economic Outlook Database*, October 2008: Nominal GDP list of Countries.

Economic Division: Thick Borders Impede Specialization

In the West, market forces operating within democratic frameworks enabled people and firms to gravitate towards areas of maximum opportunity. This facilitated the build-up of economic density in a core area which now stretches across Western Europe--from London to Paris, through Brussels and Frankfurt, and down to Milan. The ***density*** built in this core area propelled the Western economies forward. Eastern European economies were denied access to this core economic area--by ***division***, not ***distance***—and remained relatively poor.

Eastern European economies are still, relatively speaking, divided from the economic density of Western Europe. Figure 2 shows the thickness of economic borders, which has contributed to a discrepancy between the market potential in the West and in Central Europe.

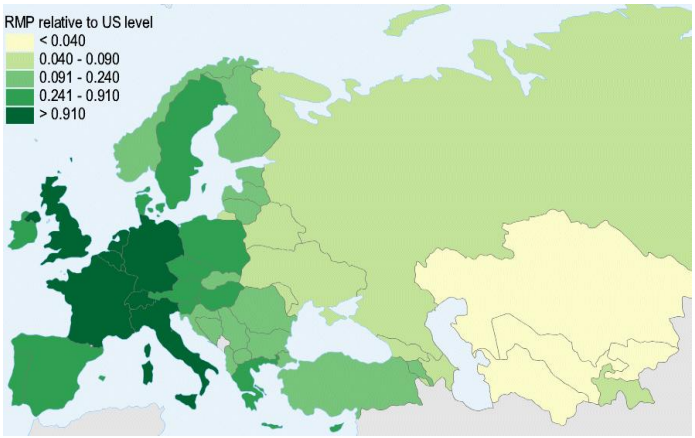
Figure 2: Economic Borders in the EU: the Thinner the Better



Source: Based on data from WDR 2009, *Reshaping Economic Geography.* The width of borders is proportional to a summary measure of each country's restrictions to the flow of goods, capital, people, and ideas with all other countries.

Figure 3. Market Access in the EU-10

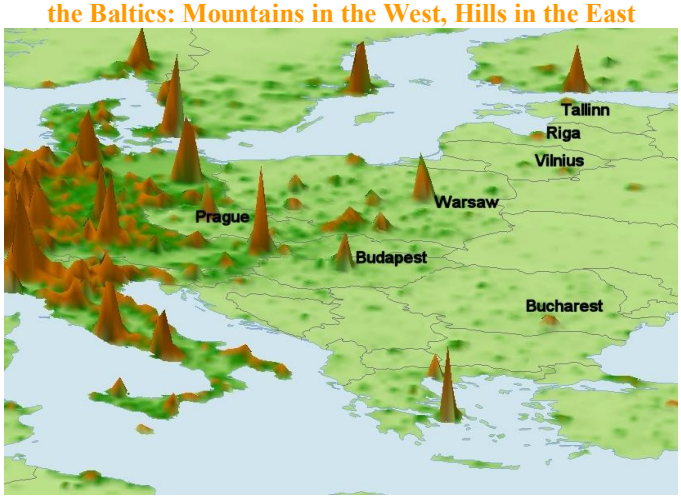
Real market potential relative to the US, 2005



Source: Based on estimates in Mayer (2008), "Market Potential and Development", background paper prepared for WDR 2009, *Reshaping Economic Geography*.

Real market access—which measures the size of nearby markets, *including* the home economies—in the EU10 (Figure 3) falls short of that in Europe's leading economies. Good access to foreign markets should help facilitate the building of domestic density, which promotes real market potential through the growth of the domestic economies. In turn, greater real market access should lead to improvements in foreign market potential because domestic growth enlarges the markets that neighboring countries can access.[6]

Figure 4: The Economic Topography of Central Europe and the Baltics: Mountains in the West, Hills in the East



Source: Estimations by staff in the World Bank's Development Research Group's GIS Lab.

Economic Density Facilitates Agglomeration

Density refers to the intensity of economic activity per unit of land area and can be measured by, for example, the level of GDP generated per square kilometer of land. Figure 4 shows Eastern Europe's economic topography--it looks spiky rather than flat, reflecting the fact that market forces generate more concentrated economic activity in some areas relative to others. While the spikes in Germany, Austria and Italy resemble peaks in a mountain range that spreads westward into other established EU member states, the spikes in Eastern Europe are more like small foothills, reflecting the great difference in density between the EU10 and the rest of Europe.

In particular, economic density across the EU's sub-national areas shows a strong association with GDP per capita. Econometric evidence demonstrates that density facilitates higher productivity and well-being (Figure5).[7] Economically dense settlements of activity and people have production advantages, including 'thick' markets which help to enhance consumption variety, and have a vibrant base of suppliers for industries, a pool of labor, and knowledge spillover within and between local industries.

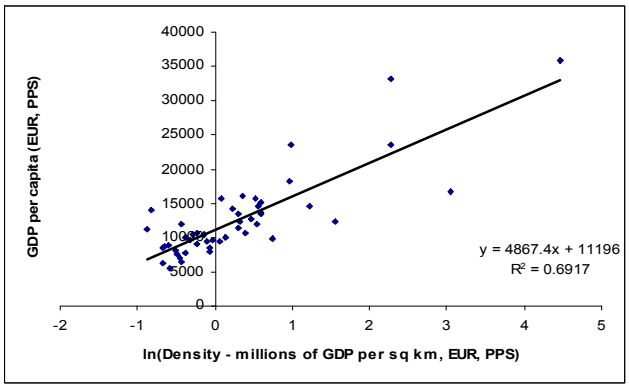
The EU has a strong commitment to tackling disparities in productivity and well-being across its member states and regions. A key objective of its new 'Cohesion Policy' (2007-2013), for which the EU has allocated total funding of €348 billion, is the 'convergence objective' that will take

[6] Mayer (2008), "Market Potential and Development", background paper for WDR 2009, *Reshaping Economic Geography*.

[7] Ciccone, Antonio (2002), "Agglomeration Effects in Europe", *European Economic Review*, vol. 46, pp 213-217.

up almost 82 percent of the spending. Some 71 percent of spending under the convergence objective is earmarked for the NUTS2[8] regions which have GDP per capita levels of less than 75 percent of the EU average; the majority of these regions are in the EU10 states. The aim of this spending is to "*reduce structural disparities between EU regions, foster balanced development throughout the EU and promote real equal opportunities for all.*"[9] This is often equated with spatial equality and the desire to 'smooth out' the economic landscape. The World Development Report (2009) suggests that such an approach may be misguided, at least at the stage of development of much of the EU10. Economic growth, by its nature, is spatially unbalanced.

Figure 5: Higher Economic Density, Higher Standards of Living



Source: *Eurostat.* This is based on data for 2005 for 48 NUTS2 regions in the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, and Slovenia.

The economies which have grown fastest in the EU over the period 2001-2005 are also those which have experienced the largest increases in spatial inequality (see Box 1). The experience of Western European and other advanced countries suggests that increased spatial concentration will initially lead to rising spatial disparities in productivity (and also in living standards), but will diminish gradually as economic density rises.

For many EU10 nations that are building density and growing, rising spatial inequality may have to be temporarily tolerated. Even though faster national growth may mean larger disparities between sub-national areas, it may bring forward the day when the living standards of even the poorest regions will have converged to EU average levels.

Promoting Prosperity in the EU10: Institutions that Unify all Places

The 2009 World Development Report suggests that the most important integration instruments for economies close to major world markets are strengthened ***institutions*** and improved governance. The policies and governance standards in countries close to large world markets have to converge with those in the nearby high income regions. Multinational firms are more likely to locate in countries that have institutional and physical connections to larger markets. The large markets also have strong incentives to foster sound policy and governance frameworks in small markets to ensure stability in their neighborhoods.

The prospect of joining the EU has accelerated the pace of reform in Central Europe, just as the prospect of better access to the US market triggered policy reforms in Mexico long before NAFTA took effect. The Stabilization and Association Agreements between the EU and the Balkans specify the pre-accession legal and regulatory reforms. The Balkans have also signed an intra-regional free trade agreement, the CEFTA (Central European Free Trade Agreement), which enhances the trade and transport facilitation initiatives of 2000. The region has established a common power market and an open sky agreement that could boost tourism. The Balkan region is so close to the EU that its firms can easily integrate into pan-European production networks. Governments can link their supply capacities to the EU's through mutual recognition agreements, conformity assessments, and trade-related coordination initiatives.

Despite their membership of the EU, the EU-10 states need to continue to reduce the thickness of their borders. They have made considerable progress (to fulfill the Copenhagen criteria to join the EU for example), but continued domestic institutional reform is still needed. Hungary, Bulgaria, Romania, Slovenia, the Czech Republic, and Poland still lag behind leading EU economies in the *Ease of Doing Business* rankings.[10] Bulgaria lost €220 million of EU funding by the European Commission over a failure to tackle corruption and organized crime.[11]

Strengthening common institutions within each new EU member state is important. Universal provision of basic and social services, as well as improved land markets, will increase labor mobility and land use convertibility. Such mobility is a primary mechanism for building density and creating spatial convergence of living standards within countries. The most striking example of the impact of migration on convergence is German unification (Box 2). However, migration from Eastern to Western EU nations may be a weak force in promoting international convergence. Many of the 350,000 Polish workers who migrated to the UK in 2004/05 have returned home due to the crisis.[12] A more important policy priority may be facilitating worker migration to 'dense' areas within the

[8] The Nomenclature of Territorial Units for Statistics (NUTS) is a geocode standard for referencing the administrative divisions of countries for statistical purposes; it comprises three levels and is instrumental in the EU's Structural Fund delivery mechanisms.

[9] Activities of the European Union: Summary of Regional Policy Legislation website (http://europa.eu/scadplus/leg/en/s24000.htm).

[10] For the full list of rankings see www.doingbusiness.org/economyrankings

[11] Article entitled "EU Strips Millions from Bulgaria", published on 25th November 2008 on the BBC website news.bbc.co.uk/1/hi/world/europe/7748300.stm

[12] *The Guardian*, "345,000, migrants since EU expansion, figures show", Wed 1st March, 2006

EU10 nations and improving the flow of workers, goods and services between poor and prosperous places. However, Europeans are usually less willing to move compared to Americans, for example, partly due to the artificially 'thicker' European borders. Domestic and EU-wide policies could help facilitate the mobility.

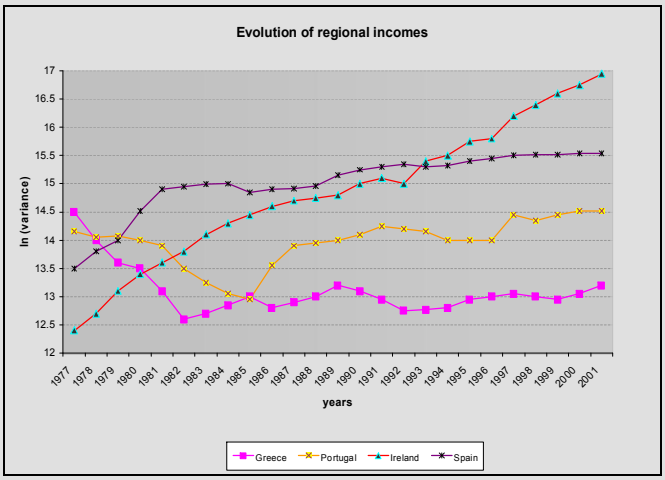
Box 1: Economic Concentration Accompanied Faster Convergence in Western Europe

Between 1977 and 2000, Ireland's per capita GDP grew from the EU average of 72 percent to 116 percent. How did this happen?

After joining the EU in 1973 and until 2003, Ireland received about €17 billion in EU Structural and Cohesion funds. In the first two rounds of funding, all of Ireland was classified as an Objective One area. From 1993-2003, about €2 billion was spent on investments in leading areas and in connecting leading and lagging areas. In 2004, Ireland-based U.S. firms exported goods and services worth US$55 billion, mostly to Europe.

The rapid rise in incomes was accompanied by rising spatial concentration of economic activity. Compared with other cohesion countries (Greece, Portugal, and Spain), Ireland's economic concentration was much higher (Figure B1) and its per capita income grew much faster. Today, almost all EU10 regions qualify for EU funding; they may want to follow the Irish example of using this financing for international convergence.

Figure B1: As Ireland's Income Rapidly Grew, Economic Concentration Increased



Source: Based on Box 8.4 in WDR 2009, *Reshaping Economic Geography*, (World Bank, 2008)

Box 2: German Integration: Convergence and Concentration with Mobile Labor

With the fall of the Berlin Wall in 1989, direct migration from East to West Germany became possible. By 2007, more than 1.7 million of 17 million East Germans (population at the time of the fall of the Berlin wall) had migrated to the West (Figure B2.1).

Figure B2.1: Migration from East To West Germany After the Fall of the Berlin Wall (net migration, 1991-2005, in thousands)

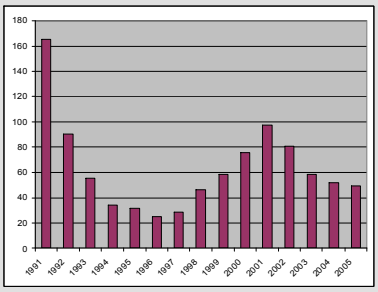
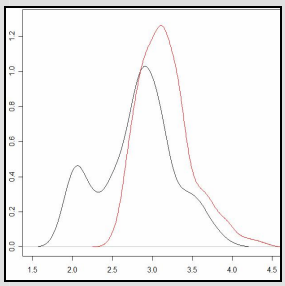


Figure B2.2: Wages in the East and West Converged During This Period (black line=1992, red line=2005)



Migration produced one desired outcome: incomes became more equal between the two areas and average incomes rose (Figure B2.2). The geographical distance of East German counties from the West remained the same but their economic distance was considerably shortened.

Convergence in incomes also had a more surprising outcome: East German women moved to the economically dynamic areas while the men, mostly, stayed behind. A likely explanation for this is that women are, on average, more educated, which makes it easier for them to study or find jobs in the more prosperous parts of Germany.

Source: Based on Box 8.2 in WDR 2009, *Reshaping Economic Geography,* (World Bank, 2008).

About the Authors

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