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How do industrial transitions succeed? Transatlantic considerations on drivers for economic development

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In recent years, the impact of industrial change on regional economic development has been gaining political attention in Europe and the United States. The sustainability and effectiveness of current policies are at the heart of the debate. Long-term megatrends such as globalisation and technological change have socioeconomic and territorial impacts which aggravate broader challenges related to economic disparities and social fragmentation.

Traditional development policies, as a means to generate successful industrial transformations, have had significant limitations in many regions.

While some regions and cities are well-equipped to address these challenges, many others are not. Territorial decline, whether real or perceived, has increased in political saliency in countries such as France, the US, and the UK. Traditional economic development policies, as a means to generate successful industrial transformations, have shown significant limitations in many regions.

This Policy Brief examines the effect of emerging global trends and puts forward policy recommendations for managing industrial transitions across the EU. It calls for an improved evidence-base, a better understanding of the territorial dimension and impacts of economic development policies, and approaches tailored to local legacies and needs.

BACKGROUND – IMPACT OF LONG-TERM TRANSFORMATIONS

The socio-economic dimension

Globalisation and technological progress are incrementally and inevitably reshaping more developed economies. These economies are relying less heavily on traditional manufacturing (with declining employment in the sector), while demand for higher quality, service-oriented industrial production is rising.[1] Investment in intangibles (e.g. software and human capital) is increasingly a source of growth, blurring the once clear distinction between industry and services.

An unintended consequence of technological advancement and innovation has been rising income inequality and job polarisation. There is growing demand (and wages) for highly skilled and knowledge-intensive jobs (including within the manufacturing sector), while digital technologies and automaticion increasingly squeeze white-collar and manufacturing jobs. Middle-skilled workers, unless they can improve their skills to match the needs of technology, will increasingly be forced into lower-skilled, lower-wage jobs.[2] Furthermore, the disappearance of middle-skill jobs is linked to reduced social mobility and career options for low-skilled workers.[3]

The territorial dimension

'Megatrends' have also had disproportionate effects on some EU regions.[4] Leading regions and cities benefit from agglomeration effects, innovation spill-overs, and the concentration of productive, innovative firms that employ high-skilled people, with high growth and investment results. For some middle-income regions, the reality is different. There are older industrial regions and cities with a long heritage of traditional manufacturing, a modest skill base, declining labour force and low productivity. Their lack of capacity to keep up with industrial and technological innovation leads to declining investment as well as stagnating growth and incomes.[5]

Globalisation compounds these struggles. In the EU and the US, some regions were once the industrial backbone of nearby innovation centres.[6] Today, as industrial production can be easily outsourced to emerging economies, these manufacturing regions have been struggling to adapt. They are too expensive for traditional industrial production and often lack the infrastructure or the knowledge base to smoothly transition towards high-end manufacturing.

Scope for EU Action

Regional disparities affect both cohesion and competitiveness. According to the treaties, the EU is committed to strengthening its "economic, social and territorial cohesion" taking account of regions in industrial transition (Art. 174 TFEU). This legal base warrants support to 'transitioning' regions to reduce the differences in economic development across the Single Market. The EU also has a mandate to mainstream industrial competitiveness (Art. 173 TFEU). A failure to address the impacts noted above would hinder the competitiveness and functionality of the internal market. It could also fuel a political backlash against the EU.[6]

The next section examines current responses (at EU, national and regional/local levels) to the trends mentioned above and highlights their limitations and trade-offs.

STATE OF PLAY – POLICY OPTIONS

The EU has reaffirmed its commitment to supporting EU territories to address the challenges associated with long-term transformations.[7] To address potential negative externalities and to re-boot stagnant economies, there is widespread recognition that the EU must re-examine its approach to economic development.

Below we describe three regional development pathways that contain actions already adopted by different regions and cities with varying levels of success. The first option – 'diffusion' – assumes automatic transfers of technology, capital, and wealth. The 'copycat' option refers to how older industrial regions replicate policy measures or promote innovations that have worked elsewhere. The third – 'managed transition' – pathway acknowledges the need for a highly differentiated and tailored approach because of specific regional endowments. These options are by no means definitive nor mutually exclusive, but they provide a useful framework for examining the underlying logic and the effects and limitations of development strategies in 'transitioning regions'.

Diffusion

Efficiency automatically drives equity

LOGIC	Automatic cascade of positive spill-over effects Focus on people, not places
EFFECTS & LIMITATIONS	Catch-up effect Agglomeration dynamics Distance decay
POTENTIAL FUTURE IMPACTS	Winner takes all Risks of political backlash Uneven spread of benefits
LESSONS LEARNT	Negative externalities of knowledge diffusion and mobility

In the EU and the US, some regions have endorsed development strategies that have relied on an agglomeration or '**diffusion**' logic.[8] These policies promote the natural tendency of economic activity, investment, and innovation to concentrate within a specific geographic area and benefit from efficiency gains due to spill-over effects and proximity. Through factor mobility, wealth and growth are expected to diffuse automatically beyond the targeted territory, supporting these areas to catch up and converge. For example, the proximity of Central and Eastern European countries to the German powerhouse has fostered technology and capital transfers.[9] Nonetheless, this policy pathway also has limitations.

- First, the diffusion of positive spill-overs is estimated to be bounded geographically to an area of approximately 200 kilometres (distance decay).[10]
- Second, the opposite effect of diffusion can also be triggered: resources – people and capital – are drained from the periphery and attracted to the centre, e.g. a city (agglomeration backwash).[11]

This model's contribution to economic convergence may be in questions, as it can exacerbate the scarcity of resources and opportunities in some territories. The territorial concentration of discontent may also lead to political backlash.[12]

Copycat

Adoption of a similar 'recipe' which was successful elsewhere

LOGIC	Innovation-driven growth for all Focus on technology and knowledge diffusion
EFFECTS & LIMITATIONS	Technological clusters in mid-sized cities Technology investment High dependency on skilled human capital
POTENTIAL FUTURE IMPACTS	Emergence of new, smart territories Gap between expectations and reality Risk of limited return on investment
LESSONS LEARNT	One size may not fit all Long-term influence of domestic endowments

In pursuit of higher levels of growth, many territories have sought to "copy" the recipe for innovation-led growth that has worked in more dynamic places. The logic of this '**copycat**' approach presumes that 'transitioning' regions can leapfrog into highly innovative, technologically advanced, knowledge-intensive sectors. A risk of this approach is the failure to consider that not all areas have the adequate skill base, global network connections and physical capacity for transforming their economic structures through technology-driven investments.[13] The emerging gap between expectations and reality implies a suboptimal use of resources. An example of such a mishap is the construction of high-tech industrial centres that do not match local business capacity or demand.

Managed Transition

Each place has its own successful recipe

LOGIC	Tailored approach Focus on endogenous potential
EFFECTS & LIMITATIONS	Acknowledgement of territorial path dependency Recognition of economic trade-offs
POTENTIAL FUTURE IMPACTS	Economic sustainability Cooperation and integration in global value chains Complementary policies
LESSONS LEARNT	Incremental change more likely than radical one Importance of political appetite

A third policy option involves a **'managed transition'** that tailors the region's economic ambitions to its existing human and physical capacity and assets. Older industrial regions have endogenous potential – albeit with a less attractive asset base than more dynamic regions – which contributes to local development and aggregate growth.[14] Here, the strategy can focus on cooperation with other cities and regions. These include improved connections to global value chains and, for example, delivering ancillary services to more dynamic, neighbouring regions. This approach can generate new and diversified opportunities, building on domestic endowments. Such a development pathways may appear unappealing and lack political support. However, accompanied by a medium-to-long-term strategy for growth and investment, such an approach can offer positive perspectives for skills upgrading and promoting social mobility.

Overall, 'transitioning' regions potentially face difficult choices. Achieving growth through cutting-edge innovation may be difficult to match with local endowments. This requires sensitive management of expectations, especially in the short-medium term. More modest growth ambitions – based on the region's existing economic structure and capacity – can offer a stepping-stone towards an incremental managed industrial transition.

PROSPECTS – RECOMMENDATIONS

How can the EU support regions in managing their industrial transitions to the new economy?

First, there is a need to **clarify the added value of EU action** in supporting alternative economic development models across the EU. Pursuing the current agglomeration logic may be a suboptimal or even ineffectuve approach for supporting industrial transformation in some regions. While EU competencies on economic development matters are limited, the negative economic, social and political spill-overs generated by regional inequalities strengthen the case for EU action. The EU should start with clarifying its added value in supporting a new trajectory towards alternative development models.[15] This could be achieved by promoting broader debates about development options, in line with a realistic assessment of each territory's capacity. Equally, the cross-border nature of the challenges examined in the first section may call for solutions with a strong cooperation logic (e.g. to strengthen economic scale and innovation capacity), with strategic guidance at EU level. For example, the EU's Smart Specialisation (S3) policy agenda's potential contribution to foster interregional cooperation should be closely monitored.

The Commission should critically review the performance of EU programmes in spurring successul industrial transitions across all territories.

The EU and its member states should **gather further evidence** on the performance of current economic development strategies regarding industrial transitions. They should consider the extent to which EU policies and funding have (directly or indirectly) favoured agglomeration dynamics. As noted above, the Commission should critically review the performance of EU programmes (such as the Smart Specialisation agenda and its recent interregional collaboration focus, with the aim of upscaling innovation in spurring successful industrial transitions across all territories.

Assess more systematically the resilience of specific EU regions to economic shocks and identify barriers to inclusive growth and innovation investment and diffusion.

In line with the direction outlined in the Commission's proposal for Cohesion Policy in the 2021-2027 Multiannual Financial Framework, EU action should consider a **more tailored approach to regional development**.[16] Concrete actions include:

- building typologies that recognise differences between traditionally backwards regions, declining manufacturing regions, and territories stuck in a new 'middle-income trap';

- using new and existing tools to assess more systematically the resilience of specific EU regions to economic shocks and identify barriers to inclusive growth and innovation investment and diffusion;

- defining new targets and creating new policy frameworks to better identify (and address) the distributional effects of horizontal measures across EU territories (e.g. regarding corporation tax rates or SME support).

This framework could start a process of rethinking EU development policies, offering a revitalised pathway for regional growth and competitiveness. Such an approach also offers the possibility of better distributing opportunities, with the potential to reduce social exclusion and political discontent.

Promoting alternative development models for successful industrial transitions will require stronger leadership and **policy experimentation** from the EU. In July 2018, the European Commission launched a pilot aimed at testing new industrial transition approaches in 12 regions.[17] This example shows how EU action can support experimentation and encourage greater risk-taking in regions facing specific challenges, such as the lack of an appropriate skill base, high unit labour costs, and low level of external investment. In the context of this project, the EU should gather further evidence, for example, on the role played by distance from major production centres, and the influence of other factors (e.g. demographic trends, lack of administrative, academic and corporate capability, weak incentives for entrepreneurship) on industrial decline.

Experimentation should become the building block of a learning process that would help to discriminate between the effective development approaches (that should be scaled up and further disseminated) from the inefficient ones (that should be abandoned). While acknowledging the need for highly tailored responses, valuable learning captured from both successful and unsuccessful efforts should be widely shared.

Drawing on the lessons learnt from **existing initiatives** across the world could also support the EU's shift to a new economic development pathway. The EPC workshop identified critical drivers of success (in the EU and US) such as the depth and the breadth of competencies, diversification, and entrepreneurship. Discussions also underlined the role of public authorities in supporting structural dialogue between business, academic and policymaking communities, and in encouraging place-based investment through financial incentives.[18] In particular, the lack of business involvement appears as one of the reasons behind the failure of some EU investment support initiatives. A more structured, institutionalised dialogue between public and private players (including universities) could help to identify and tackle existing business gaps and strengthen private sector investment in innovation. While there are clear limitations in directly replicating and transferring initiatives from the US to the EU context (and vice-versa), such programmes have the benefit of encouraging EU policymakers to 'think out of the box'.

EU action is needed to encourage and accelerate a new economic dynamism across the EU's diverse territories, ensuring that no places are left behind. An EU supporting framework for regional development and industrial transitions is vital to delivering successfully on higher ambitions.

1 Manufacturing as a share of GDP has been decreasing as ICT intensity has been increasing. OECD (2017), "OECD Employment Outlook 2017", OECD Publishing.

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6 New Pact for Europe (2017), "Re-energising Europe. A package deal for the EU27", Third Report, available here.

7 See Seventh Cohesion Report and the DG REGIO Pilot Action: Regions in Industrial Transition.

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12 Rodriguez-Pose, A. (2018), "The revenge of the places that don't matter", VOX, CEPR'S Policy Portal.

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16 Huguenot-Noël, R., Hunter, A., Zuleeg, F. (2018), "Research for REGI Committee – Future links between structural reforms and EU cohesion policy", European Parliament.

17 DG REGIO Pilot Action: Regions in Industrial Transition.

18 See for example 'The US State Small Business Credit Initiative (SSCBI)' and 'Opportunity Zone Program'.

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