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# Institutions and Development in the EU Periphery

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***Abstract:*** Those EU countries at an intermediate level of development, such as Spain, Portugal, Ireland and Greece, failed, with the exception of Ireland, to achieve convergence, despite substantial financial assistance. EU structures did not assist the heterogeneous nature of these countries. In addition, serious internal problems and institutional weaknesses contributed to a differential attraction of Foreign Direct Investment and to a failure of their domestic capital to play a more dynamic role in the developmental process of these economies.

***JEL Classification:*** F00, F42

***Key words:*** biotechnology, Cobb-Douglass production function, human capital, labour costs, neo-liberal agenda

## Introduction

Globalisation brought fundamental social and economic changes in the last few years and created new chances, possibilities and fears. The European Union (EU) addressed them by enlarging, intensifying its economic and monetary integration and creating the preconditions for a successful competition of the EU capital, at a global level. The EU thus considered essential for growth the effective adoption of a neo-liberal agenda, but the means used to achieve it were both proactive and interventionist.

The heterogeneous nature of the EU rendered difficult the balanced benefits of this outcome. Growth was dependent on the assistance and promotion of the most

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dynamic parts of capital, but this approach had an in-built regional impact. Advanced centres of finance and centres of research and technology attracted the dynamic sectors of domestic and foreign capital, creating agglomerations of industries in selected areas. A rich institutional environment assisted this process.

The lack of these preconditions in the periphery inhibited its development. Despite its cheap labour, the lack of capital, appropriate technology and very importantly of a supportive institutional framework did not assist the attraction of high value-added Multinationals (MNEs). The same weaknesses influence the development of strong Small to Medium Enterprises (SMEs). The only exception was Ireland, which managed to break from this mould partly through state intervention and partly as a result of cultural and linguistic affinities with the advanced economies.

This paper will start by examining the conditions for convergence, as stated by Solo''s neo-classical growth model and Romer's New Growth theories. It will proceed then to examine the role of EU's structures and institutions, the operations of the MNEs within the EU and the structural weaknesses of Small to Medium Enterprises (SMEs). It will finish by recommending policies for a balanced development which need to be undertaken at a EU level.

## Aspects of Economic Growth and Convergence

The aspiration for fast economic growth made the peripheral countries to look more closely at the theoretical underpinnings of growth theory. In a neo-classical Solow type growth model with a Cobb-Douglas production function (showing constant returns and diminishing marginal productivity), it is shown that, in the long term, growth per person is independent of the rate of investment. As a result of capital accumulation and diminishing returns developed economies will experience slower rates of growth, while countries at a low level of per capita income and capital labour ratios will grow faster. The main message to the developing countries was that convergence was feasible and did not require any specific policy intervention from Governments.

The seminal work of Romer (1986) shed doubts on this, almost inevitable, convergence between countries. He dismissed the notion of diminishing returns to capital. By using a wider definition of capital, one which included both physical and human capital and Research and Development, he showed that there are externalities arising out of the use of capital. Diminishing returns still exist, but only at firm level. Externalities to capital imply that divergence between countries will deepen. Deficiency in technology and human capital is thus likely to undermine the 'automatic' convergence between countries.

An important corollary of this model is the importance of Government in influencing the rate of growth. While the neo-classical growth model does not provide scope for Government intervention, within an endogenous model, national or EU policies could influence the rate of growth by influencing the level of physical or human capital (education or R&D). As Baumol et al. (1994) argue whether convergence will take place or not depends on the level of human capital and the ability to assimilate and take advantage of modern technology. Countries satisfying these criteria are a part of the convergence club while for the very poor and backward countries, possibilities for convergence do not apply.

Further, there is a wide analysis of non-economic factors, often neglected by traditional economists, impinging on theories of growth. Economic growth is the result of complicated interactions of often historically determined social, political and economic factors. Schumpeter explored the role of entrepreneurship and social attitudes in creative destruction and Myrdal (1957) pointed to the need to investigate social and political conditions in the analysis of growth ( Rodriguez-Pose 1998). Institutions further provide a framework within which growth can take place. Growth is thus the result of a number of multifaceted processes, not often easily amenable to empirical investigation.

EU countries, at an intermediate level of development, lack the necessary human and physical capital and they are thin in the institutional framework which underpins this development. It was hoped and expected that EU membership could create the preconditions for their development, by providing a new socio-political framework which could allow the easier operation of MNEs. The latter could provide the much needed physical and human capital and could rectify the existing technological deficit.

## EU Structures and Institutions

The 1950s and 1960s was the Golden Age of capitalism. A period, during which, core Europe caught up with the USA, by experiencing consistent rates of growth above their historical trends. This was the outcome of Fordist style production and Keynesian demand management. A long standing history of state intervention in core EU, particularly Germany and France, was now taking a more specific format; one which guaranteed full employment, smoothed out regional differences and brought forward a more egalitarian distribution of income within their own national state.

The EU periphery was not a part of this Fordist growth and the preconditions for successful Keynesian demand management were lacking. Instead, the period of the 1950s and 1960s was one of sluggish development and an increased gap between 'core' and 'periphery' in Europe.

By the mid 1980s the onset of Globalisation brought challenges. Within the EU we experienced a transformation of institutions intending to seek, accommodate and promote the global position of EU capital, within parameters set by neo-liberal trends, but also by a long standing tradition of regulation and intervention. The latter was not only restricted to the agricultural policy.

Globalisation is addressed by creating the preconditions for a successful development of the EU capital. Despite the claims for unrestricted and market-determined policies, the fortunes of EU capital are not left to unpredictable market forces. Instead they are managed by an interventionist Commission which accepts Globalisation as a challenge to EU capital and builds on it. Policies are adjusted to fit the new global environment.

The Single European Market (SEM) involved fundamental institutional changes assisting industrial restructuring. It intensified economic integration by removing tariff and non-tariff barriers and enhanced the conditions for the successful realisation of economies of scale.

The EU identified areas of competitive strength such as the IT, biotechnology and telecommunications and global champions are encouraged to emerge through selective assistance in R&D. The latter not only sharpens their competitive edge, but also assists the break down of old competitive attitudes along national lines. A legal framework, enhancing competition and deregulation, further compliments these policies. An environment is thus created, particularly fit to assist the large enterprises operating in a period of Globalisation. They are perceived as the vehicle to growth and to global competitiveness. They represent poles of growth.

The EMU is seen as the culmination of this process. A common currency is expected to facilitate transactions and reduce transaction costs. A common monetary policy directed by the European Central Bank (ECB) will give the necessary credibility to this process. The combination of SEM and EMU intended to enhance the dynamism and competitiveness of the finance and industrial capital in the EU. Such policies to the extent that they are successful, they are not neutral; they benefit large companies and they have a regional impact.

This global orientation is not conducive to EU's heterogeneous configuration. Its periphery is relatively dependent on a weak agricultural sector and an equally weak and backward looking domestic capital, which concentrates on low quality products such as food, drink, tobacco, clothing and footwear. Their dominance in the domestic market was often based on state support and protection. A weak institutional framework and a low skilled labour force point to a general deficit in man-made advantages. These structures exclude them from the global role enjoyed by EU core.

The issue is addressed by the EU through the periphery's inclusion in the SEM, mainly as consumers, and transfers from the core in the form of Structural and Cohesion Funds. In 1999, these Funds represented 4 per cent of the Greek, 2.3 per cent of the Spanish, 2.7 per cent of the Irish and 3.8 per cent of the Portuguese GDP (Eurostat 1998). Although these contributions were substantial, they were not sufficient to reverse years of underdevelopment. These policies are flawed, as they mainly target the periphery's infrastructure. They are the outcome of conflicting economic interests and compromise. The experience from Mezzogiorno, a beneficiary of these Funds longer than any other region, has shown that long years of improvements of its infrastructure were not translated to growth.

For the periphery, EU membership was expected to play a catalytic role by changing attitudes, bringing capital, improving the infrastructure and forging changes. Growth could be externally driven through FDIs, through the transfer of capital, new technology, skills to workers and managers as well as create linkages with the domestic capital.

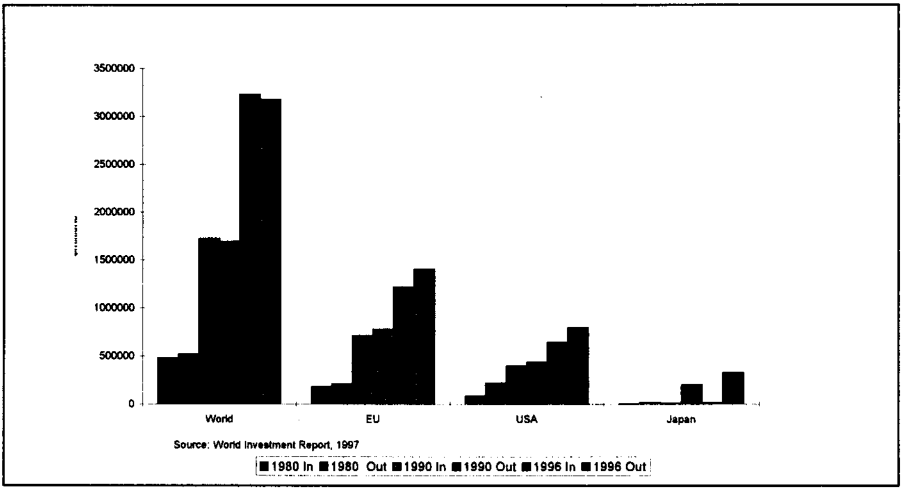
## Multinationals in the EU

Since the 1980s we have an increase in the intensity of globalisation and the EU is at the centre of it. Internal reforms, such as the impeding SEM and its expected effects on growth of GDP and employment[1] facilitate the process. Investment creation and diversion effect are present leading to investment in the EU and disinvestment in non-EU countries, such as Sweden and Austria. Greenfield investment, but mostly mergers and acquisitions are the means to entry.

The removal of the all non-trade-barriers (NTBs), as a result of SEM, in the 1990s and the subsequent liberalisation of public sector procurements, opened for the first time this dynamic, state-owned sector, to open competition, acquisition or foreign control. This sector, in the pre-SEM period, represented approximately 15 per cent to 20 per cent of total GDP and included key dynamic industries with very high levels of R&D such as the pharmaceuticals and telecommunications.

EU's central position in globalisation is highlighted by the involvement of MNEs. In 1996, the EU, as a group, is the most active participant in the global movement of capital. Its outward FDIs represented 44.2 per cent of the world stock, in contrast with 25 per cent from the USA and 10 per cent from Japan and represented 14.6 per cent, 9.8 per cent and 6 per cent of GDP respectively. Similarly, inward FDIs to EU represent 38 per cent of the total in contrast to 20 per cent to the USA and 2 per cent to Japan, representing 13.2 per cent, 7.7 per cent and 0.3 per cent of GDP respectively (Graph 1).

Graph 1.: FDI Stock - Inward and Outward



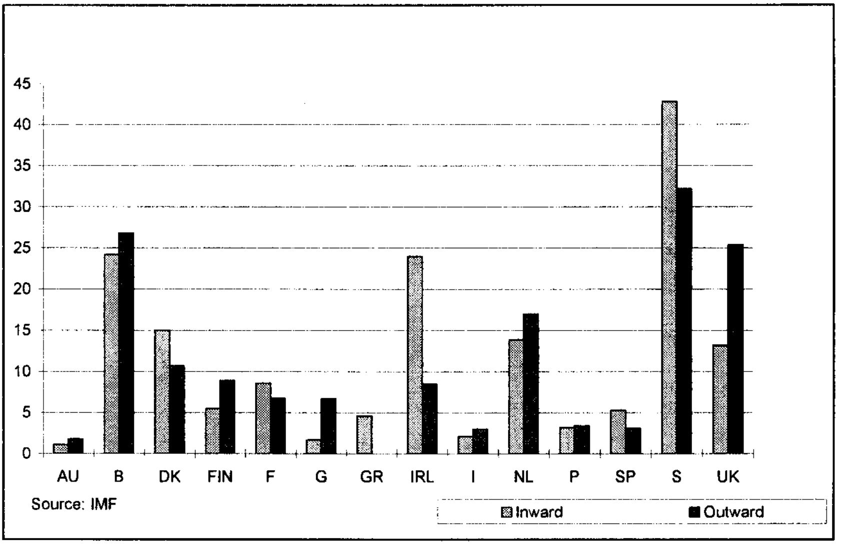

## Location

The location of the MNEs highlights market considerations as well as the importance of the national states and EU policies in shaping the industrial landscape. In the case of the core EU countries, new man-made advantages are fostered to replace old strengths; investment in R&D and the skilling of the labour force are the modern means to stimulate inward investment. The new pattern of location which are emerging point to an agglomeration of high tech industries in the core countries. This agglomeration takes place despite EU's higher wage costs. It is the result of location and knowledge-based specific advantages; it leads to economies of scale and scope and to intra- firm and intra- industries trade between EU members.

A history and tradition in knowledge and research, well developed institutions and infrastructure cemented the core's role. High expenditure on R&D allowed the development and expansion of scientific knowledge. It created scientific and technological parks and encouraged the congregation of academics around centres of learning. The existence of a skilled labour allowed the production of high quality and value-added products. Myrdal (1957) and Kaldor (1970, 1972) first explained the possibility for agglomerations which were based on the effects of cumulative causation and 'dynamic increasing returns to scale'.

Even within the core countries these advantages are unequally distributed, but when present, they contribute significantly to gross fixed capital formation and eventually to growth (Graph 2).

Graph 2.: Inward and Outward FDIs as a per cent of GFCF, 1995



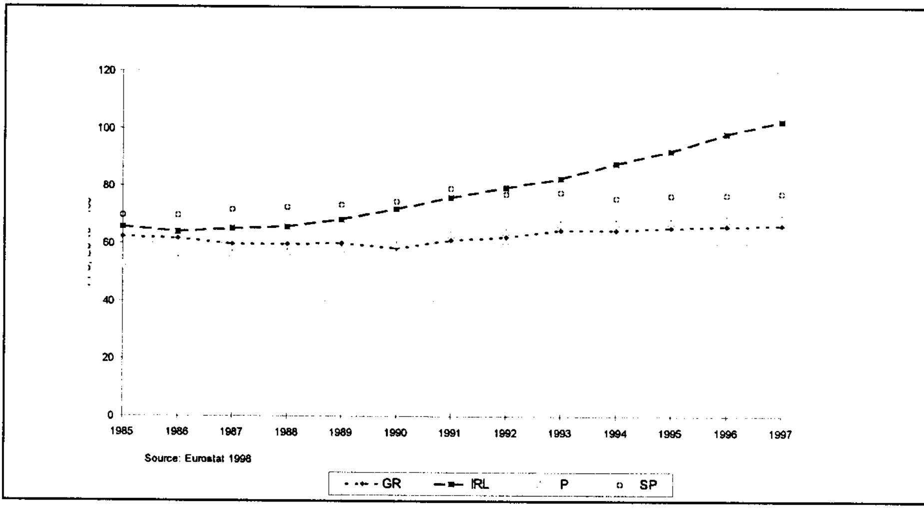

For the MNEs the European periphery, with the exception of Ireland, was not particularly attractive. It lacked the advantages of the North and, although wages were low by EU standards, they were high in comparison with wages in other countries such as the Central and Eastern European countries. The MNEs which were attracted, were of low value in low skill operations. They often tended to be in areas such as packaging and final assembly, with very little embeddedness in the local economy. Subsidies, tax concessions and preferential treatment were often the main attraction.

Experience from other countries has shown that even within the periphery, states could play a determinant role in the process of development. Japan, South Korea and Ireland are different examples of state managed development.

Ireland is the only EU peripheral country which experienced a transformation of its economy and development through an intelligent use of the MNEs. The state was instrumental in singling out the desired path of development from as early as 1969 and then proceeded to create the conditions for a successful outcome. However, its state policy evolved over time. It involved the attraction of foreign capital through financial incentives such as a very low preferential corporation tax of 10 per cent, discretionary grants only available to foreign capital, the identification of areas of high growth and the sharp rise of educational standards. MNEs flocked in, in high tech, capital intensive industrial sectors, creating clusters of high value added industrial production, solely dominated by foreign MNEs. Institutional similarities, cultural affinities and the use of English were also important in influencing the flow of MNEs.

FDIs attracted into Ireland amounted to almost 8000m ECU in 1993 representing 6 per cent of all inflows of FDI into EU and 8 per cent of GDP. They produced 68 per cent of total manufacturing output, employed 45 per cent of the workforce and exported 88 per cent of output. This is even more intense in sectors such as Chemicals (94 per cent of output, 96 per cent exported) and Electronics (92 per cent and 88 per cent respectively), (Ruane and Georg, 1997). Total factor productivity (TFP) in the MNE sector was almost 5 per cent in Ireland in 1995 in comparison to 1.5 per cent in OECD (OECD 1997).

Graph 3.: GDP *per capita* Selected Countries




The absorption of Ireland to the global world through a state initiated, MNE driven growth, led to phenomenal increases in GDP and convergence with the core (Graph 2). It had its problems as it led to a dual economy, as the domestic sector remained weak and the linkages of foreign capital with the domestic are very low[2]. This led to effectively a classic 'dual' economy.

Ireland's experience was not replicated in the rest of the EU periphery. The inflow of MNEs was not spectacular and the effects not very significant. The expectations of a successful incorporation into the core, through a foreign capital driven growth did not materialise. The periphery, with the exception of Ireland, did not satisfy the preconditions desired by foreign capital. In the post-fordist era, advanced institutional settings and centres of technological excellency are more important than cheaper labour[3].

## The Role of Small to Medium Enterprises (SMEs) in the Developmental Process

Successful outcomes through the activities of SMEs in other parts of the EU, raises the possibilities for a more successful alternative development. Post-Fordism led to a restructuring of capital and the development of new growth areas. SMEs developed as a response to flexible specialisation, subcontracting and the means to a quick response to consumer demands. Their success has been variable and they often exhibited a significant degree of dynamism, resulting from the use of modern technology leading to economies of scale and scope. In addition, they provide the benefits of local embeddedness and they have contributed in some areas to regional rates of growth above the national average.

As a result of Post-Fordism, dynamic SMEs sprang up from Third Italy, to Baden-Wurteemberg, in Germany, to West Jutland in Scandinavia. Their products extend from knitwear or furniture to car or engineering products. Their operation, not as single independent producers, but in clusters, specialising in complementary niches increases their efficiency and their embeddedness in the local economy. Their success was not based on cheap labour but instead on innovation, quality and design.

A rich institutional environment created the preconditions for their development. According to Streeck (1991) the regional structure of Italy assisted this process, as in a Post-Fordist era regional governance is better suited to satisfy the local demands of SMEs. It creates agencies, as the interface between the SMEs and national or international capital, it assists the development of networks of firms. Further, it provides assistance with R&D, with the training of labour and the re-adaptation of firms to changing conditions. Regional government, trade unions, the communist party (in Third Italy) or even the Catholic Church (in NE Italy) fostered and assisted this development (Rodriguez-Pose (1998). They provided the institutional exoskeleton which allowed firms to become competitive in the market. The regional institutional exoskeleton determines how successfully SMEs compete in the market.

The lack of regional governments in Sweden and Norway does not appear to affect the operation of SMEs, possibly as a result of the size of the national state. Important and successful assistance and intervention from the national government guarantees the operation of SMEs. Irrespectively thus of the structure of the state and the concentration of power at national or regional level, SMEs in some regions, do contribute to regional growth either as subcontractors for domestic large companies or as independent producers.

SMEs offer important advantages as a result of their close synergy with the local community. They develop within the community, as a result of communal effort and they assist the development of a socially cohesive local basis. Nonetheless, in all these cases the SMEs were not themselves the engines of growth. They operated along large companies, they benefited from structures set by the large companies and they often shared technological advances made by the latter. Most of these successful cases operate within regions which are themselves part of a post-industrial structures at a national level. The institutional exoskeleton is very important, but it is itself the product of capitalist development.

The lack of these conditions in the EU periphery make the operation of SMEs more problematic. There is a plethora of very small firms, which lack dynamism are backward looking, the result often of failure rather than success. They often operate either as independent producers or subcontractors in areas such as clothing, textiles and footwear. The lack of a dynamic sector they could attach themselves to, the lack of proximity with centres of excellency and the lack of the necessary institutional exoskeleton have not allowed these companies to play a fundamental role.

## Conclusions and Policy Considerations

The EU's institutional transformations aimed to assist the successful incorporation of its industrial and finance capital into the global world. It contributed to the process of globalisation and benefited from it. It expanded internally, encompassing countries at a lesser stage of development and it increased its global stance internationally. Yet the effects of globalisation were unevenly felt.

The EU's proactive stance has created a neo-liberal environment, considered important for the growth of EU capital and the attraction of foreign MNEs. These policies had a strong regional effect. The strong, dynamic, high-value producing MNEs, not concerned about high labour costs, concentrated in the core, contributing to its greater prosperity. This dynamism and growth concealed areas of deprivation resulting from de-industrialisation and unemployment among the older and the unskilled.

The periphery, on the other hand, being at an intermediate level of economic development and experiencing serious internal structural problems, did not participate and/ or benefit to the same extent. It became a part of the globalised world, by opening its markets and by allowing the unrestricted movement of its capital. Its own structural and institutional deficiencies prohibited the inflow of high value adding MNEs and checked the successful development of its own SMEs.

Still the new structures may provide opportunities. The example of Ireland has shown that fast growth within the EU periphery is possible. EU membership, state policies and other non-economic advantages were crucial determinants in the attraction of the MNEs and the fast growth of the Irish economy. The Irish example showed that growth is not the outcome of uncontrolled market forces. However, despite its successes, the creation of a dual economy, dependency on a volatile foreign company and lack of a parallel development of its domestic sector point to serious deficiencies.

The EU has so far assisted the periphery with substantial transfers from the centre, mostly spent on infrastructure. These measures, as well as some spasmodic national policies, have not so far produced the desired results. Development is complex. It requires a substantial intervention at both national and EU level addressing both MNEs and national capital.

Despite their controversial nature, MNEs could assist development under certain conditions. The inflow of foreign capital into the periphery could have a cathartic effect. It could not only bring the necessary capital and technology, but it could force changes in production and management as well as instil institutional and administrative changes. For this to be successful, it should be a part of an overall strategic plan and an appropriate regulatory framework.

A strategic plan should aim to evaluate a region's needs and assess the best method of achieving growth. If there is a need for the inflow of FDIs, EU grants could support the location of selected MNEs in the periphery and could provide assistance for the transfer of technology and the creation of necessary skills. Linkages with the national capital, assistance with the upgrading of local SMEs and the upskilling of local labour force will be necessary conditions for the approval of grants.

However, MNEs need to operate under a proper regulatory framework. This is important and refers to the imposition of conditions and controls and to the creation of the necessary legal and regulatory structures. This a framework needs to be imposed by the EU on its supranational role. The increasing power of the EU and the transfer of sovereignty from individual states makes it feasible. Individual states, particularly weak ones, can easily be snubbed and ignored by MNEs; the EU cannot.

This is a more positive way to assist the peripheral countries to converge. Whether the EU has the will to impose it is a different matter. Globalisation has created a new agenda, but possibilities for development still exist if this process is properly managed and controlled.

## NOTES

[1] Cecchini estimated the expected outcomes on GDP and employment using a Solow growth model and the expected outcomes were impressive. Later estimates using Romer's styles models (Balassa) were even stronger.

[2] An indication of weak linkages is the very high content of imported inputs in MNE production. Non-labour inputs from domestic industry represented 22 per cent in the chemical industry, and 23 per cent in electrical goods; in contrast, the average domestic inputs for the economy as a whole is 77 per cent (European Commission 1997).

[3] In Portugal, in 1991, the EU assisted the development of the largest flagship greenfield investment by Ford targeted to serve the overseas market. The investment was of a total value of 2,700m. ECU (40 per cent provided by a grant and a further training grant covered 90 per cent of training cost.) created employment for over 5,000 employees (Amin and Tomaney 1995). Despite the extent of the assistance offered and received, the project suffered from major weaknesses which stopped it from playing a central role in the development of Portugal. Lack of R&D, low local content, the use of semiskilled labour and the lack of close monitoring were some of its problems.

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