

Can regional policy in a federation improve economic efficiency?

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Abstract

In the European Union and in many federal and non-federal countries, the central government pays subsidies to poor regions. These subsidies are often seen as a redistributive measure which comes at the cost of an efficiency loss. This paper develops an economic rationale for regional policy based on economic efficiency. We consider a model of a federation consisting of a rich and a poor region. The economy is characterized by imperfect competition in goods markets and unemployment. Firms initially produce in the rich region but may relocate their production to the poor region. We show that a subsidy on investment in the poor region unambiguously increases welfare if labour markets are competitive. If there is unemployment in both regions, the case for regional subsidies is weaker.

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1. Introduction

In many countries, governments spend a considerable amount of public funds on infrastructure and private investment subsidies in poor regions. Europe provides several examples for this type of regional policies. The European Union (EU) uses the so-called structural funds to subsidize public infrastructure spending in regions where per capita income is below 75% of the EU-wide average. Furthermore the cohesion fund aims at supporting economic development and growth in poor member countries. In 2003, the EU

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spent approximately one third of its entire budget on regional policies.¹ After Eastern enlargement of the EU, the regional component in EU policy is likely to become even more important.

Similar policies can be observed at the national level in many EU countries. For instance, between 1991 and 1999, Germany spent approximately 30 billion Euros per year (appr. 1.5% of GDP) to subsidize private investment and public expenditure on infrastructure in Eastern Germany.² The case of the Italian Mezzogiorno provides another notorious example where investment in poor regions is subsidized by the central government. Similar examples can be found in many other countries. A common feature of regional policies is that they are designed to raise investment in poor regions by either i) directly granting subsidies for private investment or ii) improving the regional infrastructure.

This observed pattern of regional policies is not easily explained in economic terms.³ For example, the “new economic geography” literature suggests that, due to increasing returns to scale, regional agglomeration is a key engine for economic development (Krugman, 1991). In this framework it is difficult to explain why a country tries to raise investment in poor regions rather than further supporting agglomeration in successful areas. One potential argument is that regional imbalances in economic development might induce migration from poor to rich regions which is considered to be harmful. For instance, an inflow of households into rich regions may be detrimental because of crowding externalities. In this case, regional subsidies may be used to induce inhabitants of poor regions to stay at home. However, this explanation for regional policies is hardly convincing. From an economic perspective, the best way to reduce migration to rich regions is to tax migrants or to pay direct subsidies for staying in the poor regions. But observed policies often enhance the mobility of households in poor regions. For example, the EU has considerably reduced barriers to mobility across countries and subsidizes human capital investment in particular in poor regions, which also increases household mobility. Another example is the case of Germany, where the government offers considerable subsidies for unemployed people who move from the East to the West. This suggests that the main motive behind regional policies is not the objective to reduce migration flows.

Distributional considerations provide another rationale for regional policies. Subsidies on investment in poor regions may offer an instrument to redistribute income between rich and poor regions. There is a growing literature dealing with the redistributive impact of regional policies (see e.g., Martin, 1999). This literature argues that there is a trade-off between economic growth and regional income equality so that redistributive regional subsidies come at a cost in terms of economic growth and efficiency.

The present paper develops an economic rationale for regional policies based on economic efficiency, rather than distributive considerations. We consider a model of two regions. In the rich “West”, monopoly suppliers produce goods which can be exported to the poor “East”. But since wage costs in the East are lower than in the West, firms may decide to close their factories in the West and produce in the East. Since firms face different fixed setup costs for a plant in the East, an equilibrium emerges where some firms stay in the West while other firms shift their production to the East. It turns out that, in this equilibrium, the number of firms producing in the

¹ In 2003, the structural fund and the cohesion fund have a planned volume of 30.29 billion Euros. Pre-accession aid for Eastern European countries amounts to roughly 3 billion Euros while the overall budget is 101.59 billion Euros, see European Commission (2000).

² See Kroker and Lichtblau (2000).

³ For an overview on the economic theory of regional policy see Armstrong and Taylor (2000).

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