Executive summary

When considered at the scale of the OECD area, economic inequality across regions declined since the turn of the millennium. Between 2000 and 2015, inequality in regional GDP declined by 15% across the OECD and by 25% across Europe, driven by the catching up of regions in countries with comparatively lower income. However, in many OECD countries the economic disparities between the regions *within* the same country grew substantially over the same time period.

Some of the regions that fell further behind with respect to the peers in their country exhibited persistently low economic growth rates, others followed unsustainable growth models that were exposed by the global financial crisis and its aftermath. Many regions that appeared to be in the process of catching up, but relied on an expansion of non-tradable sectors, such as retail services or construction, experienced rapid declines that wiped out the gains from previously high growth rates. As of 2015, per capita GDP levels in almost two-fifths of OECD regions (135 out of 350) were still below their pre-crisis peak.

Productivity growth is a key factor in ensuring economic prosperity and setting regions on a path towards more inclusive societies. In part, the link arises as sustainable wage growth needs to be supported by productivity growth. Flexible exchange rates can compensate for a growing gap between wages and productivity, but in a single-currency area or across the regions in a country a growing gap between wages and productivity in some regions results instead in rising unit labour costs and accruing imbalances in regional competitiveness. Estimates for Europe suggest that a 1 percentage point increase in the growth rate of regional unit labour costs is, on average, associated with a 0.3 percentage point decrease in per capita gross value added growth and 0.4 percentage point decrease in per capita exports in the region.

Growing gaps within countries in terms of productivity may come at the cost of higher income inequalities. On average, productivity growth is slightly higher in countries where productivity frontier regions outperformed others. However, inter-regional inequality in these countries – as measured by the Gini coefficient of per capita GDP – increased by more than 15% over the 2000-14 period, while it remained constant in those where lagging regions were catching up. The most productive regions are also highly persistent over time and in most countries the productivity leader is typically the capital region.

Two characteristics stand out among regions that successfully narrowed productivity gaps. The first is the proximity to well-functioning cities and the links between the cities with their surrounding rural areas. The second, and main focus of this report, is a strong reliance of the regional economy on tradable sectors. Tradable sectors are those that produce goods and services that could potentially be traded and are therefore exposed to international competition, irrespective of whether trade actually takes place or not. Manufacturing is still at the core of tradable sectors, but tradable services are gaining ground and already accounted for 15% of total regional output in 2013. In many well-performing regions, tradable services were the fastest growing sector, on average

2.5% per year in terms of gross value added between 2000 and 2013. Yet, not all regions take advantage of this potential. In European regions with low levels of income or low levels of growth, tradable services expanded by only 1% per year.

There is a misconception that a greater share of economic activity in tradable sectors increases economic vulnerability. No doubt, in some regions external trade competition has caused extensive economic restructuring, especially where regions were highly specialised in specific sectors. But, as a whole, the tradable sector is not more susceptible to economic shocks than the non-tradable sector. It is over-reliance on the non-tradable sector that creates risks for a region's long-term economic performance. The 10% of regions with the largest shifts towards the non-tradable sector before the crisis also experienced the strongest employment losses after the crisis, with an average decline in employment of 2.9% annually.

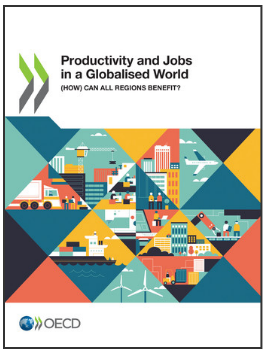
Any strategy that helps regions benefit from an increasingly globalised world and supports the development of their tradable sectors needs to be multi-faceted. Regions are different and regional policy approaches need to be tailored to their different conditions and specific circumstances. To this end, policies should follow three core principles:

- They should be well co-ordinated across the territory and policy fields.
- They should identify and build on local strengths.
- They should help regions overcome barriers to knowledge and innovation diffusion.

However, a "silo approach" to regional policy is still a common occurrence. For example, trade adjustment programmes that aim to provide laid-off workers with new skills are often disconnected from those that support firms and entrepreneurs. Skill development and utilisation policies need to be linked with wider regional economic development strategies and support for labour mobility where necessary. Likewise, policy should be co-ordinated across the territory and account for the actual extent of the economic and social ties within and across regions. Particularly leveraging the potential of urban areas requires that their links with rural areas and other cities are taken into account.

A second common pitfall to regional economic development is to attract firms through tax exemptions, financial incentives, flexible regulations or similar measures risking a "race to the bottom" for what is often only a moderate impetus to wider regional development. Building on local strengths can take the form of "niche" sectors that exploit locational advantages, strategic diversification in related sectors through a range of policies, including clusters and harnesses the skills and knowledge of the local workforce.

As productivity growth across the OECD stalls, efforts to support the diffusion of knowledge from the most innovative firms and regions to other firms and regions can unlock growth potential. Public authorities can contribute to the diffusion process. Innovation agencies and business support centres can help small businesses implement effective production and management practices; these can be combined with other assistance, such as advice on how to enter foreign markets. Finally, effective university-industry collaboration is another tool to create and spread innovation.



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