Council of Europe Development Bank conference,

“From Imperative to Urgency: Investment for Social Inclusion”

Concluding remarks by Governor Carlos da Silva Costa[1]

Good afternoon,

It is a great pleasure and honour for me to close this conference on social inclusion promoted by the Council of Europe Development Bank.

The lively debates and the range of issues touched upon in the previous sessions illustrate how challenging and complex the topic of social inclusion is.

In this closing statement, I will briefly comment on three interrelated issues:

- First, I will argue that the dynamics taking place at different jurisdictional and territorial levels are critical to our understanding of the factors promoting or threatening social inclusion.
- Secondly, I will comment on the main policy instruments available at national level to promote social inclusion;
- And finally, I will stress the key role of a community’s culture and values in determining its ability to generate and sustain inclusion dynamics.

1. The dynamics taking place at different jurisdictional and territorial levels

At a global level, we are witnessing the resurgence of nationalism and protectionist policies. The arguments by those defending such policies are largely based on the notion that **globalisation has benefited the elites and penalised a large number of workers**.

[1] As prepared for delivery.

With globalisation and technological progress, international flows of people and firms have intensified, and production became increasingly automated and integrated into global value chains. A number of **workers in advanced economies, especially those with lower qualifications, have lost their jobs and seen their relative wages and living standards deteriorate**. As a result, populist forces have risen, and **the risk of reversal of the global integration process is currently very high.**

This has occurred in spite of notable gains at a macro level over the last few decades. The world has become much richer, and poverty has declined. According to World Bank indicators, between 1981 and 2015, the share of the world population in extreme poverty declined from 42% to 10%, and the world's real GDP *per capita* grew by 63%.

Naturally, these global dynamics have produced asymmetric impacts across regions.

In 2012, the World Bank report *Golden Growth* described **Europe as a "convergence machine"**, fuelled by trade and financing. The region had gone through the largest and deepest regional integration process in recent history, generating a sizeable convergence in living standards.

However, the convergence machine has left some people and regions behind. A more recent World Bank report, *Growing United*, identifies **two emerging divides that interfere with the convergence** process: a **productivity divide** between countries and regions; and **household income inequality within countries**. If growth and wealth are not spread equitably in European regions and their several communities of citizens, the Union will be politically challenged and may even cease to be desired.

The report goes one step further to show that, **within countries, regional divides are widening**. And World Bank research found that the main reason for this is low economic potential: lagging regions have poorer institutions, a lower share of skilled workers, and limited access to markets.

Interestingly, Portugal had a contrasting experience in the recent past. An empirical study from *Universidade do Minho* shows that, **between 2008 and 2015, inequality among the Portuguese regions** in terms of real GDP *per capita* **actually decreased by 12%**. This is an encouraging performance compared to European peers, especially when compared to those that were implementing financial assistance programmes during that same period. On a less positive note, in 2016, the vast majority of Portuguese regions were still below the European Union average in terms of GDP *per capita* in purchasing power parity.

This **subnational regional analysis is** important for two main reasons:

- On the one hand, **within-countries inequalities in advanced economies have been intensifying** – they are the ultimate expression of global and supranational dynamics and are giving rise to growing social and political tension;
- On the other hand, **policy instruments** tailored to address inequality **remain mostly in the hands of national authorities**.

This brings me to the second point I would like to cover.

2. Coping effectively with inequality at the national level

The World Bank's *Growing United* report argues that the revival of the European convergence machine should be pursued by ensuring **equal opportunities for people and firms**.

This is crucial advice to all policy authorities responsible for addressing inequality: the most *effective* and *sustainable* path to reducing inequality is not by *redistributing* income, but rather by ensuring everyone has comparable opportunities to take part in the *generation* of income. In other words, although redistribution remains an important complementary tool, **the strongest instrument to promote social inclusion is inclusive growth**.

Three institutions are particularly relevant for generating inclusive growth: **education, the labour market and the business environment.**

Let me start with *education*. As already pointed out by many studies, universal access to high-quality education ensures equal access to opportunities, and subsequently, equal access to income. But the education system needs to be adequately tailored to respond to the evolving needs of labour and product markets.

As technological progress changes the nature of work at an increasing pace, firms become more demanding with respect to the human capital they hire. For example, while demanding for more cognitive skills, **they are also requiring better socio-behavioural skills**, which are crucial for agile adaptation to change.

The education system also needs to **take into account the development stage of the economy**. Any serious mismatch between the skills offered by recent graduates and those demanded by firms inevitably leads to exclusion. A recent study by *Associação Empresarial de Portugal*, a Portuguese business association, shows that, between 2011 and 2017, the share of unemployed people with post-primary education increased from 34% to 48%.

Such a growing share of high-quality untapped human resources highlights the need for an adequate interconnection between the education system and the next institution I would like to discuss: the labour market.

In turn, a sound and dynamic *labour market* not only optimises initial matches between workers and firms, but also promotes fluid movements of workers across industries, regions and skills. While employment protection legislation and wage-setting institutions have successfully reduced wage inequality, excessive protection jeopardises firms' productivity and job creation – especially for low-skilled workers and new entrants. Despite having become less restrictive since the 1990s, employment protection for permanent contracts in most of the European Union remains above the OECD average.

Lifelong learning is another critical element when considering the labour market, in the face of accelerating technological change. This means that authorities must search for the right balance between expenditure on *passive* labour market measures, such as income support and early retirement, and expenditure on *active* labour market measures, such as training or start-up incentives – for most EU countries, passive measures absorb more resources than active measures.

But as the World Bank's *Growing United* report rightly states: "**opportunities for firms and people are complementary** and jointly determine the potential to grow inclusively". If it's true that an economy with few opportunities for people loses economic and political viability, it is also true that the lack of opportunities for firms promotes the migration of both people and firms towards more dynamic economies.

This leads me to the third institution behind inclusive growth: the business environment.

***The business environment* must be**, simultaneously, **supportive and challenging**.

One relevant component of the environment in which firms operate is **physical infrastructure**. Firms need to communicate at an increasingly faster pace, and for that they need not only a good and efficient road network, but also high-speed broadband connections. It is the role of public investment to provide such conditions, without overlooking or crowding out private investment.

A second important element of the business environment is the **ease of reallocating resources towards more productive sectors**. The simplification of insolvency procedures, the acceleration of judicial decisions, or the reduction of red tape are of the essence here.

A third element is **the innovation ecosystem** and its ability to involve entrepreneurs in the production of knowledge and its successful transformation into innovative technologies, processes or products. Empirical research shows that a pro-competitive business environment fosters innovation, and that innovation is a powerful driver of employment growth. Innovation is thus instrumental for any society to remain economically, politically and socially included in today's global economy. Conversely, international trade and investment are strong drivers of domestic innovation.

In brief, these three institutions – education, labour market and the business environment – must be designed to generate **a context that fosters personal initiative**, either in the form of educational attainment, job searching or entrepreneurial activity.

Nevertheless, one needs to realise that these are necessary – but not sufficient – conditions. The World Bank points out a set of factors that undermine the success of some of its social inclusion projects. Among these, one can find cultural preferences and social perceptions. This leads me to third and last topic I promised to address.

3. The key role of a community's culture and set of values

No institutional framework can ever be successfully established *against* or even *in spite of* **the set of values, preferences and perceptions of the communities** it intends to serve.

A case in point is the dichotomy between the **North and South of Italy**. In spite of sharing the same institutional framework, these two regions show quite different development paths, due to their distinct historical backgrounds and sets of values.

In the case of Portugal, many industrial areas appeared due to the entrepreneurial initiative of a given person, family or firm, which led by example, inspiring the surrounding community and generating adjacent businesses. In such a socio-economic fabric, social exclusion appears when a given community lacks success cases to look up to, ceasing to believe in the power of education, dynamic labour markets or friendly business environments.

Socio-cultural factors must therefore be taken into account in the design of public policy, including in the design of the education system or in territorial planning.

Empirical evidence[2] points to **social segregation in schools as a driver of skills inequality**. The relatively poor performance by students from disadvantaged backgrounds is partly correlated to the fact that they are clustered together in lower quality schools.

Likewise, **social housing policies should not bring about the creation of loser and winner communities**. Each community should include individuals considered winners and losers, in order for the former to be inspired by the latter and never stop believing they have equal opportunities to generate income. Inclusive social housing is precisely one area of public policy that has benefited extensively from the expertise and contribution of the Council of Europe Development Bank, which has the noble mission of supporting social inclusion in Europe.

Conclusion

In conclusion, let me highlight the following key messages.

- Globalisation's impact operates in at least two dimensions – income and employment. Globalised trade impacts the level and distribution of income, but it also impacts the way employment is distributed across territories and across sectors.

- Redistribution will always be the reverse side of globalised trade. There will always be gains, but also losses… there will always be creation, but also destruction. Low-skilled workers and sectors competing with imports are evident examples. Studies show that redistribution costs rapidly surpass trade gains. And some of those costs are not reversible. When, for example, a given regional cluster disappears due to competition, it may never resurge again.

- If there are no compensation mechanisms, discontent will rise. The European convergence machine has partially compensated for the impacts of globalisation through cohesion policies. Public transfers are adequate as a first, more agile, response.

[2] Ridao-Cano, Cristobal; Bodewig, Christian (2018).

- However, public transfers won't effectively solve the problem of loser communities, socially and geographically marginalised. This redistribution across communities has been shown to be empirically more important than redistribution across skill levels. Without any other complementary policy, public transfers may generate dependency and destroy incentives. This problem can only be effectively solved
  - By adapting policy to the cultural preferences of those communities;
  - By designing basic institutions in a way that every community is involved in the production process and becomes the owner of its own destiny;
  - And by submitting globalisation to a set of basic rules ensuring everyone benefits from a fair level playing field and public intervention is dully framed.

- In sum, a fine balance is needed between, on the one hand, inclusive rules and institutions, and, on the other, compensatory transfers. Both must be constantly calibrated, given that
  - the destructive power of each shock depends on its intensity and duration, and
  - there will always be a shock that no rule or institution may ever prevent – and that is technological innovation.

  The most effective strategy to overcome the challenges posed by technological innovation consists of ensuring an inclusive growth of potential output. This means promoting the sustainable growth of GDP *per capita* while simultaneously involving all the communities and classes of the working age population in the production process. Entrepreneurs and managers are particularly prominent actors in such a strategy.

So, let me stop here, and congratulate the Bank for its increasingly relevant mission, and for bringing us together today to reflect on it.

Thank you.

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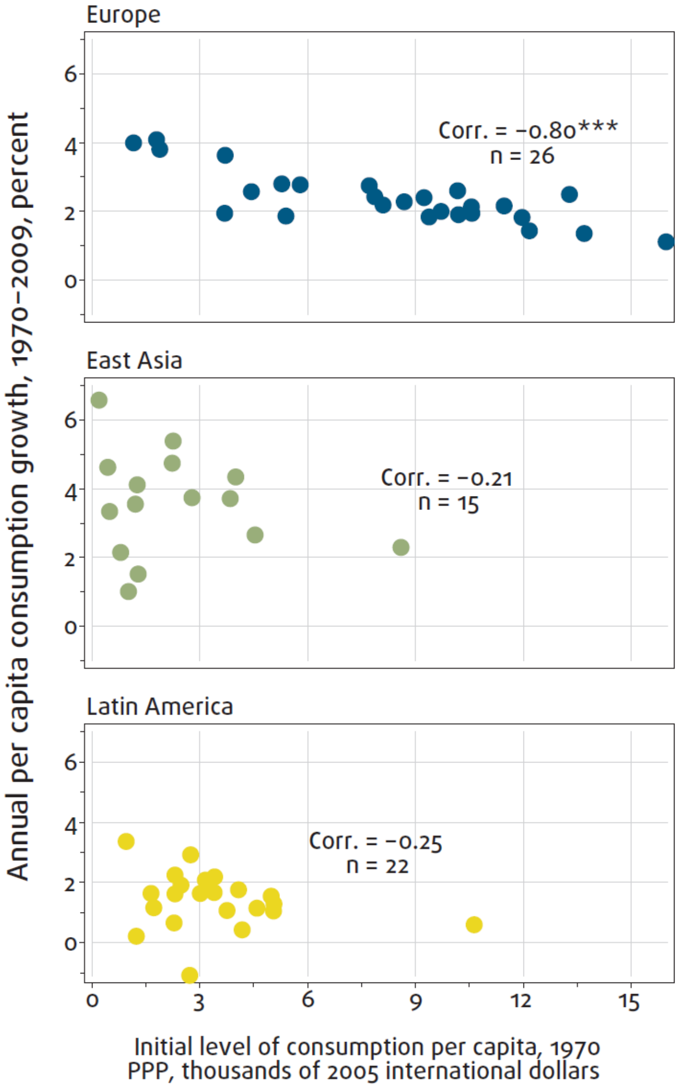
Appendix

Figures and tables from…

Gill, Indermit S., Raiser, Martin (2012), ***Golden growth: restoring the lustre of the European economic model*** (Vol. 2): Main report (English), Europe and Central Asia Studies, Washington DC, **World Bank**.

Figure 1: In Europe, a rapid convergence in living standards—not much elsewhere

(annual growth of consumption per capita between 1970 and 2009, by level of consumption in 1970)



*** Statistically significant at 1 percent.
Note: n = number of countries.
Source: World Bank staff calculations, based on Penn World Table 7.0 (Heston, Summers, and Aten 2011); see chapter 1.

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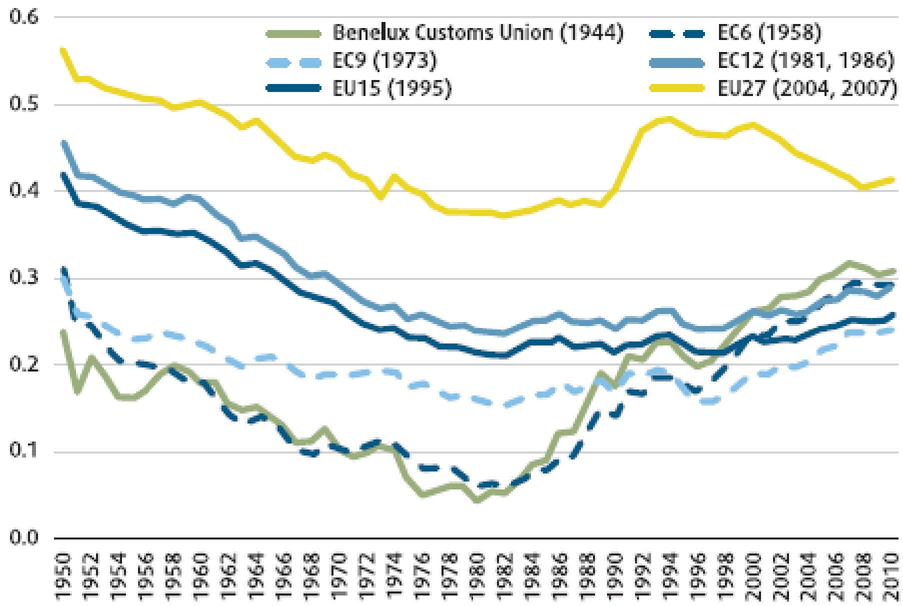
Figure S1.4: Convergence until the 1980s, divergence since

(coefficient of variation of GDP per capita in Europe, 1950–2010, US$ 1990, Geary Khamis PPP estimates)



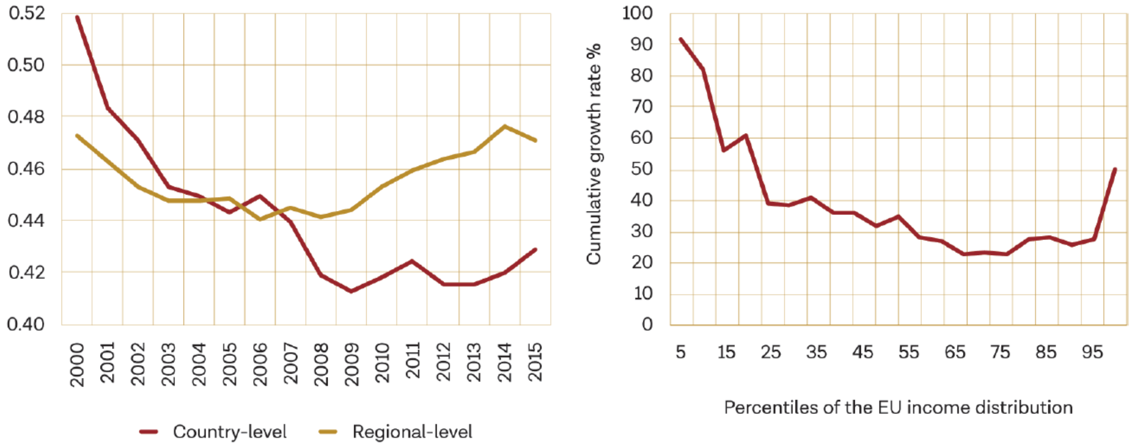
Note: The aggregates illustrate the EC or EU membership for the identified period regardless of whether that unit has been created or not. For example, the EU27 reflects data for Eastern European countries for 1950, though these countries did not join the European Union until 2004 or 2007. The aggregates reflect West Germany until 1988 when a unified Germany is added in its place.
Source: World Bank staff calculations, based on Conference Board (2011).

Ridao-Cano, Cristobal; Bodewig, Christian (2018), ***Growing united: upgrading Europe's convergence machine*** (Vol. 2) (English), Washington, D.C.: **World Bank Group**

Figure 1.2 Convergence between countries drove convergence across regions and households

A. Regions across the EU were converging until 2008
(Coefficient of variation of GDP per capita, 2000–15)

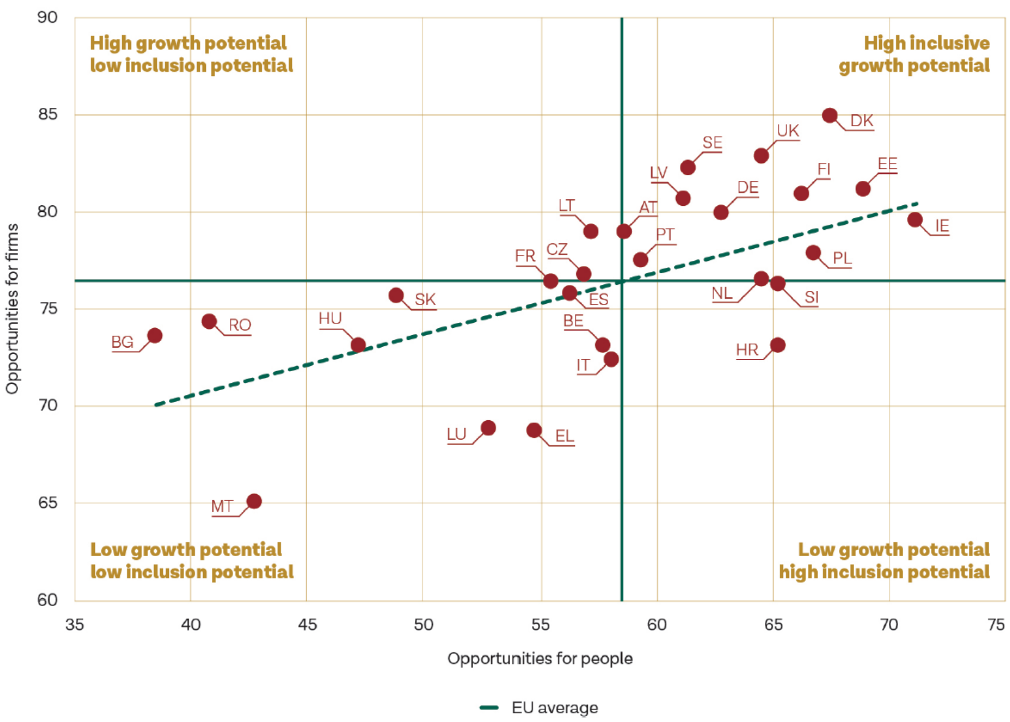
B. EU household incomes grew and converged
between 1993 and 2008



Source: Own calculations, based on Eurostat (Panel A) and Lakner-Milanovic data (Panel B).

Note: The Y-axis inPanel B displays the growth rate of the fractile average income (in 2005 PPP USD), weighted by population. EU averages include today's EU countries.

Figure O.3 The opportunities for firms and people to thrive determine the potential of countries to grow inclusively: countries in the North do well on opportunities, countries in the South do less well

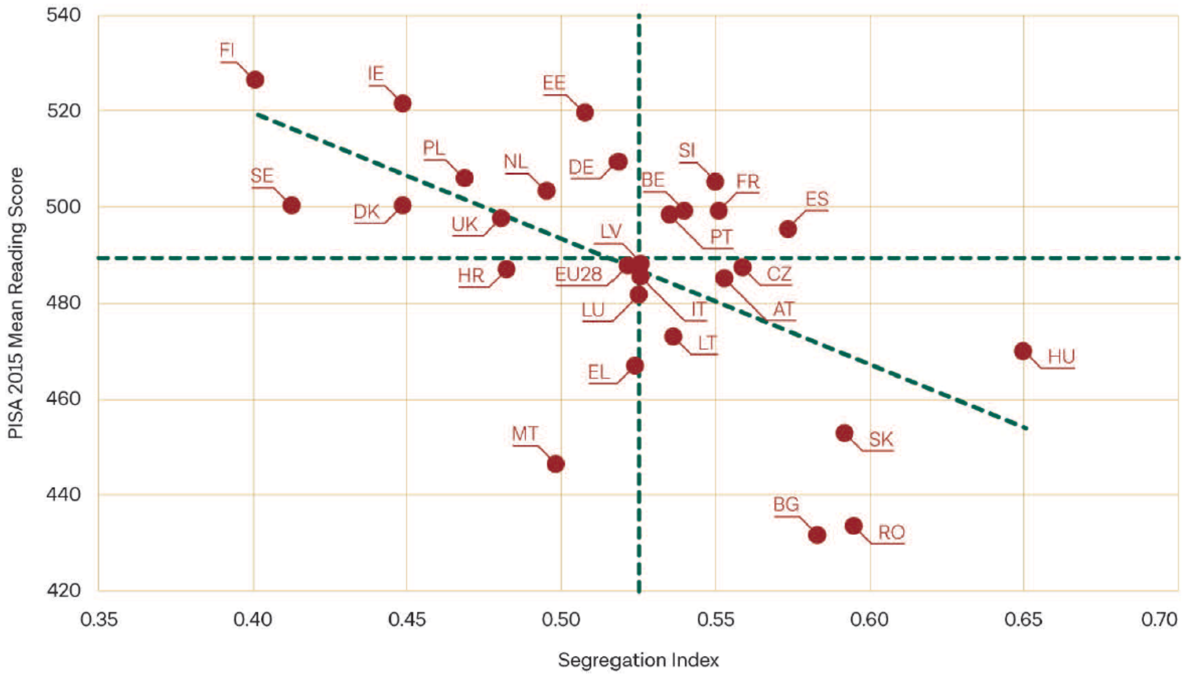


Source: Calculations based on Programme for International Student Assessment (PISA) and Doing Business data.

Note: Cross-lines are European Union averages. Opportunity for people is measured by PISA reading scores in 2015, corrected for inequality of opportunities (variation in PISA scores explain by socioeconomic status of students) and the proportion of young people that leave school with at most lower secondary. Opportunity for firms is measures by the 2017 Doing Business distance to frontier index. See "European Union Countries and Regions" table for country abbreviations. Cyprus is not included as some key data were not available.

Figure O.7 Poor students often end up with other poor students in the same school, but socially less segregated systems perform better

PISA 2015 mathematics scores and segregation scores across the EU

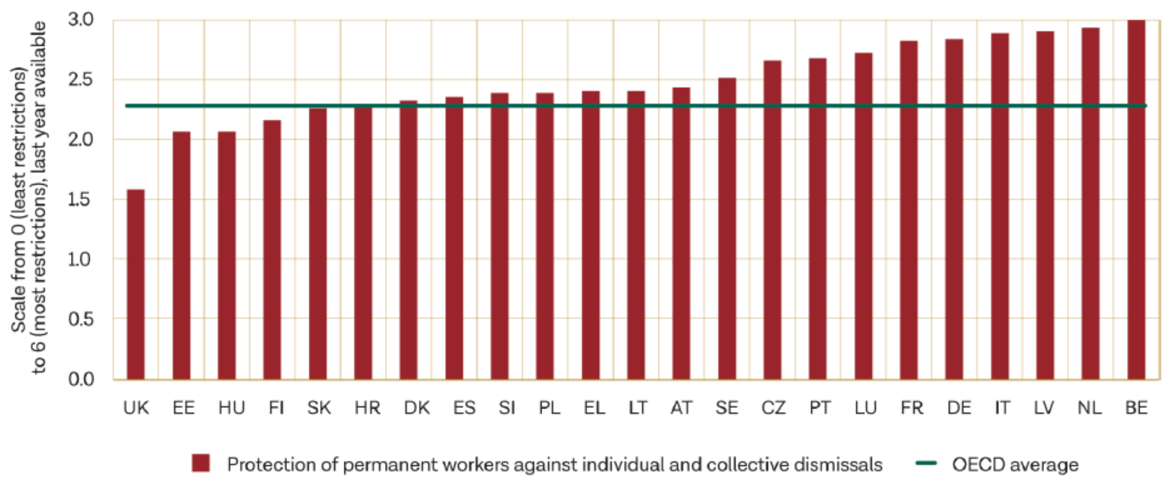


Source: World Bank staff calculations based on PISA 2015.

Note: The school segregation coefficient measures the correlation between the socioeconomic level of each student with the average socioeconomic level of his or her school.

Figure O.8 Employment protection regulations for workers on permanent contracts are above the OECD average for most EU countries

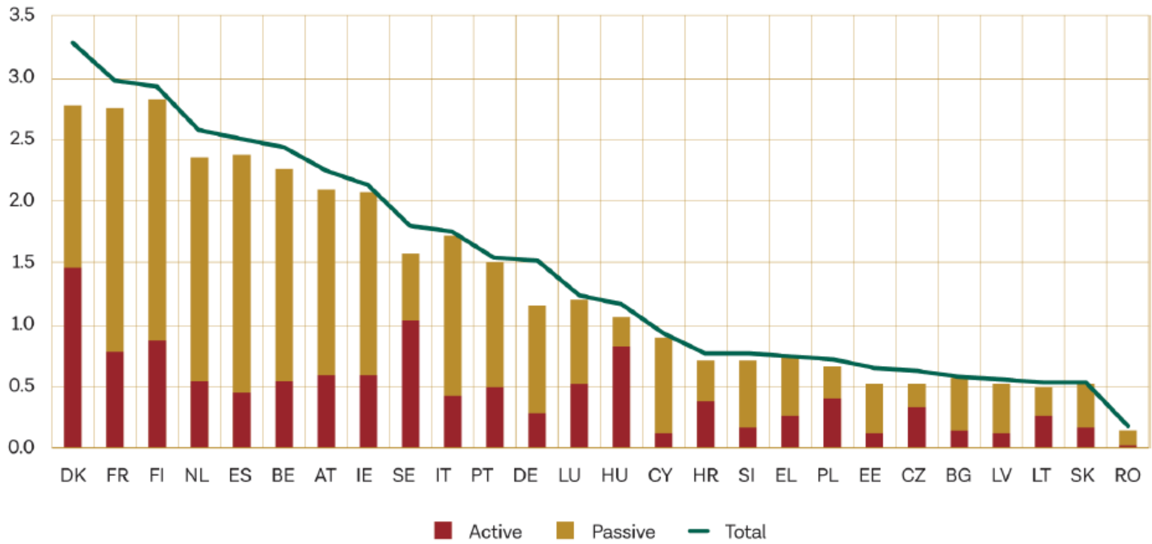
Protection of permanent workers against individual and collective dismissals



Source: World Bank staff calculations based on the OECD Employment Protection Database.

Figure O.9 Expenditures on labor market policies vary significantly across the EU

Spending on labor market policies as share of GDP, 2015 (percent)

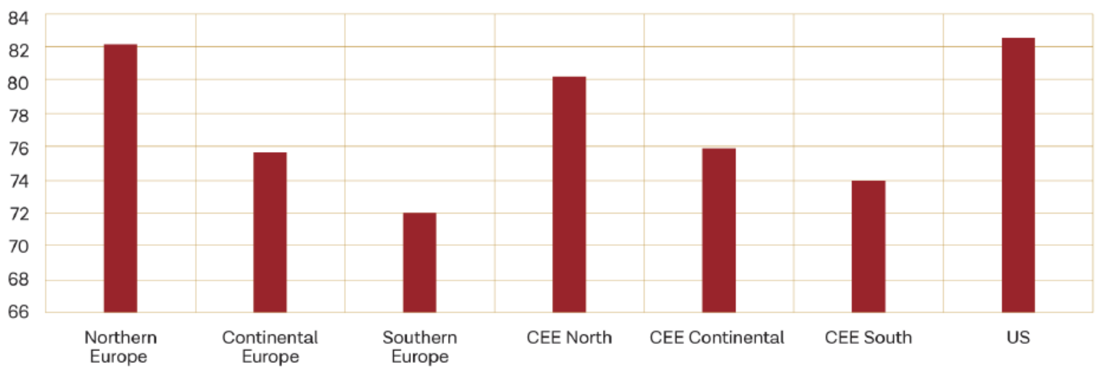


Source: World Bank staff calculations based on Eurostat.

Note: Active includes training, employment incentives, supported employment and rehabilitation, direct job creation and start-up incentives. Passive includes income support and early retirement. Total also includes labor market services.

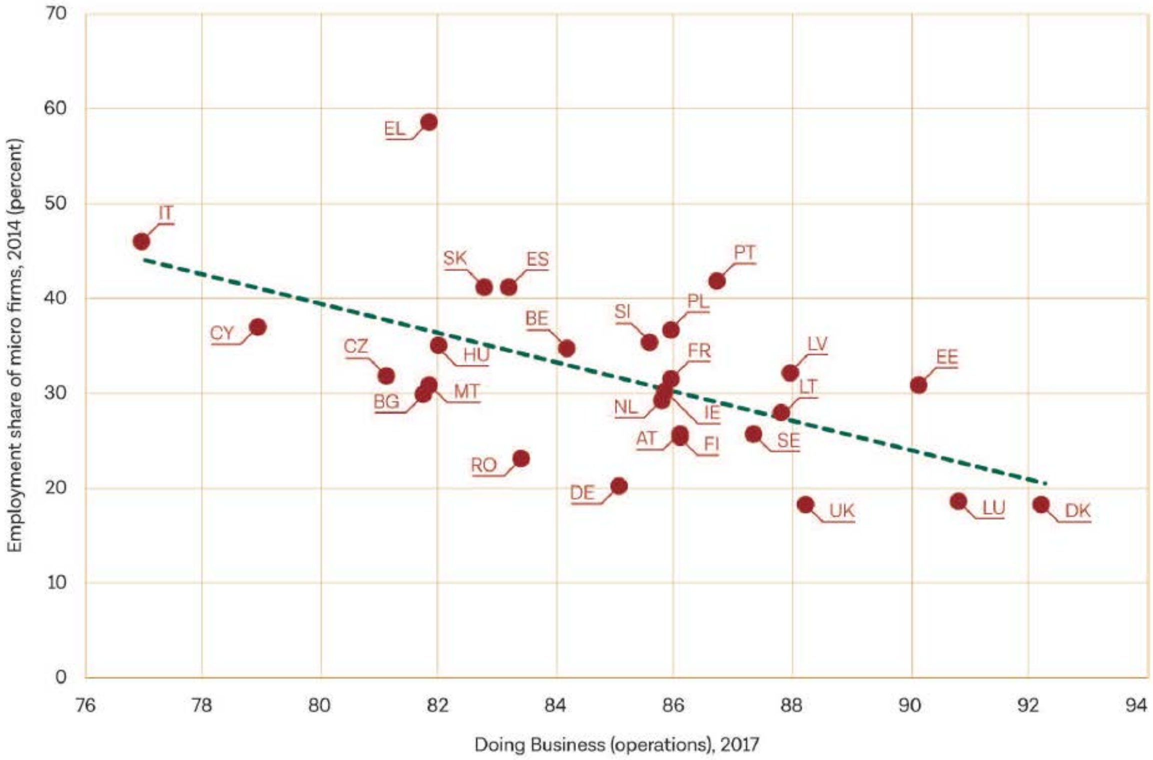
Figure O.12 Business regulations are more burdensome in Southern Europe, Bulgaria, and Romania

Doing Business, distance to best performer; best performer = 100, 2017



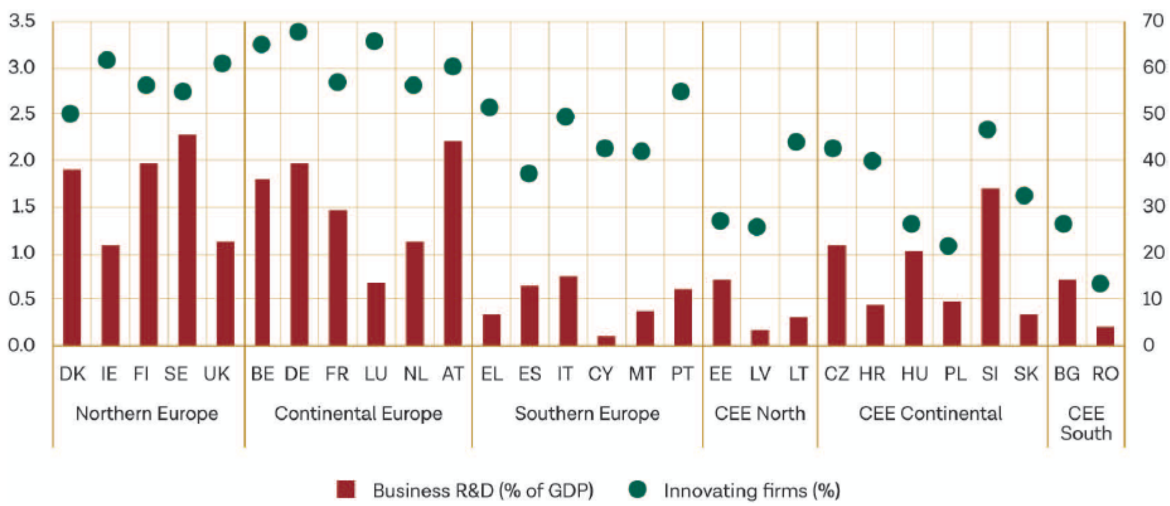
Source: Doing Business 2017.

Figure O.13 In a difficult business environment, firms stay small



Source: Doing Business and Eurostat.

Figure O.14 Northern economies innovate more, making them productivity leaders



Source: Eurostat and 2014 Community Innovation Survey.

Note: Percentage of innovating firms is measured on the right axis. A firm is innovating if it has implemented a new/significantly improved product, process, new marketing method, new organizational method in business practices, workplace organization or external relations.

Associação Empresarial de Portugal (2019), ***Dinâmicas Socioeconómicas Regionais***, AEP Estudos e Estratégia

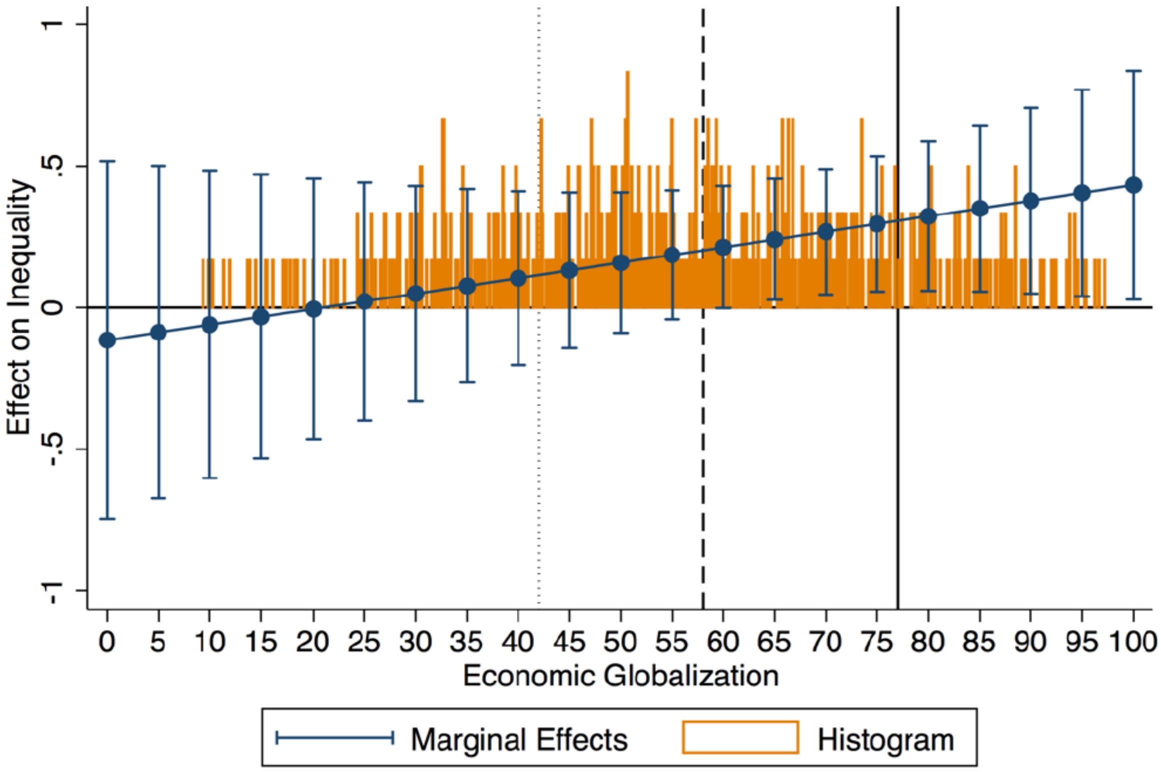
Tabela 4: População inativa, desempregada e empregada por nível de escolaridade nas NUTS II

	Nível de escolaridade	Pop. Inativa ≥15 anos				Pop. Desempregada				Pop. Empregada			
		Valor (10^3)		Estrutura (%)		Valor (10^3)		Estrutura (%)		Valor (10^3)		Estrutura (%)	
		2011	2017	2011	2017	2011	2017	2011	2017	2011	2017	2011	2017
Portugal	Total	3542	3634	100,0%	100,0%	688	463	100,0%	100,0%	4740	4757	100,0%	100,0%
	Até ao básico	2941	2881	83,0%	79,3%	456	239	66,2%	51,7%	2913	2264	61,5%	47,6%
	Sec. e pós-sec.	395	467	11,2%	12,8%	145	139	21,0%	30,0%	935	1260	19,7%	26,5%
	Superior	207	287	5,8%	7,9%	88	85	12,8%	18,4%	892	1233	18,8%	25,9%
Norte	Total	1210	1264	100,0%	100,0%	251	179	100,0%	100,0%	1673	1654	100,0%	100,0%
	Até ao básico	1025	1025	84,7%	81,0%	165	96	65,5%	53,9%	1101	867	65,8%	52,4%
	Sec. e pós-sec.	133	157	11,0%	12,4%	58	49	23,0%	27,5%	295	414	17,6%	25,0%
	Superior	53	83	4,3%	6,5%	29	33	11,5%	18,5%	278	373	16,6%	22,6%
Centro	Total	782	806	100,0%	100,0%	122	80	100,0%	100,0%	1098	1073	100,0%	100,0%
	Até ao básico	655	656	83,8%	81,5%	79	36	64,8%	45,3%	746	553	68,0%	51,6%
	Sec. e pós-sec.	85	95	10,8%	11,8%	24	28	19,4%	35,6%	193	269	17,6%	25,0%
	Superior	42	54	5,4%	6,7%	20	15	15,9%	19,2%	158	251	14,4%	23,4%
A.M. Lisboa	Total	956	974	100,0%	100,0%	201	133	100,0%	100,0%	1222	1271	100,0%	100,0%
	Até ao básico	745	709	77,9%	72,8%	132	66	65,7%	49,3%	586	448	47,9%	35,3%
	Sec. e pós-sec.	123	147	12,9%	15,1%	41	41	20,3%	31,0%	300	376	24,6%	29,6%
	Superior	88	118	9,2%	12,1%	28	26	14,0%	19,7%	337	447	27,5%	35,1%
Alentejo	Total	283	278	100,0%	100,0%	46	29	100,0%	100,0%	324	317	100,0%	100,0%
	Até ao básico	248	234	87,7%	84,5%	31	16	68,3%	55,7%	207	163	63,9%	51,3%
	Sec. e pós-sec.	24	30	8,5%	10,8%	10	8	20,7%	28,9%	65	89	20,0%	28,1%
	Superior	11	13	3,8%	4,7%	5	4	11,1%	15,1%	52	66	16,1%	20,7%
Algarve	Total	143	145	100,0%	100,0%	36	18	100,0%	100,0%	199	212	100,0%	100,0%
	Até ao básico	119	118	83,1%	81,2%	24	9	65,7%	52,6%	118	101	59,4%	47,8%
	Sec. e pós-sec.	17	18	11,7%	12,3%	8	5	22,4%	30,9%	46	62	23,3%	29,3%
	Superior	7	10	5,2%	6,5%	4	3	11,4%	16,6%	35	49	17,4%	22,9%
R.A. Açores	Total	82	83	100,0%	100,0%	14	11	100,0%	100,0%	106	111	100,0%	100,0%
	Até ao básico	75	71	90,4%	85,2%	11	8	78,7%	70,0%	79	65	73,8%	58,3%
	Sec. e pós-sec.	6	8	7,0%	9,4%	2	3	15,4%	23,6%	14	26	13,3%	23,0%
	Superior	2	5	2,7%	5,4%	1	1	6,6%	6,4%	14	21	12,8%	18,7%
R.A.Madeira	Total	85	85	100,0%	100,0%	19	14	100,0%	100,0%	118	119	100,0%	100,0%
	Até ao básico	74	68	87,0%	80,2%	14	8	76,8%	57,2%	78	66	65,7%	55,9%
	Sec. e pós-sec.	8	12	9,8%	13,6%	3	3	15,7%	24,6%	21	26	18,2%	21,9%
	Superior	3	5	3,1%	6,3%	2	3	8,1%	18,1%	19	26	16,1%	22,2%

Fonte: INE e cálculos próprios.

Lang and Tavares (2018), ***The Distribution of Gains from Globalization***, IMF Working Paper

Figure 6: Globalization and Inequality



Note: The figure visualizes the result of the inequality regression reported in table 3, column 6. The blue line depicts the marginal effect (and 95%-confidence intervals) of a one-point-increase in economic globalization depending on a given level of economic globalization. A histogram of the distribution of globalization levels across the sample is shown in orange. The three vertical lines indicate the current average globalization score of LICs (dotted), MICs (dashed), and HICs (solid).