

ZEW

Zentrum für Europäische
Wirtschaftsforschung GmbH

Executive Summary

Research project I D 4 - 15/07

**Commissioned by the
German Federal Ministry of Economics and Technology**

The Future of EU Structural Policy

Centre for European Economic Research (ZEW) GmbH

Mannheim, 13 February 2008

Contact:

Dr. Friedrich Heinemann
Centre for European Economic Research
L 7, 1
D-68161 Mannheim
Phone: 0621 / 1235-149
Fax: 0621 / 1235-223
E-mail: heinemann@zew.de

Project Team:

Dr. Friedrich Heinemann, ZEW Mannheim
Prof. Dr. Tobias Hagen, ZEW Mannheim und Hochschule der Bundesagentur für
Arbeit Mannheim
Philipp Mohl, ZEW Mannheim
Steffen Osterloh, ZEW Mannheim
Dr. Mark Sellenthin, ZEW Mannheim

Executive Summary

1 Introduction

Like all other policy fields and the revenue side, structural policies are subject to the current general review of the European budgetary system. Against this background this analysis considers dual and interdependent research questions: On the one hand the study examines the strengths and weaknesses in the current system of EU structural policies and discusses reform options. On the other hand it quantitatively evaluates which budgetary consequences the different reform options as well as the continuance of the status quo would generate.

Despite its complexity, the reform debate is characterised by various positions linked to four essential questions.

- First, should recipients be obliged to accept specific requirements about the use of the resources? While national systems of fiscal equivalence are characterised by high shares of non-earmarked transfers, the EU structural policies are often earmarked and stipulate detailed contractual agreements.
- Second, which criteria should guide a possible earmarking of structural funds? In the current program period, due to the focus on the “Lisbon-policies”, a shift has occurred.
- Third, who should be the territorial addressee of transfers? It has to be determined, whether receiving territories should be defined on a regional or national level.
- Fourth, which eligibility criteria should be used and which allocation key should be applied? So far, established wealth indicators like per-capita income serve as the major criteria.

A characteristic of the analysis is the reflection of reform options which go far beyond the status quo but at the same time take account of politico-economic and furthermore primary law restrictions.

2 The Messages of Economic Theory

This chapter illustrates important aspects of the economic literature in order to find hints for the economic rationale and the appropriate form EU of structural policies. A brief overview summarises the basic conclusions of normative (“How should this policy field be structured appropriately?”) and positive theories (“How can the actual shape of this policy field be explained?”).

In growth theory, neoclassical paradigms of explanation with their convergence optimism are contrasted to the “new growth theory” and the “new economic geography”, which follow an overall more negative tenor with regard to the convergence of economies and regions. Whereas neoclassic approaches commonly declare that growth converges towards a path defined by exogenous factors, new economic geography emphasises the possibility of cumulative processes of regional development. As a consequence, in this view the development of a region is path dependent and can be impacted by historical coincidences either in a positive or negative direction. Agglomeration and dispersion forces create centre-periphery-structures. Accumulation can be strengthened by increasing spatial returns to scale as a consequence of growing markets, by spatial externalities in the accumulation of technological knowledge and human capital as well as by transportation costs. The periphery can positively benefit from low property prices, cheap labour costs and thus cheap production costs, leading to low prices of goods and services whose trade is confined.

These theories differ extensively with regard to the justification and recommended type of regional policy intervention. Explaining growth and regional development with the neoclassical approach offers hardly any arguments for regional policy intervention due to its prominent convergence optimism. According to the new economic geography approach on the contrary, regional support measures can develop permanent improvements. However, a justification for regional policy measures is also not necessarily given with the new economic geography approach since divergence according to this theory is a consequence of an efficient spatial allocation of economic activities. Interventions which would attenuate divergence may then decrease economic welfare. Applied to the European context these insights hint to a possible conflict between the goals of the Lisbon-strategy and the objectives of cohesion: Although an aggressive cohesion policy may lead to a certain catch-up process of the periphery, this may however, simultaneously impede the overall growth performance in the EU, due to the fact that spatial economies of scale are not fully exploited.

In line with the new growth theory, it is advisable that regional interventions focus on R&D measures as well as human capital, because these create growth-promoting positive externalities.

The theory of fiscal federalism offers arguments for and against autonomy of member states for their regional policy. National preferences vary with regard to acceptable regional divergence besides the fact that regional issues are very diverse, e.g. with regard to the degree of severity and persistence. Therefore the national responsibility of countries should be strong with regard to the intensity and the objective of regional policy initiatives. Conversely, arguments against full national autonomy for regional policy result from economic and politico-economic externalities. The former arise when regional projects are linked e.g. to cross border growth effects. The latter occur e.g. as a result of political myopia and the neglect of long-run growth objectives in national decision making. In such a case contributing countries want to have a say with regard to use of appropriations and will demand a continuous policy control. The theory of federalism offers concrete advice on how to structure the allocation of regional policy transfers in a rational way. To emphasise economic externalities “matching grants” are the instrument of first choice, where the matching (or cofinancing) rate should exceed the cross border externality. Otherwise unintended incentives for oversupply can be the consequence.

Positive theories on EU regional policy are stimulated by the observation that the development of this policy field has often deviated from the normative prescriptions. Thus a first approach to explain EU regional policy considers regional policy as a playing field for distributive fights among member states where those countries tend to be successful, that have a large number of votes in the decision-making process. Further explanations of positive theory comment on the self-reinforcing dynamic of the bureaucracy, on the compensation requirements for the losers of integration, on transfers to secure regulatory cartels and also on the common-pool phenomenon. This theory suggest that politicians with regional or national constituencies are especially committed to spending policies targeting at these constituencies, in particular if these policies are financed from a common European pool of tax revenues. In this case incentives are distorted because the tax burden of the initiative encumbers their voters only to a minor degree.

From this theoretical overview first insights for the reform debate can be derived: For example, the new growth theory emphasises the importance of policies with a focus on research and human capital. And the new economic geography calls for a strengthening of dispersion forces by means of increasing the flexibility of regional relative prices, which is an important consideration. The regional flexibility of wages and prices is thus an essential precondition for convergence. Furthermore, the theory emphasises the question, whether a regional addressee is indeed more appropriate than a national addressee.

3 The Genesis of the Status Quo and its Characteristics

This chapter summarises the genesis of the status quo of the European regional policy and its characteristics. The complexity of the current system can only be understood in consideration of its development. Furthermore, such a historical reflection seems to offer an important insight into the feasibility of policy reforms.

The number of goals and policy instruments of European regional policy has increased over time and in principle, objectives once introduced have never been abandoned, instead they merely have been renamed or reassigned to other objectives. In addition, transitory provisions (“phasing in” and “phasing out”) as well as increasingly unsystematic exceptions have complicated the system. This tendency towards an increasingly diffuse system of objectives is questionable from the point of view of growth policy and prevents to identify the priorities of that policy.

The co-financing rates have been increased since 1988. The highest co-financing rate of 85% is now available in the context of cohesion fund subsidies. Under the efficiency aspect the Community co-financing should reflect cross-border externalities of projects. The link of co-financing rate with national prosperity in today’s system is at odds with normative theory. Since it is implausible to expect a correlation between national prosperity and the extent of externalities this institutional characteristic is likely to set incentives towards an inefficient allocation.

By introducing a maximum level of transfers of 4 % of a MS’s GDP in 2000 (absorption limit) a funding limit for individual MS was created. In the current funding period, this absorption rate is reduced to 3.7 % of GDP and diminishes further with an increasing per capita GNI relative to the EU average. It is obvious that these characteristics of the absorption limit are rather an expression of distributive concerns than of efficiency considerations. It is questionable to assign poorer countries a larger relative absorption limit than richer ones. On the contrary the currently low rates of call in particular on the side of new member countries rather point to the opposite.

The principle of additionality is important for the effectiveness of the EU regional policy. Only if EU transfers do not proportionally reduce national funding in similar areas, the intended effects can occur. However, only single objectives and structural funds have been subject to obligatory evaluations of this principle. The cohesion fund, for example, is still not evaluated with regard to the principle of additionality. The implementation of the additionality problem is complicated by a serious methodological issue: It is unknown how much national money would have been used for structural spending if EU funds had been absent. Hence, potential structural spending of MS net of EU structural policy can only

be estimated or more or less plausible rules have to be defined to check additionality leaving the operational conduct of that principle an ambitious task.

The chapter produces clear evidence that that the increase of the European cohesion policy was not only driven by national and regional differences in economic or social indicators, but also by specific bargaining circumstances and bargaining power of MS in the rounds of negotiations. The necessity of unanimous votes in many policy areas has led to the result, that special concessions once achieved, can rarely be abandoned– even if the original justification no longer exists. With respect to possible reforms, this experience suggests that gradual changes have a greater chance of realisation than fundamental new conceptions.

4 The Impact of Regional Policy

The fourth chapter deals with the evaluation of the impact of EU regional policy. The literature review shows that the existing literature mainly focuses on the analysis of growth effects, while other targets pursued by means of cohesion policy, such as the employment targets of the European Social Fund, are still widely neglected. The impact of structural policy on convergence has been investigated with three different research designs. These comprise case studies, simulation models and econometric analyses. Moreover, this chapter presents the results of own empirical analyses on the impact of regional policy focussing on research questions which have not yet been answered satisfactorily.

The literature review and the own empirical analyses do not deliver clear-cut (positive) results concerning the convergence effects of the structural transfers. The contradictory findings are, inter alia, the result of a broad empirical literature where different methodological approaches are applied. However, the empirical investigations and some case studies indicate that the structural funds have positive growth effects under the condition of a high quality of the institutional setup in those countries and regions receiving structural funds, an efficient bureaucracy and decentralised structures, respectively. Moreover, the existing studies show that especially investments in research and education do have a positive growth effect in the medium term. All in all, the results show that the impact of EU regional policy on economic growth might be overestimated compared to other factors like regulation, tax system, etc.

Apart from the “classical” question of convergence, to some extent this chapter tries to evaluate further intended and unintended effects of EU regional policy on other policy fields. Among those intended effects are the employment target as formulated by the European Social Fund as well as, from the beginning of the current financial perspective on, the support of innovation, human capital and entrepreneurial spirit according to the Lisbon strategy. The effectiveness of the

Lisbon earmarking can only be evaluated satisfactorily if the data availability and quality improve. By now, we find evidence of an increasing support of research and innovation initiatives within this policy field, even though this trend has already been identified in the last financial perspective without any formal earmarking regulations. Our case study shows that the poorer member countries have great backlog demands for investment in infrastructure so that a strong focus on the Lisbon goals does not seem to be appropriate. Given the strong wealth disparities among the member states, one should not condition the commitment to achieve the Lisbon aims on the fact of being a new member country or not, but on the per capita income of a country.

In the future one should pay more attention to the unintended effects of the regional transfers. The econometric analysis attests that, at least in the cohesion countries, the structural funds have not increased total public investments and that the expenditures provided by the EU seem to have led to a substitution of other investment-related expenditures. Apparently there is no reason, why the principle of additionality is not applied with respect to the cohesion fund. In some countries the EU structural support is so high that those countries then possibly have problems with ensuring the national co-financing. This is the reason why an absorption limit seems to be reasonable.

Concerning the investigation of further unintended effects we find stronger evidence for the fact that the receiver countries of EU structural policy use the transfers in order to reduce their budget deficits, than for the fact that the transfers are used in order to finance cuts in corporate tax rates. Moreover, the results only conditionally indicate a robustly verifiable employment effect of structural funds payments.

5 Individual problems, status quo extrapolation and analysis of the main parameters

In this chapter, the institutional status quo of the regional policy is thoroughly analysed. First, individual problems which hamper the proper operation of structural policy in its current form are pointed out. Subsequently, the main determinants of the allocation of funds to the member states in today's system are scrutinised and the predicted changes in the composition of eligible areas and the allocation of funds in the period 2014-2020 are quantified.

Individual problems of the status quo

The status quo is characterised by a multiplicity of problems which are related to its institutional design. A considerable weakness is without doubt the inflation of

special provisions which are by now granted to the majority of member states. This reduces the transparency of the system and is on the verge of solidifying, as reflected in the constantly increasing number of additional provisions. The elimination of these special provisions would mean a considerable increase in transparency which could be achieved in a relatively simple manner. It is shown that a bulk of these special provisions follows a systematic pattern and that this pattern – in case the political will for preferential treatments persists – could be transferred into the existing framework.

Moreover, problems linked to the support for richer regions within the regional competitiveness and employment objective are pointed out. This support can hardly be regarded as a compensation for the richer member states as the net balances of this policy area are even for the main recipients of transfers only marginally positive. The recipients of these payments are at the same time the main contributors to the EU budget; hence, they finance this objective by themselves in large parts. This observation strengthens the case against an unchanged continuation of this objective which will be discussed in the reform chapter in greater detail.

The choice of the decisive statistical indicator of GDP per capita in purchasing power standards is noncontentious due to the lack of alternatives; however, it biases comparisons of wealth levels at the regional level. On the one hand, commuter streams to metropolises are insufficiently accounted for; on the other hand, the application of national instead of regional purchasing power standards leads to an underestimation of the price level in the capitals of the CEE member states. Both result in a statistical overestimation of the GDP per capita level in these capital regions. With unchanged extrapolation of the current criteria for eligibility, this would cause the loss of eligibility for assistance of almost all of these regions in the CEE countries after 2014. This problem is not a new one, but it affects the new member states much more strongly than the EU 15 in the past. Therefore, this should be taken into consideration regarding a reform of the structural policy.

Another discussed issue is related to the discontinuity which results from the strict application of the 75% threshold for the determination of eligibility within the convergence objective. As even a marginal transgression of this thresholds leads to the loss of eligibility and consequently to a strong decline in aid intensity, incentives to remain below this threshold are created. One avoidance strategy which was used in the past was the strategic demarcation of regions. This gives a strong case for a transitional arrangement which makes the transfers to a region which exceeds the 75% threshold dependent from its actual wealth, and which does not induce a sharp decrease when the threshold is exceeded only marginally. In the quantitative part, we present an option which fulfils these claims. This option is the introduction of sliding transitions which provides for

higher transfers than under the current transition arrangements for regions whose GDP is only slightly above the threshold for the convergence objective.

Finally, the problem of long time lags in the implementation of structural policy is addressed. In the current period, there was a gap of 5 to 7 years between the period which was chosen as reference for determining the eligible regions and the beginning of the financial perspective, and payments only accrue with sizeable lags. Consequently, there is a maximal difference of 15 years between the decisive period of reference and the end of the support. In the past this regularly resulted in high aid intensity even for regions which exhibit prosperity close to the average of the EU. However, there are major practical obstacles which exclude a more efficient solution to this problem.

Determinants of the allocation of funds

Two main elements of the allocation method contained in the Council regulation determine the allocation of structural policy funds. First and foremost it is the ceiling due to limited absorption capacity which decisively determines the aid intensity for the poorer member states. In the current programming period this capping reduces the payments for all CEE countries with the exception of Slovenia significantly compared to the allocations based on the application of the calculation method given in the regulation. Without the ceiling the entire resources of structural policies would have increased in the current programming period to more than 500 billion Euro. This has to be borne in mind for the consideration of the quantitative effects of any reform option, as the only reform with a major impact on the overall amount of structural spending is a modification of this ceiling. However, an important effect on the dynamics of future structural policy spending is related to the absorption ceiling which has not received much attention until now: As the allocations to a country which is affected by the ceiling go up with increasing GDP, convergence of a country initially leads to an increase of transfers. Therefore, as shown in the quantifications below in greater detail, the overall amount of structural spending to the poorer countries can be expected to increase after 2014 even if the current allocation method will be retained.

The modified Berlin formula is identified as the second main determinant which primarily determines the transfers to convergence regions in the richer member states. Here, mainly the national prosperity coefficient is of quantitative importance and is also affected by problems due to jump discontinuity. This coefficient leads to an uneven aid intensity in two regions of equal wealth if they are located in member states which differ in their wealth levels.

Status quo extrapolation

In order to attain a better understanding for the long-term consequences of the current framework, an extrapolation of the status quo in the period 2014-2020 is

simulated. It turns out that the composition of eligible regions may change considerably as mainly in several western European countries (Spain, Germany, Greece) many regions can be expected to lose their eligibility within the convergence objective. In addition, some further regions in the CEE countries, in particular the capital regions, will exceed the 75% threshold. So regions with a total population of 35 million would lose their eligibility and would be considered for transitional support. Thereby the loss of eligibility for all Eastern German regions with the exception of Brandenburg-Nordost does not only result from a true convergence process. Further reasons for the strongly increased levels of regional GDP per capita are the statistical effect due to the accession of Romania and Bulgaria and even more so the revision of the national accounts of the German Laender in 2006.

Subsequently the allocations of funds which arise from the changed composition of eligible regions for the period 2014-2020 are estimated. All in all, the entire resources stay rather constant, but a pronounced shift of funds towards the poorest countries takes place: Mainly Poland, Bulgaria and Romania gain considerably due to the effects of the absorption ceiling discussed above, while the above cited western European countries are likely to lose notably because of the loss of their convergence regions. However, the effect on the net balances which accrue from the structural policies is smaller. This can be explained by the fact that the poorer member states' shares in own resources payments will increase as well when these countries' prosperity increases. Moreover, Italy and Portugal show increasing transfers as well due to their economic weaknesses of the past years, whereas some richer CEE countries are likely to lose slightly. As the calculational transfers will continue to exceed the ceiling clearly in the next programming period for the three large CEE countries (Poland, Bulgaria, Romania), it can be expected that the payments to these countries will increase even further in the long-term.

The examination of different variations of the parameters reveals again that a major change in the overall payments can primarily be obtained by a variation of the level of the absorption ceiling. However, an increase of the 75% threshold or a variation of the national prosperity coefficient only leads to minor shifts in the allocation of funds. As an alternative for the current transitional support, the quantitative effects of the introduction of sliding transitions for regions which exceed the 75% threshold are quantified. It becomes clear that mainly the loss in allocations which would face Spain and Germany after 2014 due to the loss of eligibility for the convergence objective of several regions, would be reduced significantly by means of such a mechanism.

Finally, the quantitative effects of the accession of the current candidate countries are analyzed. Croatia and Macedonia can be expected to become eligible entirely, but because of the capping of the transfers due to the absorption ceiling and due

to their limited population size, the effects for the EU budget would be rather modest. By contrast, in case of full application Turkey would attract much higher transfers. However, a projection is difficult, as the total amount of transfers mainly depends on the further development of the country's GDP. Assuming unchanged growth the Turkish ceiling would amount to 0.15% of EU GDP in 2015, which would correspond to about 15% of the EU budget. Here again the outstanding importance of the ceiling due to limited absorption capacity within the status quo arises, as the level of this ceiling would exclusively determine the allocations to further new members states like Turkey in case of their accession.

6 Reform Options

Summary of the reform literature

The formulation of reform recommendations benefits from an extensive literature. The heterogeneity of this reform literature is vast. The idea of limiting regional policy interventions to poor member states and regions, which is the way this policy field was initially designed, finds wide support in the scientific literature. Apparently, the positions of member states concerning the general review are influenced by net-positions and national interests. However, the strategy to set the focus of regional policy on convergence regions is not just supported by relatively poor countries, but member states like the Netherlands, Denmark, Sweden and the United Kingdom also advocate this approach.

New Challenges

The current debate over the prospects of this policy field is driven to a considerable extent by "new challenges". Special attention is given to problems related to globalisation, climate change, rising energy prices and demographic change.

The issue of globalisation is by no means an utterly new topic, over the years EU policies in their entirety have aimed towards coping with increased factor mobility. Considering the adjustment to globalisation pressure as a cross-cutting task of all policy fields is appropriate, whereas specific budgetary solutions following the idea of the "globalisation fund" is conceptually not convincing.

Rising energy prices can also not be considered as a fundamentally new challenge, however, the consideration of measures to improve energy efficiency within regional policy programs is appropriate. Otherwise it is hard to see how regional policy with its long-run perspective could contribute to buffer short-term hikes in energy prices.

It is undisputed that climate change will have a specific regional dimension eventually. The regional consequences will differ in particular depending on factors such as the occurring floods, winter sport areas lost, increased drought, or water shortage. However, currently measures which can mitigate climate change are the priority and not yet the adaptation to an inevitable climate change. In this context it is questionable whether the regional policy offers the most adequate item for addressing mitigating strategies. An efficient mitigation policy should not be constrained by requirements with respect to the regional allocation of resources.

The demographic change has severe implications for regions with a decreasing population and an ageing society since the growth potential, the labour markets and the economic activity in the region are affected. For the growth potential of those regions it is of utmost importance whether the life working time will be extended effectively, whether participation rate on the labour market can be increased significantly and whether the deregulation of the labour markets can be advanced. Therefore, various objectives of the Lisbon strategy are suitable to indirectly serve the development of those regions which are most affected by the demographic change. There are no strong arguments why demographic indicators should be considered as criteria guiding the distribution of regional funds.

A reform of the EU structural policy should not provoke a further diversification of objectives, on the contrary, it should rather be committed to a more precise prioritising. The objective of convergence stressed in Art. 158 TEC defines a priority which should remain the central guideline to measure the successes of regional policy initiatives.

The ZEW model of policy reform

This model of policy reform is based on the following insights: Measuring the per capita income in purchasing power standards is an appropriate criterion to determine the eligibility and distribution of regional policy transfers. It is an operational indicator and there is no applicable alternative. Considering the advantages and disadvantages of conditional funding, the current operational system can be considered as a fair compromise. The commonly agreed strategic cohesion guidelines, on which the specific national strategic reference frameworks are based and the operational programmes are adapted to, offer the MS and the regions sufficient opportunity to set individual priorities. Further mandatory quantitative requirements, like the Lisbon earmarking, should be avoided in the future. Although a conditional link between the regional policy transfers and the economic and fiscal conduct of individual member states would be desirable in principle, this can hardly be operationalised and is thus deemed to fail.

The issue concerning the territorial addressee should further on be tackled with a mixed system, where either the region directly or the member state can be addressed. However, the importance of the national addressee should be increased

cautiously, because this enables the member states better to make independent decisions to balance the objective of general economic growth and regional convergence. Furthermore, problems from imprecise regional statistics which are especially virulent for less wealthy countries could be neutralised.

The convergence objective should be reformulated in the following way: In a Pillar 1, member states whose GNI per capita in purchasing power standards is less than a certain threshold of X % should be eligible in their entirety. The transfers to these member states should be linked to a requirement of a minimum allocation to those regions of the member state, whose GNI is below a certain limit. In Pillar 2 specific regions of those member states which have a higher GNI per capita than the threshold X should be eligible for funds, if those regions have a GDP per capita below the threshold Y %. It would be advisable, however not obligatory, to determine Y at the traditional 75 % of the average EU GDP threshold. Pillar 2 should be combined with a model of sliding transition, in order to overcome the abrupt discontinuity of the current system.

The objective of regional competitiveness and employment has to be reassessed. There are three options with differing advantages and disadvantages. Option 1 would maintain the status quo, whereas Option 2 would abandon this objective and Option 3 would sustain the objective while abandoning the definition of fixed allocations to member states. Option 1 would be in line with the strategy of concentrating the structural policy more on less wealthy regions. However, the disadvantage is that wealthy regions would be excluded from the strategic and programming processes of this policy field. If the objective of regional competitiveness and employment would be maintained a possible compromise could be achieved by lowering the EU rate of co-financing by at least fifty percent.

The objective of territorial cooperation is well justified and should thus be maintained. The economic implications of the additionality principle have to be reassessed, while the principle has to be applied to the cohesion funds as well. For all objectives the EU rates of cofinancing should be lowered, because the currently low levels of recipients' financing shares do not guarantee the efficient use of funds anymore. Those regions which have fallen behind due to government errors require newly conceived solutions. However, it should be avoided to treat them equally to classical convergence regions. Exceptional rules have to be replaced by general rules in order to improve the transparency of the system. Furthermore the institutional structure of the evaluation system has to be reconsidered, because scientifically objective and non-biased results cannot be guaranteed in the current system.

The simulation of the suggested reform option, for appropriate parameters chosen, indicates that the reform effects on the scope of the entire structural policy as well as on the national distribution can be held to a minimum, which increases the chance of political realisation.

As a concluding remark, it has to be stressed that the EU regional policy has only a limited impact of the regional development of the EU which should not be overestimated. Wrong national policy decisions on fields like labour market regulation or the tax system cannot be compensated for by even an ambitious regional policy.