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The EU's Regional Policy and its Implications on Economic Strategies within an Enlarged EU[1]

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One of the major endeavours as well as one of the consequences of the European integration process is to reduce the differences in development between individual countries and regions and to support the less developed areas in catching up with the others. This process requires joint action to strengthen the predominance of free market forces, as well as the establishment of a support system for the regional policy managed at EU level. *An effective regional policy is crucial to the future development of an integrated EU.* If the EU does not have a commitment to reduce the disparities in income differences and living standards, the future of the integrative process would be undermined. It would be unacceptable for citizens in differing parts of the Union to be subject to significantly different standards.

Achieving a position of complete levelling out cannot, of course, be a realistic goal, partly because of the dissimilar historical and geographical circumstances, social expectations and economic resources. Completely equalizing the differences in the standard of living among the individual regions is not only impossible but would not be desirable either, as it would eliminate the basic motivating forces that influence economic activity. On the other hand, however, it is necessary to continuously stimulate regional development and protect the standards of living attained and accepted.

"Cohesion" is a strategic goal within the EU, serving to reduce social and regional differences. The most important factors that support cohesion are the improvement of the conditions of employment and the strengthening of the economic potential of the more backward regions. The crucial element in accelerating the process of catching up in these regions is to improve the conditions of economic development, since these regions are in a disadvantageous position in every respect. It should be

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noted that *the measures promoting cohesion are not meant to replace the EU policies driven by free market principles, but are applied parallel with and in harmony with them:* the cohesion measures are a concession to interventionism, but within the general framework of the market.

1. The necessity of an active regional policy

There are numerous arguments to back an active regional policy as opposed to the view that spontaneous market adaptation has sufficient impact *(see Kengyel, 2003)*:

- The major consideration is *the necessity to handle the structural weaknesses* resulting from the inflexibilities of the market, the conditions of access to the market and the structure of production.
- The problem of *utilizing the factors of production:* the reallocation of resources may be slower than would be socially acceptable. Though the classical theory of international trade postulates the free flow of factors of production, which ensures complete utilization, even Adam Smith remarked that the factor hardest to mobilize is Man. In times of recession the employment situation is difficult everywhere, and as a result the potential advantages of areas with abundant manpower disappear. The low mobility of labour prevents the levelling out of inequalities within an economic union.
- *The need to handle the distortions arising from the allocation of resources.* Capital has a tendency to move toward the more developed regions: here private investors can expect a faster return and can save the major part of the costs of infrastructure development. This tendency of the developed to become even more developed, while the less developed, in the optimal case, remains at the level already achieved, ensures significant gains for private investors on the one hand, and involves social costs on the other. From the above it follows that if private investors' decisions are not influenced by government policies, then considerable social costs may be incurred.
- In the supported region *state subsidies*, and consequently public expenditure, *can be reduced* in the long term. The incentives provided by the state and the support of economic activity can accelerate the development of the given region, unemployment may be reduced, social costs may decrease and tax revenues may increase.
- Though regional policy targets a particular region, *the positive influence of the benefits can be felt not only in the targeted region* but in other regions as

well. Integration will deepen and the factors of production will be better utilized.
- Besides the economic arguments underlining improvement of efficiency, certain political aspects are no less important. *Solidarity* and tolerance are crucial in every social community. In the course of creating an economic union, regional inequalities must also be reduced, which requires *reduction of the growing and intolerable differences* in welfare between regions at different levels of development.

The most important argument supporting the need for an EU-level regional policy is that to spread the welfare gains resulting from economic integration requires active tools, since, with market forces working freely, the benefits arising from integration cannot necessarily be felt in every region, but on the contrary, development may become even more concentrated in the central regions of the EU.

Among the factors determining regional inequalities, differences in infrastructure and human resources largely contribute to the competitiveness of individual regions. The historically low level of infra-structural investment has undoubtedly hindered the improvement of productivity and employment levels in the least developed old and new member states of the EU. *The infrastructure background, the quality of human resources, the levels attained in research and development activities, and, as a consequence of all the above, the region's ability to attract investments, are all factors determining competitiveness, which clearly reflect the development level and prospects of a region.* The EU's regional policy has to improve these conditions that influence competitiveness in such a way that the given region becomes more attractive to investors, the spirit of enterprise is stimulated, and, as a result, economic growth takes off. *(Kengyel, 2002)*

2. Regional development differences in the EU economy

An important development in EU integration is that over the past few decades a process of *levelling out among the less developed member states has been taking place*, as can be seen in the three countries (Greece, Portugal and Spain) currently the least developed, and in Ireland, though at a pace varying from country to country. In 1960 the four countries had a low level of GDP per capita in purchasing power parities: Portugal had 40%, Greece 43%, Spain 57% and Ireland 61% to the average of the EU. According to the latest official statistical publications Portugal had achieved

74%, Greece 71%, Spain 82% and Ireland 127%. *(EUROSTAT, 2003)* It can be seen that *there has been considerable approximation between the performance of the peripheral member states and the union's average development level.* EU's regional policy support is, of course, only part of the explanation for this process, and several other factors (an investment boom, increasing openness to the world economy and the structural adaptation of the national economies) have also contributed to this successful catching up. At the same time, *as a result of the strengthening of the common regional policy, in the 1990s subsidies from the EU played a decisive role in the convergence* of economic performance.

The data show that the development level of the EU15 member states compared with the EU15 average ranges between 71% in Greece and 201% in Luxembourg. On the basis of the two extreme values, it can be determined that the existing developmental difference between the EU15 member states is 2.8-fold. If we disregard Luxembourg, considering its small size, the three countries with the highest GDP that follow are Ireland, Denmark and Holland. Their GDP figures range between 117 and 127. From these data it can be established that the difference in development between the most and the least developed countries of the EU15 is 1.7-fold.

On the regional level the differences are much more significant: compared with Imperious in Greece, with a figure of 42% of the EU15 average and thus the lowest level of development, Inner London has a figure of 243%. Consequently, the developmental difference between the two is sixfold. Within the EU15, *the difference between the 10% of the regions with the highest per capita GDP and the 10% with the lowest per capita GDP is 2.4-fold.* The GDP per capita figure in the highest 10% is on average 60% more than the EU15 average, while the lowest 10% are 40% below that level. Looking at the developmental difference between the highest and the lowest 25%, we are faced with 137% of the EU15 average compared with 68% of the EU15 average: the difference is twofold.

After May of 2004, the EU's average GDP per head will fall by almost 13 per cent, because the GDP of most of the regions in the 10 new member states lies between 30-40% of the EU average. (If we calculate with 12 new countries from 2007, including Romania and Bulgaria, the statistical effect is to reduce the EU average GDP per head by 18%.) This will mean that regions whose GDP per head is between 60% and 75% the EU15 average (the latter being the current threshold for the "Objective 1" status) will have a GDP in excess of 75% in the context of EU25, even though there is no actual improvement in economic performance. *(European Commission DG Regio, 2004)*

The ratio of GDP per head in the top regions to that in the bottom in the enlarged EU is around double the ratio for the EU15. The top 25% of the regions in the EU27, therefore, would have an average level of GDP per head of 3.3 times that of the bottom 25% as against the ratio of 2.0 in the case of the EU15, while *the top 10% of regions after enlargement have a level 5.3 times the bottom 10% as compared with a ratio of 2.4 at present*. GDP per head of the 10% of the bottom regions will fall from 61% of the EU average at present to only 31% of the average for an enlarged EU.

Enlargement will pose a challenge to cohesion in two ways. First, it will more than double the *population living in regions with GDP per head less than 75% of the present EU average* – EUR 20,213 per head – from *71 million to 174 million*, or from 19% of the EU15 total to 36% of the EU27 total (or to 26% of the EU27 total if the EU average GDP per head is reduced to that of the 27 countries: EUR 16,504). Secondly, it will increase the intensity, or scale of disparity. *(EUROSTAT, 2004)* GDP per head in lagging regions of the EU averaged of the 66% of present EU average. In lagging regions of the new member states, it is much less than this: around 37% of the present EU average. So that two groups of regions together have a GDP per head of less than half (48%) the average. It is noteworthy that very few regions from the EU15 appear in the list of the least prosperous regions of an enlarged union.

3. Gradual reforms of the EU's regional policy

As early as 1957 it did not seem necessary to establish a joint regional policy, on the assumption that the integration process and the general economic upswing would result in equalizing developmental differences. Anyway, each of the member states had its own regional policy at the time, so the EU considered it its duty merely to ensure that the national policies did not contradict the aims and common policies of the Community. Only gradually did it become obvious that *economic integration could aggravate the situation of the originally backward and peripheral regions,* and that it was necessary to handle these problems at community level also.

It was not until after the second and third enlargements of the EU in 1981 and 1986 respectively, and the adoption of the Internal Market programme as part of the Single European Act, that regional policy was given a high profile among the activities of the Union. It can well be observed how the area of the existing structural policies has broadened as the number of EU member states has grown and as integration has deepened, since both processes have resulted in an increase in regional problems, while the nature of these has also changed. As it was obvious that the single market might cause serious hardships to the weaker member states, the Treaty of Rome was supplemented with articles on economic and social cohesion. In this way, *regional policy was included among the common policies; it aims to counterbalance the possible negative effects of the internal market and to increase economic and social cohesion.*

In the interest of the efficiency of regional policy it became important to improve coordination of the activities of the different funds, and to make the handling of the problems in different regions more program-oriented, instead of supporting individual independent projects. As a result of the Commission's comprehensive reform proposal, in 1988 the Council adopted the regulations relating to the operation of the structural funds, which took effect in 1989. The reform served as a basis for the subsidizing programmes for the period 1989-1993. Acting on the experience gathered in these years, in 1993 the Council approved modifications for the period 1994-1999. *(see Council of the EC, 1993a-h)* Another round of comprehensive changes was heralded by the document entitled Agenda 2000, published in July 1997, in which the EU published its plans for the period 2000-2006. *(European Commission, 1997)*

From the point of view of the extension of regional policy subsidies to new members, the Agenda 2000 and the European Council meeting in Berlin that closed the debate on it were of decisive importance. The EU's budget for 2000-2006 was approved at the Berlin summit of March 1999. This meant that the minimum reforms necessary for enlargement had finally gone through in agricultural policy and regional policy, the two areas most affected by the financing of enlargement. It also became clear that enlargement can be financed within the existing framework, i.e. it will not be necessary to raise the budget ceiling of 1.27% of the union's GDP in the future.

The three objectives of regional policy for the period 2000-2006 are (see Council of the EC, 1999a-f):

- Objective 1: support for backward regions facing the most severe difficulties in terms of revenues, employment, the system of production and the infrastructure.
- Objective 2: support for regions facing structural difficulties because of economic and social restructuring. This includes regions undergoing changes in industry and services, declining rural regions, regions dependent on the fishing industry that are in crisis and urban regions facing hardships.
- Objective 3: support for the adaptation and modernisation of systems of education, training and employment.

According to the new rule for eligibility between 2000-2006 total transfers from the Structural Funds and the Cohesion Fund to a present or future member state *should* *not exceed 4 per cent of its GDP*. This regulation actually sanctioned the situation that has developed with the main current beneficiaries and made this ratio the maximum of the subsidies provided. Part of the reason for this was certainly the wish to avert possibly very high GDP-dependent claims for subsidies by the future members. It seems that this upper limit *will be maintained also for the next budgetary period.* At the same time, it should be emphasized that making comparisons between the new member states and the experience of the less developed old member states, for several reasons, could be misleading.

The absorption capacity of the Central and Eastern European countries may be bigger than that of the peripheral countries of the EU was earlier *(see Inotai, 1997)*, because:

- the inhabitants of the new member states have a higher level of general education than those of some less developed EU countries had 10-15 years ago or have even today;
- the new members have a favourable geographic location: infrastructural projects that cross their territory may exert a substantial multiplier effect on the economy and enhance the absorption capacity;
- As a result of transformation, the Central and Eastern European countries have gained a relatively high level of social and institutional flexibility, which again correlates positively with efficient absorption.

On the other hand, obviously, there are very serious institutional (for example concerning the programming process or monitoring bodies, etc.) and financial (co-financing) conditions to be fulfilled in order to become eligible for supports.

Concerning the future of the EU level regional policy, *different old and new member states have different views on the rules for the period 2007-2013, depending on their likely receipts, and whether or not they are net contributors to the EU budget.* Despite considerable uncertainties over future rules, the Commission's Regional Policy DG (DG Regio) has been developing its views on the future of the regional policy. *(see European Commission, 2004)* Hard discussions can be expected within the next 1-1.5 years about the new budget and new rules for financing it, and the eligibility for funding.

Since the threshold for *eligibility for Objective 1 status would remain at 75% of average EU GDP per head*, the Commission suggests a differentiation of criterion for eligibility under Objective 1 for old and new member states. Otherwise, most of the current EU15 Objective 1 regions would be excluded just because of statistical quirk. To find a compromise the Commission suggests the following:

- Objective 1(a): focused on those member states with a GDP less than 75% of the EU25 average – mainly comprising the new member states, and

- Objective 1(b): for member states with a GDP less than 75% of the current EU15 average – i.e. existing Objective 1 countries otherwise excluded because of statistical effect of enlargement (it would be a kind of phasing out process).

About 78% of total funding would be spent for the Objective 1 programmes.

There is still debate about whether Objective 2 should continue and, if so, in what form. It seems that it would be advantageous for old member states to have other objectives than Objective 1, because they would be eligible for. *(Wilkinson-Baldock, 2003)* The *Commission is proposing that Objective 2 should continue and would absorb the current Objectives 2 and 3*. It could be a good compromise also for the old and new member states. According to DG Regio some 18% of the regional policy expenditures will be spent for the new Objective 2. 50% of Objective 2 would be financed by the European Regional Development Fund and would focus on the priorities set out at the European Council in Lisbon:

- *Innovation and the knowledge society.*
- *Environmental risks and disaster prevention.*
- *Accessibility and competitiveness.*

The remaining 50% of Objective 2 funding would be financed from the European Social Fund and be focused on supporting national *employment and training action programmes* already in place as part of the Lisbon agenda.

Most Community Initiative Programmes would be absorbed into mainstream programmes – with the major exception of *an Interreg-type funding for cross-border and transnational programmes.* The aim is to promote European territorial cooperation. However, *it should be noted, that only around 4% of the overall regional policy budget* would be dedicated to these activities. There would be increased scope within the programme for financing cross-border trans-European infrastructure networks. In addition, between 5-10% of the Objective 2 budget would be allocated to an "Excellence Fund" managed by the Commission. It appears that this would be used to fund the sort of projects and programmes currently covered by Community Initiatives.

4. Expenditure and impacts of subsidies

The amount of expenditure on regional policy has had *ever-increasing weight in the EU budget since the late 1980s*. Between 1989 and 1993, a total of ECU 63 billon – at 1989 prices – was spent on regional policy objectives. In the period between 1994 and 1999 the EU spent a total of ECU 143 billon, at 1994 prices, on subsidizing backward regions and regions facing structural difficulties. Over the period 1994-1999 the four less developed member states received subsidies of ECU 69 billion including those from Community Initiatives, which meant the doubling of the support given between 1989 and 1993. *(Europäische Kommission, 1995)*

The size of the support per capita also shows considerable growth. (For example between 1989 and 1993 the subsidies per capita granted under Objective 1 amounted to ECU 150 in Greece, ECU 253 in Ireland, ECU 171 in Portugal and ECU 91 in Spain; between 1994 and 1999 the figure for Greece grew to ECU 255, for Ireland to ECU 262, for Portugal to ECU 235 and for Spain to ECU 188.)

In the period 2000-2006 EUR 213 billion can be spent on purposes of regional development in the current 15 member states: of this, EUR 195 billion is provided from the Structural Funds, while EUR 18 billion comes from the Cohesion Fund. According to the final agreement reached at the Copenhagen European Council meeting in December 2002 the 10 new members will be entitled for EUR 21.8 billion (EUR 14.256 billion from the Structural Funds and EUR 7.591 billion from the Cohesion Fund) for the period 2004-2006. *(van der Putten, 2002)* Structural aid for the current financial period is laid down in the accession treaties. They are *quite modest in size compared to what the current member states receive*. This is related to the expected limited absorption capacity in the first years of membership. *Structural aid to the new member states will only amount to around 0.5% of GDP in 2004, and will be steadily increased to around 1.3% of GDP by 2006.*

The real problems are expected to start with debates on the new Financial Perspectives for 2007-2013. It is expected that around 78% of the Structural Funds will be focused on Objective 1. In fact, with the exception of only some regions, the whole territory of the new member states will be eligible for Objective 1 supports. Applying the ceiling of 4% of GDP, regional support to the new members could amount to EUR 22 billion per year, including EUR 4 billion to Romania and Bulgaria. By contrast, *support for the EU15 is likely to fall dramatically, as most of the current Objective 1 regions will no longer qualify*. They would receive, until 2013, only phasing-out support. In the period 2007-2013, Greece and Portugal will be the only countries of the EU15 that will qualify for support from the Cohesion Fund, assuming that Romania and Bulgaria joins in 2007. The income of all the new members will remain below the 90% threshold. If the EU wants to maintain support per capita at the same level, Cohesion Fund expenditure should be increased to EUR 38 billion compared to EUR 26 billion in the current budgetary period.

In conclusion we can say that the amount of regional supports will dominate the negotiations on the budgetary rules for the period 2007-2013. Some of the *current member states are likely to battle for appropriate compensation for the expected loss* of a substantial part of their subsidies after 2006. (According to some calculations Spain will be the major loser with its Objective 1 support set to fall by EUR 5 billion per year plus EUR 1.6 billion from the Cohesion Fund. This is almost 1% of Spanish GDP.)

Concerning past experiences, it can be stated that though over the last decade and a half expenditure on the Structural Funds has been gradually growing, even this cannot be considered significant help. Even through doubling the amounts available, in the period of the completion of the internal market, i.e. between 1989 and 1993, the EU expended a mere 0.24% of its GDP (ECU 63 billion) on regional development. This amount can be regarded as modest, especially since the Cecchini Report calculated on a gain in prosperity of ECU 216 billion resulting from the single market. *(see Cecchini, 1988)* The subsidies, on average, amounted to 0.43% of the Union's GDP for 1994-1999, in accordance with the decision of the European Council in Edinburgh. For the period 2000-2006, the Berlin summit *determined the ratio between the Structural Funds and the union's GDP at 0.46%.*

Concerning the new budgetary period between 2007-2013, there is no any sign for increasing this ceiling: the Commission proposes to allocate EUR 336 billion or 0.41% of the EU's GNI (Gross National Income) in support of cohesion. This means that the ratio of the amount to be spent on subsidies compared with the union's GDP will continue to be rather low. This reflects *a continuing low degree of solidarity and self-sacrifice, although experience has shown that the greater proportion of the amounts from Structural Funds flows toward the developed regions* in the form of purchases of finished products, machinery and investment goods. For this reason, increasing the level of subsidies would be beneficial for the developed regions also.

Contrary to the relatively modest supports, the *macro-economic effects of the subsidies have proved to be far-reaching.* In the three least developed member states and Ireland, the ratio of the subsidies from the Structural Funds compared with GDP reached a significant value in the period 1989-1999. The contribution of the subsidies from the Structural Funds and the Cohesion Fund to the annual investment rates of the given countries represented a major share over the past two periods. Approximately

15% of the investments in Greece and Portugal, close to 10% in Ireland and nearly 7% in Spain were completed in the support period that ended in 1999. For the current support period the share of investments is forecast at 12% for Greece and Portugal, over 5% for Spain and about 3% for Ireland.

Table 1. *The share of subsidies from the Structural Funds and the Cohesion Fund in investments (as % of investments)*

Country	1989-1993	1994-1999	2000-2006
Greece	11.8	14.6	12.37
Ireland	15.0	9.6	2.6
Spain	2.9	6.7	5.5
Portugal	12.4	14.2	11.4
EU4	5.5	8.9	6.9

Source: European Commission: Unity, solidarity, diversity for Europe, its people and its territory. Second Report on Economic and Social Cohesion. Brussels, 2001.

According to the calculations of the Commission there is evidence of significant growth in GDP and a considerable reduction in unemployment compared with the case without subsidies. In the period 1989-1999 Greece reached a GDP level 9.9% higher than in the case without subsidies; the corresponding figure for Portugal is 8.5%, for Ireland 3.7% and for Spain 3.1%. Unemployment in Greece decreased by 6.2%, in Portugal by 4%, in Spain by 1.6% and in Ireland by 0.4%, in consequence of the subsidies. For the period 2000-2006 the expected growth surplus is 7.3% for Greece, 7.8% for Portugal, 3.4% for Spain and 2.8% for Ireland. The subsidies are also expected to have the effect of lowering unemployment rates.

Table 2. Effects of EU subsidies compared with the situation without subsidies
(compared with 1989 and 2000, as %)

	Greece		Portugal	
	Increase in GDP	**Decrease in unemployment**	**Increase in GDP**	**Decrease in unemployment**
1989	4.1	3.2	5.8	3.6
1993	4.1	2.9	7.4	4.1
1999	9.9	6.2	8.5	4.0
2006	7.3	3.2	7.8	2.8
	Spain		**Ireland**	
	Increase in GDP	**Decrease in unemployment**	**Increase in GDP**	**Decrease in unemployment**
1989	0.8	0.5	2.2	1.4
1993	1.5	0.8	3.2	1.0
1999	3.1	1.6	3.7	0.4
2006	3.4	1.7	2.8	0.4

Source: European Commission: Unity, solidarity, diversity for Europe, its people and its territory. Second Report on Economic and Social Cohesion. Brussels, 2001.

Finally, it should be underlined that becoming integrated into the EU's regional policy also requires several internal changes from the new members. Being "entitled" does not necessarily mean that the new members will be able to draw the subsidies from the Structural Funds without any prior preparations. These preparations require serious changes in the domestic regional development policies of the new members. They have to be aware of the principles of operation of the EU's regional policy and must be able to ensure that those principles are followed, for which significant institutional reforms and well-prepared projects are needed.

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