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COHESION POLICY FACING THE CRISIS: WHAT EFFECTS FOR THE EU'S REGIONS?

Patrick Faucheur | *Advisor at the French General Secretariat for European Affairs (SGAE) to the Prime Minister on economic and social cohesion policies, regional development and transport*

SUMMARY

This Policy Paper on the Commission's Sixth Report on Cohesion does not intend to provide a comprehensive summary of the elements in the report but **seeks to highlight the changes that have occurred in the development of regions since the crisis. It focuses on the role that Cohesion Policy has played in this context, helping to mitigate the effects while continuing to support economic and social cohesion**. It also sheds particular light on the issue of the governance of regions and its relationship with the implementation of Cohesion Policy, especially with regard to its effectiveness.

In the first section stock is taken on the impact of the crisis on growth of regions but also on the difficulties they encounter, notably in terms of jobs. **Findings are quite harsh and testify to the reversal of trends with respect to convergence, observed after the crisis, leading to disparities of wealth between regions in 2013 returning to the level observed in 2000**. The employment situation was also strongly impacted by the crisis. Unemployment was higher than for over 20 years, particularly when it comes to young people.

In the second section, focus is on the level of public investment in regions that fell significantly after the crisis, which affected public finances on a long-term basis. **In this context, Cohesion Policy took on particular importance in offsetting lower public investment**. It was seen that in 2013, the contribution of EU funds relating to Cohesion Policy to public investment in regions was nine times higher than in 2007.

In the third section, a co-relation is made on the basis of indicators, from the World Bank in particular, between the quality of the governance of territories and the effectiveness of Cohesion Policy. **The Commission found that GDP growth in the least developed regions was especially high, at equivalent expenditure, in regions with good governance.**

"THE LINKS BETWEEN THE IMPLEMENTATION OF COHESION POLICY AND THE EU'S ECONOMIC AND FISCAL GOVERNANCE"

To conclude, the Policy Paper **points out the links between the implementation of Cohesion Policy and the EU's economic and fiscal governance** that the effects of the crisis tended to strengthen and new provisions for the 2014-2020 period that take them into account to a great extent.

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INTRODUCTION

The European Commission published its sixth report on economic, social and territorial cohesion[1] last July, a report published every three years in compliance with Article 175 of the Treaty. The previous 2011 report provided an opportunity for the Commission to present its guidelines for the 2014-2020 period. This report took initial stock of the 2007-2013 period, even though the related programmes and projects will not be completed until the end of 2015. Entitled "Investment for jobs and growth: promoting development and good governance in EU regions and cities", it highlights the role European funds supporting investment played in the crisis period the EU experienced.

"THE REPORT SHOWS THE CONSEQUENCES OF THE CRISIS ON CONVERGENCE"

The Commission presents the contribution of Cohesion Policy to implementing the Europe 2020 strategy for smart, sustainable and inclusive growth and the new challenges the EU is facing including tackling climate change, by successively dealing with the results observed with regard to these three types of growth. However the interesting thing about this report is that it explains the impact of the crisis in regions. It clearly shows the consequences of the crisis on convergence, by noting a slowdown in the narrowing of disparities of wealth between the regions.

It also documents the crucial contribution of European funds to investment in regions, especially during a period in which investment significantly decreased, and the role of the good governance of regions in implementing Cohesion Policy. The Commission concluded that good governance is a key factor of its effectiveness.

The Commission finally points out in the last part of the report, the new ways to implement European funds in the 2014-2020 period and particularly the complementarity and coherence expected between the Union's Cohesion Policy and economic and fiscal governance through the European Semester mechanism, although the two ways differ, with one using a multi-annual approach and the other an annual system.

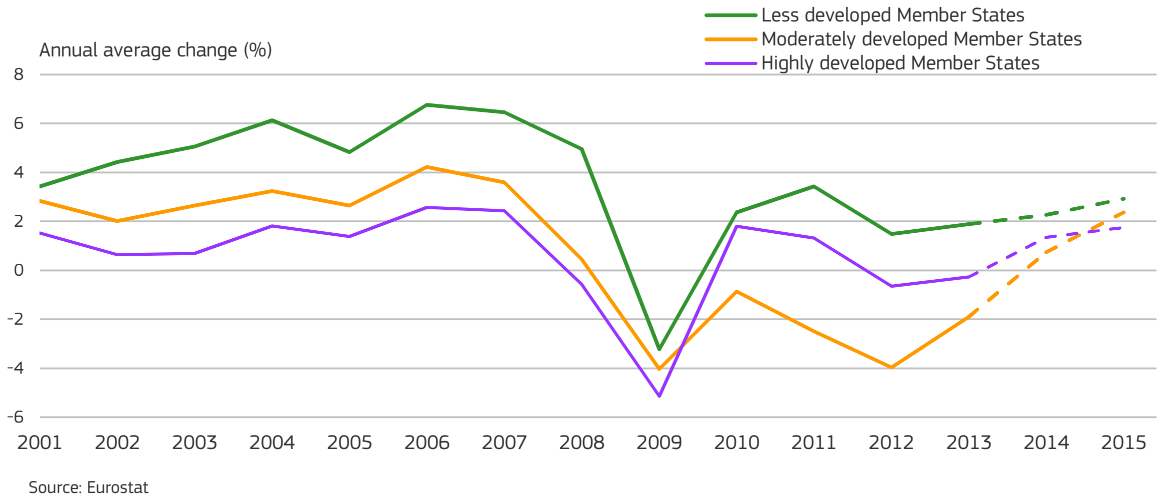
This Policy Paper does not intend to summarise the Commission's report. It focuses on its main elements related to the crisis that can shed new light on Cohesion Policy.

1. European Commission, *Investment for jobs and growth: promoting development and good governance in EU regions and cities*, Sixth Report on Economic, Social and Territorial Cohesion, July 2014.

1. Cohesion Policy and regional growth hard hit by the crisis

Taking stock of the period 2007-2013, the Commission monitored the catching up of the GDP and the employment rate, criteria used to determine the allocations of regions under the Cohesion Policy. Up until the time the crisis erupted, gaps between regional economies were narrowing. Indeed, in 2000 the average GDP per head of the most developed regions was 3.5 times higher than that of the least developed regions, which in 2008, was only 2.8 times higher. These figures effectively illustrate convergence that was occurring at that time between regions. This trend of converging however reversed after the crisis, leading to gaps in 2013 that were wider than in 2000. Observations of previous periods showed a constant increase in the GDP of regions with nevertheless a number of differences from one region to another, but after 2008 this trend reversed progressively because of the crisis.

FIGURE 1 ► Growth of GDP per head in real terms, EU-28, 2001-2015



Source: Sixth Report on Economic, Social and Territorial Cohesion.

This also concerns the situation of employment and notably youth employment. In a very large number of regions, unemployment has risen to its highest rate in 20 years. Youth unemployment has also risen considerably and was higher than 20% in half of the regions of the Union in 2012. During the same period, there has also been a rise in the risk of poverty and social exclusion. This means, among other things, that the objectives set in the Europe 2020 strategy with respect to employment and tackling poverty will be difficult to meet, moving further and further away from levels observed after the crisis.

> "13% OF THE TOTAL AMOUNT OF FUNDS WAS REDIRECTED TOWARDS AREAS THAT ARE LIKELY TO HAVE A DIRECT IMPACT ON EMPLOYMENT AND ECONOMIC ACTIVITY"

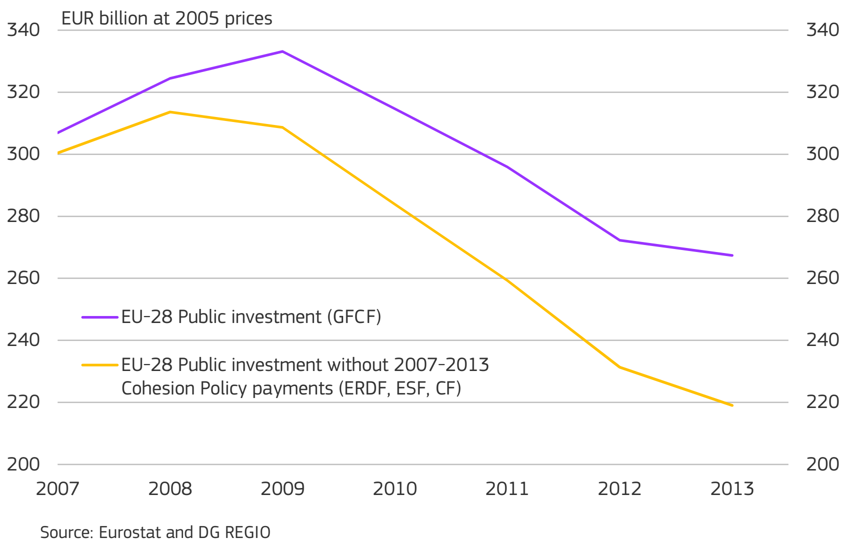
In light of this situation, some adjustments in the 2007-2013 programming of European funds were made in the hardest hit countries that benefited from substantial allocations of Structural and Cohesion Funds, including some new Member States, but also Greece and Portugal. Nearly 13% of the total amount of funds was redirected towards areas that are likely to have a direct impact on employment and economic activity. Indeed, in these countries, support of funds for investments in infrastructures was still particularly strong, while support for human resources tended to decline. Adjustments to increase the part of the European Social Fund (ESF) were therefore made to strengthen support for actions fostering jobs. Also to this end, the Commission proposed that in the 2014-2020 period a minimum threshold per Member State be established for the part of the ESF in their allocation of Structural Funds. This system is now included in regulations in force.

2. Cohesion Policy used to offset the decrease in public investment conducive to growth and jobs

The crisis that had significant consequences on public finances strongly impacted the level of investment in regions. Tax revenue losses from weaker economic activity put pressure on public finances that were, at the same time, used more to mitigate the effects of the crisis. Public expenditure from national and regional budgets for investments to promote growth was affected by significant increases in public deficits. Public investment, which had remained stable over the previous periods, rose from 2007 to 2009. At the same time, private investment dropped. This trend of increasing public expenditure reversed considerably after the crisis. Latest estimates show that public investment was expected to reach a particularly low level in 2014 and that private investment was also expected to remain quite weak.

This drop in public investment first affected investments made by national authorities, then two years later, by those made by regional and local authorities, those representing, on average within the Union, approximately two thirds of public investment. Therefore all of public investment has been affected since 2010 with considerable decreases in recent years, especially in 2012 and 2013. The decline in investment by regional and local authorities was caused by two things that are also related to the crisis. The first was the result of local tax revenue losses but also a lower number of transfers from central level, which was the case in Spain where these transfers decreased by 62%, in Ireland, in the Czech Republic, in Latvia and in Italy.

FIGURE 2 ► Impact of Cohesion Policy on public investment, 2007-2013



Source: Sixth Report on Economic, Social and Territorial Cohesion.

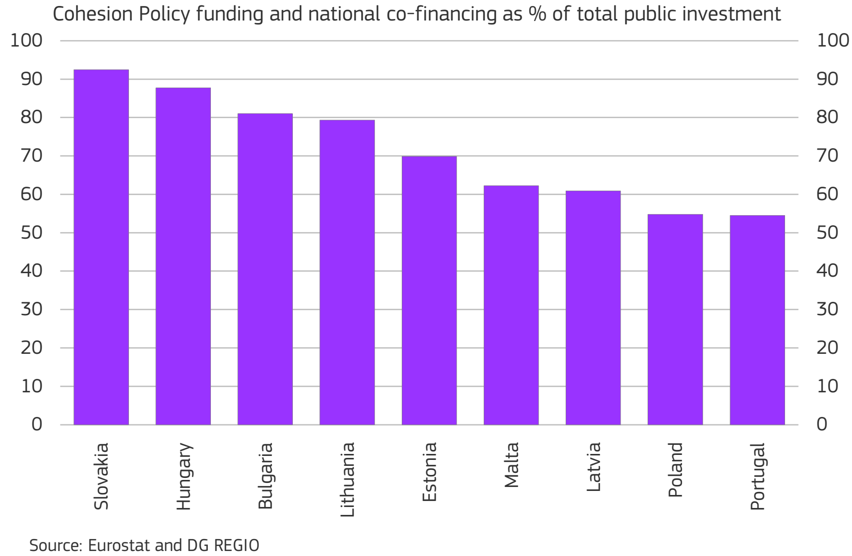
> "THE IMPORTANCE OF COHESION POLICY FOR THE FINANCING OF PUBLIC INVESTMENT PROGRAMMES NEEDED FOR GROWTH FURTHER INCREASED"

In this context, the importance of Cohesion Policy for the financing of public investment programmes needed for growth further increased. It played a major role in support provided by Structural and Cohesion Funds, a role that steadily grew throughout that period. While the EU's contribution in terms of Cohesion Policy represented 2.1% of public investment in 2007, also taking account of payments for the previous period, in 2013 it represented 18.1%, ie 9 times more.

However this proportion varied substantially across Members States. It was higher in countries benefiting from Cohesion Funds and that received a substantial amount to reach the convergence objective, taking into account the effect of the co-funding rates that were higher in these countries. Particularly high proportions could be noted, i.e. in Slovakia, in Hungary, in Bulgaria and in Lithuania where they were over 75%. Conversely, the lowest rates were seen in Luxemburg, in Denmark and in the Netherlands.

Increased reliance of Member States on Cohesion Policy to finance growth-enhancing investment observed in recent years is set to continue and also mark the 2014-2020 period. This now critical role of Cohesion Policy demonstrated with the crisis intends to incorporate cohesion in a macroeconomic perspective focused on growth and jobs and coordinate more closely with the EU's economic and fiscal governance. Moreover it was what led the Commission, the Council and the Parliament during the negotiation of texts to agree on the need to strengthen the links between Cohesion Policy and economic governance of the Union. Regulations for 2014-2020 set out that national programming frameworks—Partnership Agreements—, in their strategic component in particular be consistent with National Reform Programmes and take country-specific recommendations into consideration.

FIGURE 3 ► Part of Cohesion Policy in public investment, average 2010-2012



Source: Sixth Report on Economic, Social and Territorial Cohesion.

> **“ AN "INVESTMENT CLAUSE" WAS INCLUDED AS PART OF THE PREVENTIVE AIM OF THE STABILITY AND GROWTH PACT ”**

The challenge for the European Union is therefore to mobilise Cohesion Policy to ensure the maintenance of a level of investment that is conducive to supporting growth and employment in the framework of the Europe 2020 strategy, while pursing reform and fiscal consolidation measures. The projects targeted by public investment and co-funded by the Structural and Cohesion Funds falling under productive spending can in certain conditions be taken into account when assessing the fiscal position of Member States, notably when deciding to open an Excessive Deficit Procedure. It is with this purpose in mind that the "investment clause" was included as part of the preventive aim of the Stability and Growth Pact to allow Member States in specific adverse economic circumstances and in a context of increasing public investment to temporarily deviate from their medium-term budgetary objective or their required adjustment path. It meant to enhance the major role of the Cohesion Policy to support growth, as defined at European level, rather than only based on the needs expressed at regional level.

That is why additionality, which is a core principle of Cohesion Policy intended to ensure that the EU funds complement and not replace equivalent public expenditure, remains completely relevant. Its verification, which Member States are required to do, and that is an essential source of information, helped demonstrate that in the period 2007-2010 of economic expansion, the overall level of national spending on development in the Convergence regions was 7% higher than the level set at the beginning of the period. After 2010, this level dropped considerably and consequently there was a significant increase in the contribution of Cohesion Policy to public investment fostering growth. This drop led certain Member States to review their baselines for calculating additionality. For the 2014-2020 period the simplified verification process is closely linked to the economic governance procedures of the European Union, verification now integrating the room for fiscal manoeuvre of each Member State.

3. The effectiveness of Cohesion Policy increasingly reliant on the good governance of regions

Although the links between regional governance and local development are clearly established, there are two opposing schools of thought when it comes to these links. The first one considers good governance to be a necessary condition for development and the second, a by-product of development. The results of Cohesion Policy promotes adherence to the first approach.

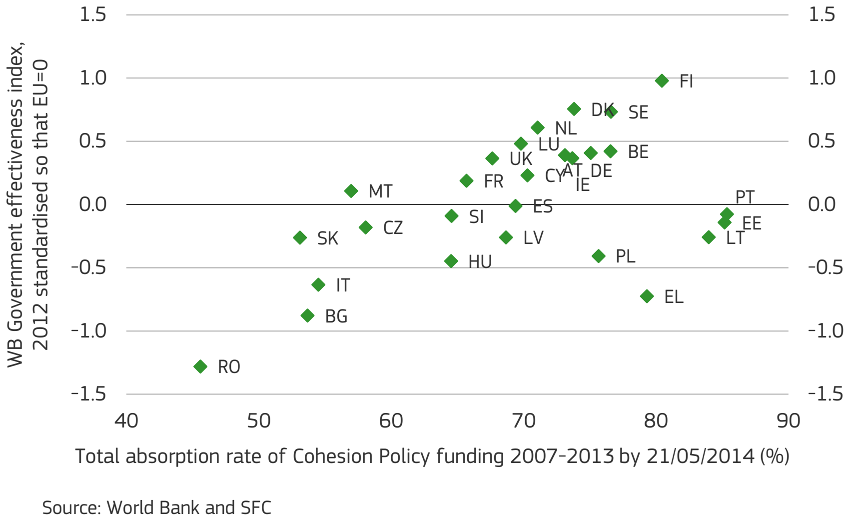
There are several definitions of good governance, from the ease of doing business to a broader approach. The broader approach takes into account the traditions and institutions by which authority in a country is exercised, the process by which governments are elected or appointed and their capacity to effectively formulate and implement sound policies in partnership with economic and social actors.

The Commission established a map of the Quality of Government Index by region in 2013. This map combines data from the World Bank established by country and those from a regional survey on the quality of governance dealing with public services in particular.

World Bank Governance Indicators measure six parameters: political stability, government effectiveness, regulatory quality, rule of law, control of corruption and voice and accountability.

On the basis of this set of indicators, the Commission established a link between good governance and the capacity to absorb European funds. Relating the rates of absorption of funding to the Government Effectiveness Index revealed that countries with the lowest index were those with the lowest absorption rate. There were thus seven Member States with a below average score for both government effectiveness and absorption of funds while 10 were above average. The 10 others, with the exception of one, were above average in terms of absorption rates while they were slightly below average with regard to government effectiveness. The Commission noted however that most of them were small countries, where a high absorption rate seems easier to achieve.

FIGURE 4 ► **Absorption of Cohesion Policy funding and Government effectiveness, 2014**



Source: Sixth Report on Economic, Social and Territorial Cohesion.

It concluded that many of the difficulties of managing Cohesion Policy problems experienced by certain Member States were of an administrative nature related to weak human resources due to their difficulty in managing the set of procedures on Cohesion Policy regulations. They are generally speaking systemic situations that should be resolved with improved administrative capabilities. When it comes to procedures, the Commission pointed out irregularities in the public procurement rules and government funds, irregularities that lead to suspension of payment and financial corrections.

In addition to this relating of good governance to the capacity to absorb funds, the Commission established a co-relation with results of Cohesion Policy in regions, analysed through its effectiveness and leverage effect. Although spending funds is a necessary step, it cannot be considered sufficient to ensure the effectiveness of Cohesion Policy on the economic and social development of regions. To this end, the Commission relied on a recent study that established a link between GDP growth in regions in the years prior to the crisis, Cohesion Policy expenditure and the quality of public administration. The results of this study revealed the link of this last factor with GDP growth. Therefore it was clearly shown that cohesion expenditure overall helped generate an increase in GDP in the least developed regions, even more so, at equivalent expenditure, in regions with good governance.

With an equivalent level of support from European funds, the GDP of some regions rose slightly, including over long periods, while it steadily increased in others, even if this increase slowed because of the crisis.

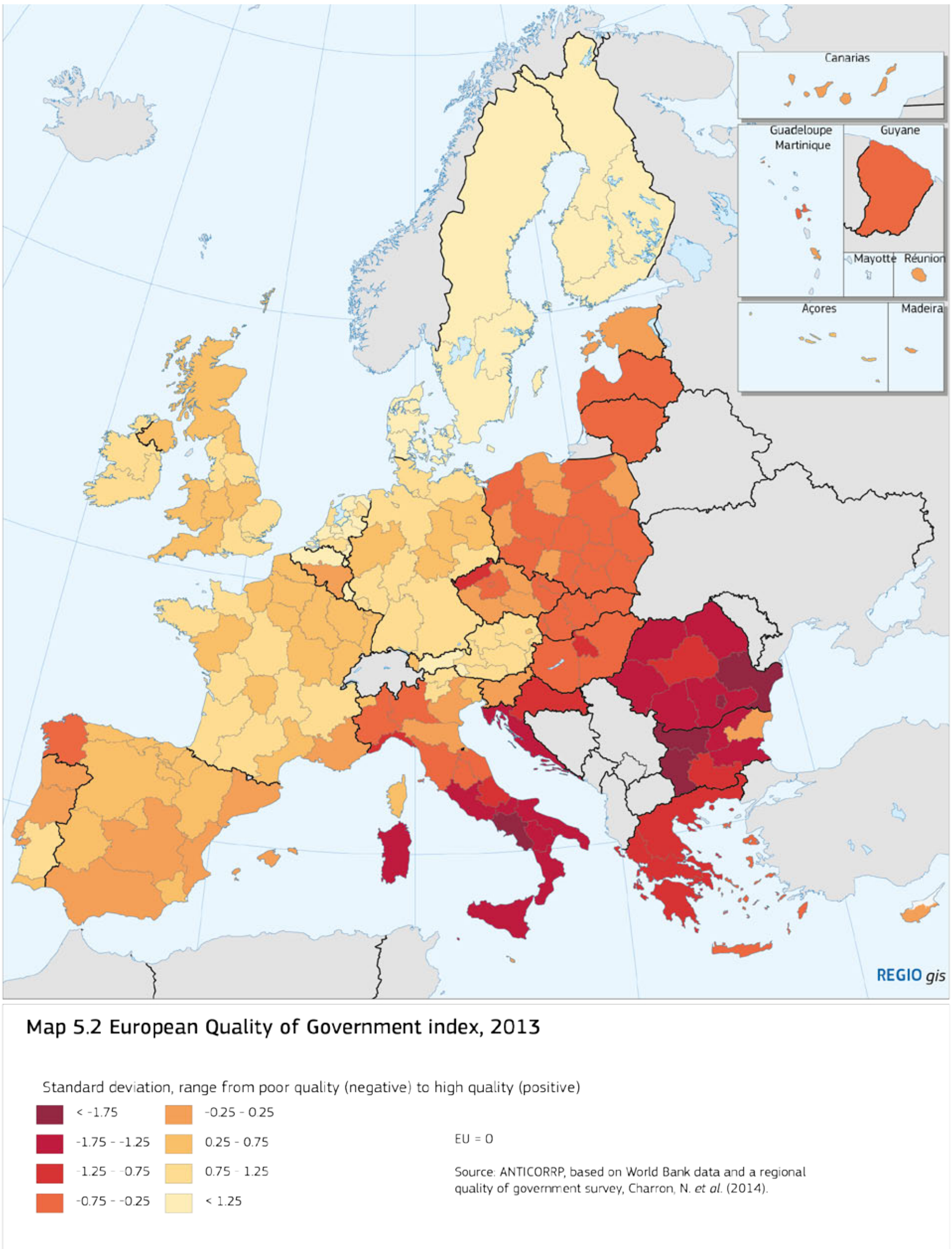
In this regard, causes can be sought for the relative stagnation of some southern regions for which convergence was much slower than for other regions, in particular eastern regions whose level of development continued to improve considerably up until the crisis.

> "IMPROVED QUALITY OF GOVERNMENT IN REGIONS IS A PRE-CONDITION FOR EFFECTIVE COHESION POLICY"

These various observations led the Commission to conclude that improved quality of government in regions is a pre-condition for effective Cohesion Policy. Conversely, it suggested that a mediocre governance system characterised by a slow decision-making process, badly organised consultations and a focus on short-term gains rather than a longer-term development strategy would curb its impact.

Good governance therefore emerged as an important condition for the proper implementation of European funds for the 2014-2020 period to guarantee their effectiveness. That is why it is one of the ex-ante conditions prior to the Commission's approval of programming documents.

MAP 1 ► European Quality of Governance Index, 2013



Source: Sixth Report on Economic, Social and Territorial Cohesion.

CONCLUSION

Conclusions drawn from the Sixth Report on Cohesion confirm, if there was still a need, that Cohesion Policy links with the EU's economic and fiscal governance in the context of today's challenges promoting growth and jobs need to be strengthened. The effectiveness of Cohesion Policy should still be improved. To this end, there seems to be three determining factors: the existence of sound macroeconomic policies, a favourable business environment and a strong institutional framework.

> "3 DETERMINING FACTORS: THE EXISTENCE OF SOUND MACROECONOMIC POLICIES, A FAVOURABLE BUSINESS ENVIRONMENT AND A STRONG INSTITUTIONAL FRAMEWORK"

These factors are directly related to the European Semester, Member States now being required to take National Reform Programmes and country-specific recommendations into account in funds programming frameworks. A connection can be made with the Annual Growth Survey 2015[2] published recently by the Commission that advocates three major guidelines to put Europe on the path of job creation and sustainable economic growth, investment, structural reforms and fiscal responsibility.

Since the financial and economic crisis, public investment has dropped dramatically. The level of investment in the United States in 2014 is close to that of before the crisis, yet this is not the case in Europe where levels of investment remain significantly lower than before the crisis. European policies are therefore more than ever, expected to preserve growth-enhancing investment, ie promoting education, research and innovation, greener energy, the modernisation of transport and environment infrastructures and the deployment of broadband connections. Cohesion Policy is now expected to play its full role in stimulating investment that enhances growth and jobs. The Juncker Plan, which is in line with this approach, is expected to contribute by taking action to foster investment likely to mobilise private funding.

However investment that is expected to help boost growth could be limited in its effects if the expected structural reforms are not made. That is why Cohesion Policy also intends to help Member States address the economic and social challenges they are facing by helping them implement the necessary reforms.

The Common Strategic Framework for Cohesion Policy 2014-2020 confirmed the direct link to establish between the implementation of funds and adherence to European economic governance. The macroeconomic conditionality introduced in this new framework must ensure that EU funds are effectively and efficiently used to implement long-term responses to these challenges rather than deal solely with issues in a short-term approach.

Finally good governance is clearly seen as one of the appropriate conditions to make Cohesion Policy more effective. But Cohesion Policy also aims to support government reform, provided that its support is part of a broader context of institutional stability and the ability of government to interact with businesses and citizens.

The regulations for the 2014-2020 period that were negotiated and adopted while the Commission's Sixth Report was being drafted anticipated to a great extent these elements drawn from the report stemming from the crisis. Moreover, the adjustments made by certain Member States after the crisis were already the ones found in new provisions.

2. European Commission, *Annual Growth Survey 2015*, Communication, COM(2014) 902 final, 28.11.2014.

Did these changes prefigure a reform of post-2020 Cohesion Policy? It is important to now start questioning the future of this policy. Without challenging its basic content in treaties relating to the objective of convergence between regions, a new role for Cohesion Policy is being supported that is more focused on structural reforms for Member States to conduct, reforms that are considered as support, if not a pre-condition for growth. And with this in mind, do current tools still work?

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NOTRE EUROPE JACQUES DELORS INSTITUTE
19 rue de Milan, F – 75009 Paris
Pariser Platz 6, D – 10117 Berlin
info@notre-europe.eu
www.notre-europe.eu

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