THE MACRO-ECONOMIC CONDITIONALITY, THE STORY OF A TRIPLE PENALTY FOR REGIONS

Marjorie Jouen | Adviser at the Jacques Delors Institute

SUMMARY

Despite constant opposition of the local and regional authorities (LRA) and mixed feelings of the national governments, a link between the effectiveness of the European structural and investment funds (ESIF) and good economic governance, in other words the macro-economic conditionality, has been introduced in the 2014-2020 regulation for the ESIF.

The critic against this link was based on the firm belief and documented explanation that this new provision will impose a double unfair penalty to the local and regional authorities as they are not responsible for excessive national deficits, since most of them are constitutionally bound to balance their budgets.

First, sanctions linked to deficits are likely to make the fiscal situation in the concerned member states even worst. Since current transfers and capital transfers from the national authorities are the key sources of revenues for LRA any cut will destabilise their budgets and hinder their capacity to contribute to public investment. Second, a suspension of payments and/or commitments of ERDF or ESF will not only disrupt financial planning at the programme level but could also lead to projects being stopped on the ground.

The Commission recently adopted guidelines to implement measures linking the effectiveness of the ESIF to sound economic governance. Among others, the communication details the content of reprogramming which may be centralised at national or European level, thus putting a third penalty on LRA.

As the debate re-opens in the European Parliament and other EU institutions discussing the communication of the Commission, the real purpose of the macro-economic conditionality should be questioned. Does it aim at ensuring sound economic governance or at preventing from multi-level governance?

In order to answer the question, this Policy paper comes back to the reasons for putting in place this conditionality and the three main critics it raises:

- The first part presents all the conditions imposed to ESIF in order to improve the quality of the European public spending, and the specificity of the macro-economic conditionality which existence is directly linked to the euro area crisis.
- The second part explores the inappropriateness of the link between excessive national public deficits and the management of the ESIF.
- The third part analyses the risk that threatening suspension of payments weights down on local and regional economies and investments.
- The fourth part questions the effectiveness of reprogramming as a method to give cohesion policy an anti-cyclical role.
TABLE OF CONTENTS

INTRODUCTION

1. Introducing conditions for the ESIF, as a response to the search for better quality European public spending 4

2. Excessive national public deficits and the management of the ESIF, an inappropriate link 6

3. Threatening suspension: a pointless risk that weighs down on local and regional economies and investments 7

4. Reprogramming, a questionable method for turning the cohesion policy into an anti-cyclical tool 9

ON THE SAME THEMES... 10

CONCLUSION 10
He 2008 financial crisis followed by the 2011 euro area crisis has resulted in a shifting of the tougher aspects in negotiations over the cohesion policy for 2014–2020. Instead of concerning the overall amount of the budget devoted to structural and cohesion funds as it did for the previous two programming periods, the debate among the European institutions got bogged down over the quality of public spending and the measures supposed to ensure the policy’s effectiveness and efficiency. And indeed in an effort to respond to concerns being voiced both by the European Parliament and by the Council, the Commission introduced a number of conditions into the framework regulation. While most of those conditions were instantly considered by the stakeholders (local and regional authorities, social partners, civil society organisations) and by the negotiators to be part and parcel of a process for improving the implementation of European funds, one of them, which goes by the name of “macro-economic conditionality”, was hotly disputed. Local and regional authorities, in particular, deplored the “double penalty” being thus inflicted on them, because they were not responsible for excessive national deficits but they were in danger of being penalised by a suspension of funding.

It was only in the course of the final trialogue that it proved possible to thrash out an agreement on the modalities for its implementation. One of the terms set for accepting the conditionality was that the Commission would explicitly state the manner in which it would apply the measures establishing a link between the effectiveness of the European structural and investment funds (ESIF) and good economic governance, in other words the macro-economic conditionality addressed in Article 23 in the framework regulation. To honour that commitment, the Commission issued a communication on 30 July 2014 announcing those guidelines.

Far from reassuring the local and regional authorities that were the party chiefly opposed to this conditionality, the communication appeared to increase the threat hanging over the managing authorities. In fact, the Commission explained in detail the content of the reprogramming that might occur if the procedure were to kick in. It explained that in order to meet the short deadlines and to ensure compliance with specific country recommendations, this reprogramming could be centralised, at least at the national level and at best at the European level. That announcement highlighted the basic inconsistency between the centralised approach of the EU’s economic governance and the multi-level approach that is a feature of the cohesion policy. Thus for local and regional authorities we are looking at the possibility of a third penalty looming.

As the debate on this communication gets under way again in the European Parliament and in the EU’s other institutions, we must ask questions regarding macro-economic conditionality’s true purpose: is it concerned solely with promoting good economic governance or is it an attempt to call multi-level governance into question?

After reviewing the economic and political context that prompted the Commission to propose the introduction of conditions in the ESIF framework regulation (part 1), we will be taking a look at the arguments put forward by local and regional authorities to justify their opposition to macro-economic conditionality. We will go on to analyse the issue of the link between the cohesion policy and economic governance (part 2), the implications of the threat of sanctions for local and regional economies (part 3) and reprogramming modalities (part 4).

---

1. Introducing conditions for the ESIF, as a response to the search for better quality European public spending

While the crisis may have fostered a propitious climate in the search for increased efficiency, this is rather a long-term trend. Since 2000 a number of measures have certainly been put in place to improve the quality and speed of spending, for instance a penalty in the shape of automatic de-commitment for sums not-programmed after two years, or the performance reserve handed out mid-term to reward those programmes that have been satisfactorily implemented. This reserve, which became optional in 2007-2013, has become compulsory again since 2014.

More recently, the European Parliament and the European Court of Auditors have goaded the Commission over the management of regional development programmes and the magnitude of the mistakes made by the management authorities. A series of procedural adjustments to make them safer and, at the end of the day, more effective have been proposed to enable local and regional authorities to successfully conclude their programmes. This laborious process has highlighted the importance of the implementation modalities, of the need for simplification and of the need to ascertain the institutional and administrative capabilities of the authorities in charge of these programmes.

In 2010 the Commission noted that the targeting of regional development programmes towards the priorities in the Lisbon Strategy had worked fairly successfully, but that implementation has progressed too heterogeneously in the various member states. In its Fifth Report on Economic, Social and Territorial Cohesion, it stated that “an alignment of rules on eligibility of expenditures across policy areas, financial instruments and funds would simplify use of funds by beneficiaries and management of funds by national authorities, reducing the risk of errors while providing for differentiation where needed to reflect the specificities of the policy, the instrument and the beneficiaries. […] In order to boost its effects, it is worthwhile further encouraging recourse to simplified methods of reimbursement, such as the standard scale of unit costs and lump-sum payments for subsidies introduced for the period 2007-2013”.

So while the definition of a common strategic framework for all shared-management funds – ERDF, ESF, Cohesion Fund, EAFRD and EMFF – hereinafter termed ESIF, responds to the entry into force of the Lisbon Treaty and to the recognition of the territorial dimension, it also meets the need for greater efficiency.

In addition to this, ex ante conditions were introduced on the strength of past experience which showed that “the effectiveness of investments financed by the Funds has in some cases been undermined by obstacles at the action and regulation framework and institutional framework levels”. The Commission now has to ensure, before any programme gets under way and in connection with the management authorities’ investment choices, that minimal regulatory or operational conditions are effectively in place in the country or region for a programme to be able to start and to be implemented.

The effectiveness of Structural Funds and their contribution to the creation of jobs and to economic recovery have also become major issues in connection with the 2014–2020 programmes. The preface to the Fifth Report on Cohesion was clear in this regard: “We all share an interest in a Cohesion Policy that brings results […] The link to the Europe 2020 strategy must be even stronger in the future. This requires putting in place good programmes, with clear conditions and strong incentives. Pre-conditions could require, for example, that investment in environmental infrastructure is preceded by a transposition of the relevant EU environmental legislation. Incentives would reward regions and countries that have performed well and reached agreed

---

5. Ibid.
European objectives.” This imperative has been translated into the ESIF’s goals, which must contribute not only to strengthening economic, social and territorial cohesion but also to smart, sustainable and inclusive growth embodied in a list of 11 thematic objectives.

Moreover, faced with the magnitude of the Greek public debt, the European institutions were eager as long ago as Spring 2010 to embrace the practices of such international financial organisations as the IMF or the World Bank enforcing tough demands on debtor countries, talking about “conditionality”: “The aim should be to establish fair, timely and effective incentives for compliance with the Stability and Growth Pact rules. Conditionality could be enhanced”.7

A few weeks later the Commission was to go even further, proposing that “in cases of non-compliance with the rules, incentives can therefore be created by suspending or cancelling part of current or future financial appropriations from the EU budget”.8 Two types of sanctions were envisaged: first of all, the suspension of commitments in the event an excessive public deficit was mentioned and secondly, the cancellation of commitments for year “n” in the event of failure to comply with initial recommendations designed to correct that excessive deficit. The Commission further specified that such sanctions would involve payments to member states, paid to co-fund shared-management programmes, rather than direct payments to the beneficiaries, as happens with the first pillar of the CAP and with research programmes.

Following an urgent meeting of the euro area Council on 21 July 2011, the president of the French Republic and the German chancellor addressed a letter9 to the president of the European Council calling for the closer coordination of national fiscal and economic policies: “Structural and cohesion funds must serve to bolster the crucial reforms designed to improve economic growth and competitiveness in the euro area. The macro-economic conditionality of the cohesion fund should be extended to structural funds [...] In countries benefiting from aid programmes, the Commission must automatically institute supervision to ensure that structural and cohesion funds support the macro-economic programme in the best way possible: it should also take part in the selection and implementation of the projects [...] In future, payments from structural and cohesion funds should be suspended in countries in the euro area which fail to comply with the recommendations of the excessive public debt procedure. These changes should be built into the new rules governing structural and cohesion funds proposed for the next multi-annual financial framework.”

In the framework regulation10, the very long article devoted to measures establishing a link between the ESIF’s effectiveness and good economic governance combines sanctions, threats and strengthened support. The Commission assumes the right to suspend all or part of the payments and commitments in the event a member state, despite using the funds better, nevertheless still fails to act effectively in the context of the economic governance process. Thus it indicates that it will be possible to “lift the suspensions and to make the funds available to the member state concerned again as soon as that member state adopts the necessary measures” and that “decisions regarding suspension will be proportionate and effective”, taking into account both the country’s economic situation and the very uneven impact that such a decision might have on the national budget. The reprogramming requirements concerns only the ESF and the ERDF but not the EAFRD or the EMFF, while the cohesion fund, for its part, has been subject to them ever since it was first set up.

---

2. Excessive national public deficits and the management of the ESIF, an inappropriate link

No sooner had the Commission’s proposal been submitted in October 2011 than it became the target of adamant opposition from the European Parliament, the Committee of the Regions and the European Economic and Social Committee. It sparked reservations in the European Court of Auditors\(^{11}\) and it prompted the adoption of very different positions within the Council\(^{12}\).

The Polish presidency report on the Council meeting of December 2011 clearly illustrates the substance of the dispute among the member states: “Delegations were divided on the applicability of the instruments proposed by the Commission – some of them found it necessary to ensure a stable macroeconomic environment for the CSF Funds, while other believed that macroeconomic conditionalities cannot be reconciled with the Cohesion Policy’s objectives. […] Many member states expressed doubts whether the principles of equal treatment and proportionality had been appropriately reflected in the Commission’s proposal […] Several MSs proposed applying macroeconomic conditionalities to other parts of the EU budget in order to ensure a level playing field.”\(^{13}\)

The transposition of the mechanism applicable to the cohesion fund raises a serious legal issue, because while the link between the objective assigned to the cohesion fund is meant to compensate for and to anticipate the imbalances linked to the implementation of the EMU and compliance with the Stability and Growth Pact is not open to question, that is not the case with the other funds.

Naturally, when the real estate bubbles burst in Ireland and Spain in the late 2000s, those in favour of a minimal European budget gleefully fuelled a controversy over the part played by the cohesion policy in the excessive debt of certain senior member states. Yet the cohesion policy cannot be directly blamed for the debts or for the excessive public deficits of certain member states, because the sums paid out by the EU have never been in excess of 4% of national GDP. And indeed that ceiling was reached only for a few years for Greece before 2004, while on average the contribution from structural funds has amounted to 2.5% of national GDP for the less wealthy countries (Spain, Ireland and Portugal). Where the new member states are concerned, since 2007 the ceiling has been altered to reflect the countries’ wealth, oscillating between 3.23% and 3.78% of national GDP. Ironically, the only thing for which one might blame the structural funds, on account of their leverage effect, is to have changed mentalities and prompted “nouveau riche” behaviour in beneficiary regions and countries\(^{14}\).

Unlike with loans from two donors, the EU’s payments under the ESIF are not pegged to any cyclical economic issue but to the implementation of policies benefiting all of the member states and to predetermined eligibility criteria linked to the level of development or the rate of unemployment, applied primarily at the subnational – and in this case at the regional – level.

Moreover, out of all the measures envisaged in Spring 2011, the Commission had tested the one consisting in linking the ESF programmes to a “structural reform conditionality”, in other words the devising of initiatives to pursue reforms in those areas affected by Council recommendations on the basis of Article 121(2) in the TFEU and of Article 148 (4) in the TFEU in the context of the European semester. That approach was abandoned in the face of widespread opposition based on the absence of any connection between national reform plans and partnership agreements. Indeed while strengthened coordination between the two European processes would be a wonderful thing, the timing simply does not match. A structural reform by its very nature


\(^{14}\) Marjorie Jouen, La politique européenne de cohésion, La documentation française, Paris, 2011.
takes a long time to produce any tangible effects and so those effects cannot be considered to be prerequisites for a regional development programme due to get under way concurrently with it. Moreover, the players or authorities responsible for the implementation and the result may not be the same people; the implementation of national reforms is largely out of the hands of the local and regional authorities that manage operational programmes.

To justify their opposition, local and regional authorities explain that this link rests on the mistaken assumption that they are equally as responsible for budget excesses as the national authorities. Retracing the impact of the crisis on subnational public finances, the Sixth Report on Economic, Social and Territorial Cohesion provides valuable information in support of their argument.

**“The deterioration in subnational public finances cannot be compared with that of the national budget”**

Most of local and regional authorities are obliged to balance their budgets in order to comply with constitutional rules. In fact, the EU-27’s overall deficit in the sphere of subnational public finances, which accounted for 0.1% of GDP in 2007, amounted to approximately 0.8% of GDP in 2009 and 2010. Even though the deterioration in subnational public finances is more marked in a certain number of countries such as Belgium, Spain, Finland and Germany, where the deficit rose by more than half a percentage point between 2007 and 2013, it still cannot be compared with that of the national budgets. Thus in 2013, in Spain and in Finland, the subnational deficit stood at approximately 1% of GDP, while in Hungary it was in surplus (2.6% of GDP), as it was in Greece, in the Czech Republic and in Bulgaria (0.4% of GDP).

The same applies to the subnational indebtedness level, because the rise in the public debt is due primarily to the activities of central government. The overall indebtedness of local and regional authorities without legislative powers remains well below the 10% of GDP mark in every member state. The only countries where indebtedness gives cause for concern are Spain, Belgium and Germany, and to a lesser extent also Austria.

It is clearly worthwhile distinguishing between the two categories of member states on the basis of their size. For approximately half of them, the national level matches the implementation level fairly accurately, but for the others, whose institutional setup is more complex, the implementation of cohesion policy depends crucially on local and regional authorities.

### 3. Threatening suspension: a pointless risk that weighs down on local and regional economies and investments

The suspension clause, which has existed for the cohesion fund since it was first set up in 1994, had never been implemented before January 2012. On that occasion it was invoked by the Council, which considered the Hungarian government’s efforts to lastingly and sustainably adjust its excessive public deficit to be insufficient. The Hungarian government was threatened, in the event of its ongoing failure to comply with the Council’s recommendations, with suspension of funding worth approximately one billion euro between then and the end of 2012. The threat, which was more political than economic in nature, was lifted during the year, amid widespread indifference, after Hungary had gone through the motions of implementing a few reforms.

---

While the Hungarian experience is not very convincing, the risk is not taken lightly by local and regional authorities, which recently voiced their concern in the course of an enquiry\textsuperscript{16} conducted by the Committee of the Regions. Its report shows that 57% of the local and regional authorities questioned consider that the application of the macro-economic conditionality creates a high-risk situation for the co-funding of programmes, while 32% consider it to entail a moderate risk, meaning that almost nine authorities out of ten consider it a risk factor.

Here again, the Sixth Report on Cohesion bolsters the argument of the local and regional authorities, which are responsible for approximately 33% of public spending – a figure that has risen by 2 percentage points over the past two decades (1995-2013) – in other words 16% of GDP. While their share differs from one country to the next on the basis of a country’s institutional setup, they play a far more important role than central governments in the provision of public services and, above all, in the kind of spending that is likely to foster growth as defined by the Commission itself in the spheres of education, health care, environmental protection, transport, R&D and energy.

An assessment of the crisis shows that local and regional authorities have been affected in three ways by budget consolidation measures adopted at the national level. First of all, those measures have seriously hampered their ability to contribute to public investment, which accounted on average for 2.3% of GDP in the EU-27 between 2002 and 2007 and has dropped to just 1.8% of GDP. Above all, this investment dropped in real terms by 7.2% in 2010, by 5.9% in 2011, by 3.3% in 2012 and by 8.6% in 2013. For some countries, such as Spain, the drop was higher than 22% per annum between 2009 and 2013, than 18% per annum in Ireland, than 16% per annum in Cyprus, than 13% per annum in Slovakia, and than 12% per annum in Portugal.

Secondly, given that current transfers and capital transfers from central government account for subnational authorities’ most important resources in most of the EU (the exceptions being Germany, Austria, Spain and Sweden), their revenue has been badly slashed, producing an immediate unbalancing impact on their budgets. The case of Spain’s regions has been even more serious because they have suffered a 62% decrease in their revenue in real terms following a major cut in transfers from central government (45%) on the one hand, and a substantial increase in regional transfers towards central government (from a mere 1.4 billion euro to fully 10.1 billion euro at 2005 prices).

And lastly, according to the OECD, budget consolidation measures have further reduced their investment capability and they have had to cope with a worsening of borrowing conditions.

In this context, the role played by the ESIF in public investment is crucial because from 11.5% of all public investment in the EU (GFC) in 2007, it rose to 18.1% in 2013. Its contribution accounted for over 75% of public investment in Slovakia (85%), in Hungary (74%), in Bulgaria (72%) and in Lithuania (80%). Over the period from 2007 to 2013, structural and cohesion fund allocations and their attendant national co-funding accounted on an annual basis and on average for approximately 0.55% of GDP in the EU-27. On a more general level, and in the light of these figures, the introduction of a threat to ERDF and ESF credits when a member state is in difficulty may seem like a contradiction.

\textsuperscript{16} Committee of the Regions, “CoR online consultation on public investments, growth and the national co-financing of ESIF”, 2014.
4. Reprogramming, a questionable method for turning the cohesion policy into an anti-cyclical tool

Reprogramming was broadly used by the Commission in the context of its plan for recovery in 2008 and over the following years, in particular in an attempt to speed up the return to growth in countries benefiting from aid programmes. It was a matter of trying to speed up the implementation of the cohesion policy for 2007–2013, thus in fact, it meant focussing on what had already been programmed. This approach led to a boost in the rate of European co-funding for cohesion policy, fishing and rural development programmes. The Commission also despatched task force groups to Greece and to Portugal in an effort to implement the measures provided for in the economic adjustment programme and to guarantee a more rapid absorption of European funds in technical terms. On the basis of this experience, in its communication on guidelines, the Commission has identified the modalities which potential reprogramming might follow between 2015 and 2019; it does not rule out the need to intervene in a centralised manner.

Once again, the Sixth Report on Cohesion provides figures that are fuelling local and regional authorities’ fears that they may be deprived of their role in the management of ESIF. In fact, the result of reprogramming that has taken place since 2009 appears to be a matter of concern for several reasons. The urgency of the situation has prompted the Commission and the member states to afford priority to projects already under way, in order to speed up the use of credits and to bring fresh money. These choices have made it broadly possible to increase the share devoted to R&D and innovation, to generic support for business, to renewable energy sources, to road and highways and to the labour market, with measures more especially designed to boost jobs for young people. Yet, on occasion, they have led to the abandonment of projects in sectors likely to foster growth such as digital services, investment in the environment, rail transport, education and training, and the strengthening of institutional capabilities.

This reprogramming has mobilised important human resources for the eight member states concerned, including those of the European Commission. As envisaged by the Commission for the future, it is in danger of being very costly and awkward to handle for national, local and regional administrations because it is going to have to be put into practice very rapidly. It is likely to have only a limited impact because it is going to be necessary to respect the concentration on the eleven thematic objectives and the balance between the ESF and the ERDF. It will generate an overdose of bureaucracy because it will entail the same obligations as for the drafting of partnership agreements (performance indicators, conditions and so on and so forth).

This guideline from the Commission raises a fundamental issue which cannot be only resolved by the establishment of a democratic watchdog mechanism such as the one which is currently being debated in the European Parliament and which would consist in subjecting reprogramming and sanctions to parliamentary supervision. The recentralisation, both at national and European level, that underpins the whole of the mechanism envisaged, with major interference on the Commission’s part, raises a major issue: it leads implicitly to a questioning of the principles of partnership and multi-level governance that underlie the cohesion policy and its primary added value over all of the traditional sectoral policies.
CONCLUSION

For many years, Jacques Delors with other Maastricht Treaty’s initiators described the EMU as a handicapped creature moving forward on one monetary leg because its economic leg was atrophied. At the same time, the cohesion policy thrived following very specific and original governance, taking advantage of the diversity of the Member States’ institutional organisations and the multiple levels of democracy inherited from the history of our European continent. Since 2009, having regards to the accelerated change imposed to the economic coordination, this handicap is less obvious: the EMU can now walk on its two legs. With the measures linking the effectiveness of the ESIF to sound economic governance, one may ask if it is possible to maintain the 20-years old peaceful coexistence between on the one hand the centralised macroeconomic and fiscal rationale of the EMU and, on the other, the decentralised microeconomic rationale of the cohesion policy. The Commission, as an EU institution, obviously has an interest in keeping in its hands all the EU policies, but is this interest really shared by all the people and socio-economic players living in very small villages and cities?