The Future of EU Cohesion Policy in a Time of Austerity

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WHAT'S NEW AND WHAT WORKS IN THE EU COHESION POLICY 2007–2013: DISCOVERIES AND LESSONS FOR 2014–20

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"The consequences for human welfare involved
in questions (of growth) are simply staggering:
Once one starts to think about them, it is hard
to think about anything else".
Robert Lucas, 1988

The Cohesion Policy challenge

From the economists' perspective there have been three major internal EU policy innovations since the mid-1980's.[1] First, a single market was designed in the mid-1980s and launched in 1992. Second, and with the aim of ensuring the success of the single market initiative, cohesion policy was completely redesigned and greatly expanded after 1989. Third, a single currency was adopted by most member states in 1999. The single market and single currency were systemic changes to EU economic governance whose implementation required detailed preparatory analysis and political will rather than big budgetary allocations. The restructuring of cohesion policy, on the other hand, required significantly increased financial resources, and these came mainly from reallocations of funds released by long overdue CAP reforms rather than from any greatly expanded EU budgetary envelope. Indeed, the resources available in the EU budget have shrunken in recent years when expressed as a share of EU GDP.

In preparation for the single market and single currency, massive, well-funded research projects preceded their launch and were used to explore all aspects of the proposed policy changes.[2] The results commanded wide acceptance and became instrumental in building consensus around the initiatives (Cecchini, 1988; Emerson *et al*, 1988; Monti, 1996; *European Economy*, 1990). However, no such research initiatives were carried out in the case of cohesion policy. On the contrary, cohesion policy has tended to muddle along, with the guidelines, rules and regulations being formed and reformed as the various EU budgetary programme periods came and went: 1989-93; 1994-99; 2000-06; currently 2007-13, and we now prepare for 2014-20.

There were both political and economic reasons for the absence of any detailed, rigorous and searching justification of and preparations for the new and expanded approach to EU cohesion policy. The political reason has been stated in fairly stark form by Tony Judt in his book *Post War: A*

[1] We regard the progressive EC/EU enlargements of 1982, 1986, 1995, 2004 and 2007 as "external" rather than "internal" developments.
[2] Recent troubles in the euro zone probably have more to do with unanticipated institutional deficiencies in the face of an unprecedented global financial crisis than with any failure of the original economic research.

history of Europe since 1945. In his analysis of the preparations for the single market, he concluded that:

> "In order to make the Maastricht conditions more palatable, cash bonuses were made available to recalcitrant governments: Jacques Delors, the Commission President, all but bribed the finance ministers of Greece, Spain, Portugal and Ireland, promising large increases in EU structural funds in return for their signatures on the Treaty" (Judt, 2005, p.715).

Although it may be overstated, if Judt's interpretation is even partially correct, then it goes a long way to explain the asymmetry between the systematic and intensive preparations made prior to the single market and the single currency and the more ad hoc approach to expanding expenditure on EU cohesion policy after 1989. The big debates on the single market and EMU were orchestrated by the Commission itself and served to galvanise all of the member states into thinking deeply about their justification and likely consequences. However, rather than staking out a central role for the European Commission in developing and clarifying all aspects of cohesion policy, the investigation of many deep questions was either ignored or – at best –put out to the market in the form of consultancy and academic studies. The legacy of this initial failure is still with us, particularly in the regular *Cohesion Reports* published by the Commission, where regional improvements tend to be subliminally and uncritically attributed to EU Cohesion Policy and failures are quietly swept under the carpet.

Although we are only four years into the current seven year EU budgetary programming period which started on January 1st, 2007, public discussion is well advanced on the nature of the next budget which is likely to cover the seven-year period 2014-2020. Since about one third of total EU budgetary resources are currently devoted to implementing cohesion policy, it is understandable that the donor states need to be reassured that their money is being spent wisely and used effectively to achieve their stated goal of promoting growth and convergence of standards of living throughout the EU. Moving beyond any altruistic desire to promote cohesion in <u>beneficiary</u> states, there has been increasing interest in the spillover benefits to the <u>net donor</u> states, a topic which, curiously, had never been the subject of much attention until recently.[3] More generally, there is increasing need to justify the continuation of EU Cohesion Policy funding at a time when all member states have suffered the consequences of global recession and are under severe fiscal pressure,

[3] See Bradley, Untiedt and Zaleski, 2009, for an integrated analysis of the direct impacts of Cohesion Policy on the "lagging" states and the consequences of cohesion policy-related trade creating spillovers on the "advanced" states, taking into account the economic costs to the "advanced" states of contributing to the EU budget.

requiring cut-backs in domestic expenditure programmes across the board as well as higher taxes and – in the cases of Greece and Ireland – massive financial bail-outs by the ECB and the IMF.

The problem

Design, implementation, monitoring and evaluation have always played a dominant role in EU Cohesion Policy. However, there has to be a proper relationship and balance between these activities. For example, specific questions of "evaluation" need to be nested inside a wider strategic debate on the intended role of Cohesion Policy. If evaluation is carried out in isolation, then there is a risk that it may degenerate into ever refined, technical investigations into policy initiatives that may be sub-optimal and/or misdirected at a more strategic design level and poorly implemented on the ground. Only when the strategic positioning of a nation's Structural Fund programmes is correct is it be possible to focus evaluation activities where they are most needed and where they will yield high returns and greater insight. Clarity at the strategic level of policy-making is an essential input into the more tactical level of policy impact evaluation.

Where do we stand with respect to these issues as we face into the renewal of Cohesion Policy for a fifth budgetary programming period? The design stage is probably the very weakest, since examination of the performance of lagging states, and identification of their development needs in terms of public investment and all other policy issues has been at best superficial and at worst practically non-existent. Implementation has been difficult for the new EU member states who were undergoing massive structural and institutional changes and who joined the EU at levels of development that were considerably lower than the older so-called "cohesion" states (Greece, Ireland, Portugal and Spain). Monitoring has been strong, perhaps even too strong, and problems identified by regular reports of the Court of Auditors have been relatively minor. Evaluation has been weak and – in our view - misdirected, an outturn that is closely related to the above mentioned failures at the initial design stage.

The official EC celebration of the first twenty years of Cohesion Policy hosted a debate between some of the senior EC officials who had overseen that policy since its transformation after 1988.[4] The issues were wide ranging, but a clear implication emerged, perhaps summarised best by a contribution by Jérôme Vignon (page 31):

[4] See "Looking back to 1988: A debate between officials of the European Commission", in European Commission (2008, pp. 26-36)

> "Two [...] elements which justified giving strong influence to the European Commission were the questions of evaluation and of additionality – which should assure the net contributors that the money would be safely used everywhere. I think one of the difficulties is that we have not been able to deliver on those specific innovations. 'Evaluation and added value' are large failures in my view and to demonstrate that we have been effective is not much reflected, for example, in the Cohesion Reports. The same is true for 'additionality'. Some of the bigger Member States have failed to deliver on this, and these facts have weakened our position".

A more nuanced version of this stark verdict was contained in the most recent *Cohesion Report*[5]:

> "Higher-quality, better-functioning monitoring and evaluation systems are crucial for moving towards a more strategic and results-oriented approach to cohesion policy. A number of changes would support this shift."

Our paper explores the challenge posed in the *Fifth Cohesion Report* both in terms of what it says (the need for better monitoring and evaluation systems) and in terms of what it does not say (the need for better ex ante design of Cohesion Policy). This is a tough agenda since questions of better design and evaluation take one into new and complex areas of economic policy research where much is known but little is settled. We examine these issues in terms of the specific complications posed by Cohesion Policy as it has unfolded over the past 22 years; the serious challenges posed by policy design issues; the search for criteria that can be used to select investment priorities; how evaluation can be rescued from its present confused state; and how Cohesion Policy can be linked better to national strategic thinking. We conclude with some recommendations on what we need from the next Cohesion Policy programme.

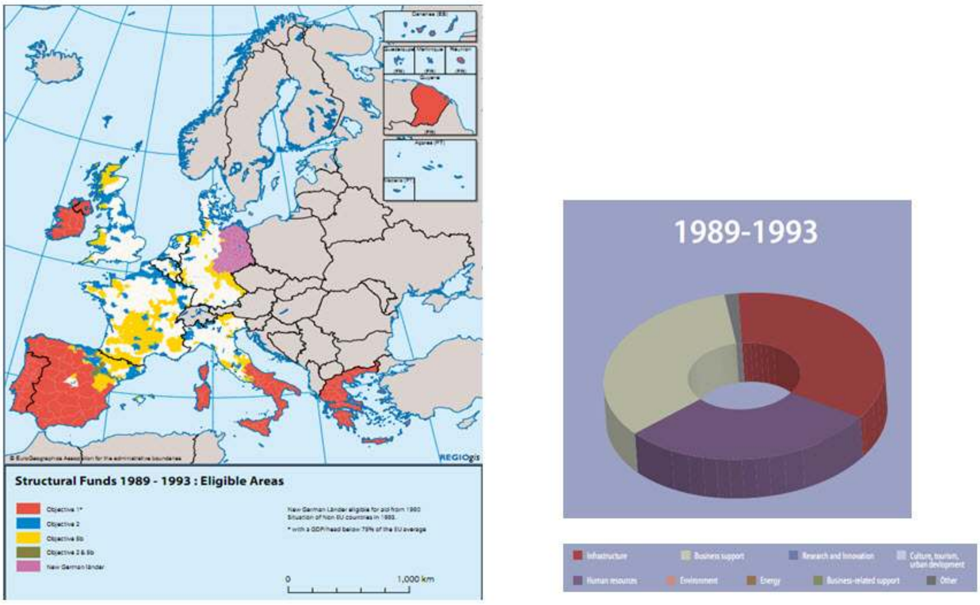
Complicating factors

As we try to learn from previous cohesion policy experience we face a major complicating factor. Not only have the policy goal-posts been constantly moved, but the football stadium has been relocated as well! This is best illustrated in Figures 1.1 – 1.4 below, where the changing investment priorities and the shift in geographical location is dramatically evident. This a complicating factor for many reasons. First, the institutional arrangements within the "old" cohesion states were already diverse, but all four states had functioning market economies and broadly appropriate institutions. The new member states, joining in 2004 and 2007, had made a painful transition from forms of central planning and their economic production structures were still adjusting to the consequences of free trade and integration into EU and global markets. Second, the levels of GDP per head in the new member states were, with few exceptions, considerably lower than those of the "old" cohesion states in the late 1980s. Third, the composition of investment shifted from a three-way split

[5] European Commission (2010, p. xv).

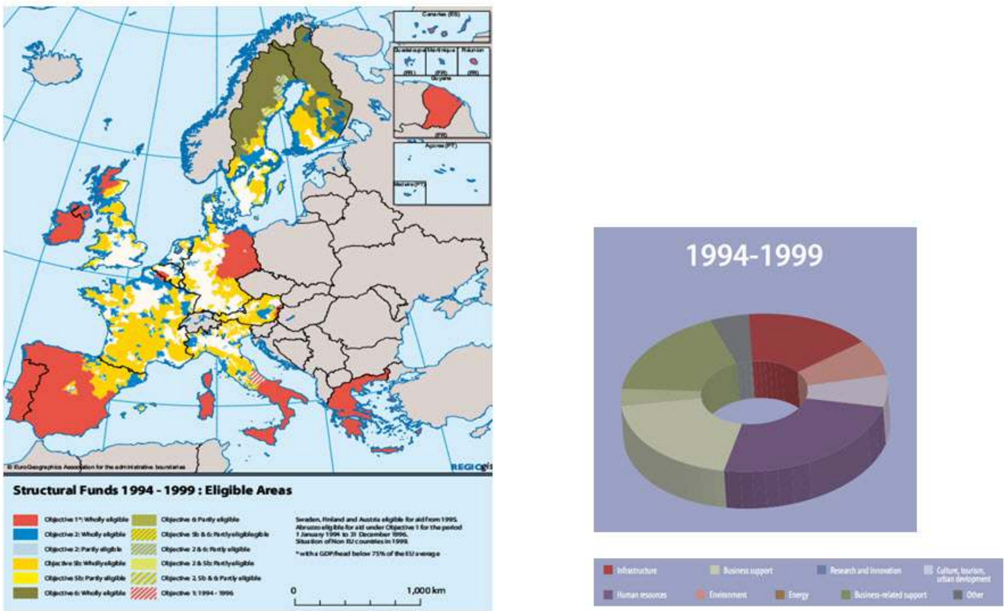
between physical infrastructure, human resources and direct aid to firms to a much more complex mix of categories that additionally targeted R&D and environmental issues. If knowledge of the likely impacts of the earlier investment mix was weak – and it was – then knowledge of the likely impacts of the more complex recent investment mix was almost non-existent.

Figure 1.1: Cohesion Policy 1989-1993



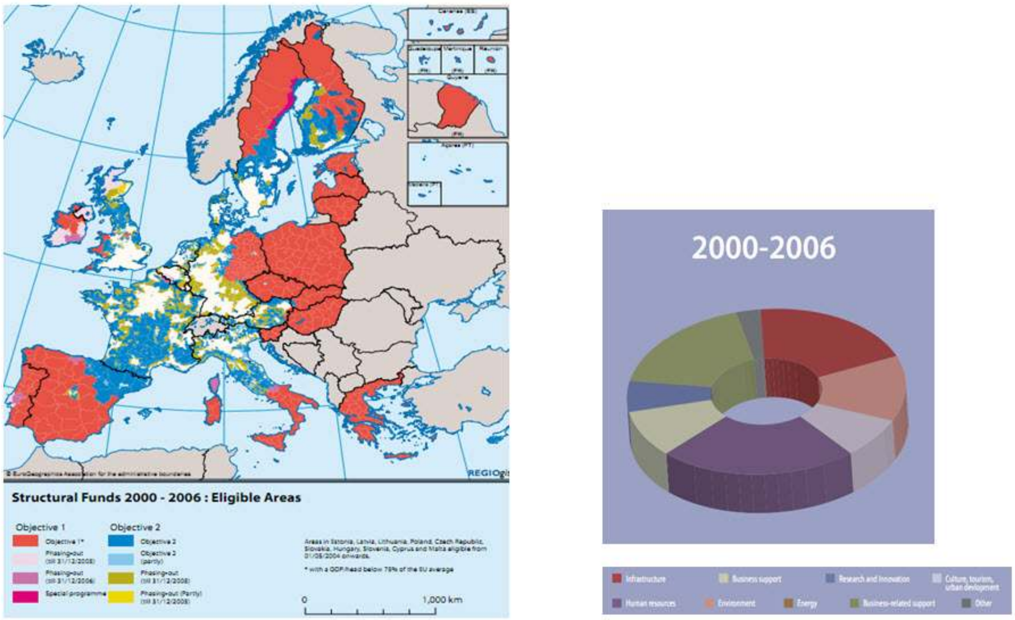
Source: European Commission (2008)

Figure 1.2: Cohesion Policy 1989-1993



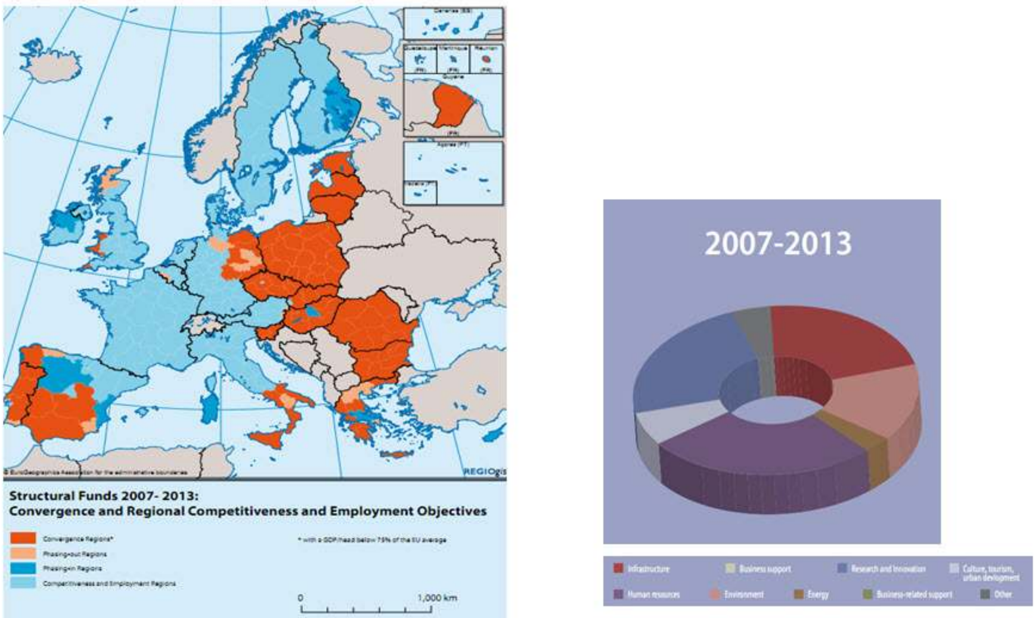
Source: European Commission (2008)

Figure 1.3: Cohesion Policy 1989-1993



Source: European Commission (2008)

Figure 1.4: Cohesion Policy 1989-1993



Source: European Commission (2008)

There were many other complicating factors that muddied the waters in our ability to understand cohesion policy in all of its sectoral and regional dimensions. In particular, research on and understanding of the "spatial" elements of economic policy was often lacking, even if great progress had been made since the pioneering work of Fujita, Krugman, Venables and others in the 1990s.[6] An important, if poorly understood, implication is that it is very difficult to define a policy "counter factual" for the evaluation of cohesion policy, i.e., how to examine a situation where cohesion policy was not implemented in order to be able to compare it with a situation where it was. A basic requirement for this to be possible is that we understand the functioning of the economy being studied – national, regional or urban – sufficiently well enough to be able to model its behaviour and to trace through the chains of causation that link policy instruments to policy consequences.

But perhaps the most serious complicating factor is that there are conflicting schools of thought on the drivers and characteristics of national and regional economic growth, and disputes can become acrimonious.[7] At the core of what is a complex debate is the question of whether responsibility and resources for development policy should be devolved to, and focus on regions (usually referred to as "place-based" policies) or should they be used instead to promote national development and better economic integration of lagging with leading regions (usually referred to as "people-centred" policies).[8] As with most academic debates, polarised positions tend to be adopted by the protagonists, accusations and mutual recriminations fly, and the blindingly obvious, pragmatic conclusion that policy needs to understand and embrace elements of both approaches tends to get lost in the heat and noise.

Back to basics in policy design and criteria

In its idealised form, the design stage of cohesion policy takes place within each state in receipt of Structural Funds (henceforth, "recipient" state), when national policy makers are supposed to examine the performance of their economy, identify development bottle-necks, and propose policy actions that are likely to relieve these barriers, where EU assistance will be used to finance the required investments. This process is overseen by the Commission in a partnership process.

However, in practice the reality is very different. In the case of the so-called "Convergence" states, where the entire economy is classified as "lagging" on the basis of GDP per head, there is a

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[6] Krugman's early, and very accessible 1991 book on *Geography and Trade* was the starting point of what is now a vast and complex literature on economic geography. However, this still remains a largely theoretical literature that is long on theory and plausible narrative but surprisingly short on robust policy guidance.

[7] For example, see the recent debate between Indermit Gill (a supporter of "people-centred", spatially blind regional policy) and Fabrizio Barca and Philip McCann (supporters of "place-based", regionally directed policy) in www.voxeu.org.

[8] The "place-based" approach to reforming EU Cohesion Policy was espoused by the Barca-led team for the European Commission (Barca, 2009), and now appears to exercise a major influence of European Commission thinking on the future of Cohesion Policy.

requirement to understand both national and internal regional development issues in order to identify barriers and obstacles to growth.[9] At the national level, the analysis of economic performance is sometimes carried out in a superficial and perfunctory way, and serves merely as a lead-in chapter to the national development plan that will set out the manner in which Structural Funds will be spent. It seldom focuses on the production or supply-side of the national economy. Rather, it focuses on the income and expenditure sides and is about spending rather than about producing. It examines how the national "cake" is divided between (say) public and private consumption, investment and exports, rather than how the "cake" is actually produced. We do not learn much about how output and wealth is being produced, or not produced: what sectors are growing and what sectors were in decline. In other words, it is usually an analysis that is completely inappropriate as a preparatory stage of cohesion policy design.

When the "Convergence" states turn to the analysis of the performance of their regions as a preamble to designing their regional Operational Programmes, they face even more complex challenges. In most of the new member states, regional accounts are incomplete and often unreliable.[10] The regions defined by administrative boundaries do not always coincide with regions defined as distinctive economic entities. It is even more difficult to understand the supply-side structure and performance of the region than it is to understand the national economy supply-side. Regional administrations often have very limited policy instruments at their disposal, and the power of these is always overshadowed by the much greater power and scope of policy instruments set at the national level. This is not to say that regions are completely powerless to influence their destinies, but it does imply that they have to formulate policy in the context of a spatially competitive market where the main terms are set at a national level and that they have very little autonomous power. These are only some of the practical realities within which the conflict between "place-based" and "people-centred" approaches to policy-making must be worked out.

The lack of focus on the performance of the supply side of the recipient economy can be attributed to the fact that most economic analysis and forecasting activities are preoccupied with the demand side of the economy. But the failure to come to grips with spatial issues on the supply side has other, additional explanations. The process of spatial allocation of investment resources is fraught

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[9] Under the "Competitiveness" criterion, certain regions of the advanced member states are designated specifically for regional aid. The issues that arise here are often similar to the regional challenges faced by "Convergence" states, but where domestic resources are much greater than in the less advanced states..

[10] For example, in a project to model the 16 Polish voivodships, it was necessary to generate and approximate many missing elements in the regional accounts (see Bradley, Tomaszewski and Zaleski (2005), for details).

with political difficulties, where equity almost always trumps efficiency.[11] A bridge in region A has to be compensated for by a road in region B and urban renewal in region C. Neighbouring regional administrations sometimes refuse to co-operate on policies that require pooling resources, co-ordinated planning and joint implementation. Consequently, identification of Cohesion Policy priority actions has tended to become an ad-hoc "shopping list" of investment projects lacking robust, rational integration with other national public policies, regional strategy and with other overarching national and EU enterprise strategies.

A Cohesion Policy programme, however well designed, can only be a part of a much wider network of policy actions that are likely to influence economic development and catch-up in a lagging state. In some states – alas, very few – the network of policies is brought together in a strategy that tries to link many diverse actions and objectives and to eliminate potential policy conflicts. Such strategic frameworks are no longer narrowly directed at "picking winners", since the state is known to have an abysmal record in doing so. Rather it is about using all the available policy instruments to bring about what might be called a "winning environment" in which businesses develop and prosper and households increase their standard of living.[12] We have never seen any national or regional cohesion programme where such policy links were clearly identified and in which the narrow set of Cohesion Policy actions were embedded in the wider set of encompassing national policy actions.[13]

The progressive "Lisbonisation" of Cohesion Policy simply risks adding more layers of misunderstanding in a context where a national development strategy is weak or entirely missing. The Lisbon Strategy had its origins in the late 1990s in the fear that even the advanced EU states were slipping behind the USA and Japan in their ability to innovate and transform as new waves of technology and globalisation became important. However, there was an inadequate understanding of the differing needs of the more advanced "donor" states (i.e., the EU member states making large net contributions to the EU budget) and the less advanced recipient states. The investment requirements of the latter were more basic and grounded in the need to improve physical infrastructure, increase effective human capital and foster a dynamic business environment, all at a time when their administrative institutions were undergoing dramatic change. It could also be

[11] For example, the Irish *National Spatial Strategy* was only published in 2002, half way through the third Cohesion Policy programme, and played a rather minor role in economic development planning.

[12] The kinds of enterprise-based frameworks that we have in mind are those of Michael Porter (1990) and Michael Best (2001).

[13] Perhaps the closest any country has come to embedding Cohesion Policy within a wider national development strategy is the case of Ireland, where decisions taken during the two programme periods 1989-1993 and 1994-1999 were very closely integrated with a strategy of export-led growth based on foreign direct investment. The fact that this strategy is still largely intact in spite of the catastrophic banking-induced recession is a tribute to its robustness.

asserted that “Lisbon”, however admirable in principle, has deflected attention away from the need to upgrade and improve the performance of “traditional” enterprise sectors towards excessive focus on “new” high technology enterprise sectors.

A final missing element in the design stage of Cohesion Policy relates to the need to justify the policy intervention in terms of cost. This was put succinctly by Honohan, 1997, in his path-breaking microeconomic evaluation of the second Irish cohesion policy programme:

> “Any formal project evaluation of the Structural Funds needs to be able to quantify the social cost of the main distortions and the social costs of additional public funds. The impact of the programme deadweight must also be quantified.”

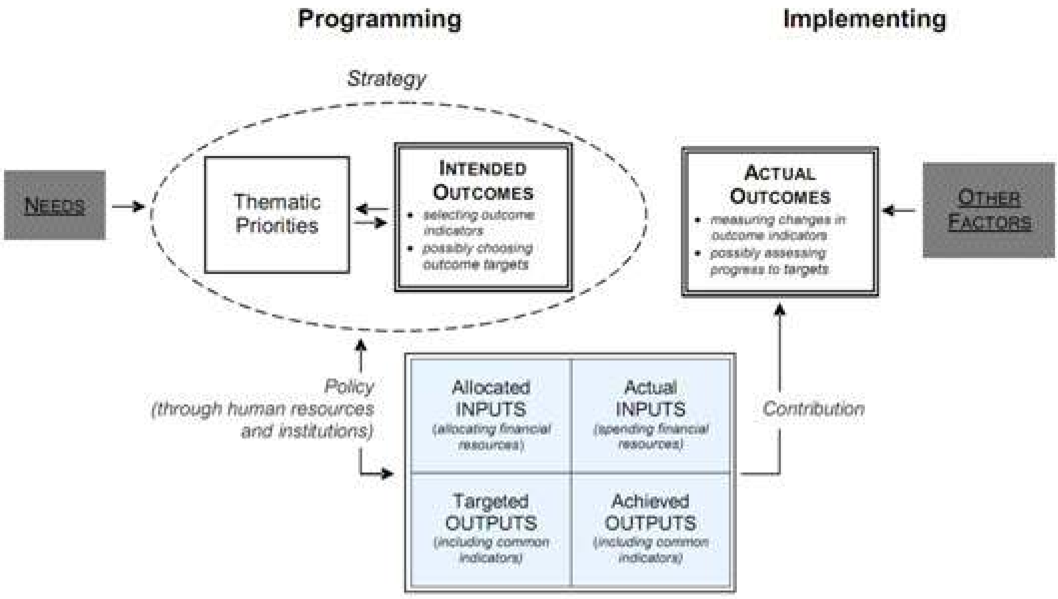
Honohan went on to propose a set of selection criteria that attempted to identify aspects of market failure that are the only underlying justification for public policy interventions (Honohan, 1997, pp. 72-133). This is an aspect of Cohesion Policy that has generally been neglected and such neglect makes it almost impossible to evaluate policy impacts, an issue to which we now turn.

Back to basics in evaluation

At its most basic, policy evaluation addresses the following question. If we implement policy action X, what impact is it likely to have on economic target Y? If policy action X was: “increase the rate of VAT by one percentage point”, then the implications for VAT revenue would be reasonably easy to approximate using a simple tax revenue model, or to predict more accurately using a more complex economy-wide macro-model in which the tax revenue sub-model was embedded. But when we try to predict the likely impacts of Cohesion Policy, we enter a far more complicated world.

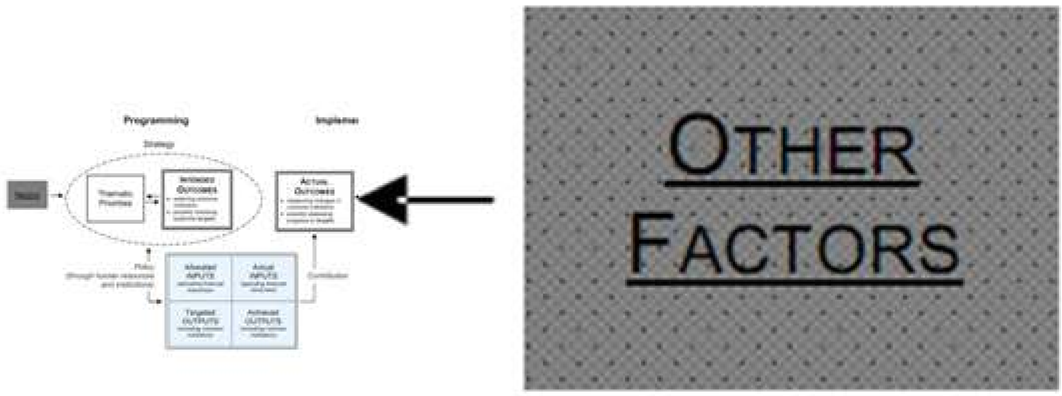
By way of illustrating the basic problem with most existing approaches to evaluation, in Figure 2.1 we reproduce a schematic diagram of the process of evaluation from a recent paper by Barca and McCann, 2011. This might be termed an “insiders” view of the evaluation process, where Cohesion Policy is the centre of attention. Focus is on an elaboration of indicators, of which 62 are listed in an annex to the Barca and McCann paper.

Figure 2.1: Barca and McCann, 2011: Cohesion Policy - Input, Output and Outcome Framework



Standing back from the details of Cohesion Policy in order to get some perspective, we have re-sized the Barca and McCann diagram in a way that we consider more accurately indicates what are the dominant drivers of economic development and cohesion.

Figure 2.2: Barca & McCann re-scaled to represent driving forces of cohesion processes



What we emphasise in Figure 2.2 is the simple fact that Cohesion Policy actions, however worthy or effective, are simply a very small part of the forces that bring about cohesion. A dramatic illustration of this is provided by the performance of our host country, Lithuania, which has suffered seriously as a result of the global recession. To be useful, any methodology used to evaluate the impacts on

Lithuania of its Structural Fund programme must also be able to disentangle this modest effect from the much larger impacts of what the diagram calls “other factors”.

There are many other aspects of evaluation that need to be emphasised. For example, cohesion policy is an intrinsically strategic and long term process that spans many separate EU budget programme periods. Portugal has benefited from four programmes, and is likely to benefit from a fifth. Yet the EC continues to insist that each EU budget period be evaluated in isolation from all others, even though there is considerable continuity as one programme leads to the next. This might make some sense in narrow accounting terms. It makes no sense at all in economic policy terms.

Many previous attempts to evaluate Cohesion Policy impacts do not distinguish between “implementation” impacts and “post-implementation” impacts. While programmes are being implemented, and investment expenditures supported by Cohesion Policy are being made, there can be significant demand-side (or Keynesian) impacts.[14] When the programme ends, and expenditures are assumed to cease, only supply-side impacts remain and can continue to benefit the economy for many years if “good” policies were implemented. Evaluation reports regularly conflate these two kinds of impact, and draw distorted and misleading conclusions.

Perhaps Cohesion Policy impact evaluation is at its weakest in the microeconomic area. The rigorous and logical micro analysis framework set out in Honohan, 1997, and elaborated by Bradley et al, 2006, has never been adopted or mainstreamed by the Commission. The “place-based” approach advocated by the Barca team is a very poor substitute. However useful the elaboration of “target” indicators is, as set out in Barca and McCann, 2011, the fact remains that we continue to be in the dark about how actual policy actions might be related to targeted outcomes. In the methodology described by Barca, 2009 and elaborated in Barca and McCann, 2011, evaluation degenerates in to a kind of elaborated monitoring procedure. For example, we may learn how many SMEs introduced product or process innovations, but we will still have little idea how this outcome was related to Cohesion Policy actions.

The serious weakness of microeconomic evaluation of Cohesion Policy actions has consequences for their macroeconomic evaluation. Here, use is made of structural macro models of various kinds. Economists still argue about which model is best, but there is wide agreement on many aspects and

[14] Economists argue about the existence and strength of Keynesian “implementation” impacts, although they tend to agree more on the “post-implementation” supply side impacts. See Bradley and Untiedt, 2008 for a treatment of this issue.

where model-based impact evaluations differ from each other, the differences can usually be reduced to differences of emphasis, interpretation of research and even ideological preferences. However, all macro model-based evaluations suffer from the paucity of good micro-based evaluation research and are forced to use approximations to quantify specific relationships between policy instruments (say, investment in physical infrastructure) and macro-sectoral impacts (say, increases in sectoral output or sectoral productivity). The paper by Bradley et al, 2006 develops this argument in more detail, but it remains an inherent barrier to improved and more robust evaluation of Cohesion Policy.

What do we need for the 2014-20 programme?

At the EU level, we believe that there is an urgent need to reverse what we might term the "Balkanisation" of Cohesion Policy into a multitude of policies that risk becoming incoherent or incompatible with each other. If the EU needs to implement policies that, however admirable, may have a limited role in directly promoting the catch-up of lagging states and regions, then it would be better to strip these out of the Cohesion Policy budget, operate with a smaller but more coherent Cohesion Policy, and build up other, new, non-Cohesion Policy areas that can be justified, implemented, and evaluated on their own specific terms.

Again at the EU level, there is an urgent need to clarify the benefits of EU-wide development for the so-called "net donor" states as well as for the "net recipient" states. We believe that Cohesion Policy is a positive sum game at the EU level, in much the same way as the Single Market is, or ought to be, a positive sum game. But until the process of evaluation of Cohesion Policy at the EU level is made more rigorous and far reaching, this will be very difficult to carry out.

Turning to the national level, there is an urgent need to integrate Cohesion Policy more closely into the full set of domestic policy actions, national and regional, that are likely to affect economic development. In this process, it will be important for governments to recognise that Cohesion Policy actions, however vital, are by no means the major policy input into promoting faster, sustainable development. It is often the case that responsibility for Cohesion Policy is separated into a specific policy group and isolated from more "mainstream" domestic policy considerations. There are even cases where responsibility is hived off to a line "spending" Ministry that runs the risk of being seen by the Finance Ministry as a "supplicant" rather than as a main actor in promoting development.

At the national level, the integration of Cohesion Policy with other relevant aspects of domestic policy carries the requirement to place the evaluation of Cohesion Policy firmly in the context of a wider framework of domestic policy evaluation. The obvious challenges to be faced in attempting to achieve this should not prevent an effort being made, since the likely benefits of an integrated policy framework could be very great.

Turning to the regional level, there is a need to explore politically and socially acceptable ways of acknowledging that some regions are likely to develop earlier and grow faster than others. This essentially comes down to the need to reconcile the increasing emphasis on “place-based” development policy with the additional insights and evidence from analysis of “people-centred” policy. This is a huge political challenge for national governments. It does not imply that national governments should ignore the benefits – moral as well as economic – of subsidiarity, i.e., devolving power to local actors. Nor does it imply that the unsustainable growth of huge metropolitan areas at the expense of impoverished rural hinterlands is inevitable or desirable. But governments who manage to leverage national development by initially harnessing the development potential of their most favoured regions (e.g., cities with their sophisticated education establishments; existing successful enterprise agglomerations; regions with good communication links to external markets, etc.) will quickly be able to generate the resources and the skills necessary to bring their less favoured regions into line.[15] The wrong way to do this is by uncritically devolving too much policy making power down to regions that may have conflicting priorities. It would also be wrong for the centre to retain all policy-making power and address cohesion issues exclusively by means of income re-distribution between regions, since this can engender long-term dependency of weak regions and hamper the resource-generating power of strong regions. For better or worse, “place-based” and “people-centred” policies have to act jointly and getting that crucial balance right will generate synergies that will best promote the achievement of the EU cohesion objective.

[15] An example, if an imperfect one, of this sequential development process is provided by the performance of the Irish economy in the period 1990-2000, before the catastrophic policy failures in banking regulation that led to a property bubble (Gill, 2010).

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