EUROPEAN PARLIAMENT

DIRECTORATE-GENERAL FOR RESEARCH

RESEARCH AND DOCUMENTATION PAPERS

A NEW STRATEGY FOR SOCIAL AND ECONOMIC COHESION AFTER 1992

Regional policy and transport
Series

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A NEW STRATEGY FOR SOCIAL AND ECONOMIC COHESION AFTER 1992

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with the assistance of
Alan Shipman and Malcolm Levitt

Foreword by Sir Donald MacDougall

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This study was carried out by an independent institute. It was commissioned by the Directorate-General for Research in the European Parliament's secretariat, but the opinions expressed are in no way binding on their authors and do not constitute the European Parliament's position.

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Preface
by Enrique Barón Crespo,
President of the
European Parliament

The question of the Community's cohesion in the period following the completion of the internal market is already one of the major questions faced by the Community's institutions and is likely to remain an important and controversial issue for many years to come. It is, of course, a point on the agenda of the current intergovernmental conferences, which – if not the most controversial – is certainly one of the most difficult to resolve.

There is, however, general agreement that cohesion needs to be seen in the perspective of efforts to raise the level of economic and social development of the Community's poorest regions towards the average levels prevailing in the Community. These efforts risk being overshadowed by recent developments in the Community's external environment, but they are of very great and increasing importance if the process of European integration is to be maintained.

The regional development of the Community's present – and future – Member States is certainly an issue which is also of great interest to the participants in the Second Conference of the European Parliament on 'Regions of the Community' which takes place in Strasbourg from 27 to 29 November 1991 and whose proceedings I shall have the honour to open.

The European Parliament, aware of the growing role which the regions are called upon to play in the future development of our continent, wishes to contribute to the clarification of the debate.

It was in the knowledge of the interest on your part and of the important place of cohesion on the agenda of the Conference that I requested the Directorate-General for Research of the European Parliament to commission an outside institute to carry out this study, which we hope will now be of assistance to your discussions in this field. We asked Sir Donald MacDougall, who chaired a study group for the Commission of the European Communities on the role of public finance in European integration, to advise us in this work. The report produced by his group in 1977 is widely acknowledged to be of classic importance in this field and has formed the basis for all subsequent discussions. Sir Donald assisted in the preparation of the terms of reference for the present study, commented on an interim version and produced for the Parliament the foreword which follows this preface.

The National Institute of Economic and Social Research of London was selected to carry out the study on our behalf, following a call for tenders. The work has been carried out to tight deadlines under the supervision of the Parliament's Directorate-General for Research. However, the National Institute has been encouraged to produce independent recommendations which are, of course, entirely its own responsibility. The European Parliament and its Committees have not yet had the opportunity do debate this study, but I believe that it constitutes a major contribution to work in the field of cohesion. The National Institute has an excellent reputation and the principal researchers responsible for this document have a wide experience of preparing studies in this and related fields. Other similar institutes in several other Member States were asked to contribute and have had the opportunity to comment on the study and its conclusions.

Foreword
by Sir Donald MacDougall

This study was commissioned by the Directorate-General for Research of the European Parliament at the suggestion of President Barón Crespo. I agreed to the President's request, that I should assist Parliament in drawing up the text of the specification for the study, in reviewing the interim report and in writing this foreword.

The study is one of a series on regional policy commissioned by the Directorate-General for Research as part of its external studies programme. Together with studies on 'The regional impact of Community policies' by the Deutsches Institut für Wirtschaftsforschung (DIW) in Berlin and on 'The impact of 1992 and associated legislation on the less favoured regions of the European Community' by the Institut für Wirtschaftsforschung (IFO) in Munich, it forms a trilogy of studies prepared for the Second Conference of the European Parliament on 'Regions of the Community', to be held in Strasbourg in November 1991.

The theme of the Conference is 'The regions of the Community and economic and social cohesion on the eve of the completion of the internal market'. Cohesion is a subject of very great importance for the European Community at this time and is also an important issue in the work of the intergovernmental conferences on political and on economic and monetary union which should draw to a conclusion this year.

Cohesion is, however, not a new issue even if the word itself has come to the fore in Community parlance only recently. The original signatories to the Treaty of Rome stated in 1957 in the Preamble to that Treaty establishing the European Economic Community that they were 'anxious to strengthen the unity of their economies and to ensure their harmonious development by reducing the differences existing between the various regions and the backwardness of the less favoured regions'. Although the market forces released by the creation of the Customs Union and by the legislation creating an 'Economic Community' have helped to bring about a transformation of the European economy, including its least-favoured regions, the gap in living standards between richest and poorest remains very large; both economically and politically this could represent a real threat to the single internal market and to economic and monetary union. This is a fundamentally important fact which must be faced by the authorities of the Community at all levels.

The role of public finance, and in particular of the Community budget, is therefore a crucial factor in creating the climate of mutual confidence necessary for progress towards European Union, the objective proclaimed regularly by Heads of State or Government meeting in the European Council. This progress had been the subject of four major reports – the Werner Report of 1970 on the implementation in stages of Economic and Monetary Union in the Community,[1] *the report in 1977 of the study group on the role of public finance in European integration,*[2] *which I had the honour to chair (sometimes referred to as the 'MacDougall Report'), the Padoa-Chioppa Report of 1987*[3] *and the Delors Report of 1989.*[4]

The social and economic cohesion of the Community is now the main theme of Parliament's Conference on the regions – and in particular is the subject of a draft report prepared for the Conference by the Committee on Regional Policy and Regional Planning, with Mrs Izquierdo Rojo as rapporteur.

The present study by the National Institute of Economic and Social Research of London is a most useful contribution to the debate on cohesion in the Community and the development of regional policies. It covers a great deal of ground, is highly informative and helps to clarify many of the complex issues involved. It sets out, in a well-balanced way, the arguments for and against the numerous possible ways of achieving greater cohesion, and makes many interesting suggestions.

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[1] *Supplement 11 to* Bulletin of the European Communities, *No 19, 1970.*
[2] *Studies collection of the Commission of the European Communities, Economic and financial series, No A 13, 1977.*
[3] *'Efficiency, stability and equity: a strategy for the evolution of the economic system of the European Community', Commission of the European Communities, Brussels, 1987.*
[4] *'Report on economic and monetary union in the European Community', Committee for the Study of Economic and Monetary Union, Office for Official Publications of the European Communities, Luxembourg, 1989.*

It rightly regards cohesion as much more than convergence of inflation and interest rates and of budget balances. There is an apt quotation from the Delors Report:

> *'If sufficient consideration were not given to regional imbalances, the economic union would be faced with grave economic and political risks'. (p. 18)*

One might add another quotation from the same report:

> *'The permanent fixing of exchange rates would deprive individual countries of an important instrument for the correction of economic imbalances'. (p. 16)*

The present report makes a powerful case for stronger regional policies in the Community. It paints a worrying picture of the outlook for many of the less prosperous regions (and of some areas, hitherto relatively prosperous, but likely to lose ground); and of the possible adverse effects on them, relative to the rest of the Community, not only of the single internal market and the transition to EMU, but of a number of other unrelated developments likely to occur in the 1990s.

The authors, rightly, do not refrain from discussing a number of possible measures that seem to them unlikely to be acceptable in the foreseeable future, either for political reasons or because they would involve excessive demands on Community funds; some of these might become feasible at a later date, for political attitudes change – and may indeed need to change if the degree of integration hoped for by many is to be achieved. They include quite radical changes in the Community's agricultural policies, although the authors believe the most likely outcome, at least in the medium term, is that agricultural support will be 'held in check'; a Community unemployment fund, as proposed in the MacDougall Report; a Community-wide progressive tax on individuals or households, although they do propose an interesting new welfare fund to provide income support for less favoured households; abandonment of the concept of juste retour*; automatic transfers from richer to poorer regions on the lines of the German* Länderfinanzausgleich.

The report, however, concentrates in its final recommendations on measures designed to improve cohesion – or at least to reduce or prevent growing lack of cohesion – that would be consistent with a Community budget of 1¼ % of Community GDP, only marginally higher than at present, over the period to 1998.

Now the MacDougall Report suggested that in practice a much larger Community budget would be necessary to provide sufficient equalization of productivity, living standards and cushioning of temporary fluctuations to support a full EMU. We suggested a budget of the order of 5 to 7 % of Community GDP, but the precise figure does not matter in this context. (We took this view even though in theory unconditional transfers of much smaller amounts between the national governments of the richer and poorer member countries could have achieved the same reduction in inequalities in national per capita incomes as taxation and public expenditure did in the existing EMUs we studied.)

The size of the Community budget we proposed is not, however, necessarily inconsistent with the much smaller one assumed in the present report to be feasible in the medium term. First, the report also considers the possibility of more ambitious programmes, including a package of real, not just financial, objectives, with quantitative targets for reductions in regional disparities in such measures as GDP per head or unemployment levels which might well require a budget of considerably more than 1¼ % of Community GDP. Secondly, the report recognizes that its recommendations would go only part of the way to achieving cohesion, and proposes that later in the decade a thorough examination of possible mechanisms for more substantial interregional redistribution should be carried out.

A larger Community budget need not increase total public expenditure at Community, national and regional levels taken together to the extent that it consisted of a transfer of functions to the Community, e.g. through a Community unemployment fund; and in so far as favourably placed countries or regions paid more to the Community under any redistribution scheme they might, in the communautaire *climate assumed for a sustainable EMU, be prepared to cut back somewhat at least the growth of their public spending on things other than help to less favoured areas.*

I am attracted by the possibility, discussed in the report, that the European Investment Bank (EIB) might make a much greater contribution to the achievement of cohesion. EIB loans for regional development are already of the *same order as structural Fund grants for this purpose. The provision of 'soft' loans (subsidized by the Community), and possibly of venture capital (perhaps administered by a separate body), might make a substantial additional contribution, at relatively small cost to the Community budget, and thus lower somewhat the total required.*

In conclusion, I commend this report not only to the participants in the Conference to be held in Strasbourg in November 1991 but also to what I hope will be a much wider readership.

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Summary

Purpose

1. This research, undertaken by the National Institute of Economic and Social Research (NIESR) of London with a group of researchers drawn from right across the Community, was commissioned by the Directorate-General for Research of the European Parliament on the initiative of President Barón Crespo. The report on this work should be read alongside two companion pieces commissioned from DIW in Berlin on the regional impact of Community policies and from IFO in Munich on the regional impact of completing the internal market.

2. The NIESR report seeks to provide the background necessary for determining and formulating a strategy for social and economic cohesion in the European Community after 1992. It proceeds by defining what cohesion is and why it is important. In the light of an evaluation of the likely new pressures on cohesion in the 1990s and the success of previous policies, it explores the options for policy, looking at both the principles and how they can be applied in practice. Drawing on this analysis, the authors put forward their view of an optimal strategy for moving the Community towards social and economic cohesion in the 1990s. They stress the practical constraints on policy and the issues which have to be faced by the Community if it is to achieve its objectives.

Cohesion

3. Cohesion in the context of the European Community has no easy definition. It is best explained as the degree to which disparities in social and economic welfare between different regions or groups within the Community are politically and socially tolerable. Whether it has been achieved is thus largely a political question and the answer varies both across the Community and as time passes. However, objective indicators have a role to play both in determining absolute gaps and in formulating targets for addressing them. GDP per capita and the percentage of the workforce unemployed are the indicators most widely used, although in this report we conclude that these alone are inadequate criteria, particularly of social cohesion.

Cohesion is important

4. Cohesion has always been an objective of the Community and an explicit commitment is set out in Article 130a of the Single European Act. It is widely expected that this commitment will be reinforced as a result of the two intergovernmental conferences that are currently taking place.

5. Without adequate cohesion the process of integration in the Community may be slowed, halted or even reversed if less advantaged groups feel they can improve their welfare without some of the constraints of membership. The process of economic development is inherently unbalanced, with the competitiveness of some regions outstripping that of others for prolonged periods, often with a cumulation of advantage and disadvantage. Most nation States, while seeking to foster a high rate of growth, redistribute the benefits more equitably through taxation, public expenditure and direct intervention. Not only does the European Community lack such a redistributive mechanism, but disparities are greater than for most States and the process of integration tends to exacerbate them. As a consequence it has to pay more than usual attention to the problem of cohesion.

As the President of the Commission puts it in the Report on economic and monetary union (p. 18):

'If sufficient consideration were not given to regional imbalances, the economic union would be faced with grave economic and political risks.'

Cohesion will become even more important in the 1990s

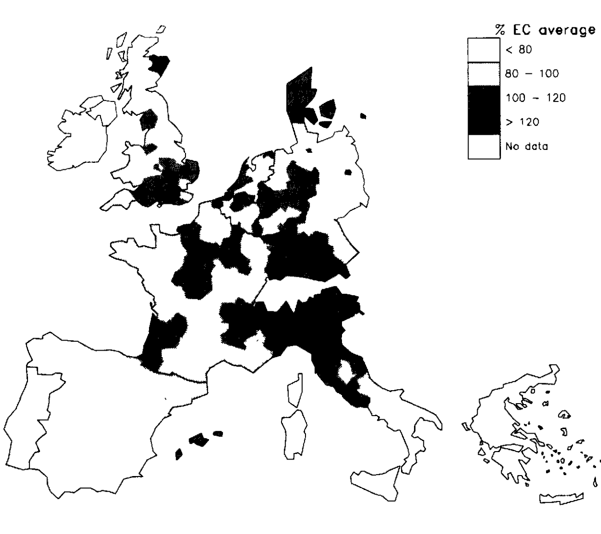
6. Although there has been some improvement in recent years, disparities shown on the map (see Figure 1) of GDP per capita have not tended to narrow markedly. As time passes, the less favoured tend to become more impatient for improvement. Events in the 1990s may well push the Community away from cohesion rather than towards it:

- completing the internal market reduces barriers between countries hence reducing the protection of the less efficient and increasing the importance of economies of scale and scope. This is likely to increase disparities;
- progress towards economic and monetary union imposes harsh conditions of convergence on Member States with problems of inflation, debt, internal and external imbalance, such as Greece and Italy, with consequences for their domestic ability to achieve structural change and to promote regional equality. Achievement of the required convergence

is likely to result in substantial unemployment in some parts of the Community. Within a monetary union, the inability to change the exchange rate may impose a greater unemployment cost for adjustment to external shocks for some regions;

- widening of the Community is likely to add to disparities as the applicants are at both ends of the spectrum of income per capita;
- the need to deal with the problems of Eastern and Central Europe may divert funds from existing purposes and increase the number of people in need, whom the Community should help effectively;
- demographic changes, notably the ageing of the population and the threat of substantial immigration from Central and East European countries, means that dependency on those in employment in the West will intensify;
- the environment, energy sources and transport are all likely to become more important in the 1990s, adding to the cost burden on those who are currently less well endowed;
- the escalating costs of German unification have provided a salutary lesson about the possible extent of the political and technical difficulties of achieving cohesion and the resources needed to put it right. They also tend to divert investment funds from elsewhere in the Community towards the former German Democratie Republic.

Figure 1:
Income per capita in the Community, 1989



7. Not all influences are adverse. The increasing pressure to reform the common agricultural policy, both from outside in the Uruguay Round and from inside, through rising costs of price support and the squeezing of the Community budget, should result in the reduction of the main element in the Community budget which actually redistributes funds away from many of the less favoured regions, thus increasing not diminishing some disparities.

Problems with existing policy

8. Although we are approaching the agreed target of doubling the Community's structural Funds and awaiting the mid-term review of progress, it is clear that current programmes, even though they result in transfers of 3 to 5% of the GDP of the countries with the lowest GDP per capita, will come nowhere near solving the lack of convergence in real incomes. It is not merely that spending on this scale, however effective, can only have a limited impact but also that there is no assessment of the efficiency of programmes in achieving cohesion. This may give scope for reallocating existing funds to more effect. Furthermore, the process of monitoring and evaluation used does not itself achieve the best practice amongst Member States. Problems of absorption and administrative difficulty mean that even the funds which are available are not taken up in full. Spending is concentrated on a relatively narrow range of physical infrastructure and human resource development projects. A widening of criteria for eligibility could assist in addressing social cohesion in particular through spending on areas such as health and education. Lack of involvement of the social partners means that the relevance and gearing of projects are not all that they might be. But most important of all, not only does two-thirds of the Community's budget not have the aim of redistibution towards the less favoured regions but much of it actually distributes resources away from them.

Principles for a new strategy

9. The underlying principles of a strategy for cohesion should balance equity and efficiency – the available funds should be applied where there is greatest need and the Community should be convinced that it is getting the best possible value for money in their application. At a minimum, equity should involve equality of opportunity. In an ideal world, the steps which the Community is taking in liberalizing markets to allow the free movement of labour, capital, goods and services under a regime which prevents the exercise of monopoly power and restrictive practices should ensure an efficient allocation of resources. However, imperfections in the market such as the immobility of labour through choice and the existence of economies of scale, scope and agglomeration mean that the opening of the market alone is insufficient to ensure that the benefits percolate to all parts of the Community.

10. There are two main mechanisms which can be used to try to compensate for these imperfections in order to provide adequate equity. The first is simply to redistribute the benefits to the less favoured regions by fiscal transfers, giving them the resources to raise the income and welfare of their inhabitants to a level relative to the rest of the Community which is sufficient to achieve cohesion. However, unhypothecated transfers of this magnitude are widely thought to act as a disincentive to economic activity and efficiency in the recipient regions, increasing the dependency on unemployment benefit rather than encouraging the seeking out of employment opportunities. At the same time the higher taxation required in the more favoured regions may also act as a disincentive. The alternative is to use specific transfers to try to achieve a structure in the less favoured regions which generates the capacity to compete on equal terms with the rest of the Community. This implies investment aimed at bolstering long-term economic performance, notably by improving the infrastructure in terms of public facilities, communications, information and the availability of finance and improving the quality of the workforce through education and training. While, initially, the emphasis is on the creation of such assets, subsequently it will change towards their maintenance, operation and repair.

The scope of policy to achieve cohesion

11. Achieving social cohesion requires more than economic measures, and extends the need for such structural support into health, social services and other facets of the enhancement of the quality of life. Experience from regional policy in Member States and elsewhere round the world shows that even this level of intervention will be insufficient to achieve cohesion and ultimately that there will have to be some element of fiscal transfers.

12. Creating a framework to enable a region to compete effectively involves far more than building structures. It also involves creating institutions. Innovation is an essential ingredient for success, since simply trying to emulate what is happening elsewhere is a recipe for being a permanent follower and institutionalizing less favoured status. Successful regional development tends to involve local R&D activities and the existence and close involvement of institutions of higher education and research. It also seems to involve a strong sense of partnership between sectors of the economy and between the various organs of government.

13. Emphasis on purely regional and economic indicators disguises some of the problems of social cohesion which relate to urban areas and disadvantaged social groups such as ethnic minorities. Identifying the need for action to achieve social cohesion requires social indicators, which may relate to facets such as the condition of the private housing stock, the provision of health services, literacy and mortality rates. In rural areas, sparseness of population and fragmentation of communities pose similar problems. This implies a wider range of objectives for the use of the structural Funds than is currently accepted in the Community and a more flexible determination of eligibility. Disparities which affect cohesion relate not just to levels of indicators but also to their rates of change. Areas which are in decline also feel lack of cohesion. They do not necessarily require the same sorts of intervention, needing resources to maintain rather than build up the economic and social infrastructure. Both absolute and relative disparities bear on cohesion. Targeting those in greatest need and focusing on programmes which deliver the greatest improvement in cohesion entail a detailed and complex programme.

14. Targeting at present is mainly on the basis of regions. However, it can be argued that it is those households that are most disadvantaged which are the real target and that spending is focused on regions because those households are regionally concentrated and that characteristics of those regions which can be altered by structural spending are responsible for the disparities. Furthermore, richer regions can be expected to solve their own internal disparities since they have resources to do so. However, targeting regions alone runs the risk that resources will be transferred from the poor in rich regions to the rich in poor regions. Hence even at this stage, the structural Funds can be supplemented by payments targeted on households. One means of doing this would be to have a social security fund. A second possibility that has been widely canvassed is an unemployment fund, whereby those in employment throughout the Community contribute to trying to improve the condition of those who are not. Normally this means expenditure on training and job creation rather than payments to the unemployed themselves.

Implementing the strategy

15. There are two prime concerns in trying to make sure that the limited funds available are applied effectively. The first is the need to ensure that the funds are properly administered and the second that the principle of subsidiarity is applied. These two may appear to conflict. Three mechanisms need to be employed to ensure that budgetary management is of a high standard. First, spending programmes need to be subjected to full *ex ante* appraisal, to establish their objectives, their costs and benefits relative to alternative projects and alternative ways of achieving the same objective. Secondly, projects need to be monitored in terms of tangible progress as well as payments. Lastly, *ex post* evaluation is necessary to ensure not just the legality of the spending but that it has achieved value for money by being used with maximum efficiency and effectiveness. The Community also needs to be convinced, as far as this is technically possible, that the funds are being used to add to domestically-financed expenditure in these areas, not to substitute for it. The idea of additionality is that the Community should enable achievement of what is not currently within the capacity of less favoured regions and the Member States within which they lie.

16. The Court of Auditors has complained of weaknesses in the past at both national and Community level in all three mechanisms and the Commission has raised doubts about the proper application of additionality by some States. These deficiencies must clearly be rectified as a matter of urgency. They are the responsibility not just of public administrations and the Commission but also of legislatures in providing a proper scrutiny of expenditures. For the Community as a whole, this is in part a role for the European Parliament and its Committee for Budgetary Control. The intergovernmental conference on political union may result in a strengthening of these powers.

17. It is clear that some regions have reached the limits of absorptive capacity and cannot use all the funds available. To some extent this is because of their own lack of fiscal capacity to provide matching funding and here there is a case for increasing the proportion of eligible expenditure from the Community budget if the money can be well spent. In other cases, it is a problem of lack of administrative and technical capacity in defining, running and evaluating programmes. In such cases, capacity can be increased by technical assistance, indeed it can be made a condition of the grant. A widely canvassed means of achieving this is through task forces in the field. Experience in other areas of policy such as small and medium-sized enterprises suggests that a task force in the Commission would be a possible means of ensuring rapid achievement of targets, separating political decisions from issues of implementation.

18. Trying to ensure efficiency through Community-level action and rules is only one facet of a successful approach. There are tiers of responsibility at Member State, regional and local levels. Successful programmes require not merely local knowledge and involvement, but motivation as well. The principle of subsidiarity, assigning responsibility to the lowest efficient tier, is one means of helping this but the principle of partnership between the tiers of government and the Commission embodied in the Community support frameworks needs to be extended and the role of the regional tier reinforced. Ultimately, it is the private sector which will make use of the improved infrastructure and greater workforce skills. It is therefore only prudent that they should be involved in defining the needs and where possible should have a stake in the enterprise to reduce the chance of creating assets which are of little benefit. Establishing the right relationship between the tiers of responsibility is clearly difficult, but the idea of an agreed contract between central and regional government on a plan for regional development with clear performance targets (as practised in France) might be an innovative means of trying to combine compliance with the objectives and flexibility in the means of execution. Similar performance contracts are used with considerable success in other Member States for providing equipment and services. There are clearly strong arguments which suggest that the most efficient treatment of regional problems requires a level of government low enough to be fully conversant with the variety of local needs and flexible enough to allow effective local methods of meeting them, while on the other hand being large scale enough to provide a full range of experience and technical and administrative competencies. These point to an enhanced role for regional government.

Paying for cohesion

19. It is unrealistic to estimate at the outset what a programme to achieve cohesion might cost because cohesion as a target will vary over the future and the behavioural responses to spending are highly complex. In any case, cohesion can be advanced by policies to reduce disparities as well as actual achievements in reducing them. It is also possible to invert the question and to explore (as the MacDougall Report of 1977 did) what most countries feel they have to spend to achieve it. National budgets represented about 40 to 50% of national income in the countries studied for the report, while federal budgets for countries using that structure were lower at 25 to 30%. On average the countries used interregional transfers, both specific and unhypothecated, to reduce outstanding disparities in GDP per capita by about 40 %. In 1977 it would have required a transfer equivalent to 2 % of Community GDP to reduce the disparity between the six richest and the three poorest Member States by 40%. The total Community budget consistent with achieving such a transfer would in their opinion have been 5 to 7 % of GDP in a 'federal' Community. With the accession of Greece, Portugal and Spain the task has become greater.

20. A figure of the order of 2 % still seems appropriate but with a Community budget currently only 1.2 % in total and likely to reach only 1.3 % by the end of the 1990s at current growth rates we are clearly not discussing an approach to cohesion of that degree of effectiveness. Roughly a quarter of the Community's current budget is spent on structural operations and less than half that spending goes to the four countries with the lowest per capita GDP (Greece, Ireland, Spain and Portugal). By comparison, just over half of the total budget goes on agricultural price support. There is, therefore, considerable scope for having a major impact on cohesion for the least-favoured regions and groups in the Community within the existing budget on its current growth rates. A target for spending on cohesion of 0.6 % GDP by the end of the 1990s, which would be more than a further doubling in real terms and thus be a relatively modest and attainable target, would reduce the disparities of the Objective 1 regions to 85 % of average Community GDP per head on current growth rates. However our view remains that the targets set for programmes should relate to the ultimate objective of improving cohesion and not to the means. Input targets, such as amounts spent or proportions of GDP, should not substitute for output targets such as real convergence.

21. The principle of equity also suggests that net contributions to the Community budget should follow ability to pay in terms of the resources of the Member States, perhaps along the lines suggested by the Padoa-Schioppa Report of 1987. At present, because of the structure of the common agricultural policy, there are two major departures from this: the Netherlands and Denmark, although well above average Community GDP per head, are net beneficiaries, while among the four lowest income Member States, Spain seems to receive a considerably smaller net benefit than might be expected. Even if the structure of the Community's expenditure programme is broadly preserved, these net budgetary concerns can be addressed to improve cohesion.

22. These inconsistencies can be addressed in a number of ways: by direct transfers between Member States in an equivalent of the *Länderfinanzausgleich* form of regional equalization in Germany; or by a change in the structure of spending and income raising. As the relative importance of agricultural price support falls, the latter will be achieved automatically.

23. There is a tendency to emphasize grant rather than loan finance in achieving cohesion but both are valuable in the process of economic development. Loans can perform two major roles which are not played by the commercial banking sector: firstly the European Investment Bank can provide lower cost finance because of their access to funds at the most favourable rates of interest. Such loans can be used for projects where there is a more direct pay-off and where public revenue can be obtained from the services which the investment provides, for example. Secondly, in the transition to economic and monetary union a number of pressures for adjustment are placed on Member States with higher budget deficits or inflation. Temporary assistance beyond that available through the mechanisms of the EMS would be valuable, subject to conditions in the same way that loans are provided to Member States by the IMF.

24. Since the purpose of Community funds is both to augment and to focus domestic expenditures on programmes of action it would appear sensible to include not just public sector sources of finance but the private sector as well. Gearing up public funds with private money would be not just a useful means of increasing the size and effectiveness of projects but a means of trying to ensure commitment and relevance to local economic and social needs. This indicates a more comprehensive and flexible concept of additionality than is used at present.

Proposals for a new strategy

25. In our view a suitable strategy to tackle the Community's objectives for cohesion after 1992 should contain six elements:

(1) An evaluation of existing policies, to ensure that funds achieve their maximum impact on achieving cohesion and give value for money.

(2) A development of the structural Funds to make them more effective and better targeted; even without expanding the range of objectives, existing funds can achieve a greater pay-off by being more closely focused on more precise indicators of local need.

(3) A broadening of the range of current objectives to increase social cohesion. There has been a tendency to focus on economic aspects of cohesion, in part because they are easier to measure and it is easier to show how they contribute to regional growth. Nevertheless, social aspects relating to the quality of life of all people in the Community, whether or not employed or seeking work, are an integral part of ensuring that Article 130a is applied and harmonious development achieved. The Community is for the benefit of citizens, not just some economic interest groups.

(4) A tightening of the administration, evaluation and monitoring procedures to improve accountability on the one hand and the operation of subsidiarity on the other. With limited resources, it is essential to ensure that they are used to their best effect and that administrative competences are available at all levels to carry through their impact on cohesion as soon as possible. Full participation by both public and private sector at local and regional level is required if the dynamism for inducing cohesion by indigenous growth is to be generated and sustained.

(5) The introduction of a new instrument to assist the poorest households in the Community. Current policy focuses on providing support for regional infrastructure, but cohesion also involves the welfare of citizens directly, and the next logical step in the development of policy would be to target new funds on the welfare of those people in greatest need.

(6) A reappraisal of the Community's budget to reform its structure towards a greater emphasis on cohesion; help with specific projects will only go part of the way towards achieving cohesion. The Community still has to grasp the challenges of an equitable system of fiscal transfers set out in the MacDougall Report of 1977 and refined 10 years later by Tommaso Padoa-Schioppa in 'Efficiency, stability and equity: a strategy for the evolution of the economic system of the European Community'.

A need for action

26. With the intergovernmental conferences presaging progress to economic, political and monetary union, the internal market nearing completion and the dramatic changes in Central and Eastern Europe, the Community not only needs to refocus its strategy for cohesion but it needs to do so forthwith before it is overtaken by events. Several of our recommendations can be implemented now – the tightening of administrative procedures, the development of task forces to ensure that programmes can be fully developed and taken up, the involvement of the private sector in development, implementation and financing, the evaluation of the relative merits of various structural measures. Others will be addressed when the conclusions of the intergovernmental conferences have been agreed.

27. A new five-year budgetary perspective is required for 1993-98 and this will provide the timescale for the implementation of most of our other proposals: the expansion of the scope of the structural Funds to have a greater emphasis on social cohesion, the creation of a new social security fund, the expansion in the role of the EIB and the provision of new lending facilities for Member States with transition problems for convergence to EMU. At the same time, the objectives of the Funds could be revised to target them more closely on needs, particularly of groups like those in urban areas that tend to be neglected by the present system. This new budgetary perspective could also bring a greater balance to net contributions by Member States to take account of their ability to pay.

28. During the same period, while the regions of the former GDR will have already been incorporated within the Community support frameworks, attention will have to be turned to the needs of the new applicants, whether from EFTA, Eastern and Central Europe or elsewhere.

29. Taking a rather longer-term perspective, the Community still has to come to terms with how it will approach cohesion more fully along the lines set out in the MacDougall Report. Our suggestions here only relate to immediate improvements that can be made within the existing budgetary framework and its trend development. That will not be enough to ensure cohesion and a quantum leap into interregional transfers will be required if the Community is to approach the more federal systems that have been outlined in the intergovernmental conferences. Current arrangements are not sufficient for economic, political and monetary union.

A target

30. Targets have been very successful in the Community in galvanizing action and support for initiatives, particularly in the case of the 1992 programme for completing the internal market and the doubling of the structural Funds in five years. We feel strongly that another memorable target is required for a policy of moving towards cohesion if this is to be perceived as a reality within the regions of the Community. It is tempting to pose this concept in terms of another financial target, such as a 50% increase in the share of Community GDP going towards cohesion during 1993-98. However, we have argued strongly in favour of output targets, not input targets, since the former do not have any requirement for the efficiency with which funds are financed. We suggest therefore that a real target is developed such as a reduction in disparities by 2% a year over a five-year period. On that basis it would take a decade to reach the halfway point of achieving a 40% reduction in disparities by Community action. On current policies a reduction of only 1% a year seems likely.

In short

31. There can be little doubt that the European Community will have to revitalize its approach to social and economic cohesion after 1992. Completion of the single market, progress towards economic, political and monetary union, the likely admission of new members to the Community and the need to deal with the problems in Central and Eastern Europe are just some of the prospective influences on the future development of the Community that can be expected to affect its cohesion. At the same time, different constituencies within the Community will have to be persuaded that it is ultimately in their best interests to remain part of the Community and to continue to work to achieve its aims. The increasing focus on social and economic cohesion testifies to the growing recognition that its achievement is central to the future of the Community rather than being simply a temporary obstacle to be overcome.

32. Yet, despite the explicit commitment to social and economic cohesion written into Article 130a of the Treaty, current efforts to secure cohesion are inadequate. The resources available to the Community are limited in scale and are not always used to optimal effect. Indeed, much of Community expenditure is spent in relatively more prosperous regions. Shortcomings in strategy, in coordination and in policy delivery diminish the impact of policy, with the result that there has been little success in narrowing regional disparities in the Community. We consequently argue in this report for a more comprehensive approach to the achievement of social and economic cohesion coupled with improvements in policy instruments.

33. We recognize in our proposals that achievement of social and economic cohesion is a long-term objective. Transformation of less competitive regional economies takes decades rather than months, while new sorts of problems are inevitably going to arise from time to time. Nor does cohesion imply that there should ultimately be complete equality and standardization within the Community; on the contrary, regional diversity is a strength that has to be sustained. Nevertheless, the guiding principle for a new strategy for social and economic cohesion should be the achievement of equality of opportunity for the regions of the Community as a basis for confronting the competitive challenges of the 1990s. More emphasis also needs to be placed on the identification and channelling of assistance to disadvantaged social groups.

34. We propose the following as part of a fresh approach to a strategy for social and economic cohesion after 1992:

- The focus of policy should be on the achievement of cohesion, and not on how much money is spent where. This will mean an enhanced role for regional authorities in setting priorities and in monitoring the effectiveness of policy.

- The resulting strategy should have plausible targets to be met within sensible time-frames and policy should be sufficiently flexible to adapt where necessary.

- The principle of additionality needs to be reviewed so that it is the total effect (including private-sector responses) of assistance that is monitored.

- A new instrument operating through the social security system should be established to target aid directly at disadvantaged individuals and households. In the longer term, an explicit mechanism for effecting interregional transfers is likely to be needed.

- The structural Funds should be empowered to intervene in improving social provision, as well as in building up infrastructure and human resources.

- Procedures for effective monitoring and, more importantly, evaluation should be introduced as quickly as possible, and where these reveal administrative shortcomings, task forces to provide technical assistance should be called in. Community-funded initiatives are needed to improve administrative capacity.

Glossary

Additionality

The aim of the structural Funds is to add to the expenditure of Member States or regional tiers of government for structural purposes. Additionality is a measure of the extent to which this actually occurs, and is meant to be a criterion for the authorization of structural Fund expenditure.

Comparative advantage

The principle of comparative advantage is that an economy will gain by specializing in the production of goods (or services) which it can produce relatively more efficiently than a trading partner, even if its productivity is below that of the trading partner in the production of all goods. The key implication is that, by agreeing to integration, both high and low productivity economies stand to benefit.

Competitiveness

Competitiveness is measured by the extent to which a company is able to offer goods or services which are more attractive to purchasers than those of its competitors. Lower operating costs, superior products, or a well-differentiated product are among the main attributes that enter into the competitiveness of a company. Exchange rates, wage rates and other aspects of economies contribute to their general competitiveness.

Conditionality

A grant-giving body or the issuer of a loan may impose conditions which do not necessarily relate to the direct use of the assistance. The International Monetary Fund, for example, has often insisted on structural changes as conditions for short-term loans for macroeconomic adjustment.

European Agricultural Guarantee and Guidance Fund (EAGGF)

The main instrument of the common agricultural policy (CAP), the EAGGF absorbs over half the Community budget. Most of this expenditure goes on providing guaranteed prices for farm products, with the balance going on restructuring aid.

Externalities

When a proportion of the costs or benefits of economic activity do not accrue to either the producers or consumers of the activity, they affect others not directly involved. Congestion or pollution are examples of external costs, while the opening of new transport facilities may yield non-user benefits to users of other forms of transport.

Financial perspective

The central feature of Community budgetary discipline is a five-year expenditure framework known as the financial perspective. This sets binding ceilings for total spending and the priorities for different categories of Community expenditure.

GDP

Gross domestic product (GDP) is a measure of what is produced in an economy. Although not an ideal measure of economic well-being, because it does not take account of transfers or factor incomes, it is widely used as a measure to compare economies.

Intergovernmental conferences

Two conferences on economic and monetary union and on political union are currently in progress. Their purpose is to pave the way for the negotiation of a new treaty which will be the basis for the next stages of European integration.

Länderfinanzausgleich

In Germany, there is a system of equalization payments between the 11 Länder of the former West Germany, which transfers income directly from relatively richer to poorer *Länder.*

Maghreb

The Arab countries of North Africa.

Market failure

Markets may not always produce outcomes which are socially optimal, for instance, if there is too short a payback period or where collective consumption makes collection of revenue difficult. Major infrastructure projects or education and training are widely held to be examples of investments that will be under-supplied by the market, necessitating public intervention.

NUTS

The Nomenclature of territorial units for statistics (NUTS) is a classification of regional boundaries in the Community. It is hierarchical, with three levels of spatial disaggregation defined, and the lower tier mapping into higher tiers.

Objectives of the structural Funds are sometimes used as shorthand for classifying types of regions:

Objective 1 regions are those judged to be lagging behind in their economic development, comprising all of Portugal, Greece and the whole of Ireland, parts of Spain and Italy, as well as Corsica and the overseas departments of France;

Objective 2 refers to industrial regions in decline, mostly areas of high unemployment in the northern countries;

Objective 5b comprises rural regions in northern Member States which have too high a level of income to be part of Objective 1 but which face difficulties in development.

Two further objectives (3 and 4) concern action on long-term unemployment and youth unemployment. Objective 5a is concerned with agricultural restructuring.

Own resources

The income of the EC comes from certain revenues raised by Member States which are hypothecated directly to the Community. The two traditional own resources are agricultural levies and Common Customs Tariff duties (27.7% of revenue in 1989). The main source of income is a charge on Member States' VAT receipts (58.5% in 1989). In the 1988 reform of the budget, a fourth resource based on Member State GDPs was agreed. This is only called in if the first three resources do not yield sufficient revenue.

Reservation wage

Unless wage levels are high enough to be attractive, workers will not be inclined to take job opportunities. The level and availability of welfare support will be a key element in setting this reservation wage.

State aids

Public-sector assistance to commercial undertakings which confer competitive advantage. As the Second survey on State aids reveals, these take many forms and are substantially greater in value than regional policy.

Structural Funds

There are three structural Funds which are intended to support the restructuring of economies. These are: agricultural guidance which is intended to support change in agriculture; the Social Fund (ESF), which supports training and initiatives to promote social change; and the Regional Development Fund (ERDF), charged with supporting less favoured regions through investment in infrastructure and in productive capacity.

Subsidiarity

The principle of subsidiarity asserts, to quote the Delors Report, that 'the functions of higher levels of government should be as limited as possible and should be subsidiary to those of lower levels. Thus, the attribution of competences to the Community would have to be confined specifically to those areas in which collective decision-making was necessary'.

Trickle-down or spillover effects of growth

A rise in the income of any region or social group usually gives rise to an increase in its spending. Some of this will flow to other regions or groups, so that a change which initially favours only part of the Community will 'trickle down' or 'spill over' to others.

Uruguay Round

Following earlier multilateral trade agreements under the auspices of GATT (General Agreement on Tariffs and Trade), an international body set up after the Second World War to promote free and fair international trade, a further round of negotiations was initiated in 1986 and is now known as the Uruguay Round. As well as trying to promote further liberalization of trade in goods (notably agricultural products), the Uruguay Round agenda includes negotiations on traded services and intellectual property rights.

1. Introduction: Why is cohesion a critical issue?

It is now generally accepted that the pursuit of economic integration in Europe can only be justified if mechanisms exist to ensure that the benefits of integration are widely and equitably distributed. This has been evident as the two intergovernmental conferences have proceeded, with the issue of cohesion moving steadily up the agenda. Failure to achieve a satisfactory accord on cohesion could ultimately jeopardize agreement on a new Treaty. Even if a new Treaty is agreed, inadequate action to achieve cohesion could undermine the development of the Community and conceivably lead to its disintegration.

There is an explicit commitment to cohesion in Article 130a of the Single Act which states that:

'In order to promote its overall harmonious development, the Community shall develop and pursue its actions leading to the strengthening of its economic and social cohesion. In particular the Community shall aim at reducing disparities between the various regions and the backwardness of the least favoured regions.'

It is plain from the various papers which have been circulated in connection with the intergovernmental conferences that the corresponding article in any new treaty will be at least as affirmative. However, despite the clarity of this commitment, it leaves open a large number of questions about what achievement of cohesion entails and what it means in social, economic and political terms. An important objective of this report is to review what is meant by cohesion, to assess what is required in order to make progress towards it and to consider what Community policy can do to further cohesion.

As explained below, Europe's medium-term economic development, assuming there are no major changes in the scale of policy support for less favoured regions, is likely to be unbalanced. The initial advantages of the single European market, economic and monetary union (EMU) and related measures are expected to accrue disproportionately to the more favoured Member States and the more prosperous regions within them. To the extent that it creates 'areas of excellence' in investment and innovation, making Europe more competitive on a world scale, this imbalance should enable more rapid growth in the Community overall. This could be in the long-term interests of the less advantaged regions as well as the favoured ones, but only if there are instruments to ensure that the benefits are equitably distributed. In the absence of policy action, a widening of economic disparities is, however, likely, with some regions, including some which had, hitherto, been favoured, losing ground. In the 1990s, many new factors beyond EMU, such as the changes in Eastern Europe, the possible accession of EFTA countries to the Community, pressures on European agriculture resulting from the GATT negotiations and a range of other factors can be expected to affect social and economic cohesion.

For these reasons, a fresh look at cohesion and at how to attempt to achieve it in the 1990s is timely. This report consequently reviews the objectives for a new cohesion strategy, considers what instruments are or could be used to pursue the strategy, and discusses problems of implementation.

1.1. Assessing the meaning of cohesion for the 1990s

It is useful to start by posing the question: What is cohesion? Fundamentally, cohesion within the Community is a political objective. Failure to achieve it carries the risk that the political will necessary to achieve European integration will be lost. Social groups, regions or Member States which conclude that economic integration does not yield sufficient advantages, may be tempted to opt out. Cohesion can consequently be thought of as the absence of an effective desire to do so, although it has to be recognized that that this is not a measurable phenomenon. More narrowly, cohesion concerns economic and social welfare. A simple definition is that it is the degree of disparity between different regions or groups within the European Community which is politically and socially tolerable. This, however, is only a starting point. It leaves open issues such as which indicators to use to measure cohesion and how to draw boundaries between relevant statistical populations. These will vary depending on which objectives are being pursued and on the weight that is attached to different priorities, although it is common to equate cohesion with convergence in per capita real incomes. Simply looking at income is an inadequate measure of social and economic well-being in the Community, since account also has to be taken of its distribution and of other aspects of the quality of life. Dynamic considerations also have to be examined.

In the context of the acceleration of economic integration that will occur in Europe in the 1990s, the dynamics of cohesion must be expected to be particularly important, since major restructuring will be engendered. It is a concept that will evolve through time: achievements that seem to go rather too far today may well seem inadequate 10 years from now. It might also be the case that there is an asymmetry between 'winners' and 'losers' of different types. A previously prosperous region which lost ground as a result of economic integration may be more sensitive to such a change than a region which had a long history of lagging behind. Cohesion, therefore, has to be seen as a concept open to multiple and changing interpretations.

1.1.1. Cohesion as a political imperative

Several of the political leaders interviewed in the course of this study have made the obvious, if easily overlooked, point that cohesion is not a prerequisite for economic integration. From a technical perspective, both a single market and an economic and monetary union (EMU) can function in a perfectly satisfactory manner without any policies to promote cohesion. It follows that it is political imperatives which are central to a search for cohesion, rather than economic necessity. Indeed, cohesion may even necessitate forgoing some potential gains to Community GDP. In view of the political and institutional circumstances of the Community in which there is mounting disquiet about the 'democratic deficit' (Martin, 1991) and in which a reappraisal of the roles of different bodies (the Parliament, the Council, the Commission, etc.) is taking place, the political dimensions of cohesion are especially important as the Community moves towards a new Treaty.

What are these? A first dimension concerns decision-making in the Community. Cohesion as a principle is closely bound up with equity, so that if major decisions are being made which affect the distribution of income, employment and welfare, different constituencies within the Community will want to be convinced that their voices are being heard. This implies that the form of democratic control of such decisions inevitably enters into the debate. A second aspect is citizenship and the sense of belonging to the Community. Being part of the Community implies rights – to social standards, to opportunities and to a share in the rewards as well as the obligations of membership. If inhabitants of less favoured regions are led to believe that there is no real economic advantage to them in belonging to the Community, they must be expected to doubt the wisdom of persevering. It is worth noting that this point may also apply to relatively favoured regions which feel they incur burdens or losses as a result of integration.

The economic and social disparities within the Community are much wider than those within most unitary States or federal systems and there is a much greater diversity of political traditions and administrative structures. Political solidarity must also be taken into account as a necessary condition for the creation of a structure for income equalization. The issue is that, although disparities in factor incomes in the Community might not be much greater than in another economy of similar size such as the USA, the absence of redistributive mechanisms means that differences in disposable incomes remain almost unaffected by integration in the EC, whereas they shrink in the USA, even though the latter is not known for the generosity of its welfare system. As the MacDougall Report (1977) showed, a system of budgetary-equalization transfers on the scale of, for example, Germany, would require revenue considerably in excess of the current Community budget. Since this would imply much larger levies than at present on richer regions, a much stronger political commitment to assist less favoured regions would have to be achieved for such a system to be feasible.

A third aspect of political cohesion is that the capacity of the Community to move forward and to take initiatives in its own right will depend on being able to win over support for its actions from its various constituencies. Cohesion is, therefore, an important element in assuring the legitimacy of the Community as a political entity, although its priority on the political agenda is open to doubt. Like 'motherhood and apple pie', cohesion is something that few oppose, but it is difficult to judge the depth of support for it. For some observers, cohesion could well be the rock on which the ship of EMU founders. Others regard it as a worthwhile target, but not one that should be allowed to stand in the way of progress. A critical political question, then, is what weight to give to cohesion relative to other policy targets.

A further political issue is 'subsidiarity' and its implications for accountability. As the Delors Report makes clear (p. 14), it is desirable for lower tiers of government to be responsible for policy unless there is a compelling case for a higher tier to be involved. Equally, higher tiers of government have a role to play in mediating potential policy conflicts between lower tiers. If economic integration threatens to remove effective control over key economic factors from the local, regional or Member State level of public administration, this in itself could undermine cohesion. Instead, there is a pressing need for all levels to be and to be seen to be involved in the political process. There is a difficult and delicate balance to be struck between central power in the EC and the maximum possible devolution of power to regional authorities. The tensions this engenders are graphically demonstrated by recent events in Yugoslavia and the Soviet Union.

Traditionally, it has been Member States which have been seen as the main protagonists in any dialogue about the Community. In the circumstances of the 1990s, however, the regional tier of the Community can be expected to play a more prominent role. Many of the effects of further economic integration will be felt at the level of the region rather than of the Member State, highlighting the need for the regions to be able to have a distinctive voice in any negotiations. In parallel, there has been a trend towards assertion of regional identities in many countries, suggesting that a more active role for a regional tier of government will be sought in the 1990s.

This, however, raises significant problems. One is that it is difficult to define what is meant by a 'region': should the criteria be administrative, cultural, economic, geographical or something else? Because models of government vary enormously amongst Member States, there is no common system of regional government in the EC. Whereas Member States have responsibility for an identifiable range of policy fields (macroeconomic policy, defence, foreign affairs, etc.), assignation of administrative competences varies substantially from country to country. Germany, for example, has a very devolved system, while in the UK it is highly centralized. For the regions to play a more meaningful role in addressing problems of cohesion, it is clear that a review of their role is important.

1.1.2. Economic cohesion

Conventionally, it is disparities in economic indicators – usually some measure of income per head or of unemployment – which are used to compare the welfare of different regions. Since cohesion is in large part concerned with relative economic welfare, economic relativities are bound to figure prominently in appraisals of cohesion.

A basic question, therefore, is the extent to which cohesion requires 'real convergence' (see Section 2.1) of social and economic conditions, the less favoured regions advancing relatively faster so as to close the gap with the more advantaged. Given the expectation that integration will not have a spatially balanced economic impact, some regions will, *ex ante*, enjoy a greater share of the benefits. Even if no region loses absolutely, therefore, there can be no presumption of convergence in living standards. Yet, for the process of integration to be effective in achieving higher rates of growth in the EC as a whole, unbalanced growth is almost certainly required: it is only because, to quote the 1985 White Paper (Commission of the European Communities, 1985), resources move to 'areas of greatest economic advantage' that the gains are realized in the first place.

This raises a number of problems concerning cohesion. First, it highlights the important question of whether cohesion is seen as an absolute or a relative concept. If it is the former, it would be sufficient for there to be net benefits to all regions from integration for cohesion to be served, even if disparities widened. But if cohesion requires that existing disparities should be narrowed, there would have to be some degree of convergence. It is important, in this regard, to consider which relativity to use in measuring disparities, as these could be:

(a) Ratios of the level of an indicator in favoured and less favoured regions;

(b) absolute differences in the relevant indicator.

Achievement of cohesion could well be affected depending on which concept is chosen. It is possible, for example, for the ratio of incomes in different regions to narrow at the same time as the absolute gap widens. A scenario in which disparities narrow, but in which overall gains are lower can also be envisaged. Would this be more or less cohesive? In the end the answer must rely on a value judgement, although a view attributed to the late Professor Saraceno of Svimez provides useful guidance:

'It is better for the South of Italy to grow rapidly, though more slowly than the Centre-North, than for the South to grow slowly, but more rapidly than the Centre-North.'

A second dilemma is whether policy should seek to stimulate activity (whether by supply-side improvements or by aids to enterprises) in uncompetitive areas, since this carries the risk of negating the favourable effects of integration. If taxes in competitive regions have to rise in order to subsidize the output of less competitive firms, the outcome could be lower aggregate output. On the other hand, unbalanced growth could lead to unemployment of factors of production. Indeed, one of the main arguments for regional policy is, precisely, that it enables idle resources to be activated.

The prospect of loss of activity further implies that, for the less competitive regions, there is little point in proceeding with integration unless there is some prospect of gain. To forgo protection or to adopt macroeconomic policies which cause losses of output may, in the long term, be beneficial, but the short-term price may not be worth paying. Regions which stand to lose from integration must, consequently, be persuaded that any short-term losses will be limited in scale and duration.

1.1.3. Social cohesion

Social aspects of cohesion are altogether more difficult to pin down than the economic, since it is far from easy to reach a consensus on objectives or to obtain relevant comparative indicators. The word 'social' is also open to varying interpretations. In some countries, the emphasis is on interactions between the social partners – the State, the employers and organized labour. In other countries, the concern of social policy is more with disadvantaged groups. The term is further confused by the debate on the Social Charter which aims to promote common standards in areas such as conditions of employment or workers' rights.

There can be little doubt that economic integration will cause social change whichever perspective on social affairs is taken. The spatial reallocations of resources that will be induced by economic change must be expected to affect different social groups unevenly. In particular, if the intensification of competition that is one of the main objectives of integration causes a labour shakeout, the bulk of the resulting job losses will be amongst the least qualified employees. This could create problems for the most vulnerable social groups – for example, ethnic minority immigrants or displaced agricultural populations migrating to large congested cities – and may also lead to concentrations of social problems in specific localities. In France, as an illustration, the 'Délégation inter-ministériel à la ville' (DIV) has identified over 400 disadvantaged precincts in urban areas, many in cities which are otherwise prosperous.

According to DIV, residents in these areas face multiple handicaps in trying to secure better opportunities. In addition, crime, drug-dependence, declining standards of health and other consequences of social deprivation tend to accumulate in such areas. Although organized crime in Calabria, Sicily and Campania or terrorism in Northern Ireland are phenomena with deep historical roots, they must, nevertheless, be seen as issues to be confronted. Social cohesion calls for recognition of the effects of economic and political change in fomenting social problems and for action to alleviate them.

Equally, there will be pressures for harmonization of levels of social protection and means of delivery of social policy, building on the current round of proposals for the Social Charter. There is an economic dimension to this in so far as it is considered desirable to avoid 'social dumping' – cutting levels of social provision in order to lower the burden on business taxes and thus to secure competitive advantage. Improving social provision can, in addition, be regarded as a political objective aimed at consolidating the sense of belonging to the EC. If residents of less favoured regions or of disadvantaged communities in favoured regions perceive the gap in social provision between them and more favoured areas either to be excessive or not narrowing sufficiently, social cohesion will be difficult to achieve. In particular, if the Community is not able to address poverty in whatever form it manifests itself (low rural incomes, inactive or discriminated-against inner city or suburban populations), it will struggle in vain to attain social cohesion.

The ultimate test of social cohesion, however, is whether or not residents of certain regions face long-term inequality in opportunities relative to the rest of the Community. Education and training play a crucial part in determining economic opportunity and consequently deserve attention. Similarly, standards of health care and housing, as well as the quality of the environment contribute substantially to the quality of life. Social cohesion, though rather more amorphous as a concept, has to be seen as a key target of policy for the Community in the 1990s.

1.2. The economics of integration and regional disparities

Existing regional disparities are the product of a large number of diverse factors which have been the subject of extensive theorizing and analysis by economists. A comprehensive discussion would be out of place in the present document, but it is worth highlighting the main strands of the debate.

The prevailing orthodox view is that disparities arise largely because of obstacles to the effective functioning of markets. This philosophy is implicit in the rationale for seeking to complete the internal market, and there are many who would argue that by far the most effective way to overcome disparities (and thus to advance cohesion) is to ensure that the free play of markets is not impeded. Much the same approach is followed in analysis of the desirability of monetary union. Under this reasoning, prices will send signals to economic agents which will prevent disequilibria from causing persistent disparities. However, it has to be recognized that the implied mechanism may require greater factor mobility than is realistically attainable.

In particular, the capacity of the labour market to be the principal vehicle for market adjustment is open to considerable doubt. Migration of unskilled labour, which played a considerable part in reducing labour market imbalances in the early development of the EC, depends on there being demand for such labour. For a variety of reasons – social, occupational and political – migration of unskilled labour is unlikely to be a powerful mechanism for alleviating regional imbalances in the 1990s. In general, opportunities for unskilled labour are likely to be much fewer in the 1990s, with the main job opportunities occurring in the more knowledge-intensive industries. To the extent that there is an increase in labour mobility, therefore, it is much more likely to be amongst skilled, professional and managerial groups, which could induce problems of deskilling in less competitive regions.

Theories of regional growth and of interregional trade (see, for example, Armstrong and Taylor, 1985), are not easy to relate to the circumstances of European regions in the 1990s. In models relying on analysis of comparative costs, factor endowments are considered to play a large part in determining both what type of activity a region has and the extent to which it is able to grow, and they are portrayed as the determinants of regional specialization in different forms of economic activity. Opportunities for cross-regional trade stem largely from differences in factor endowments, while monetary issues are assumed not to affect regional prospects. Similarly, the theory of customs unions and other conventional trade theories do not provide very satisfactory models for understanding the effects of integration on regions. In such models, the regional question is effectively assumed away, because the assumptions of complete factor mobility within countries and constant returns to scale ensure that regional economies maintain equilibrium. This model and the strong assumptions on which it relies are so far removed from the realities of Europe today – where intra-industry trade between regions is the norm, where economies of scale are critical, and where markets are both segmented and oligopolistic – that it offers few insights into how regions will fare in a more integrated Europe.

Recent developments in trade theory (see Helpman and Krugman, 1985; Kierzkowski, 1987), such as explicit acknowledgement of the role of economies of scale in explaining trade patterns and of the predominance of intra-industry trade in differentiated products, can be extended to give more convincing predictions of regional outcomes. Contemporary theory also recognizes the significance of trade between subsidiaries of multinational companies – a phenomenon that must be expected to become more relevant as activity is reorganized on a European rather than a national basis.

Although these approaches to trade theory do not directly identify possible regional ramifications of integration, they do at least help to point to aspects of economies that will influence how they are affected by it. For instance, the prediction that agglomeration externalities will induce industries subject to increasing returns to concentrate in countries with larger domestic markets (Helpman, 1981), would be expected to have parallels in a single market with the distribution between 'core' and 'peripheral' regions. Centripetal pull towards the core regions would tend to favour industries subject to increasing returns locating centrally, leaving less dynamic industries in the periphery. The types of activity (such as headquarters activities, low-skill assembly) in which a region specializes will, similarly, have a bearing on its potential to gain from integration, in the same way as countries do.

An alternative approach is to acknowledge that there are wide and persistent differences in the endowments and attributes of different regions. There are, moreover, longstanding differences in the social and economic structures of different regions which mean that fundamental changes in economic circumstances have to be measured in decades rather than short-term adjustments. Models of regional development which emphasize regional competitiveness in what are termed 'export-base' activities provide an alternative to the comparative costs approach. What is clear from these export-base models is that in a dynamic context, it is easy to predict a persistent widening of regional disparities giving rise to cumulative change. Certain attributes of regions will favour or discourage the implantation and growth of different forms of economic activity and, as a result, the dynamics of the region will depend on how successful it is in attracting and nurturing growth-orientated activity. In the present-day environment of oligopolistic competition and segmented markets, it is unrealistic to expect market solutions to be sufficiently effective. Rather, persistent cycles of advantage or disadvantage have to be regarded as the norm.

Through time, the characteristics of a region which confer such absolute advantage on it may become dissipated or lose their relevance. The recent deterioration in the economic circumstances of a number of regions partly reflects the loss of competitiveness of Europe in many of the industries which provided much of the stimulus to post-war growth. Equally, the rise of new sectors (such as high-technology manufacturing or producer services) has highlighted different regional attributes as critical in driving economic growth. Propensities to innovate are coming to be seen as decisive in improving competitiveness, and more attention is being focused on indigenously-generated economic growth.

A basic question, therefore, is whether market mechanisms can, in practice, be relied upon to deliver cohesion. Given the degree and persistence of disparities both within countries and between them, it is difficult to believe that they can. Nor is it likely that the market will respond sufficiently quickly to congestion and overheating in favoured regions and thus bring about a rapid diffusion of improved economic efficiency. On the contrary, the evidence is that it is only when cost differentials become considerable that companies are prepared to overcome the inertia and sunk costs of current locations, or to contemplate the greater uncertainty of new locations.

Perhaps the key to analysing the regional impact of European integration is to recognize that the benefits of integration stem directly from improved allocation of resources. Seen in this way, the gains from integration are generated endogenously and result from a one-off shift, rather than being the result of an exogenous change, such as technological progress. For any region, the benefits from integration will come from two mechanisms. First, it would be expected that some of the additional growth (assuming it is actually realized) for Europe as a whole would 'trickle down' to all regions, though not evenly. Second, the process of reallocation implied by resources moving will, particularly in a dynamic context, mean that there will be net inflows or outflows of factors of production. In a neoclassical world, this would lead to adjustments of factor costs and changes in regional specializations, but would not be expected to give rise to regional problems. Past experience suggests, however, that adjustment simply does not occur in this way. Plant closures, losses of skilled labour or outflows of capital are cumulative in their effect and lead to worsening regional problems. For uncompetitive regions, therefore, the rationalization of production on which the success of the 1992 programme is predicated could cause severe difficulties.

1.3. Implications for cohesion as an objective

If the presumption that growth is intrinsically unbalanced is correct, the inference to be drawn is that an acceleration of economic integration in the EC will produce winners and losers. This means that unless a satisfactory policy towards cohesion is formulated and implemented, the solidarity necessary to sustain Europe as a genuine Community will be threatened. Such a policy has to take account simultaneously of multiple objectives, limited resources and conflicting economic and political constraints.

What aims should policy have? A successful policy for cohesion must ensure an adequate diffusion of economic advantages from the growth centres to other regions, without stifling the creation of those advantages. 'Recipient' regions must be satisfied that growth imbalances have been kept to an acceptable minimum, while 'donor' regions must believe that any short-term sacrifice will contribute to greater market stability and reduced need for redistribution in the longer term. Equally regions which have their competitiveness damaged by the integration process have to be persuaded that this is ultimately in their own best interest, while regions that gain have to recognize that their gains stem in part from others' losses.

If 'cohesion' means purely redistribution of income, whether between regions or households, the main concern will be to ensure that the money is successfully transferred to target groups. How it is spent is then their affair. Resources could be transferred in a relatively simple manner, according to a key based on an indicator such as GDP per capita or the yield of some tax on a harmonized basis. It is important, in this regard, to distinguish between pre- and post-tax disparities in incomes, since regions with high incomes will tend, automatically, to pay a larger amount of tax. Many federal States also have redistributional budgets for transferring resources to weaker areas, which leave considerable discretion to the recipient State authorities as to how the money is spent. However, within such federations (e.g. Germany, Canada, Australia) there is typically a significant commonality of administrative capacity and quality of budgetary management. Similarly, there tends to be a shared set of political and social values between the different regions of such countries.

The main alternative approach is to improve the long-term productive potential of the weaker regions, promoting future rather than current income. In principle, such policies would be transitional, their intention being to raise the regions' income-generating capacity until a further transfer of resources is unnecessary, although in practice they may be unable to generate an effect sufficient to achieve this aim. They imply a closer targeting of transferred resources towards 'productive' investment in physical capital, human capital and infrastructure. With this approach, three major issues need to be confronted: the financial management capacity and culture of Community institutions (and of the national and regional institutions with which they have to cooperate), the question of subsidiarity, and the role of the private sector.

1.4. National differences in definitions and priorities

Inevitably, there are differences between countries in their views of priorities for attempting to attain cohesion. In much of Northern Europe, where systems of public social support are well established and the regional dispersion of per capita incomes is not enormous, the main concern tends to be to avoid excessive disparities in unemployment. By contrast, for much of the periphery of the Community, catching up in terms of economic development has been seen as the most immediate priority. There are, however, many intermediate positions, while the spatial focus of attention within countries has shifted from time to time. Thus, in recent years, urban problems have come more to the fore in countries such as France and the UK. Forestalling rural depopulation as well as general economic development is considered important in Ireland, while economic development has been regarded as a means of consolidating the reform of political institutions in several of the Mediterranean countries.

In some countries, there have also been specific considerations to take into account. The tensions between the two linguistic communities in Belgium are an obvious example, having been exacerbated by the relative decline of the economy of Wallonia in the last 15 years. Religious divisions endure in Germany as well as in a highly publicized region like Northern Ireland. Similarly, pressures for autonomy have been evident in Spain, as well as in some regions of France, the UK and Italy.

Such differences in priorities have to some extent been reflected in policy packages. Some countries have favoured regional incentives to industry; others have placed more weight on infrastructure development. The scale of commitments to spatially targeted policies has also fluctuated over time and in response to changing macroeconomic circumstances. This diversity in the assessment of and approach to cohesion within countries makes it clear that a cohesion strategy for the 1990s will need to be carefully judged to accommodate a wide range of objectives as well as to be flexible in application. In addition to the problem of coping with the diversity of cohesion aims, the Community has to contend with the double problem that disparities between countries are greater than within countries, yet most of the mechanisms used by countries are not available to the Community. This is made more poignant by the expectation that integration may exacerbate disparities, emphasizing Community responsibility to take action.

2. Measuring disparities and the role of current policies

Before any progress can be made in formulating a new strategy for social and economic cohesion, it is essential to have a clear picture of what it is that cohesion policy should target. Debate on cohesion has been clouded by confusion in the jargon, by disagreements on the choice of indicators to measure disparities and by conflicts in the aims of policy. This chapter looks at the problems posed in measuring cohesion and considers the extent to which the present mix of Community policies advances cohesion.

2.1. Concepts of convergence

Considerable confusion surrounds the use, in the debate on cohesion, of the term 'convergence'. This has arisen partly because of differences in emphasis on what the most important issues are for economic integration, but also because of a lack of understanding of what different concepts imply. For present purposes, at least five definitions of convergence can be distinguished:

(i) harmonization of inflation rates and other macroeconomic indicators as a prerequisite of a single currency (nominal convergence);

(ii) coordination of budgetary and other policies to ensure that these do not put undue strain on monetary policy under EMU (policy convergence);

(iii) narrowing of gaps in disposable incomes. It may, further, be appropriate to adjust for differences in levels of social provision, since the latter clearly affect the standard of living (real convergence);

(iv) structural adaptation which produces more closely related structures of economies in different parts of the EC economy, thereby diminishing vulnerability to external shocks (structural convergence);

(v) increasing similarity in various behavioural phenomena such as savings ratios, systems (formal or informal) of welfare support or the character of industrial relations (behavioural convergence).

These various forms of convergence are germane to different aspects of economic integration and cohesion. The first two are essentially concerned with the mechanics of integrating previously separate economies. Thus, an approximation to nominal convergence is seen as desirable from the point of view of making the transition to EMU as painless as possible. If economies with very different parameters for the relevant macroeconomic variables were to try to integrate, the shock involved in adapting would be more pronounced. Similarly, once an economic or monetary union has been achieved, the scope for divergent budgetary policy will be limited. Policy convergence is, therefore, vital if the internal balance of an EMU is to be maintained, although it has to be recognized (as Begg and Weale, 1990, argue) that this does not call for complete equivalence on fiscal stances.

Real convergence relates directly to cohesion since it is a measure of the relative well-being of different parts of an EMU. However, it is neither an essential precondition for an EMU, nor a necessary outcome of one. If it is accepted that economic cohesion implies a narrowing of disparities in command over real resources, then the test of cohesion is whether or not real convergence occurs, irrespective of the institutional framework within which it operates or the values of nominal variables. In the neo-classical approach to economic analysis, there is a presumption that the long-run trend will be towards convergence because markets will ensure an efficient allocation of resources. The empirical picture, however, is less clear, not least because the substantial net fiscal flows within a nation State (as the MacDougall Report, 1977, shows) play a considerable part in reducing *ex ante* disparities.

Research on the USA (Barro and Sala-i-Martin, 1990) suggests that the gap between rich and poor States, in terms of both per capita income and product, has tended to narrow in the long term, though at a slow rate. The research finds that migration of labour towards areas of capital abundance has played a part in bringing about convergence of income levels. In the long term, the same authors (Barro and Sala-i-Martin, 1991) reach a similar conclusion about the European economy, although as the discussion later in this chapter shows, the results are far from unambiguous.

Structural and behavioural convergence are important because they exert a major influence on the long-term scope for real convergence to be achieved and sustained. If parts of an EMU are very different in these two respects, common macroeconomic policies will affect them differently. This, indeed, has been used as an argument by separatist movements to justify disintegration. Given the considerable divergences in structure and behavioural parameters amongst the regions of the EC, it can be argued that progress towards sustainable, long-term cohesion will require action to bring regions more into line with one another.

2.2. Measuring disparities

The most widely used measure of relative economic advantage among nations is gross domestic product (GDP) per capita. It indicates the average annual value of goods and services produced by each inhabitant. Comparisons of GDP across regions and countries pose problems because prices vary and may be expressed in different currencies. If no account is taken of different absolute and relative prices, then exactly the same activity could be measured differently. Unfortunately, regional price indicators are not available for all countries in a harmonized form. However, national price data are readily available, so that, rather than making comparisons using nominal exchange rates (which may fluctuate for reasons unconnected with relative price movements), it is possible to use purchasing power parity ratios as an alternative. These weight together components of national spending in a way which gives a more directly comparable measure of changes in the purchasing power of GDP (see Summers and Heston, 1991). If we try to compare standards of living in different parts of the EC, it may, in principle, be better to use measures of real spending power rather than GDP, though these are more difficult to obtain on a harmonized basis.

For EC regions, GDP per capita is also available (disaggregated to Level 2 of the NUTS classification), although for many countries the lack of harmonized regional price data makes it difficult to assess the growth of real GDP per head in the regions in terms of purchasing power. GDP measures a region's output rather than income, the difference arising from interregional payments and transfers. A net inflow will raise a country's gross national product (GNP) above its GDP. Conversely, in countries such as Ireland, facing high debt service charges and profit repatriation, GNP has recently been considerably below GDP. The degree of income inequality revealed by either measure will generally tend to rise the more narrowly defined is the region across which it is averaged.

There are other problems due to statistical methodology. For example, the Groningen region of the Netherlands appears to have one of the highest average incomes in the Community, but this is because gas production is treated statistically as being part of the output of the region. In reality, because most of the value-added flows to other regions rather than being retained as regional income, the region's income is below the Dutch average. Certain smaller city-regions such as Hamburg or Brussels owe their high per capita GDP partly to the fact that inward commuters generate a proportion of the region's output, but are not counted in the resident population which is the denominator for the per capita income calculation. Although these particular problems are taken into consideration by the Commission in designating regions for assistance, they illustrate the complications that arise in making use of indicators which are apparently objective.

A more intractable problem, especially in certain less-favoured regions, is the extent of unrecorded economic activity. The informal or 'black' economy – most prominent in construction and the services sector where cash transactions replace formal invoicing – is recognized to contribute substantially to income, and is complemented in some regions, notably in parts of the Mezzogiorno, by illegal activity such as drug dealing, gambling or prostitution. Average GDP also fails to capture those elements of living standards not revealed in income flows, such as home production and barter (especially in rural regions) and external costs of production. Ideally, a measure of retained value-added, which captured the rewards from output retained in the region would be more revealing than GDP.

A measure of economic welfare, such as disposable income, rather than GDP (an output indicator) may be a better means of signalling relativities which bear on cohesion. This would raise greater problems of measurement, but would offer a more convincing indicator of need as it would signal the real resources a region has at its disposal. Such an indicator might be constructed from income surveys or from the results of market research studies aimed at identifying variations in consumer spending power. Indeed, since monitoring of cohesion is bound to require information on economic welfare, there is a case for regular surveys to be conducted under the auspices of Eurostat.

Differences in income levels are not the only indicator to have been used to measure the gaps between different parts of the Community. Labour market indicators are commonly used as an alternative to income or GDP in signalling regional disparities. The most obvious is the unemployment rate, although the use of this is complicated by variations in methods of measurement and by social or institutional factors, in particular the presence in some regions of agricultural underemployment. In Galicia, for example, the apparent unemployment rate is held down by the custom of absorbing labour in family-run smallholdings, in contrast to Andalusia where, with agriculture dominated by large landowners, displaced workers have no such cushion to fall back on. Migration also tends to mitigate unemployment rates, yet has to be seen as a labour market response to an imbalance between labour supply and demand. Such imbalances arise in some areas because of job losses (including many of the Objective 2 regions), but result more from natural increases in the working population in areas like Ireland.

In the 1980s, the Commission attempted to amalgamate income and labour market disparities by creating the 'synthetic index', a composite indicator made up of four components:

(i) GDP per head of population in PPS (25 % weight);

(ii) GDP per employed person in Ecus (25 % weight);

(iii) n unemployment rate adjusted to take account of underemployment in agriculture (40 % weight);

(iv) Estimated employment shortfall due to projected labour force growth (10 % weight).

This index, itself a refinement of a similar earlier composite, was discontinued by the time of the fourth periodic report (Commission of the European Communities 1991b) because of political ambiguity about what it measured and questions over the reliability of the data.

Many other characteristics of regions can be considered to bear on cohesion. Peripherality, for example, not only puts a region at a competitive disadvantage because of higher transport costs and access difficulties, but also creates psychological barriers which inhibit cohesion. Obstacles to internal communication (mountainous terrain, the need for sea-crossings to islands) can mean that a larger investment in infrastructure is needed to attain the same level of service. In remote, sparsely populated rural areas, such as North-West Greece or the Highlands and Islands of Scotland, such problems are especially acute.

An altogether different approach to cohesion would be to look at the relative social condition of regions. This may be assessed by a number of measures of per capita input (e.g. public expenditure on health and education), intermediate output (e.g. number of doctors per 1 000 inhabitants, length of compulsory schooling) or final output (e.g. life expectancy, incidence of health problems, flow of educational and vocational qualifications). Measures of consumption, such as the ratio of cars and household machines to population, are also available at regional level. These sometimes reflect differences in preference or in provision of substitute goods (e.g. public transport and marketed household services), but they also indicate the household distribution of income and wealth not fully captured in average GDP figures. On the whole, the 'output' measures are preferable, since regions may have different mixes of private and public social-service spending, and different efficiencies of service administration. They are also easier to compare across regions, although data are not always available in the detail required. Again, surveys could be used to collect harmonized data without undue cost, since these are indicators that change relatively slowly.

2.3. How cohesive is the Community?

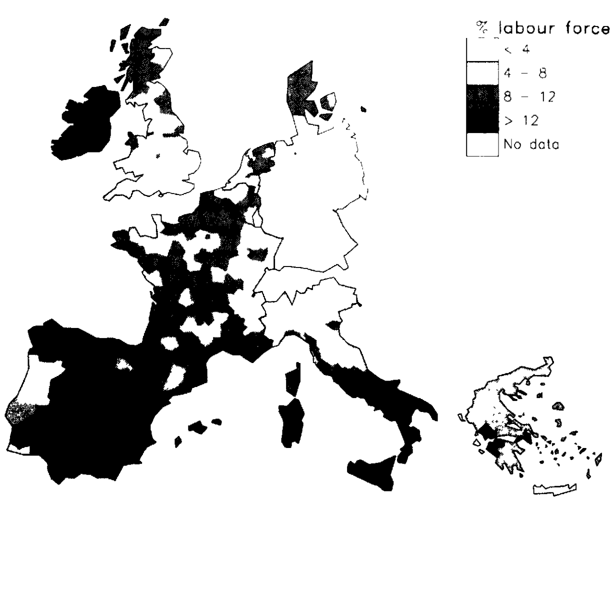
Although there has been progress in the long term towards real convergence in Europe, it has been observed that the broad pattern of disparities in per capita GDP in the European Community has fluctuated in line with variations in the overall economic performance of the EC. Thus, in the period up to the mid-1970s, a period of comparatively rapid growth for the EC, there had been a trend towards convergence, with the less prosperous regions gaining ground. In the following decade, when there was a marked slowdown in growth, disparities were aggravated (Commission of the European Communities, 1987). Since the mid-1980s, however, at least some of the less favoured parts of the EC have again had more rapid than average economic growth (Commission of the European Communities, 1991b; Larre and Torres, 1991), although Greece appears to have gone backwards.

Figures 1 to 3 provide snapshots of levels and rates of growth of income, and the rate of unemployment, key indicators of convergence. Figure 1 (see p. 14) shows clearly that it is core regions of the Community that have the highest income while the periphery lags behind. Unemployment, by contrast, exhibits a more varied spatial pattern, with high rates in traditional industrial areas as well as in lagging regions of Spain and Italy.

The two static economic indicators – GDP per capita and the percentage of the labour force unemployed – tend to reveal the same favoured and less favoured regions, though Greece and Portugal are major exceptions. However, the highest-income regions do not always record the lowest unemployment, perhaps because they enclose large urban regions which tend to attract unemployed migrants from other regions. High total unemployment levels often accompany extremely high levels of youth (below age 25) unemployment: 67 % in the Calabria region of Italy, and nearly 50 % in the Andalusia region of Spain. However, as noted earlier, high unemployment in other regions may be partially absorbed as underemployment. Figures on long-term unemployment tell a similar story, and have been another source of great concern within the Community. Income growth is much more variable, with Spain and Portugal showing well in the late 1980s, in contrast to Greece and the Mezzogiorno. As a rule, the rate of growth of the Member State tends to be the main determinant of regional growth, though Figure 3 suggests that the assisted regions in many countries have failed to keep pace with the rest of the respective country.

Rather less attention has tended to be given to indicators of change in determining eligibility, though they entered into the designation of Objective 2 regions. Some forthcoming developments can be expected to generate rapid relative changes and will have to be taken into account in a strategy for cohesion. Time-lags in the publication of data can make it difficult to identify fast-moving changes and thus delay a policy response. This highlights the fact that some of the more awkward political problems that arise in establishing criteria for the allocation of assistance come from disagreements over the choice and method of calculation of indicators.

Figure 2:
Unemployment rates in the Community, 1990



2.4. Existing Community policies

All the Member States have some form of explicit regional policy (for a description, see Yuill et al., 1991; and for an evaluation of their effectiveness, PA Cambridge Economic Consultants, 1990). Regional disparities are also affected by Community expenditure and by the incidence of other Community policies such as competition policy or external trade agreements. The regional impact of these Community policies has been comprehensively examined in the study for the European Parliament by DIW (Franzmeyer et al., 1991). This study measured the extent to which various Community policies contributed to a redistribution of welfare towards less favoured regions, concluding that although some instruments were effective in redistributing, others had a perverse effect.

The Community instruments which generate flows of expenditure in the attempt to overcome regional economic imbalances are the European Coal and Steel Community (ECSC), the European Social Fund (ESF), the European Regional Development Fund (ERDF) and the Guidance Section of the European Agricultural Guidance and Guarantee Fund (EAGGF) which is designed to assist rural restructuring. Loans for economic development purposes, targeted predominantly at less favoured regions, are provided by the European Investment Bank (EIB) and the New Community Instrument (now largely replaced by additional EIB lending to SMEs).

The Brussels Summit in early 1988 agreed a doubling of the structural Funds (ERDF, EAGGF-Guidance Section and ESF) to ECU 14 billion (at 1988 prices) by 1993, at which time they will comprise around 25 % of the Community budget and 0.3 % of Community GDP. Table 1 shows the planned allocations from the structural Funds over this period, and the proportions going to the six stated objectives.

The 1988 reform also brought in concentration of assistance on more clearly defined regions, a shift from individual projects to integrated programmes in recipient regions. In addition, a number of programmes of Community interest have been initiated. Amongst these are the integrated Mediterranean programmes (set up in 1985) which include an additional contribution for these regions, as well as coordinating structural Fund and EIB assistance; programmes aimed at specific objectives, such as STAR (telecommunications infrastructure and services), Rechar (aid to coal-mining

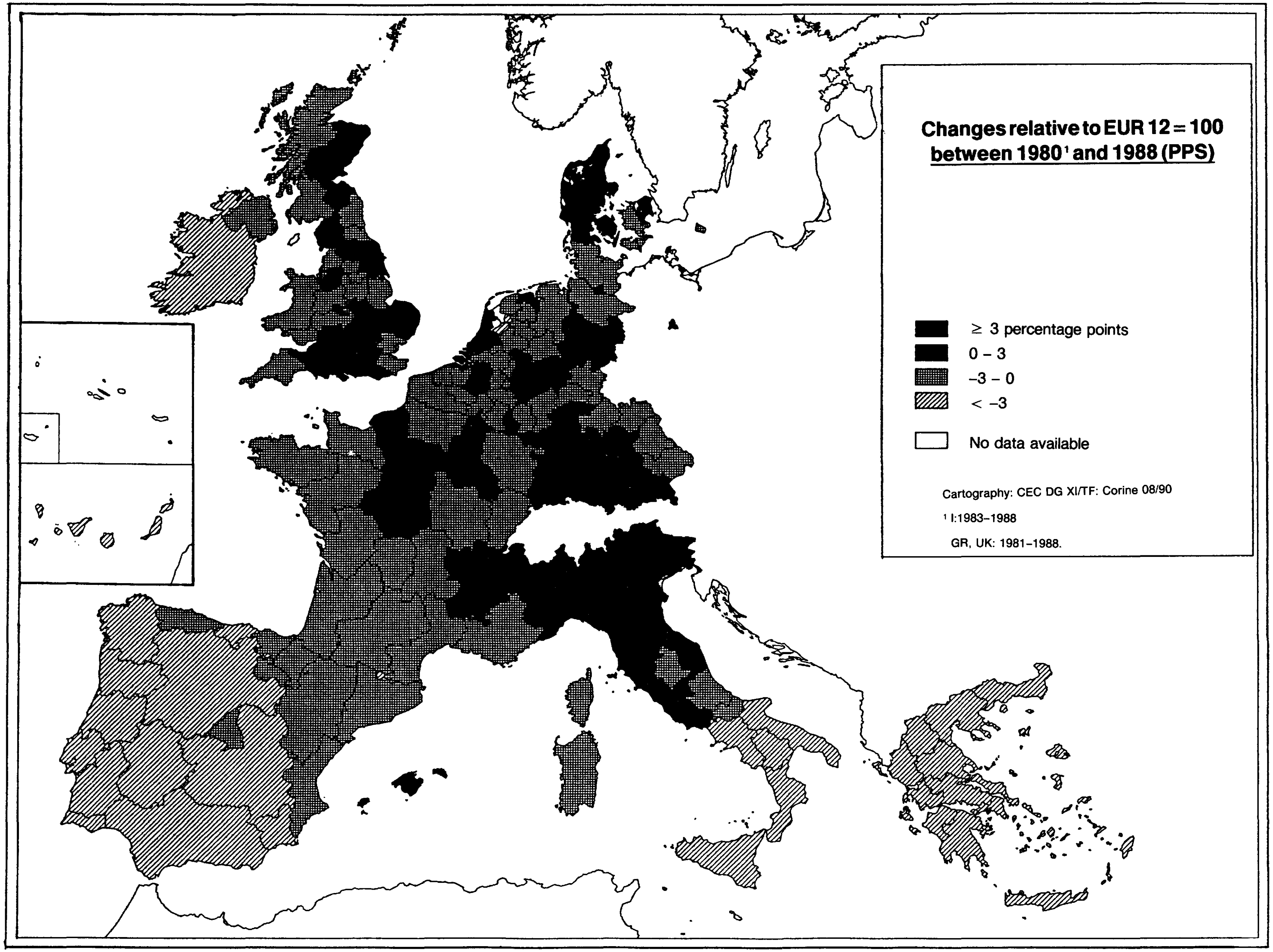


Figure 3: **Gross domestic product per capita in the Community**

Stride (help for research and technology development). Pedip is a programme aimed at assisting the development of industry in Portugal.

Table 1:
Structural Fund instruments and allocation, 1989-93

Proportion (%)	Objective	Instrument	billion ECU
63	1 Lagging regions	All funds	38.3
12	2 Declining regions	ERDF, ESF	7.2
12	3 Long-term unemployment	ESF	7.5
	4 Youth employment	ESF	
6	5a Agricultural adjustment	EAGGF	3.4
5	5b Rural development	All funds	2.8
2	Other		1.1
		Total	**60.3**

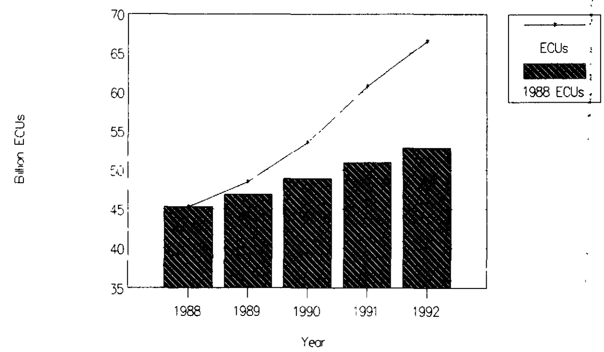
Some of the main conclusions of the DIW study are:

(i) in 1990, 63 % of the Community budget was spent on agricultural policy (59 % on guarantee payments and 4 % on guidance). The direct expenditure on agricultural support has, by and large, exacerbated rather than reduced disparities. The impact of the CAP on price levels also has to be considered, because the outcome of guarantees is to increase the price paid by all consumers. If higher prices are taken into account, as well as the flows of guarantee payments, the discohesive effect on disparities is reinforced;

(ii) the structural Funds do act to reduce disparities in income, and to the extent that they raise levels of investment in less favoured regions, assist long-term economic development. DIW note, however, that only some 60 % of appropriations were actually paid out, with substantial variations between Member States in this respect;

(iii) EIB loans are judged to be equalizing in their effect, whereas ECSC reconversion loans and interventions favour the Northern countries and thus tend to widen disparities between Objective 1 regions and the rest of the Community (though as the ECSC loans are deliberately targeted at Objective 2 regions, DIW's conclusion, by looking at the overall effect on distribution throughout the Community, does not take account sufficiently of the diversity in the aims of policy). DIW make the additional point that assistance from Member State policy to coal and steel industries has tended to work in the same way, although it is being challenged in EC competition policy.

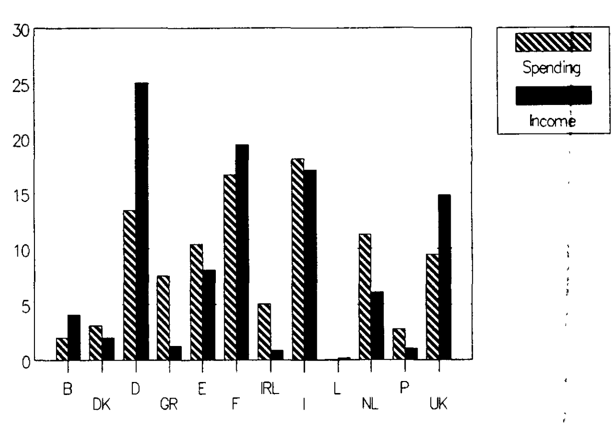
Figure 4: **Growth of the Community budget, 1988-92 (based on the financial perspective)**



2.5. Current EC fiscal flows

Following the reforms agreed in 1988, the EC budget is now cast within a five-year medium term framework known as the 'financial perspective', running from 1988 to 1992. This is intended to set a ceiling for calls on own resources,[1] and allows for real growth of 3.9 % per annum (10 % per annum in cash terms) in the budget. Figure 4 shows the planned growth of the budget. This will take the budget from 1.15 % of Community GDP in 1988 to 1.2 % by 1992. A new financial perspective will have to be negotiated soon for the subsequent period.

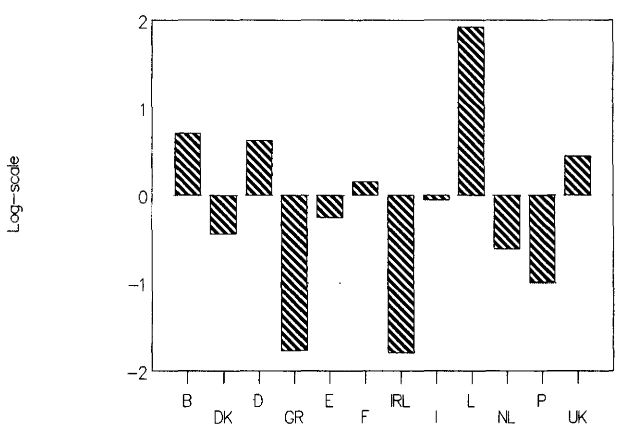
Figure 5: **Income and expenditure of the Community Budget**
(% shares of the Member States)



[1] Revenue raised in Member States which is directly hypothecated to the Community budget. The three resources are: (1) agricultural levies imposed on extra-Community imports; (2) customs duties; (3) the proceeds of 1.4 % of harmonized VAT receipts. A fourth resource based on Member State GDP may be called upon if the first three resources do not yield sufficient revenue to cover agreed expenditure.

As the DIW (Franzmeyer et al., 1991) report has already made clear, the incidence of EC policies, including the aggregate impact of Community expenditure is not convincingly pro-cohesive, largely because of the distorted pattern of agricultural guarantee payments. Figures 5 and 6 show a crude breakdown of the income and expenditure by country in the 1989 budget. The data for income are the Commission's calculations of the own resources raised in each Member State. The expenditure figure is the identifiable expenditure by the Community in each Member State, and consists mainly of spending by the CAP and the structural Funds.

Figure 6: **Ratio of 'Member States' contributions to receipts**
(% of the Community budget, 1989)



The total for expenditure is about three-quarters of the income. This is because some money is not spent on Member States (for example, foreign aid), while some goes on administration and a proportion, in 1989, remained unspent. Because so much of the spending on administration occurs in Belgium and Luxembourg, the figures for these countries must be expected significantly to understate the true position for these two Member States. However, the two charts provide a reasonable, if crude, measure of net benefit from the Community budget. Figure 5 shows that, on the whole, the least-favoured countries contribute considerably less than they receive from the Community budget. To this extent, the budget does promote cohesion. However, because of agricultural payments, Denmark and the Netherlands, two of the more prosperous Member States are substantial net beneficiaries. In an attempt to standardize for differences in the level of contributions, Figure 6 shows the log of the ratio of each Member State's contribution to its receipts. This form of presentation means that the size of the bar for the respective Member State shows the degree to which it is a net beneficiary. For Ireland and Greece, the calculation reveals that the EC budget is acting in a strongly procohesive manner, and does so less emphatically for Portugal. However, the fact that Denmark and the Netherlands are greater net beneficiaries than Italy or Spain suggests that cohesion could be improved by a redirection of the budget. Illustrative calculations of what a redistribution might achieve are presented in Chapters 4 and 6.

2.6. The example of German unification

The unification of Germany in 1990 provides an instructive case study of the integration of economies with large disparities in incomes, structure and behavioural characteristics. Although political imperatives were obviously paramount in the manner and pace of the unification, the magnitude of the economic problems facing the five new *Länder* suggests that there may well be lessons for the EC.

By the spring of 1991, 30 % of the workforce was unemployed or working on short-time schemes. Industrial output had fallen by half in just a year, and it is expected that for the second consecutive year, the fall in the GDP of the former GDR will be 15 to 20 %. In a new assessment of the German economy the OECD (1991) notes:

'In the event, the full and abrupt exposure of the structurally weak Eastern German economy to competition both from Western Germany and from abroad in combination with strong pressure for wage convergence have resulted in a virtual collapse of production and employment in the five new *Länder.*'

According to Akerlof et al. (1991), there are two main reasons for the depression affecting the former GDR. First, the exchange rate at which German monetary union occurred has put a price-cost squeeze on firms because of the wages paid to workers. Second, demand has shifted away from Eastern goods, both because of a shift from Eastern to Western goods by Eastern consumers, and because of falling demand from CMEA countries. The shift in consumption was partly because of the availability of goods that had hitherto been prohibitively expensive, but also arose from the perception of a quality gap between Eastern and Western products. There was, though, less of a consumption boom in the East than had been expected in some quarters. A third factor mentioned by the OECD and highlighted in research carried out by the Technical University of Berlin for this study is administrative and institutional problems.

In assessing the relevance of the German example in understanding how economic integration might affect the Community, it is useful, first, to consider the extent to which it provides a model for what might happen in the EC as a whole. The changes in Germany consisted of an immediate shift from two entirely separate and quite different economies and political systems into a single political and economic entity (in this context, the short delay between monetary union and full unification is immaterial). This differs radically from what is in prospect for the EC in three crucial respects:

(i) it is inconceivable within sensible time horizons that the Community will become a single political unit as in Germany, so that Member States will continue to play a central role in policy;

(ii) the transition will be protracted and will proceed by stages;

(iii) systems of income support on the scale available to the new *Länder* will not be in place.

The scale of the economic problems facing the new *Länder* also has to be highlighted. Although, in the language of Section 2.1, nominal and policy convergence were attained virtually overnight, while real convergence is being advanced by transfers, the economic problems facing the new *Länder* centre primarily on changing its economic structure and behavioural characteristics: what we have called structural and behavioural convergence. Since this includes building up a market economy virtually from scratch, it is very different in degree from the challenge faced by the Member States. Compared with the magnitude of the challenges in Germany, EC integration is more modest in its ambitions and starts from a more auspicious position.

In Germany, apart from the overriding political objective of consolidating the unification, an important aim of policy has been to slow the outflow of labour from the East, both to avoid political and social problems and to limit economic disruption. This has required a vast flow of transfers from West to East in order to provide income support. Although capital inflows have occurred and emigration has been persistent, neither factor flow has been sufficiently large or rapid to prevent the rise in unemployment, and it is now clear that structural action will take a considerable time to work. Transfer payments have, therefore, been the principal policy instrument used to assure social and economic cohesion in Germany, though the growing political unrest associated with rising unemployment in the East (and resentment of the fiscal burden in the West) demonstrates that use of such payments is not a recipe for social and political harmony, even if standards of living are safeguarded.

The fiscal capacity of the new *Länder* has been subjected to a double squeeze, from declining receipts and rising demands. Public transfers from the West have, therefore been crucial. In 1990, these amounted to DM 45 billion, and are expected to be around DM 100 billion in 1991, about half of which has gone on infrastructure, the rest on income support. To put these numbers in perspective, this is roughly the same order of magnitude as the entire EC budget for 1991. Subsidized credit programmes have also been substantial.

Akerlof et al. reach the interesting conclusion that a sensible short-term policy response now would be to introduce a wage subsidy. They argue that this would not only have a low budgetary cost, since there would be lower outlays from other budget heads, but would also be 'self-eliminating' because it would foster economic development. Longer-term, economic regeneration is the obvious way forward, but since the capacity of residents of the East to generate the savings that will be needed to restructure is weak and falling, investment in the East will necessitate substantial capital imports. In addition, major efforts will be needed to improve productivity, business organization and the legal and regulatory framework.

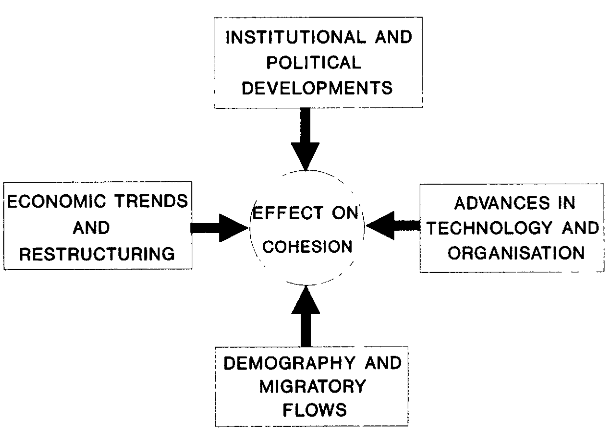
For EMU, the main lesson from the German experience is that if the pace of integration is too rapid, the problems must be expected to be more intense. Integration may cause significant dislocation in regions where major structural change is required in order to fit into the integrated economy. In the short-term, this may engender a rise in unemployment as well as making a proportion of the capital stock redundant. If this happens and there are low social and political barriers to mobility, migration may accelerate. A key point to note about such a scenario is that the problems arise before the benefits begin to flow.

For this reason, cohesion policies have to be a priority from the outset and should be implemented early in the process of integration. In Germany, it has become abundantly clear that structural policies are not enough, hence the scale of the transfers to support current consumption. However, developments in Germany are so different in character that the parallels are limited.

3. New considerations for the 1990s

During the 1990s several developments which are currently in the pipeline can be expected to affect cohesion in the EC. Many of these, such as the advent of the single market or the accession of East Germany are well documented, though not necessarily properly understood. The prospective impact of EMU or of a widening of Community membership is rather more speculative since the eventual terms of any agreements can only be guessed. These factors have in common that they will cause structural changes in markets and in supply relationships between different regions of the Community. Various additional factors will come into play in parallel with these already mentioned to affect cohesion. The various influences on cohesion are summarized in Figure 7, which sets out a framework for understanding the factors that will affect it in the 1990s.

Figure 7: **Influences on cohesion in the 1990s**



All four factors in the figure have endogenous as well as exogenous elements to them. The way in which the process of integration is found to operate will itself affect further political developments, the nature of economic restructuring, the process of innovation and the degree to which the population decides to relocate. What we can hope to do at this stage is isolate those exogenous factors which will affect the 1990s whatever happens in the process of integration and then discuss the likely range of influences that are not independently determined. Thus, although the political and economic changes being discussed by the two intergovernmental conferences are bound to be at centre-stage in the future of the Community, they are by no means the only prospective political developments that will affect cohesion. How events in Eastern Europe unfold (graphically illustrated by the troubles in Yugoslavia and the Soviet Union), the resolution of the Uruguay Round, or the emergence of new topics, such as concern for the environment, on the political agenda are examples.

These will be complemented by and will engender an assortment of economic trends. Any GATT agreement can be expected to usher in new competitive conditions for the textiles and agricultural sectors, with disproportionate effects on certain regions. In many regional economies, the growth of the services sector will continue to be a central feature. In parallel, as business adapts to the fact of a single market in Europe, the tendency for businesses to reorganize on a pan-European basis will be reinforced so that the competitive attributes of different locations will come under scrutiny. This will interact with the underlying trend in the corporate sector for a spatial separation of functions within organizations: some regions are more attractive for back-office functions; others offer better conditions for R&D.

A shift towards high-technology manufacturing processes and more research-based activity will alter labour demand, putting a premium on skills and higher qualifications. As a result, a Europe-wide labour market is likely in key occupations. Labour supply will be affected by demographic changes, notably the ageing of the population in many Northern countries, but also by social changes such as the increasing participation rate of females. Migratory flows will affect the availability of different types of labour and will also have social consequences which enter into the cohesion debate, especially if racial tensions are exacerbated.

The current discussions in the intergovernmental conferences under the heading of political union can, themselves, be seen as part of the process of cohesion by ensuring that the issue of cohesion is sufficiently prominent on the Community's agenda. The effect of economic integration on the standard of living or level of unemployment in a region is likely to be viewed differently by the local population from changes that are largely the result of local actions and decisions. Even if the eventual policy response is the same, it is important to have the recognition by the Community that it, rather than national or regional government, is the appropriate tier of government to assume responsibility where necessary. How such decisions are arrived at, or are seen to have been arrived at, affect their legitimacy and are important arguments behind the principle of subsidiarity. The justification for subsidiarity is in part a question of economics, involving efficiency and the treatment of externalities. But the major justification for moving responsibility to the lowest possible level of government in circumstances where the economic arguments are relatively unaffected by the decision is that locally agreed actions tend to be more popular and generate an increased chance of an enthusiastic response and a wish to participate.

This chapter looks first at how the single market and EMU are expected to affect cohesion, then goes on to discuss a range of other significant factors. It starts with a discussion of demographic change and migration and goes on to cover several of the other topics shown in Figure 7.

3.1. From the single market to economic and monetary union

The acceleration of the pace of economic integration that will follow from the advent of the single market and progress towards EMU will be critical in shaping cohesion. Economies which have been able to shelter behind protective barriers such as preferential public procurement will face new competition, while the competitive advantages of alternative locations will be more carefully scrutinized. Monetary union entails fixed exchange rates and ultimately a single currency. There will, eventually, be a single monetary policy for the Member States and constraints on the use of fiscal policy. Behaviour will be affected by the change in the currency regime and by the changes in macroeconomic policy that accompany it. On the whole, it is assumed that the effect will be to exert a tighter fiscal discipline which will make it more difficult for countries to use deficit spending to respond to internal imbalance.

Assessments of how the completion of the internal market will affect regional disparities have generally concluded that favoured regions would have more to gain (at least in the short to medium term) than the peripheral or other weaker regions (see, for example, the report of Nam and his colleagues at IFO to the European Parliament, 1991). There are bound to be exceptions to this, not least because the way in which investment flows will adapt to the new circumstances is hard to predict. It is important to emphasize, however, that completion of the internal market is an incremental process in which many of the main measures are already in place, while the effects of others will only filter through gradually. This distinguishes it from monetary union which, if and when it comes, will be more in the nature of a 'Big Bang', although once it is agreed that a monetary union will occur, there is sure to be an extended transition as economic agents adjust their behaviour in anticipation of the change of regime. Moreover, the point of stage two of the Delors Plan is to engineer a gradual nominal convergence so that when monetary union actually occurs, the 'bang' will not be as big as it might be.

Centripetal and centrifugal forces will also apply in relation to EMU, and will be reinforced by convergence in certain macroeconomic indicators such as inflation rates and thus in the stance of macroeconomic policy. Countries like Greece, Belgium and Italy which currently have substantial budget deficits, will have to implement large shifts in their fiscal stances in order to conform to the disciplines of EMU. For such countries, the burden of adjustment will, thus, be relatively greater. If this means a prolonged period of slower growth while budgetary positions are brought into line, it could result in a widening of disparities. Although the mechanism in this case is macroeconomic, the incidence of cohesion problems may be felt in particular regions.

3.1.1. The single market

There is a widespread faith that once impediments to the free movement of goods, services, labour and capital are removed, regions will specialize according to their comparative advantages, and that all regions will thus gain from the single market. Under this scenario, there would be an upsurge in interregional trade and specialization, because barriers holding it back would be removed. Less favoured regions would gain because their lower relative wages would attract external capital investment, especially in labour-intensive production, and improved infrastructure and lower transport costs would widen the markets they could supply competitively. In principle, labour mobility would also be enhanced since higher wages in areas of capital abundance would attract workers to migrate.

An alternative viewpoint is that the competitiveness of regions will come under the microscope and that those which are shown to be most competitive will gain at the expense of the less competitive because the latter's protection has been removed. This could happen as a result of economies of scale or the capacity for the strongest firms to achieve dominant market positions – outcomes that are assumed away under the 'neo-classical' theory which underpins the comparative advantage approach. Since existing disparities tend to reflect inherited and current characteristics of regions, there are good grounds for believing that integration will reinforce the competitiveness of strong regions and undermine that of weaker regions, notably those on the periphery of the

Community. This could set cumulative processes in motion and thus run counter to cohesion objectives.

The study by Nam et al. (1991) for the European Parliament explores the inherent competitiveness of the lagging regions through a survey of business and concludes that only four such regions – Valencia, Murcia, Abruzzi and Molise – have potentially good development prospects. Seven further regions have 'open' prospects – national centres in Greece and Portugal, Puglia, Andalusia, Canary Islands, Northern Ireland, Ireland – while the other Objective 1 regions have problems which are likely to worsen. It is immediately apparent that there is a strong correlation between the extent of existing disparities and the expectation that problems will worsen; all the regions in the bottom 10 % of the EC in terms of income per head are in this 'tending' to worsen category.

The position for Objective 5b and 2 regions, according to this analysis, is much more promising. The majority have potentially good prospects and only two in the case of Objective 5b – Highlands and Islands and rural Wales – and four in the case of Objective 2 – Basque country, Cantabria, Lorraine and North-East Wales – have problems which are likely to worsen. Part of the problem is that the comparative advantage of many of these disadvantaged regions lies in industries like clothing and food whose prospects are not good; in the case of clothing, because of the threat from the developing world as the barriers under the Multifibre Arrangement (MFA) are dismantled, and in the case of food, because of the way the industry is restructuring towards the more modern technically advanced and high quality products. Thus, even if they are successful in attracting investment in industries where low cost is an advantage, they are then disproportionately exposed to exchange rate and other costs, giving them asymmetric adjustment problems. This emphasizes their structural divergence rather than leading to greater convergence.

If the pattern of integration of recent years is a good guide, much of the growth encouraged by 1992 will be in intra-industry trade – the two-way flow of intermediate and final goods and services between regions of similar industrial structure. These are markets from which most disadvantaged regions will be largely excluded if they continue to specialize in existing traditional activities such as textiles, heavy industry or agri-business. Faster growth in better-off regions, based on trade creation between their industries, may increase the derived demand for other regions' products, but it will not directly assist them unless they can change their industrial structures relatively quickly.

The EC Commission's own assessment of the impact of the internal market (Buigues et al., 1990) tends to favour the intra-industry scenario. The study examines the prospects for each country in 40 industrial sectors judged to be particularly sensitive to completion of the internal market. It paints a mixed picture of the immediate prospects for the four less favoured countries. Ireland, with only a small proportion of employment in sensitive sectors which are reckoned to be uncompetitive, has little to gain or lose. It is also argued that, as a small market where transport costs restrict foreign access, Ireland has a natural protective barrier, although this is clearly also a problem for Irish exporters. Spain and Portugal have most of their employment in industries unaffected by the single market or competitive within it, but their external trade is in deficit and areas of strength are in labour-intensive or commodity-based industries where demand growth will be slow and extra-EC competition intense. Greece has a high proportion of employment in sensitive industries which are currently heavily protected and inefficient and it is again competitive only in slow-growing markets.

In the service sectors most affected by the single market, there is likely to be a trade-off in the effects on the Objective 1 regions. Financial and business services, for example, will almost certainly become more efficient as a result of competitive pressures, thereby providing users of these services with better quality at lower cost. But there may be a shakeout in some of the less competitive financial entities which will lead to job losses (PA Cambridge Economic Consultants, 1990). It is not yet clear what proportion of the output of these hitherto little-traded industries is actually tradable in practice. Although headquarters of major service organizations have been relocated out of the main centres of population in the higher income Member States to exploit the lower location costs that modern IT systems permit, it is not yet clear that they would take one step further and relocate in other countries where problems of language are added.

Although Greece, Spain and Portugal have been granted some derogations which will delay the impact of the single market on some of their less-developed industries (notably financial services), other policy instruments to be abandoned as the single market is completed are of great importance to disadvantaged regions. In particular, preferential public purchasing has been used to provide stable and 'high-quality' demand to new industries, and subsidies used to help firms grow, modernize or restructure.

For Objective 2 and 5b regions, the issues are rather different. As the fourth periodic report notes, they do not at first sight appear to be vulnerable to restructuring induced by 1992, because their markets are already open (Commission of the European Communities, 1991 b). However, these regions still have relative concentrations of declining or slow-growing sectors and of medium-sized firms ripe for rationalization. A notable problem for the Objective 2 regions in dealing with the single market will be their poor record in innovation which is the legacy of earlier decline. Some of these regions will also be affected by the opening up of public procurement for equipment for utilities (Cegos-Idet, 1989).

In the financial and business services sectors, few Objective 2 regions possess major financial centres, though there are several second-tier centres in these regions. Agglomeration economies will, however, tend to concentrate major financial entities in leading international centres, posing a further threat to the Objective 2 regions. Again, the challenge they face is how best to move towards new specializations.

Diffusion of the gains from the single market will depend partly on patterns of investment, so that inward investment will be an important element in cohesion. It produces benefits both as an immediate source of employment and income and as a means of acquiring new technologies and labour skills useful in the longer term. Such fixed investment may take the form of 'green-field' developments, or of acquisition of (or joint venture with) a local enterprise which results in capital input from outside. As well as investment by European firms spreading or relocating their activities, there has been substantial investment by Japanese and American companies seeking to position themselves for the completion of the single market. Both trends seem likely to continue, Japanese firms, in particular, having targeted certain activities for expansion in Europe, with plans to extend their location to more Member States.

In attracting inward investment, lagging or declining regions generally suffer from an undersupply of 'hard' infrastructure (short- and long-range transport, communication, energy) and 'soft' infrastructure (human capital, cultural and leisure facilities). This has left them with an under-representation of large internationalized companies and an over-representation of localized small and medium-sized enterprises (SMEs), which will face the strongest competitive and takeover threats after 1992 (IFO, 1991). There is, however, evidence of marked differences between different regions in their attractiveness to inward investment. Amongst Objective 1 regions, Ireland, parts of Spain and Portugal seem to have been more successful than Greece or the South of Italy. Some of the Objective 2 regions such as South Wales have benefited more than others.

The 1992 programme is a complex process of legislative change, which will induce behavioural change as well as responses by regulatory institutions and the regulated as the system evolves. Six years after the programme was announced, most of the changes are still to take place and initial evidence reveals relatively little about what is likely to happen. Mayes et al. (1991) who undertook a study of manufacturing industry across the whole of the Community as a follow-up to the work on individual countries by Buigues et al. (1990) found that, on the whole, the expected changes to costs and behaviour were much less than might have been expected from the theoretical analyses in the Cecchini Report and its related studies (published in *European Economy*, No 35 and 'The costs of non-Europe'). This was in part because some legislative changes had not yet occurred, like tax harmonization, in part because responses were yet to be observed, like changes in public purchasing behaviour, and in part because technical cost reductions were not available in practice, either because of the pace of technical change (as in engineering) or because of sunk costs (as in the case of railways, where tunnels and bridges would have to be replaced to achieve full standardization).

This does not mean that rapid changes were not occurring (at least in some branches) in European industry, as indicated by the mergers and acquisitions boom, for example, but that many of these changes were driven by wider global considerations. In this context, therefore, there was no indication that the relative position of the disadvantaged regions would play much role in determining company strategy. The trend towards concentration both of ownership and activity was clear and this focused on existing industrial areas rather than on the less favoured regions. The scale of change offers some hope for some Objective 2 regions but in general the prospects in manufacturing are not encouraging for cohesion as a result of the single market. Unfortunately Mayes et al. (1991) do not cover services and a smaller parallel study for the Commission will not be completed for some time.

The single market will open up opportunities where none previously existed because of regulatory barriers. It will change the scope of opportunities by altering relative prices and relative costs and will enable factors to move as well as products. On the whole, the removal of effective prohibitions will tend to work against the less favoured regions because they are not the best sources of the goods and services. Public procurement might therefore shift towards the more general pattern of competitive products, for example. Relative price shifts may be more minor than hoped for and, as Nam et al. suggest, inward flows of private capital in an open market seem to offer only a limited opportunity and one which tends to be concentrated in just a few areas.

One might, therefore, expect that the market might equilibrate the other way round by labour moving to where it can get better rates of return, now that the difficulties are being reduced with the mutual recognition of qualifications, the ability to move families as well as the employed person through transferability of benefits and eligibility for benefits in the new location. However, this does not seem to be the case except where the economic disparities are extreme or the cultural and language differences small – the best known examples being Ireland to the UK and East to West Germany. In so far as the social dimension of the completion of the internal market leads to increased wage and non-wage labour costs in the low cost areas, this may discourage the movement of capital somewhat, thereby exacerbating the problem of providing employment but increasing the incentive to move. In general, the movement of labour, *ceteris paribus*, might be thought to ease problems of low income and high unemployment, but the general tendency is for the more qualified and productive to move, thus increasing dependency ratios in the areas they leave from and decreasing rather than increasing average incomes. It is thus perhaps fortunate that this side of the completion of the internal market seems to be having little impact.

In some respects, the absence of migration can be seen as an indicator of cohesion. However, given the great impediments to migration, it is not a convincing indicator and since major changes would be a signal of severe rather than marginal problems, it is also a bad indicator to use, as it is biased and masks the extent of the problem.

3.1.2. Economic and monetary union

Four major forms of impact on regional cohesion resulting from EMU can be readily distinguished:

(i) microeconomic costs and efficiency gains;

(ii) macroeconomic costs and benefits from increased stability and reduced adjustment mechanisms;

(iii) the reform of public finance;

(iv) transition costs.

Taking these in turn, there is common agreement that there will be cost and efficiency gains throughout the Community as a result of EMU because transaction costs will be reduced where foreign exchange is no longer required. There will no longer be the need to hedge against currency fluctuation within the EC, which will also reduce costs. Furthermore, since one cause of uncertainty is reduced we can also expect an increase in investment in the future which will tend to increase the rate of growth in the Community thus providing a dynamic gain rather than just a step improvement in costs. These remarks assume that EMU goes the full distance to the adoption of the ecu as the single currency. If it stops short at 'fixed' exchange rates, leaving open the possibility of future exchange-rate changes, the costs will be higher because currencies would still need to be exchanged and the credibility of the scheme enduring will be lower. The result will be larger interest rate premiums for the weaker States with consequent changes in their macroeconomic policies.

These efficiency gains are very much on a par in conceptual terms with the gains from lower transport costs, decreased bureaucracy and lower cost of capital likely to stem from the single market, which also provides benefits for enterprises and consumers in all regions with both static and dynamic elements to them. The extent of the benefits in each region will depend upon the pattern of their transactions – the larger the proportion that involves other Community currencies the greater the gain. The Commission's assessment of the benefits in 'One market, one money' (Commission of the European Communities, 1990b) suggests gains to individual Member States in the range 0.1 to over 1 % of GDP, with an EC average of 0.3 to 0.4 %.

One implication of these changes is that, with a single financial market, the least favoured regions actually have most to gain as their ability to raise funds locally will have been weakest. However, it is by no means clear what will happen to the capital account of regions in EMU. Most analysis restricts itself to the current account and to inward direct investment. If prospects seem better in stronger regions, then portfolio capital will tend to flow out if investment barriers fall. Although this will be offset by the resulting income flows in the longer term, it will exacerbate the short-term adjustment problems. In the same way, if lending is seen to be riskier in the less favoured regions, both the availability and terms of credit will be constrained. Opening up may give access to new sources of finance but it also makes the operation of favouring local businesses more difficult. There have been complaints in Germany, for example, that local banks are turning towards the lure of international opportunities at the expense of the perceived role of assisting the local market. Thus, although there is a clear general microeconomic benefit, it is not clear whether the relative benefit for less favoured regions will be positive or negative.

To set against these microeconomic benefits there are technical costs of change. For example, it has been estimated that it might take 10 years of full-time use of available minting capacity if the Communities' coinage is to be changed. In the transition period, it will be necessary to run in the new accounting systems in parallel and vending machines might need to be modified. In general these transition costs come first and the gains from longer-term cost reductions second. Similarly, one of the less trumpeted findings of the 'Cost of non-Europe' research that fed into the Cecchini Report (1988) was that there would be some initial loss of employment before the dynamic gains emerge. This juxtaposition of short-term costs and longer-term benefits is, in itself, an anti-cohesive pattern since the ideal pattern for improved cohesion is continuing favourable movement which demonstrates that the changes are beneficial. If there is a perception that integration imposes costs, however short-lived, the political consensus for the change may be threatened. For these reasons, there are discussions afoot for reducing the costs of ECU transactions at an early stage of the transition.

These microeconomic costs and benefits are not, however, the main focus of concern about the impact of EMU on cohesion. They are relatively small in size for most enterprises and few suggestions have been made that they will increase regional disparities. It is the macroeconomic aspects which attract attention. The particular form of management of EMU proposed for the Community will have the control of price inflation top of its agenda. Optimists expect European inflation to converge on the lowest current rates. However, even pessimists recognize that there will be major falls in inflation for those countries with higher rates. The common feature of both positions is that EMU entails considerable convergence of nominal magnitudes in the economy. Indeed, given the way the EC appears to be intending to implement EMU, Member States have to demonstrate considerable convergence to a common level before the final two stages of implementation of the new system can be put in place. In particular, the extent to which governments borrow, and the scale of external deficits, will have to be made consistent with the common target of low inflation.

Achieving this convergence will pose considerable problems of adjustment for some Member States, since reducing inflation, borrowing requirements and external deficits, and stabilizing debt all usually entail deflation. Slowing growth in States already well below average Community levels of GDP can only exacerbate short-term disparities, even if it is a prescription for long-term convergence. Because voter preferences reflect short-term as well as long-term wishes, this could have a major impact on cohesion and might well call into question the achievability of EMU for the entire Community in the foreseeable future.

This degree of nominal convergence has no real counterpart. Real variables such as GDP per capita and the rate of economic growth are not likely to be included in the measures of convergence and, furthermore, it is clear from previous work (e.g. MacDougall, 1977; Delors Report, 1989) that many existing federal and unitary States operate with far higher discrepancies in real variables. There is thus not only no requirement to have real convergence to reach EMU, but there is no direct economic link which would suggest that the one tends to induce the other. Indeed, as we have already noted, the transition to EMU may entail a widening of existing disparities and the operation of common policies could result in their continuance.

As a rule, the higher the current inflation the greater the expected fall. It is generally accepted that unpredictable inflation is undesirable as it redistributes inequitably between sectors in the economy and that since total indexation is difficult to achieve and likely to cause instability, that convergence on a low rate of inflation is generally desirable. In this case, therefore, less favoured regions which lie within countries with current inflation problems can be expected to experience some sources of gain relative to those whose countries have already lowered their inflation rates satisfactorily. They would, so to speak, be able to remove a nominal disparity and as a result experience an opportunity for extra activity which could help remove the real disparities.

Some economic models posit even greater gains, as they treat inflation as a cost and argue that inflation inhibits economic growth (particularly as a result of the economic policies commonly used to control it). This view is not universally shared. Some feel that the great emphasis on keeping inflation down actually imparts a deflationary bias to the system, slowing the rate of growth. Even so, the equity and efficiency gains might outweigh the deflationary costs. Evidence set out in the *National Institute Economic Review* of November 1990 suggests that the deflationary costs for France and Italy of trying to maintain their exchange rate with the DM within the

EMS are considerable, amounting to a total of one and three-quarter million unemployed. This may be a transitional, rather than a permanent cost, but that transitional period may be very long. Work currently in progress at NIESR indicates that this same finding applies to the other Member States.

The particular mechanism for gain that most people see is that the risk premiums that borrowers in the weaker currency areas pay in their interest rates will be substantially reduced. Evidence from existing monetary unions suggests that they will not necessarily be eliminated. This fall in the cost of capital, added to those from the opening of financial markets as part of economic union, should stimulate the growth of the whole Community through increased investment. However, as 'One market, one money' points out, *real* interest rates in higher inflation countries like Portugal and Greece have actually been below the average in the Community. As they manage to bring down their inflation rates, greater convergence of real as well as nominal rates is likely, it is far from clear for these two States, whose regions tend to be the most disadvantaged in the EC, that the interest rate effect will be positive.

As Mr Karl Otto Pöhl, the former Chairman of the Bundesbank, has observed, a single interest rate may be bad for less favoured regions. On the one hand, they may be able to operate with lower real rates and, on the other, they may be able to weather adjustment problems more easily by allowing rates to vary. By this argument, EMU would not be suitable for such regions until they had achieved sufficient behavioural convergence with their more favoured partners. (These remarks are of course only yet another way of saying that the EC may not yet be an optimal currency area.) If EMU still goes ahead because of the extent of benefit for those that have readjusted, then the consequential requirement to compensate those who have not achieved this 'behavioural convergence' will be high on the agenda.

The Commission also argues that increased monetary stability is likely to lead to increased real stability. Increased stability helps people plan for the future with more certainty, reducing the need to hold precautionary reserves for unexpected fluctuations, hence also contributing to the growth process. Such an expectation would be disputed by those who believe that there are underlying cycles to economic behaviour. In such a case counter-cyclical policy, rather than stable policy, may tend to produce the best result. It is difficult to produce evidence to resolve this difference of opinion. The improved growth path of the second half of the 1980s is cited by some as is the better relative performance, over an extended period, of Germany whose monetary regime is in a large part the model for the proposed European system.

We thus observe two potential adverse effects on cohesion. If there is a deflationary bias, then average unemployment will tend to be higher – that in itself lowers cohesion between the employed and the rest of the population. Secondly, unemployment tends to rise most in the weakest areas, hence exacerbating existing disparities. Of course EMU may decrease unemployment if its favourable effects on output exceed those on productivity and if increased real incomes diminish labour supply.

However, the major macroeconomic worry is that EMU restricts the ability of disadvantaged regions to adjust. In most economies, labour markets are slow to adjust. Hence if there is a shock to the system, say in the form of an increase in oil prices, other markets will overadjust in the short-term until the labour market catches up. If the required adjustment is a fall in real wages then this can be assisted by a short-term fall in the exchange rate and some extra inflation.

This will only work for a larger monetary union if all parts of it require the same degree of exchange-rate and inflation adjustment. A monetary union enforces a considerable degree of inflation and price convergence. Because goods and people can move freely and all prices are expressed in the same currency, arbitrage and migration will limit differentials. Such nominal convergence does not necessarily improve cohesion because it may entail wide differences in real incomes and unemployment for its achievement.

Two other forms of convergence also have to be considered in this context. The first is structural convergence. If the economic structure of regions differs, with some specializing in particular industries, and some based on natural resources, they respond differently to the same shock. For example, fishing quotas have a disproportionate effect on regions employing deep-sea fishermen. The difference most frequently pointed out is that between oil producers and oil importers in response to an oil-price shock.

The second component is behavioural convergence. As a result of long-standing traditions and cultures, people and organizations respond differently to the same circumstances. Family support in adversity is greater in some parts of the Community than in others, while the propensity to save windfall gains varies, etc. The study of French and Italian wage and price formation in the *National Institute Economic Review* of November 1990 cited above shows how slow labour markets may be to converge. Taken together, these two components of convergence mean that, despite the regulatory framework of an EMU, outcomes are not uniform. The restrictions on policy intervention and response mechanisms that follow from EMU will, therefore, have the greatest impact on those regions which differ most from the Community average in terms of structures and behaviour. This tends to apply to the regions which are currently least favoured.

Research at NIESR published in *A strategy for the ECU* (NIESR, 1990) suggests that as time passes and integration increases, the differences in response to shocks among the main Member States are diminishing. Ten years ago the response of the UK and Italy to an oil-price shock was very different from that of France and Germany, making the extra flexibility of an adjustable exchange rate well worth having. Now, as the importance of oil production has diminished and trade with Europe has increased, these economies are much more similar. The NIESR results suggest that by the mid--1990s the differences among the Member States will be such that the benefits from having an adjustable exchange rate would be too small to provide a realistic reason for rejecting EMU on these grounds given the microeconomic gains. There might, nevertheless be other grounds for questioning the gains from EMU, for instance if the costs of transition are too high.

However, all this analysis refers to Member States and indeed only to some of them directly. In countries where there are significant internal disparities, the less favoured regions have already had to cope with being part of an economic and monetary union. Despite continuing regional disparities this has generally proved acceptable in EC Member States. Cohesion thus seems to exist in most of those cases. It must be recognized, though, that public finance transfers from favoured to less favoured regions within Member States will already have mitigated the degree of disparity.

The question, therefore, is whether regions currently less favoured within a Member State's EMU will be more or less disadvantaged by joining an EC-wide EMU. That is clearly difficult to answer. If the region's characteristics are more similar to the Community norm than is its Member State then it may gain. If it is even less like it then the forces of divergence will be enhanced. On the whole, regions which are most dissimilar also tend to be the least favoured. As a result, the adverse effects of EMU are likely to be greatest for the less favoured regions in less favoured Member States. By contrast, some of the relatively advantaged regions ed Member States, because they are joining a monetary union where the stance of policy may suit them better, may be net gainers, providing a twist to the process of cohesion.

Within Member States, the less favoured regions tend to run substantial balance of payments deficits and, in effect, run substantial fiscal deficits for their local administrations because local funds are supplemented by central government revenues. Furthermore, the tax and benefit system as a whole redistributes from the richer to the poorer reducing the problems of supporting local incomes from local resources.

According to the MacDougall Report (1977), taxation and public expenditure reduced regional inequalities in per capita income in the countries studied by about 40 % on average. Within EMU for the Community as a whole, a similar form of behaviour is not available to Member States. States will not be permitted to run large and persistent deficits in order to obtain 'involuntary' transfers from the rest of the Community and the contributions from the richer to the poorer within the Community budget may in future not extend much beyond current levels which amount to around 3 to 5 % of GDP in recipient countries. This falls far short of the 2 % of Community GDP the MacDougall Report estimated would have to be transferred from the six richer to the three poorer Member States for the latter to achieve that 40 % reduction in disparity for their income per capita.

Table 2: **Main indicators of nominal convergence problems in the Community, 1991**

	Inflation		Public finances			External accounts	
	Deflator of private consumption	Nominal unit labour costs	General government net borr. requirement (% of GDP)	Public debt as a % of GDP: 1991	Public debt as a % of GDP: change from 1990	Current account balance (% of GDP)	National savings (% of GDP)
B	3.2	3.4	**6.5**	128.1	+0.6	1.1	**20.8**
DK	2.4	1.4	1.3	62.3	−0.1	1.6	**19.0**
D	3.5	**5.4**	**4.6**	45.4	+2.4	0.1	23.4
GR	18.0	14.2	15.3	**86.0**	**−0.3**	−5.0	13.6
E	**5.9**	**5.7**	2.7	44.5	+0.3	−2.9	23.0
F	3.1	3.3	1.6	37.3	+0.9	−0.9	20.1
IRL	3.0	**4.9**	**3.8**	**97.4**	**−2.4**	2.2	21.7
I	**6.3**	**6.9**	10.1	103.3	+2.6	−1.3	19.5
L	3.5	2.8	(−1.6)	4.7	−1.6	26.4	57.4
NL	2.8	3.4	4.8	78.8	+0.3	4.0	24.9
P	11.5	14.6	5.5	63.8	−3.5	−1.2	27.1
UK	6.5	8.2	2.2	44.5	+1.3	−1.1	14.6
EC	5.0	5.9	4.6	60.0	+1.4	−0.6	20.3

NB: The shaded cells give an indication of convergence problems.

Source: Commission services, forecasts May 1991.

This presents States suffering from existing high inflation and high deficits with a twin problem. Not only do they have to reduce the deficit, but the degree to which they have been able to use inflation as an implicit form of tax is greatly reduced (this latter mechanism is often referred to as seigniorage – the government does not pay interest on currency and compels banks to have compulsory reserve deposits on which below-market rates of interest are paid).

According to 'One market, one money', the average level of seigniorage among lower inflation States (including the UK) was 0.5 %, over 1 % in Italy, in Spain 1.5 %, Portugal nearly 2.5 % and Greece nearer 3 %. These same four States have the highest budget deficits in the Community combined with current account balance of payments deficits, as shown in Table 2. Greece is clearly in the worst position with the highest inflation, largest internal and external deficits and a fairly substantial debt ratio. Although Portugal is the only other country with inflation exceeding 10 %, it is Italy which has the second most difficult public finance problems. Reducing the deficits and the consequent loss of seigniorage levels will require deflation, on a major scale in Greece, to a lesser extent in Portugal and Italy. There must be some small concerns for Spain but in general these nominal convergence problems are focused on Greece, Portugal and Italy.

To some extent this is a transitional problem. Once inflation rates are reduced, borrowing costs for these countries will fall, assisting the balancing of their budgets. But from a practical point of view, this is a non-trivial problem, because the lower the income of a region, the larger a proportion of its GDP has to be used to provide any given level of public services. Increasing the rate of taxation may be difficult to achieve politically and cutting services may reduce cohesion. The sequence will only be possible if the rate of growth is sufficiently fast that rising incomes can be used to provide the extra expenditure without any need for unacceptable cuts in public services. It is, consequently, important to ascertain the overall effect of economic integration on the regional incomes of the Member States with the greatest adjustment problems in order to assess the impact on their fiscal capacity.

As an illustration, although the Greek deficit is large in comparison to Greek finances it is only 1.8 % of the EC budget and hence a problem of a magnitude that could be dealt with as part of a period of transition. The Italian deficit on the other hand, though only two-thirds as big in relation to Italian national income, is much larger compared with the Community budget (18.7 %). This easily be met from EC resources and thus requires considerable internal action if it is to be reduced to acceptable levels.

The problem can, of course, be looked at the other way round. Ireland is an example which shows that a country which is classified in its entirety as a less favoured region of the EC can adjust to be in a position to be a full member of the EMU. It is other aspects of convergence which hinder the process, and not just income and unemployment disparities. It does, however, seem clear that the process of adjustment to being able to be a full participant in EMU must make the problems of cohesion worse for Greece and Portugal and probably for Italy and Spain as well. The benefits are promised for the longer term.

Such a structure of change is unlikely to be appealing, as the costs become obvious before the benefits. This will be particularly clear if the length of the transition period is not fixed and is dependent upon successful adjustment. The harder the task, the less the credibility that any government has in its commitment to achieve the objective. The less the credibility, the harder the task because inflation and exchange risks will remain, with adverse consequences for the costs of borrowing and the stimulation of growth. It is, therefore, no surprise that countries with adjustment difficulties to EMU are seeking direct offsetting measures to assist cohesion. Without such offsets, moving to EMU is a much more difficult political task.

It is for such reasons that some countries are suggesting that EMU should progress at more than one speed, with those who have achieved the necessary convergence forming the union first. However, this in itself is anti-cohesive because those who join get the cost and growth benefits, thereby widening disparities and making the adjustment for the second tier of countries more difficult to achieve – and simultaneously increasing the pressure on them to do so. Creating a two-tier Community, though, is itself anti-cohesive. Until now it has been possible to rely on the fact that Spain, Portugal and Greece have transitional arrangements as part of their accession Treaties but this process is attenuating. Extending it, particularly if this involves older members of the Community, will reduce cohesion at the national level, not just on a regional basis. EMU is thus a key factor in the debate about cohesion in the 1990s.

3.2. Other influences on cohesion

Although it is correct to emphasize the impact on cohesion of changes brought on by completion of the internal market and major policy initiatives such as EMU, it is important not to lose sight of additional, if less dramatic, ingredients shown schematically in Figure 7. This section considers how some of these can be expected to impinge on cohesion.

3.2.1. Population growth and migration

Demographic trends are mostly predictable and slow-acting, but can nevertheless exert a profound influence on social and economic change. Differences in natural rates of increase in the population are the main determinant of relative regional growth in labour supply, with higher rates of growth in many of the less favoured regions. It is often this relative increase in the working population as much as the pace of job creation that gives rise to the labour market imbalances which cause high unemployment and emigration. The composition of the population not only shapes the character of different regional societies, but can also affect income levels. Where there is a large dependent population, the income of the economically active has to be shared more widely, diminishing per capita values unless there are net transfers from other regions. Demography consequently plays a central role in determining the magnitude of interregional transfers and migration, so that it has to be seen as a critical factor in cohesion.

Imbalances in employment opportunities in the Community, with jobs being created faster in the favoured regions, while working population grew faster in the lagging regions, has in the past been offset by internal migration. In the 1960s, this was effective both in reducing unemployment in the weaker regions and in transferring income to them through migrants' remittances. Although economic growth and low natural population growth in the better-off regions may recreate these conditions in the 1990s, technological change means that fewer jobs will be created there, and these will mostly have higher skill requirements. Migration will therefore be a less effective adjustment mechanism. Past experience also shows that significant social costs can arise from relying on migration to correct economic imbalances.

In Northern Europe especially, there is increasing concern about 'ageing' of the population, as birth-rates fall and life expectancy increases. By the year 2000, median age in the EC will be 37.7 years, compared with 32.7 in 1980 (Forward Studies Unit, 1991), though with big differences between countries, ranging from 29.9 in Ireland to 40.7 in (West) Germany. Ratios of dependency of the retired population (population aged over 65 relative to working population) are rising in all Member States except Ireland. Three causes of ageing have been distinguished:

(i) declining fertility rates, reducing the proportion of children in the population;

(ii) longer life expectancy increasing the share of the elderly;

(iii) population bulges from previous 'baby-boom' generations becoming older, resulting in a bigger weight for the groups in question.

The situation is not uniform across the EC. Birth-rates are above the EC average in France, Ireland, the Netherlands, Portugal and the UK, and below it in Denmark and Germany. Within each country, they tend to be above average in the lower-income regions. However, lower-income regions also have shorter life expectancy – an important indicator of social deprivation – so some poorer regions show an above-average death-rate as well as an above-average birth-rate. Social trends such as earlier retirement or longer education reinforce the demographic effect on the proportion of economically active in the population. The relative rise in the number of retired or inactive citizens will require increased funding of social and pension provision from a diminishing tax-base. More positively, it will help to reduce youth unemployment, improve the chance to work beyond retirement age for those who want it, and improve the prospects for women to find employment or return to it after career breaks. A further consideration is that labour 'supply' for the voluntary sector becomes greater.

Different sorts of migration flows can be expected to alter the population map in the 1990s. Labour market imbalance is, as noted above, one of the main reasons for migration. If the pattern of growth in the EC is as predicted in Section 3.1, economic integration will reinforce the existing trend of migration from lower- into higher-income countries and regions. In the past, such migration may have had positive effects. Rural-to-urban migration has the potential to raise labour productivity in both regions if there is underemployment in agriculture and scale economies in industry. Migration from labour-surplus to labour-shortage regions may narrow wage and unemployment differentials. But the effects can also be negative. Economically, migration by the younger, more highly-skilled population can create downward income multipliers and reduce the savings rate. It is estimated, for example, that 30 % of graduates of Irish universities emigrate within one year of finishing their courses. In the destination region it can cause housing shortages, competition for jobs and social tension resulting in discrimination against migrants.

It is important, moreover, to distinguish between long-distance and intra-regional migration. Greece, the Mezzogiorno, and parts of Spain are witnessing population shifts from agricultural communities towards urban areas which are already congested and have badly overstretched infrastructure. The migrants are typically displaced agricultural workers or youths who see no economic future on the land. In cities like Naples, where few job opportunities exist, the consequences are self-evident. Economically stronger host regions could, conceivably, accommodate migrants with less stress, but there are obstacles which have resulted in most migration now being intra-regional moves.

A wholly different kind of migration occurs for, essentially, social reasons. Regions with agreeable climates (for example, parts of Spain) are proving attractive to wealthy retired people. Such moves also occur within regions. The comparative decline of the largest cities in many Northern countries has been occasioned by a combination of residential choices and changing location demands by producers. As Cheshire and Hay (1989) have shown, the trend has been away from urban cores, first to suburban areas of large conurbations, then subsequently to smaller urban centres. This not only moves spending power but also has effects on the host and origin communities. Local social cohesion can be affected where the well-off immigrants clash with the indigenous population, notably over housing costs. In areas which lose the wealthy, there can be adverse effects on the local tax base which accentuate deprivation. The lack of mobility of socially disadvantaged residents 'trapped' in urban ghettoes, as identified in France, is a potential outcome. From a number of perspectives, therefore, it is apparent that social and demographic shifts in urban areas need to be examined, and there is increasing recognition that greater account needs to be taken of cohesion problems in urban areas.

3.2.2. Extra-EC immigration

As a wealthy economic area, the EC is an attractive destination for migrants from other parts of the world. Traditionally, it was colonial ties (France and the UK) or labour shortages (Germany) that gave rise to this immigration, but, in recent years, emigrants have been moving to other countries as well, for example, Italy. Most Community countries have been experiencing small net immigration; the exceptions being Ireland which has had a net loss of population and France which has had no net gain. Migration into Luxembourg, Germany (West) and Denmark has been especially heavy, at 1986 rates of 5.3 %, 3.2 % and 2.2 % respectively. This reflects both the 'pull' of relatively high living standards in these countries and their relative openness to immigration.

Fears of a sharp increase in external immigration centre on the eastern border with the former centrally planned economies, and the southern border with North Africa. Eastern Europe is currently experiencing economic hardship due to restructuring and (especially in the Soviet Union and Yugoslavia) serious internal political conflict. Applications for refugee status to Germany have risen from under 50 000 in 1984 to nearly 200 000 in 1990, a figure which excludes ethnic Germans (who are accepted automatically) and those who enter illegally (Aeppel, 1991). Italy and Greece have also experienced recent well-publicized influxes, especially from Albania and Yugoslavia. Much of Eastern Europe appears to be experiencing a 'demographic decline' similar to that in the north of the Community, but employment prospects for its younger, often skilled workforce are temporarily very poor. Immigration from North Africa and the Maghreb, a response to rapid population increase and limited work opportunities in these areas, concentrates initially on the southern entry points of Italy and Spain. These are areas where unemployment is already high, and living standards below average, making a large-scale influx more difficult to absorb.

Migrants are often willing to work for comparatively low wages and under inferior conditions, and some are comparatively well-trained. As a result, they are frequently prepared to take jobs in regions where the 'reservation wage' – the minimum wage needed to persuade someone to take a job – of the indigenous population is high (as it is said to be in parts of the Mezzogiorno). Many industrial countries have encouraged immigrants in the past to help overcome anticipated labour shortages, often according them 'guest worker' status falling short of full citizenship, to provide flexibility in the event of a downturn. If the growth projections from the completion of the single market are fulfilled, it is possible that such migration could be mutually beneficial. Some form of common screening will probably be necessary, as an applicant accepted by one Member State is then free to move on to others in keeping with the principle of free movement of labour in the single market. It might appear undesirable to create a second-class category of labour with restricted rights of residence and such arrangements may prove more difficult to enforce.

However, as with migration inside the Community, inward migration is a sign of regional inequalities which could be corrected by other means. It is in the Community's long- term interest to help improve the economic situation of the countries currently experiencing emigration. This is already being done in Eastern Europe through bilateral arrangements, special financing facilities and the lending programmes of the EIB and the European Bank for Reconstruction and Development (EBRD). More will also need to be done to help the Community's southern neighbours, beginning with an improvement in their access to the European market.

Extra-EC immigration is an increasingly significant social and political issue, as recent events in France demonstrate. Racial tensions are apt to be worsened, especially when a second generation of immigrant origin grows up. Education systems have to adapt to linguistic and cultural demands, and there are frequently difficulties in integrating housing supply. Common controls on immigration may put a brake on the numbers entering the Community, but would give rise to increased illegal immigration and associated social problems. For all these reasons, the prospective impact of increased migration on social cohesion is likely to be substantial.

More generally, it has to be accepted that migration, in many ways, is a problem to be solved in a strategy to achieve social cohesion, rather than an easy solution to economic imbalances. This highlights the fact that there is often a conflict between what is desirable from the perspective of ensuring economic cohesion and the attainment of social cohesion.

3.2.3. The changes in Eastern Europe and the potential peace dividend

The pace and scale of change in Eastern Europe since 1989 has exceeded nearly all expectations. For the EC, the transformation may well affect cohesion in a variety of ways. On the one hand, the opening up of these countries will increase the range of location choices open to investors, possibly diverting resources from less favoured regions which might otherwise benefit from the investment. In the same vein, if the better-off Community countries choose to assist in the regeneration of the economies of Eastern Europe, this is bound to reduce investment in the less favoured regions of the Community. German public opinion, for example, seems to have become concerned that commitments to aid the new *Länder* and Eastern European countries is as far as the country should go. On the other hand, the diminution of tensions and the new access to markets creates opportunities for complementary economic development.

The disappearance of the strategic division between 'East' and 'West' Europe, and the decline of the Soviet threat, give Community countries an opportunity to reduce their total expenditure on defence significantly. The Community's growing economic strength and political unity will give it new international responsibilities, but the defence requirements created by this should cost substantially less than the current total of Member States' defence expenditure. The Community must work to achieve a rapid 'conversion' of military R&D and production to non-military uses. Absence of this conversion might create new problems of falling output and employment in defence-related industries and regions. The challenge is to realize the gains from this reallocation without causing intolerable structural impacts.

Reduced defence expenditure will also assist the East European economies, not least the Soviet Union. Yet it is clear that the scale of the problems these countries face is rising by the week. Both the Polish and Czechoslovak presidents have recently made clear that the economic difficulties they currently face can only be contained for a short period. Unless there is a fairly rapid improvement in their economic circumstances, the fear is that these countries will revert to totalitarian rule. Considerable pressures for transfers from the EC to countries to the East are likely to arise on the basis that the EC is benefiting from the 'peace dividend'.

3.2.4. Widening of the Community

Cohesion is bound to be affected if additional Member States join the EC. The acceptance of additional members into the EC has been postponed by the Community until the single market and associated measures have been successfully implemented. However, the success of current integration programmes will increase the attraction of the Community to those outside it. Prospective entrants fall into three groups: the EFTA countries, two of which (Sweden and Austria) seem set to be the next members of the EC; liberalized Eastern European countries (Poland, Hungary, Czechoslovakia, Yugoslavia); and countries to the south and south-west of the present Community, such as Turkey and Morocco. Various reforms of the Community's institutions will almost certainly need to be enacted before this can happen, but it is still worth considering the potential effects on cohesion of a widening of membership. These will include macroeconomic impacts, changes in patterns of competition and new resources for and demands on policy towards cohesion.

The EFTA countries are already convergent with the Community in both nominal and real terms, with GDP per capita significantly above the Community average. Negotiating difficulties can be anticipated on agriculture, which is at present more heavily protected and subsidized in most EFTA countries than in the Community. Fishing rights may also be a problem, two of these countries being landlocked and two having extensive coastlines. The Scandinavian countries are at the forefront of reforms to protect the environment and ensure 'sustainability' of industrial processes – for example, by cleaning up coal-burning emissions, replanting forests and running down nuclear programmes. Scandinavia also has a tradition of generous treatment for immigration, but there seems to be no reason why this should not fit the approach adopted by the EC as a whole.

Accession of the Scandinavian countries and Austria, if not Switzerland, would mean more high-income countries in the Community, and should facilitate the raising of more money for cohesion-related expenditure. Indeed, the possibility of EFTA candidates being asked to contribute to a 'cohesion fund' has surfaced in preliminary discussion. Though there are signs that it may be changing, Scandinavia also has a tradition of generous welfare provision financed by relatively high personal and corporate taxation. This might provide an obstacle to entry, if the Community decides to standardize these taxes. But recent work commissioned by the French Senate suggests that only indirect taxation is in need of greater harmonization (CERDP, 1990).

The need for Eastern European countries to upgrade their industry and agriculture and construct an open financial system will require a longer adjustment to full Community membership, especially if the single market is followed by monetary union in the later 1990s. But there is every reason, as part of the Community's assistance to the Eastern economies, to make some of the benefits of membership available much sooner – in particular, preferential access to the internal market and participation in Community programmes promoting technological, educational and cultural cooperation. Current assessments of the Czechoslovak, Hungarian and Polish economies suggest that full membership might be possible around the turn of the century. Though the prospects for Romania, Bulgaria, Yugoslavia and Albania are less propitious, it is vital that the Member States and the Community assist reform and restructuring in these economies, and political reform where national cohesion is under threat. The consequence of not doing so, already witnessed, may be increased migration from these countries which creates problems both for the Community and for the human capital base of the countries left behind.

Turkey is currently on a difficult but apparently successful path towards nominal convergence with the Community, which should assist the progress of its real economy. However, it is a long way from real convergence (GDP per capita, measured in current prices, is about 10 % of the Community average), and certain questions about its social and political situation remain unanswered. A long phase of further economic consolidation, with Community assistance, seems likely to be needed. But Turkey's expanding trade with Europe provides an incentive to work towards membership, and its geographical location would significantly widen the Community's southern frontier into the Middle East.

The North African States will be of increasing concern to the Community because of the likely increase in economic migration from them. Even though membership is not feasible in the short term, considerable help could be given to these economies by improving access to the European market, particularly for agricultural and textile products. Greater investment and technical help would also be in the Community's own interest, by improving local employment opportunities for the expanding populations in this region.

In terms of the outlook for divergences in living standards, there are various possibilities. The accession of some or all of the EFTA countries would raise average Community income, and might sharpen debate on widening disparities in living standards, even if absolute levels were unaffected. On the other hand, if low-income countries join, there would be increased 'demand' for assistance, putting additional strains on the Community budget. Some regions currently classified as less favoured would, as a result, risk losing their designation. As one interviewee noted, if Turkey became a member of the Community, several regions in the Mezzogiorno would be lifted over the 75 % of Community average threshold, and thus not eligible for assistance. Yet there would have been no material change in the regions' circumstances.

3.2.5. German unification

The experience of the union between West Germany and the former GDR raises a number of issues which are dealt with elsewhere in this report. First, there is the impact on the European economy of West Germany's heavy investment in modernizing the economies of the eastern *Länder*. In the short term, this has significantly reduced the country's external trade surplus, opened up a sizeable budget deficit and slightly raised its rate of inflation. It is likely that some of the fixed investment now being made in the east of the country would otherwise have flowed into other EC countries, including disadvantaged regions. Clearly, to the extent that the former East German *Länder* are suffering serious economic, social and environmental problems, it is justifiable that additional resources should be channelled towards them. A critical question for the 1990s will, nevertheless, be whether or not the new *Länder* have to be regarded as a problem requiring continuing Community action, in which case other regions which warrant assistance may lose out relatively.

In the longer term, unification will reinforce Germany's role as the largest economy within the Community. There is optimism concerning the prospects for a fairly rapid reduction of inflation to traditional rates and for an eventual re-emergence of its trade surplus with renewed scope for capital export to other EC countries. Although the scale of current problems may have been underestimated initially, there appears to be little danger that unification will impede the continued growth of Germany or of the Community as a whole.

A separate consideration is the effect on Germany's preparations for economic and monetary union. This will be conditional mainly on the speed with which inflation in the Federal Republic is brought under control. Although unification may take priority on the current political agenda, there is again no immediate reason why progress towards EMU should be seriously delayed, and it is possible that the current situation may accelerate nominal convergence by other member countries.

The economic implications of German economic and monetary union for the Community's EMU also merit attention. East Germany has suffered in the short term from the competition of higher-productivity, higher-quality producers, coinciding with a rise in unit labour costs and a loss of the exchange rate as an instrument of adjustment. Although sustainable in the German case, this is a scenario which the Community has sought to avoid by pursuing nominal convergence in advance of any moves towards a single currency, and by delaying full entry into the single market for particular national 'infant industries'. The general implications of European EMU were discussed in Section 3.1.2. The German experience has focused attention on the potentially dramatic effects of entry into monetary union (though other European countries, such as Ireland and Italy, had earlier experiences which were equally instructive). Additional caution may now be observed over the European EMU process, but the timetable does not require significant revision.

3.2.6. Environment

The environment is increasingly being regarded as an integral component of the quality of life. The state of the environment is consequently emerging as an additional dimension in which disparities need to be scrutinized in the search for cohesion. The range of environmental problems now claiming political attention includes those related to fossil-fuel burning (acid rain, global warming), to nuclear materials (low-level radiation, accidental discharges), to hazardous and polluting chemicals in agriculture and industry and to the general destruction of natural areas by industrial and residential development. Badly-hit regions in the EC include the industrial areas of the former GDR between Halle and Leipzig (where soil and water are badly polluted), the Mediterranean coast (where sea pollution now threatens the fishing and tourism industries) and the forests of central Europe (damaged by acid rain).

The character of policies to safeguard the environment will, itself, have an impact on competitiveness and thus on cohesion. Recently, the focus has been on the market approach to prevention of environmental degradation – raising the cost of environment-damaging activities, for example by taxing polluting substances or by auctioning discharge rights – over a policy of direct control. This is bound to favour those firms best able to face additional operating costs or those which have already had to adapt to stricter standards. At the same time, direct control of polluting activities sometimes harms existing producers, who have made unrecoverable investments which now fall foul of the rules, many of which will be long-established.

The Commission is already working towards the setting of minimum standards for environmental care, one reason being to prevent regions competitively dropping their standards in pursuit of inward investment – 'eco-dumping'. Any centrally-organized initiatives for pollution control, either through regulation or through market-based charges, must assess the progressivity of both revenue-raising and expenditure and, if necessary, relieve the burden on disadvantaged regions which are required to take expensive remedial measures.

The regional impact of current and proposed environmental measures is difficult to assess. Taxation or direct control of environmentally-damaging industrial activity might be doubly progressive – the main burden falling on higher-income industrial regions, and significant benefits going to lower-income regions which currently pay the external costs of pollution. However, many of the problem industries are located in Objective 2 regions, and some problematic agricultural practices result from the attempt to raise labour productivity in Objective 1 and 5b regions. Firms in disadvantaged regions are often less well placed to absorb higher pollution charges, or to make the investments to meet new quantitative controls. A solution might be to put the proceeds of a carbon tax or similar market-based measure into a new fund for the finance of environmental improvement in EC-assisted areas.

3.2.7. Energy supply

Energy was central to two of the agreements which began the formation of the Community (the ECSC and Euratom Treaties), and its future supply and usage have important implications for EC economic and environmental progress. Access to secure energy supply also has to be regarded as a fundamental economic and political objective, so that prospective developments in the energy market can affect economic and political cohesion. The development of the North Sea area has provided the Community with a substantial source of hydrocarbon fuels in the medium term (to which the prospective accession of Norway would obviously add).

The distribution of fossil fuels is, nevertheless, distinctly uneven. The UK and Germany supply a large proportion of their coal needs, though both have virtually halved their output in the last 20 years and increased their imports of cheaper coal from outside the EC. Spain also produces most of its own coal, and has been expanding output. The UK has been a net exporter of oil since 1980 and is close to self-sufficiency in natural gas, while the Netherlands has a substantial net export of gas. Denmark supplied about half its own oil needs by the late 1980s. Despite increasing its oil and gas output and moderating its consumption, the EC as a whole runs a substantial energy deficit. If there were to be further substantial fluctuations in oil prices, the effects on cohesion could be considerable.

Community energy policy has three major tasks. The first is to continue to reduce total energy consumption by introducing more energy-efficient industrial processes, switching to less energy-intensive industries, 'extensivizing' agriculture, and conserving and recycling energy-using products. The second is to continue the development of new (especially renewable) sources of energy. An imaginative proposal (first put forward at the 1990 Dublin Summit) is for a European Energy Community linking the EC and the Soviet Union (or its constituent republics). Soviet output is limited by technical and infrastructure problems, so that a programme of joint exploitation would not only open up new supplies to the West, but would also strengthen political ties and provide a source of revenue with which to finance economic reconstruction.

The third task is more microeconomic in character: to overcome the geographical imbalance in energy supplies to households and businesses in order to ensure that possible problems with the supply of energy do not inhibit regional development. The current imbalance usually shows up in cost, but sometimes (especially with electricity) the existence and continuity of supply is also a problem. For many enterprises in disadvantaged regions, particularly in manufacturing, development of energy supply is as important as improvements to physical infrastructure and telecommunications. Some regions which lack conventional indigenous energy sources have the potential to develop water, wind or other renewable sources, so a wider programme of energy exploitation would be better adapted to developing their potential.

3.2.8. Transport

As with energy, transport presents both Community-wide and regional problems. The Community has a general interest in promoting a transport system which improves its energy balance and protects its environment. For Community cohesion, it is equally important to improve access to transport services for regions and localities which are currently poorly served by it. Yet almost paradoxically, poor transport access has, on occasion, been an effective form of protection for relatively uncompetitive economies. This illustrates a particular feature of economic integration which could have a noticeable bearing on cohesion. In isolation, a regional economy may cohere fairly well, even if its rate of growth is unexciting. But when it is opened up, all sorts of new relationships may be forced on it, upsetting internal cohesion.

Much current policy, most notably the single market programme, presupposes that transport costs will continue to form a fairly small proportion of total costs in most industries, so that there will be gains from using lowest production-cost locations to serve the whole of the market. The continued development of transport infrastructure, especially in the currently less well-served regions, will further reduce the costs of goods movement, while the shift to higher value-added products, and information-based services that can be moved by telecommunications, should weaken the connection between transportation and trade. Caution must, however, be exercised on two counts. Firstly, the Community continues to import about 70 % of its crude petroleum, and it is impossible to rule out future price increases due to production or political disruption. Reduction in oil use should remain an objective, to avoid the threat of growth interruptions on the scale of those that followed the two OPEC shocks. Such interventions are problematic given the increasing aspiration towards car use (especially in lower-income and rural regions), and the differences in national balance between road and rail transport which might make pro-rail legislation appear as a non-tariff barrier.

Alongside these overall changes in the use of energy for transport, the Community will continue to improve the quality of transport facilities in its regions, particularly those which are geographically distant from major markets. Much is already being done through the ERDF and EIB to upgrade road, rail, air and waterway communications. A perhaps more neglected need, identified in the context of the single market, is for short-range public transport tailored to users' needs in the assisted regions, for example by subsidized 'citizens buses' (IFO, 1991).

3.2.9. Agricultural policies

The prominent position of agriculture in the affairs of the EC makes it a key area for policy towards cohesion. Since the early days of the Community, agricultural policy has been the flagship of Community action. As the first 'common' policy, the EAGGF system of price support and structural assistance can be credited with creating food self-sufficiency in Europe, and has substantially improved the level and stability of agricultural incomes. By the same token, the CAP is seen as distorting trade (to the detriment of the Uruguay Round) and having a perverse effect on income distribution in the Community. Yet political difficulties have meant that agricultural policy has been resistant to change. For these and other reasons, the sector now faces a variety of challenges which will have to be confronted in the next decade.

Because of past inertia, many of the problems have now become fairly urgent. Budgetary costs are central: agricultural guarantee expenditure has risen substantially – up 250 % in real terms between 1975 (when it totalled ECU 4.5 billion) and 1991 (when it will reach ECU 31.5 billion). The current reforms, while intended to reduce expenditure in the long term, will add ECU 4 billion per year by 1996 (Commission of the European Communities, 1991d). This is in addition to the higher food prices paid by Community consumers, and the cost of storing, converting or disposing of excess food stocks.

Externally, the Community is under growing pressure from agricultural producers who have dismantled their own price-support systems, but are prevented from competing for the EC market by the external tariff needed to support high guaranteed prices. This complaint, long voiced by developing countries negotiating through the Lomé Convention, has now been taken up by the USA and the Cairns Group at the Uruguay Round of GATT negotiations.

Internally, the full impact of Iberian accession to the EC is still to be felt, since the transitional period is only now nearing completion. The most direct reverberations of this will be felt in regions with similar structures of agriculture, notably Italy and southern France which will face more intense competition in horticulture, wine and olive-oil production. Iberian producers will, similarly, face more intense competition for products which enjoyed protection. There will also be an effect on the balance of power, since the regions producing 'southern' products will now have a blocking vote, making it likely that the balance of support from the CAP will need to shift to accommodate this.

Most of the EAGGF spending goes on the guarantee scheme, which tends to benefit the larger farms that are disproportionately represented in the better-off regions. The Guidance Fund, which assists rural restructuring, represents only 5 % of agricultural spending. Commission calculations show that 80 % of EAGGF support goes to the largest 20 % of farms, and analysis of the regional allocation of guarantee payments shows that they are regressive for the lowest 40 % of population ranked by income (DIW, 1991). This also reflects the entry of Portugal and Spain, with regional incomes generally below the Community average and a different composition of agricultural production. (With cereals and rice, which are mainly northern-EC outputs, the lowest 40 % of regions by income received only 30 % of payments in 1986-89.)

The programme for CAP reform (Mac Sharry, 1991) involves cuts in intervention prices most severe for beef and cereals – with compensation for the disposal of livestock and the setting aside of land from production. Small producers will receive most compensation, without set-aside obligations. The long-term objective is a return to 'competitive' pricing, which will remove the double subsidy to producers (for producing above market price, and then disposing of surplus). However, the short-term effect of the reforms is to increase the agricultural budget, with no financial savings in prospect until 1997.

Since small farms, which include those with the lowest labour productivity, will receive the most compensation, the scheme has also been criticized for protecting inefficient producers and punishing the more efficient. This conflicts with the CAP's long-term structural aim of raising the efficiency of agriculture, and helping small marginal producers to find alternative employment. The UK, with a predominance of high-productivity large farms, has raised particular objections. Unlike structural expenditures, agricultural guarantee expenditure is not targeted either regionally or according to the needs of the recipient. Thus the compensation proposals cannot discriminate between small farmers who have alternative employment opportunities and those who rely on farming, or between those who are heavily dependent on Community support and those who could survive without it.

The tangled links between agricultural policy and cohesion include the effects of higher prices on consumers and the benefits to economic agents further down the value chain as well as the support to farmers. Support for agriculture is also prone to being confused with development of rural economies. In the long term, a significant real reduction in CAP guarantee expenditure will be necessary not only to honour the Community's international trading obligations, but to increase the budgetary resources available for other purposes including structural policy.

3.2.10. The Uruguay Round

Though currently stalled, it is to be expected that the GATT Uruguay Round will eventually culminate in the establishment of a new multilateral framework for world trade. Agriculture is certain to be one major source of contention between the EC and its main trading partners when the negotiations resume. There has been sustained pressure by the Cairns Group of agricultural exporters (Australia, New Zealand, Canada and 10 developing countries), and by the USA, which is also a major primary exporter, to accelerate the reform of the CAP. These countries, as Table 3 shows, pay substantially lower rates of producer subsidy as a proportion of total output value.

Table 3: **Agricultural producer subsidies, 1984-88**

(subsidies as a % of the value of output)

Country	1984	1985	1986	1987	1988
EC 10	33	43	52		
EC 12			52	51	46
USA	28	32	43	41	34
Australia	10	14	16	11	10
New Zealand	18	23	33	14	8
Canada	33	39	49	46	43
Japan	67	69	76	77	74
All	34	41	51	50	45

Source: Neville-Rolfe, 1990.

These and other figures for agricultural support show that the Community subsidizes farm output more heavily than the USA and Australasia, though less than Japan (and also than the EFTA countries). Apart from seeking lower subsidies, the USA has called for income support to be detached from price support, by switching to a compensation system that no longer requires external protection or encourages overproduction. The EC has argued for action to reduce surpluses first, with subsidies possibly increasing initially to preserve current income levels. As either would affect agricultural incomes, effects on cohesion are inevitable.

A second area of current reform is the Multifibre Arrangement regulating trade of textiles and textile products. This is designed to assist restructuring and redeployment within the textile industries of industralized countries by slowing down the rate at which they are exposed to low-cost imports. Many European textile firms are SMEs which already face stronger competition within the EC after 1992, and many of these are located in Objective 1, 2 and 5b regions. In the long term, liberalization of imports from the Far East and other developing countries will reduce prices and raise consumer welfare in the Community. But in the short term, quota controls are seen as a means to prevent further regional imbalance. Pressure from developing country producers to speed the abandonment of the MFA is now reinforced by some EC retailers and wholesalers, as well as producers who import semi-finished inputs keen to increase their non-EC sourcing as a way to retain cost-competitiveness.

The last year has seen some internal trading of national MFA quotas, as countries which have exhausted their quota buy additions from those with surplus quota. This may be rendered unnecessary by the current shift from country quotas to a composite Community quota. But this shift introduces an additional threat to cohesion: the attainment of additional quota for imports of semi-finished products by larger producers at the expense of small and medium-sized producers – their former suppliers – which tend to be more heavily represented in the disadvantaged regions.

A successful outcome to the Uruguay Round can be expected to include the opening up of world markets for financial and business services in which many EC regions are now comparatively specialized. Much of the activity in these sectors is concentrated in relatively favoured regions. Thus, while the Uruguay Round may be of benefit to the Community as a whole, it could produce an outcome similar to the process of economic integration if it favours the more prosperous regions.

3.2.11. Foreign investment trends

Inward investment has long been regarded as an important factor in regional development, although there was a marked reduction in the supply of 'footloose' capital in the aftermath of the first oil-price shock 1974-75 (Wadley, 1986). Short-term capital flows have also been important for several countries in financing external imbalances, and thus avoiding excessive deflation. Foreign investment trends are bound, therefore, to have an impact on regional economic development. In the 1970s and 1980s, Europe's financial systems gained from large inflows of portfolio investment from the oil-exporting countries. Since the early 1980s, its real economies have also gained from an inflow of foreign direct investment, principally from Japan, which continues to run substantial trade surpluses from which to finance capital export.

The inflow to Europe, which is about a fifth of the annual total of all Japanese foreign investment, rose from USD 1.9 billion in 1984 to USD 14.8 billion in 1989. Two countries, the UK and the Netherlands, have received 55 to 65 % of the total so far, but there are signs of a broadening of investments to other Member States. Most of the investment (47 % in 1989) has gone into developing financial services, but manufacturing has accounted for 15 to 20 % of annual inflows. (Anglo-Japanese Economic Institute, 1991). The cumulative investment came to USD 45 billion at the end of 1989 (Thomsen and Nicolaides, 1991).

Molle and Morsink (1991) provide evidence that the volume and allocation of intra-EC foreign direct investment has been encouraged mainly by the push factors of high unit labour costs, strong R&D capacity and surplus financial resources in the investing country, the stimulus factors of trade intensity and taxation differences, and the frictional factors of physical distance, cultural difference and exchange-rate risk which inhibit trade. If this is also true for non-EC direct investment in the EC, then the heavy trade flows of the EC countries with investing countries, together with high unit labour costs in the investing countries may explain some of the large investments in certain Member States (Spain, Portugal and the UK). Britain appears to have attracted its majority share through the access this gives to the UK and EC markets and through investors' familiarity with its language. Factor-based explanations, such as the skill and relative cost of labour, are cited, but tend to be outweighed by market-based explanations (Thomsen and Nicolaides, 1991).

The net benefits of inward investment for the recipient are difficult to assess. On the positive side, they may introduce new technologies and organizational methods, raise the general investment rate, encourage modernization by domestic firms, and improve the host country's trade performance by substituting imports. Inward investment to a region offers both direct demand and employment stimulus and opportunities to acquire new technologies, commercial and working practices. It is also common for a major investment to spawn work for subcontractors as well as facilitating the spin-off of smaller companies in the same sector. While there is a danger that investment originating elsewhere in the EC may simply have been diverted from another region in a 'zero-sum game', investment from outside the EC represents a potential gain for the Community as a whole. On the negative side, investments may raise the cost of local labour and capital to indigenous businesses, out-compete indigenous enterprise and displace some existing employment.

Studies of Japanese investment in the UK conclude that there was net employment creation between 1979 and 1985, even though the immediate impact may have been to destroy jobs by driving out domestic production. The volume of investment was important, providing about 3 % of UK fixed capital formation in the late 1980s, and it helped to revive certain manufacturing industries which the country appeared to be losing. But the main gains came from exposure to Japanese methods of doing business. Although the product and process technologies were fairly mature, UK competitors were forced to adopt new quality control and production-scheduling standards. The UK also gained from a reduction of its trade deficit with Japan (Norman, 1988, 1990).

Some recipient regions, especially those with less developed human and physical capital and infrastructure, are concerned that inward investment will create 'branch-plant' assembly operations which do little for local demand or factor conditions. The experience with Japanese investment in Portugal and Spain confirms that older technologies tend to be exported, but that these are generally compatible with current factor conditions in the host region. Local sourcing is usually developed, providing important linkages to domestic enterprise, and local management is trained to take over the operations. There is also evidence of substantial re-investment of profits in the foreign subsidiaries.

Host governments can improve the positive impacts by setting performance targets (e.g. for the proportion of inputs purchased locally, or for that of output exported), and by encouraging joint ventures with indigenous firms. The danger is that too much regulation will deflect the investment to another region. Competition among regions to attract investment can result in a 'zero-sum game' involving subsidies, tax concessions and exemption from regulations. The Community has already created rules to prevent undesirable forms of inducement, but it could go further in presenting a united front as regards the conditions for external investment in an EC country.

On balance, it seems that Europe's less advantaged regions could gain from policies to attract direct foreign investment. The integration of the Community itself will assist this, by offering increased opportunities for market growth, lower capital costs, free movement of goods and services, and tariff-jumping opportunities as motives to invest within its borders. Countries and regions can supplement this with policies to upgrade labour skills, improve physical infrastructures and generally improve knowledge of their advantages among potential investors. However, the increasing importance of skills, R&D capabilities and market opportunities, as opposed to low labour costs, makes it likely that external investment will continue to concentrate on the more advantaged regions. Inward investment will be an instrument for accelerating Europe's development, but not for evening out its distribution.

3.3. Assessment of the demand for cohesion in the 1990s

Priorities for action to ensure cohesion inevitably differ between countries, over time and amongst different political and social groups. This means that whatever policy towards cohesion is eventually implemented must represent a compromise. Some of the options are implicit in the objectives put forward for the structural Funds and will almost certainly continue to figure on the agenda for the 1990s. Other factors may come more into prominence and will call for new responses.

What then are some of the main demands on policy for the 1990s? There can be little doubt that the current priority accorded to lagging regions will continue to be necessary in the next decade. Greece, Portugal and parts of Spain, Italy and Ireland still have a long way to go before they attain levels of development that compare with those in the core regions of the Community. As peripheral regions, it is likely that they will find it relatively more difficult to keep up with core areas in the context of economic integration. The new *Länder* of East Germany almost certainly have to be placed in the same category. Although the aim of stimulating economic development to assist catching-up will remain in these regions, the means can be expected to evolve. Rather less emphasis will be needed in building up basic infrastructure, though there are inevitably areas where this will remain important – especially in Greece and the Portuguese interior. Instead, it is primarily in the realms of human capital and social conditions that a greater effort will be needed, although enhancement of services based on infrastructure will also be called for. Improvements in administrative capacity and in the political control of implementation of policy are also sought, chiefly in parts of the Mezzogiorno and in Greece.

The aim of industrial reconversion has long been prominent in the objectives of the Northern European countries. Though this will remain on the agenda in some regions, the likelihood is that it will recede as a major priority, since so much has already changed. Instead, the indications are that the demand will be for a more flexible approach to economic regeneration. Transformation of urban economies, rural development or the creation of new growth centres should perhaps be seen as variants on the same sort of cohesion need, rather than being seen as distinct aims of policy.

In the 1990s, economic regeneration will be an issue in all countries, but in a much more varied manner than in the past when entire regional economies were afflicted by the decline of staple industries such as shipbuilding, textiles or steel-making. Instead, loss of competitiveness or the need for structural adaptation can be expected to be a more localized problem. Shocks affecting sectors in which localities specialize, whether caused by fluctuations in demand, new competition or supply-side factors may require specific responses. Some frontier regions may face problems, while new transport developments can be expected to affect the competitiveness of localities they affect.

In many ways, economic regeneration in the 1990s has to be seen as a social objective rather than a purely economic one. There is an emphasis in France and the UK, for instance, on different sorts of urban problems – deprivation in inner city or suburban ghettoes of large conurbations or in smaller towns. This is often associated with concentrations of immigrant populations and high incidences of youth and long-term unemployment. In the past, such areas were characterized by poor housing and insanitary conditions – slums. Now, however, although the housing may be far from wonderful, it is above all social deprivation which is the problem. Urban problems of this sort are also evident in some of the major cities of the Mezzogiorno, where high crime rates and burgeoning illegal and black economies are important features of local society. If immigration from outside the Community continues to rise, this could give rise to accentuated social problems at entry points or in major urban reception centres. This is a growing worry in Germany in relation to Eastern Europe, and in Italy and Spain in relation to Maghreb immigration.

Among other emerging demands linked to cohesion, action on the environment is increasingly being seen as a goal to which Community policy should pay more attention. This sentiment is particularly strong already in Germany and the Netherlands, but can also be expected to increase in prominence in those areas where environmental damage poses a threat to the economy. Tourist operators, especially in Mediterranean coastal areas, the Danish fishing industry and residents afflicted by congestion in urban areas are examples of sources of pressure. A specific concern is water quality which has been degraded for many reasons and will need substantial investment. Congestion and air pollution are increasingly conspicuous political issues in urban areas, highlighting the importance of quality of life rather than narrow economic indicators such as income or unemployment as cohesion issues. A general preoccupation for the Community is to ensure that the less favoured regions do not become subject to eco-dumping – tolerance of lower standards of environmental protection in less competitive regions as a means of attracting investment.

Much the same applies to social dumping from the viewpoints of both favoured and less favoured regions. Achieving advances in levels of social provision is a key political objective in Spain, while those Member States, such as Belgium, with mature welfare systems, are anxious to maintain their standards. The worry is that competitive pressures resulting from economic integration or harmonization which diminishes provision will prove to be politically damaging.

It is inevitable that commitment to cohesion will be greater within a country than between countries, and this is a constraint that has to be taken into account, particularly where there are pressing indigenous priorities. Germany's willingness to contribute to cohesion-related outlays in other countries will, for example, be circumscribed because of its obligations in the new *Länder*. Political influences on how to achieve cohesion also stem from the power of different lobbies (notably the farm lobby) and from the approaches of different governments. The UK, for example, is a leading advocate of the view that market forces offer the best hope for progress. A cohesion strategy for the 1990s will need, consequently, to accommodate a range of objectives and constraints. The next chapter considers the principles that should guide such a strategy.

4. Principles for and constraints on a cohesion policy for the 1990s

There can be little doubt that the Community will have to elaborate a strategy for social and economic cohesion for the 1990s, principally because some Member States and regions have legitimate fears that the benefits of economic integration will pass them by. Unless they can be persuaded that the Community is sensitive to their needs, progress towards economic integration could be jeopardized. At the same time, there are worries that cohesion policies will distort markets and lead to excessive demands on public expenditure, ultimately diminishing the realization of potential benefits from integration. These contradictions signal that a new strategy for cohesion will have to be carefully designed to ensure that equity and efficiency are both served. This chapter discusses the principles that should guide the formulation of a new strategy and the objectives that should be pursued within it.

Equity implies that the distribution of the benefits of integration should be sufficiently wide to assure the support of most constituencies in the Community. A more negative approach would be to say that a strategy for cohesion is needed, in the colourful metaphor of one expert interviewed for the study, to forestall 'a mutiny by the troops'. At a minimum, equity should involve equality of opportunity which may, in practice, imply positive discrimination in favour of certain regions or groups. In this regard, it is worth distinguishing between those which are relatively less well-endowed in terms of the quality of their attributes, and those which for one reason or another do not make sufficiently good use of their resources. While there might be only weak arguments on economic grounds for slowing integration, the political reality of the EC is that Member States could exercise vetoes if the perceived benefits to them are not evident. The danger of a failure to address unbalanced growth was recognized in the Delors Report:

'If sufficient consideration were not given to regional imbalances, the economic union would be faced with grave economic and political risks'. (p. 18)

Efficiency needs to be taken account of in two senses. First, the underlying rationale for economic integration is that it encourages the Community's productive resources to be deployed in a manner which enables a greater aggregate output to be achieved. Any policy towards cohesion should, therefore, be fashioned as far as possible in a way that does not prejudice these prospective gains. Second, if money is spent in trying to achieve cohesion, it is important not only that it actually succeeds in doing so, but also that the expenditure yields sufficient gains per ecu spent. These are onerous demands and are bound to be hard to meet. Yet if net contributors as well as recipients are to be satisfied that policy is soundly based, they are precepts that will need to be met.

It would, however, be wrong to view cohesion purely as a problem of social welfare in which 'donors' provide largess to less fortunate 'recipients'. A significant part of the demand which enables competitive regions to benefit from integration will come from less favoured regions. It is acknowledged, for example, that much of the fiscal transfer to the Mezzogiorno ends up in the turnover of firms in the Centre-North of Italy. Similarly, supply-side shifts which favour some regions at the expense of others are the direct result of agreements to liberalize markets by dispensing with protection. Regional interdependence is, consequently, a feature of the Community economy that has to be given proper attention in relation to cohesion.

4.1. Market forces, Community growth and distribution

A fundamental question to begin with is whether cohesion is best served by trying to let market forces work as effectively as possible, or whether explicit intervention is necessary. Three basic approaches can be distinguished:

(i) The market approach which, as noted in Section 1.2, underpins much of the theoretical justification for integration. It is argued that the optimal way forward is to liberalize markets as comprehensively as possible because this will maximize allocative efficiency. As higher output and income are achieved, demand will then trickle down to all regions thereby guaranteeing cohesion. Indeed, if it were possible to achieve perfect markets, economic theory predicts that there would be a trend towards equalization of wages.

(ii) The redistribution approach also implies trying to achieve the fastest rate of growth for the Community as a whole by encouraging production where it is most efficient. However, on the assumption that unbalanced growth would lead to wider disparities in incomes, intervention would be needed to redistribute the benefits of that faster growth so that household income disparities are reduced across the Community. This means using market mechanisms to ensure that output is optimized, with intervention being used to distribute income.

(iii) The structural intervention approach starts from the presumption that there are market failures which result in unemployment or sub-optimal use of productive resources. Policy should, therefore, aim to direct investment in infrastructure and productive capacity from advantaged regions to the less-favoured in the hope that it is possible to increase the rate of growth of the less-favoured relative to the average thereby narrowing differentials. It is sometimes argued that such intervention can, in fact, be a positive, rather than a zerosum game in so far as idle resources are activated.

The relative merits of these approaches for achieving cohesion are difficult to establish. If the Community economy functioned as predicted by neo-classical economics, with regions specializing according to comparative advantage, there would be a tendency for incomes to be equalized. On this reasoning, the best policy to advance cohesion would, therefore, be to do as much as possible to eliminate barriers to the functioning of the market. But while comparative advantages can show the optimal allocation of resources at a point in time, they provide few clues to the optimal direction for long-term change. Where, for instance, would Japan be now if it had stuck resolutely to specialization in comparative advantage?

An unfettered market approach may also require far greater mobility of labour and capital than is either economically realistic or socially and politically acceptable. Labour mobility in the USA, where there is a common language, culture and (broadly) institutional structure, has traditionally played an important part in the trend towards convergence. In Europe, by contrast, the degree of diversity in social characteristics makes migration of labour particularly problematic. Moreover, the trend towards a strengthening of regional identities that appears to be developing hand-in-glove with political and economic integration would be expected to accentuate the political importance of preserving regional diversity.

Even if factor mobility were feasible, the speed with which markets are able to adjust is a further obstacle. Shifts in final or intermediate demand can be expected to occur rapidly as economic integration proceeds, whereas factor flows tend to take a long time. This could result in perpetuation of disequilibria, especially if new shocks result in further dislocations.

The alternative view is that, with free markets, the process of growth is inherently unbalanced. If regions are going to be successful in the current international environment they have to possess attributes which make them more competitive in the particular markets they are addressing. Under this reasoning competitiveness means absolute more than comparative advantage, so that if the less favoured regions limit themselves to specializing in current comparative advantages which exploit relatively lower labour costs, they risk being left behind in capital- and knowledge-intensive industries which tend to be the more dynamic parts of the economy.

The work of Michael Porter in *The competitive advantage of nations* provides an interesting alternative approach to understanding competitiveness. His ideas refer primarily to nations, but they can also apply to other regional entities which have effective decision-making powers and control over a substantial range of internal economic policy. This certainly extends to the first level of disaggregation of regions used in the Community, although to differing degrees in different countries because of their constitutional make-up.

In his model, building an effective competitive structure involves creating a four-pointed reinforcing structure where the points are:

(i) factor conditions;

(ii) demand conditions;

(iii) firm structure and rivalry;

(iv) related and supporting industries.

This inevitably results in a clustering of activity, not necessarily geographically, but certainly in terms of industrial structure. In this way, he argues that the sources of Europe's success come from the concentration of various activities, such as areas of mechanical engineering in part of Germany, ceramic tile-making in a particular town in Italy, financial and related services in London, etc. These clusters are seen by Porter as a desirable feature and are to be encouraged rather than resisted. There is a long list of sought-after characteristics which includes:

(a) the concentration of support through local linkages;

(b) purchasers demanding high standards from suppliers – the model from Japan is often cited in this regard;

(c) innovative small firms providing the ideas for larger scale producers such as design in the clothing and textile industries in Italy;

(d) support from local research institutions and universities who not only produce ideas themselves but help train the people who will then work on research and development within the companies;

(e) support from local authorities in trade fairs, attractive packages for inward investment, mutually supportive trade associations, like those for machine tools in Italy and Spain.

The message is: let the potential sources of success blossom and redistribute the benefits. Cohesion then comes from an acceptance by both the successful and those who are disadvantaged that the degree of redistribution is equitable. For it to be both equitable and efficient, incentives for innovation and growth must be maintained in both the recipient and the donor regions. There is strong feeling in some quarters that high marginal tax rates act as a disincentive – in any case if the rates are too high, firms will migrate to regions where they are more favourable. At the other end of the spectrum, providing subsidies is thought to dull entrepreneurial effort and to reduce the likelihood of the self-generation of faster growth in the less favoured regions that is being sought.

Porter's analysis is rather more limited when it comes to proposing how regions, nations or the Community should seek to exploit the advantages of clustering. While policy can aim to encourage existing clusters to build up the four sources of strength, it would be a legitimate end to try to promote potential new clusters. Such a policy would be consistent with trying to create favourable conditions throughout the Community so that new clusters can develop. One idea is the encouragement of *milieux innovateurs,* areas which display a strong propensity to innovate (see, for example, Camagni, 1991). This involves looking at examples of success and assimilating lessons that can be learned. However, policy has to be alert to the danger that it may not be possible exactly to replicate either the conditions or the outcomes. It would be wrong to seek a magic formula in which science parks, university-industry links and access to venture capital are mixed together in proportions that have worked elsewhere. Instead, flexibility in approach is needed to tailor the policy package both to what the region has to offer and to what can realistically be achieved.

Like all strongly argued and simplified approaches, clustering does not provide a universal solution to maximizing growth. One of the sources of growth is the very diversity of the Community. Because of the artificial separation of various regions in the past through national non-tariff barriers on the freedom of movement of goods, services and labour there has been limited contact between disparate approaches to the same problem. Without any requirement to adopt a common position, regions can develop rapidly by learning from ideas to which they have not previously been exposed. As a crude generality, the least-favoured Objective 1 regions have often been those that have been most protected from outside influences, unlike Objective 2 regions which have generally been exposed to stiff external competition. Such gaps in linkages are not just one way from the centre to the periphery but between different parts of the 'periphery'. The one-way model of the diffusion of ideas, techniques and products from the centre to the periphery can be replaced by a more dialectical approach (Hingel, 1991).

4.2. The case for structural policies

The foregoing discussion suggests that although there are dangers in trying to distort market allocations, there are also powerful arguments for trying to improve the use of resources in less favoured regions by stimulating investment. These are articulated clearly in Article 130c of the Treaty which defines the function of the ERDF:

'The European Regional Development Fund is intended to help redress the principal regional imbalances in the Community through participating in the development and structural adjustment of regions whose development is lagging behind and in the conversion of declining industrial regions.'

The main justification for investment in infrastructure and other resources is that it helps to ensure equality of opportunity. Because of their own lack of fiscal capacity, the less favoured regions cannot provide the structure which will place them on an equal footing with the more prosperous regions. Indeed, given that they have inherent disadvantages like geographical peripherality, the desire to place them on an equal competitive basis may require an infrastructure base in excess of that in the advantaged regions – in essence, a form of positive discrimination. This sort of argument would follow very much the lines that are used for encouraging the development of small firms or infant industries (or advancing the interests of minority groups in society) that, because of their circumstances, need greater support than mere equality in the provision of particular facilities in order to overcome inherent obstacles.

Direct investment in the infrastructure or human resources of assisted regions has obvious attractions in that the funds are spent on improving the productive base of the local area and are thus visible evidence of policies that help to achieve cohesion. This does not mean that the incidence of the expenditure falls entirely on that area, as suppliers and equipment may come from outside the region. A much larger proportion of investment in training is likely to be spent in the regional economy, although it has to be accepted that ultimately those trained may exercise the right to migrate. If such investment helps to overcome a constraint that the market cannot, because the social return is greater than the private return, other productive resources may, in addition, be activated, helping to engender positive cumulative processes.

In addition, there are externality arguments to consider. If the free play of market forces leads to unbalanced growth, the outcome may be congestion and bottlenecks in favoured regions and underutilization of social capital in less favoured areas. Equity arguments are also relevant. There is a deep-rooted presumption that it is better to attempt to move jobs to people rather than the reverse, particularly if a lack of opportunities threatens to damage the coherence of communities. This philosophy is central to the case for attempting to stimulate indigenous activity in less competitive regional economies.

Measurement of performance or effectiveness of any kind of public support for industry and employment is notoriously difficult. However, one indicator of particular relevance in the present context is the extent to which additional private sector investment – especially inward investment – has been encouraged in the assisted regions. This was recognized by Commission officials at a conference held in Dublin in June 1990 ('Regional policies in the European single market: a new partnership with business'). However, the private sector should not simply be regarded as lying on the 'demand' side of regional development initiatives, as it has a potentially valuable role to play on the supply side also. Its contribution can include:

(i) expertise in the packaging and provision of financial resources to include not only grants from the structural Funds, but also debt and, for projects with an income-generating potential (for example, transport, power and telecommunications projects), the provision of an element of equity funding;

(ii) skills in project design, selection and implementation including project management and control;

(iii) expertise in *ex post* project evaluation.

A pro-active role for the private sector could be considered, in view of the shortage of skills in initial programme/project design and selection, financial engineering and high quality project management and control. The creation of partnership between public authorities and private sector bodies would help to ensure that viable development initiatives are selected in the first place, that wherever possible private sector funding is used to supplement structural Fund grants, that projects are properly managed and controlled, and that they represent effective contributions to regional development once they are completed.

It has to be recognized, however, that structural policies, in the widest sense of the term, may be insufficient to achieve equality of opportunity with the budgetary resources currently available. For significant new resources to be available for expenditure on cohesion-related policies, either the balance of expenditure in the next budget perspective would have to shift markedly or the overall budget would have to increase substantially. Even if more were spent, equality of opportunity, which is a concept of potential rather than of realization, may still not be enough to assure cohesion. Additional policy instruments would therefore be required.

4.3. Reviewing objectives for support

At present, the structural Funds have five objectives which can be seen as a distillation of the priorities for action to promote cohesion. Since these arrangements have only recently been introduced, and are just building up to full operational status, their effectiveness cannot easily be judged – even if the technical problems of evaluation could be resolved. However, in the light of some of the emerging influences on cohesion, it is pertinent to ask whether these should remain as the principal aims of policy towards cohesion (both for the structural Funds and any other policy instruments), or whether other objectives need to be considered. This is given added poignancy by the evidence of absorption problems in some of the recipient countries.

A particular issue for the 1990s is whether social objectives should figure more in cohesion policies. In line with the principle that cohesion means assuring equality of opportunity, there is a compelling case for policy intervention in education. If residents in a less favoured region cannot obtain as good a standard of education as in favoured regions, they will face long-term disadvantages. The less educated will have a more limited choice of employment opportunities (including being relatively disadvantaged if they seek to migrate). There are, moreover, economic as well as social arguments to consider. As economic activity becomes increasingly knowledge-intensive, regions deficient in human capital will become progressively disadvantaged and risk being confined to specialization in stagnant or declining sectors.

A more radical approach would be to set objectives in terms of positive attributes such as target rates of employment creation, levels of infrastructure provision or environmental quality, rather than negative characteristics such as unemployment rate or gaps in income. Clearly, though, the incidence (and purposes) of other policy areas needs to be taken into account in the setting of objectives to promote cohesion. In considering whether wider objectives should be targeted, the scale of resources has to be considered. Adding further objectives, such as environmental improvements or educational levels, will be more difficult without increased funding, as it would risk stretching resources too thinly and could mean that action fell below a threshold of effectiveness.

Apart from the environment, a number of other new topics has emerged in the course of this study as warranting action on cohesion. These include:

(a) Urban problems. With industrial decline having been most acute in urban areas in much of Northern Europe breaking internal cohesion, and concentration of social problems in cities in Southern Europe, attention to the urban system is needed.

(b) Disadvantaged social groups. In the Europe of the 1990s, where social and occupational mobility is an increasingly prominent aim, the fact that certain groups in society face greater barriers than others is, itself, anti-cohesive. Ethnic minorities, the less competitive groups in the labour market and segments of the population who might be adversely affected by integration are examples. Such a focus should not neglect those who are economically inactive.

(c) Fragile economies and communities. An apparent paradox of economic and political integration is that it tends to accentuate the desire for diversity and cultural identity. Some of the more fragile economies, notably in peripheral rural areas, face the specific problem in relation to economic integration that they have few options for restructuring. Where they depend on fishing or on precarious tourist or agricultural sectors, the challenge to policy is to provide options which are economically viable while preserving social and cultural values and the viability of local communities. The West of Ireland, North-East Portugal and the Scottish Islands are all examples of this.

4.4. Principles for determining eligibility and responsibility for cohesion policy

A critical question for the Community is where its responsibility for cohesion ends, and what should be left, instead, to national or regional tiers of government. Though there would be resistance to too narrow a focus for cohesion policy, it is highly unlikely, as the discussion in the following section shows, that the Community will command budgetary resources sufficient to finance transfers of the magnitude available in Member States. The need for limited targets was already manifest in the 1988 reform of the structural Funds which brought in a concentration of assistance on the least favoured regions. Nevertheless, all Community countries currently obtain some assistance from the structural Funds, even though most of the resources go to Objective 1 regions. In total, eligible areas comprise 43% of the population of the EC – 138 million inhabitants. Eligibility for the ERDF, for example, ranges from areas containing 7% of the population in Denmark and 12.9% in the Netherlands to 100% in Greece, Ireland and Portugal. This spread of activity inevitably means that whatever resources are available become more thinly spread.

A key question for the 1990s, therefore, is whether this eligibility is too broad and, if so, how it should be narrowed down. The present arrangements are an uneasy compromise between giving assistance to the most deserving cases on the basis of Community-wide criteria and provision of some return to every Member State. This raises the question of whether *juste retour* ought to figure in any way in revised arrangements. In principle, this would be hard to justify, but it may be a necessary political element. All the same, the logical response to limited resources would be to confine Community expenditure on cohesion policy to the most deserving cases. As well as enabling more concentrated action, a clear advantage of a narrowing of eligibility would be to make the scale of problems more manageable.

4.4.1. The role of regions in assuring cohesion

With limited resources, it is important for the Community to concentrate on assisting those regions which face the biggest constraints. This is a matter of principle as well as of resource constraint: it is incumbent on relatively prosperous regions or Member States to be responsible for the less-advantaged within their boundaries, and only to seek the help of the Commission where the scale of problems is beyond their capacity. In this regard, the scope for the regional tier of government to assume a greater role in helping to secure cohesion plainly has to be considered.

The degree to which responsibility for cohesion-related policies should fall on the regional tier is open to debate. In essence, the question revolves around the effectiveness of different tiers of government in formulating and delivering public policy. The main argument for public intervention in a market economy is that some form of market failure occurs which means that social welfare is less than it might be. In responding, the public sector has to strike a balance between achieving administrative efficiency and being sufficiently attuned to potentially conflicting demands. It is in meeting this balance that there are compelling arguments for a greater involvement for the regional tier. If public intervention occurs at too low a level of government, the prospect of actions in one locality affecting another are considerable. In France, for example, the proliferation of communes is considered to make collective action on issues such as transport links hard to achieve. Everyone wants access to improved facilities, no one wants the new road or airport to despoil their community.

The regional level, on the other hand, is sufficiently large to be able to 'internalize' such spillover effects. Once it is accepted that, say, a new road is required, the region should be able to assess how it is best achieved to maximize regional welfare. At the same time, regions, being closer to their populations than the Member State tier of government, are typically better placed to identify local needs and to shape policy so as to take account of regional culture and diversity. This is particularly true of economic development policies, where examples abound of superior results being achieved where an effective regional government or agency is involved. A trend towards regional rather than Member State intervention is apparent not only in many European countries (the shift in emphasis in France being a notable example), but also in the USA where there has been a proliferation of new schemes in individual states of the union.

The problem with seeking a greater role for regions in cohesion-related policies, however, is that the institutional structures vary enormously from one Member State to the next. As a result, it is likely to prove very difficult to create a common framework for the formulation and delivery of policy.

4.4.2. Eligibility criteria

Determination of eligibility for Community assistance will require the application of appropriate criteria. Criteria for identifying regions or localities where social cohesion is an issue will not necessarily yield the same results as the economic indicators. Relevant social indicators include:

(a) indices of social deprivation, including housing, health and environmental conditions. These have to be looked at for quite narrowly defined geographical units to capture the incidence of poverty in what may otherwise be relatively prosperous regions;

(b) measures of need in terms of infrastructure, both physical and social, in order to attain agreed targets. On the basis of periodic audits, revised targets for provision would be desirable;

(c) information on the distribution of income and of social and economic mobility. Identification of particularly intractable ghettoes would be important;

(d) assessment of the characteristics of the dependent population.

Among the factors which to consider including in respect of economic cohesion are:

(i) income per head or levels of current expenditure;

(ii) fiscal capacity of the competent tier of government, taking into account existing compulsory transfers from other tiers of government;

(iii) suitably defined measures of labour market imbalance. These have to be sensitive to social and institutional peculiarities of different regions.

Subject to satisfactory arrangements about how State aids affect cohesion, responsibility for assistance outside regions of Community concern would then fall on Member States or regions. While such an arrangement will almost certainly create an outcry, it represents the most logical division of responsibility.

4.4.3. Spatial boundaries or individuals?

A further aspect of eligibility that has to be broached is whether it makes sense to designate purely on spatial boundaries, that is transfers from richer to poorer regions determined by regional indicators. An alternative would be to operate at the level of individuals or households. A Community-wide progressive tax, for example, would not penalize poorer households in rich regions, whereas a general levy on a region would. Currently, it is rather hard to determine the incidence of the Community's revenues because of those which arise through the CAP. However, it is clear that the pattern of expenditure in some fields tends to go to richer households in a group than to the poorer (as indicated by Franzmeyer et al. (1991) for the CAP). In any case, deprivation is not equally distributed across all indicators for any given region and more closely targeted support on particular problems might be appropriate.

These moves would extend equity at the level of the Member State not just to the regions but to individuals and households as well. To achieve the latter, part of spending would have to be related to household incomes and for this reason we have set out a simple example of a social security fund for the Community which would allocate funds to regions on the basis of household needs.

4.5. Who pays and the availability of resources

Policy on cohesion is bound to be constrained by budgetary limits. There are good reasons for believing that the own resources of the Community, even if they are supplemented by agreement on raising more money from national exchequers, are unlikely to increase substantially during the 1990s. As Michael Emerson, one of the leading contributors to the debate on economic integration, has written recently:

'It is certain that the Community will not expand its budget in line with established federal models'. (May 1991)

There would be strong opposition to a significant increase in the Community budget from the countries which are already net contributors. Moreover, although it can be argued that those Member States which benefit most from integration should be prepared to contribute more to the budget as a *quid pro quo,* it has to be accepted that this argument carries little weight where the Member States in question already have well integrated economies. Experts consulted in Belgium, for instance, held the view that the Belgian economy had been opened up to such an extent that consolidation of the single market and EMU would make little difference. Similarly, sentiment in Germany is that although there is a strong disposition to be *communautaire,* support for the five new *Länder* coupled with the commitments that Germany is making towards Eastern Europe and the Soviet Union must limit what the country is prepared to spend on the EC. As the leading net contributor to the budget, Germany's voice would be very influential.

Resistance to the establishment of new criteria for revenue-raising is also probable. A greater weight on the fourth resource would increase the progressiveness of the revenue-raising and may be a possible direction for change. Major change on the revenue side must, nevertheless, be considered implausible.

The scope for cohesion to be addressed by expenditure from the EC budget will, consequently, depend mainly on whether or not there is a willingness to reallocate money from certain existing programmes to cohesion objectives. The data presented in Section 2.5 of this report suggest that there may well be some room for manoeuvre in this regard. Illustrative calculations, drawing on the 1992 draft budget and the patterns of expenditure by Member State in the 1989 budget, show what might be possible.

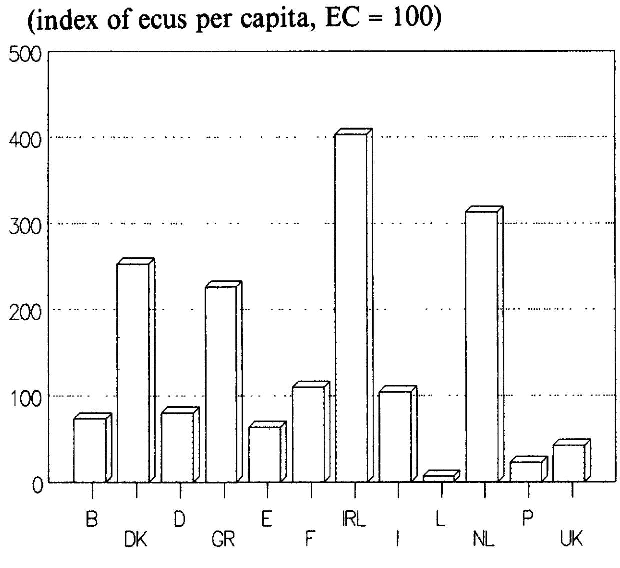
Although the size of the EAGGF budget makes it an obvious target, it is by no means the only one. In 1989, for example, identifiable expenditure from the structural Funds in Member States amounted to just under ECU 8 billion. Less than half of this was spent in the four Member States with the lowest per capita GDP (Greece, Ireland, Spain and Portugal), even though these are, by common consent, the countries where most needs to be done. If all of the expenditure from the structural Funds were directed at these four countries, rather than being spread around, it follows that twice as much could be spent. It is true that the lagging Spanish regions compare with some of those in the Mezzogiorno in their disparities from the Community average, and political realism suggests that exclusion of less favoured regions in higher income Member States is improbable. Nevertheless, it could be argued that where the Member State in question is above a development threshold, it, rather than the Community, should assume responsibility for its own less favoured regions. Ability to pay, a basic principle of public finance, would be respected. It would further be consistent with the principle of subsidiarity, with fiscal capacity determining which tier of government pays.

Table 4: **Preliminary draft 1992 budget**

	million ECU	%
EAGGF Guarantee Section	34 660	53.2
Structural operations	17 965	27.6
Policies with multiannual allocations	2 700	4.0
Other policies	5 048	7.7
Repayments and administration	3 833	5.9

Turning to the classes of expenditure in the preliminary draft 1992 budget, the proposed breakdown of commitments[1]) is as shown in Table 4. From this, it can be seen that agricultural guarantee payments continue to absorb over half the budget, while all structural operations add up to just over a quarter. The structural operations include the Guidance Section of the EAGGF, which is not spatially targeted, while there are small amounts in the multiannual programmes and the 'other policies' which are regionally targeted. Making allowance for these, approximately 25 % of the budget could be said to be directed at cohesion aims. This means, for instance, that if there were to be transfers from the agricultural guarantees heading to cohesion objectives, a percentage point reduction in the former would increase the latter by two percentage points – an elasticity of about 2. This gives considerable scope for intensifying the flow of assistance to the least favoured regions via cuts in agricultural guarantees, without greatly altering the scale of support for agriculture.

Figure 8: **Agricultural guarantee payments (index of ecus per capita, EC = 100)**



Computations based on figures published in the Official Journal (12. 12. 1990) show that per capita payments of guarantees are very inequitably distributed amongst Member States (see Figure 8). The major beneficiaries are Ireland, Greece, the Netherlands and Denmark. If the latter two countries had their inflows cut to the Community average, the saving on guarantee payments in the 1989 budget would have amounted to ECU 2 950 million, which is the same as the *total* outlay of both the Regional Fund and the Social Fund in that year in Spain, Greece, Ireland and Portugal together. The chart also shows that Spain and Portugal received per capita payments well below the Community average. Although the operation of the EAGGF means that there is no easy way of planning reductions in spending, the point of the exercise is to demonstrate that a fairly unambitious reduction in EAGGF outlays could enable a near doubling of the flow of cohesion expenditure to the four least developed Member States.

A more general point is that given the sheer weight of agricultural spending, modest reductions in it can permit very substantial increases on key targets of policy. At the same time, it has to be accepted that if a comprehensive system of transfers from favoured to less favoured regions in the Community, as envisaged in the MacDougall Report, is sought, much greater resources would be required. By the end of 1992, the budget will amount to 1.2 % of Community GDP. If this ratio increases at the same rate as in the current financial perspective, it might reach 1.25 % by 1997. How big an increase in cohesion outlays would this permit?

If agricultural guarantee outlays (and the new compensation payments for price reductions) are scaled down gradually, it would not be unreasonable to expect these to fall from the current 0.64 % of Community GDP to 0.5 %. If, in addition, all other heads of expenditure remain at their present 0.26 % of Community GDP, it would be possible for cohesion-related outlays to rise from 0.3 % to 0.49 % of GDP by 1997. But even this increase of two-thirds would fall far short of the targets put forward in the MacDougall report. These sums would need to be spent only on a relatively small number of regions if they were to play a significant part in reducing disparities.

[1] The budget terminology refers to 'commitments' which can be interpreted as planned spending and 'payments' which will be the outturn.

These simple calculations suggest that mechanisms over and beyond the current or likely Community budget will be needed if a degree of equalization is considered to be the route to cohesion. Alternatively, targets have to be more modest than might seem appropriate. If a more extensive system of transfers (as called for in the Spanish submission to the intergovernmental conference) is sought, then it is almost certain that some new redistributive mechanism will need to be created. Would this have to be outside the traditional own resources of the Community and, possibly, outside Commission control? Although there would be objections on grounds of accountability and control, the answer to both questions is almost certainly 'yes'. One model would be the German *Länderfinanzausgleich*, through which there are automatic transfers from richer to poorer regions, though this would need a far greater political cohesion than at present.

If it is accepted that need is a useful basis on which to grant assistance, a wide range of possible methods of allocation could be considered. A flat rate can be paid to all those above a certain level, payments can be proportionate to need (approximated by a series of steps in payment levels perhaps) or payments could be focused disproportionately on the most needy. There is a common irony here that the greatest number of regions could be removed from the category of the needy by focusing on those with the smallest need as it is cheapest to meet it. The Community has chosen the route of trying to focus on the most needy but with some element of progression so that those with less need still tend to receive something. Since categories are used into which a region may or may not fall, the receipts are inevitably somewhat unevenly spread compared with the graded need. However, these transfers have to be paid for and application of ideas of equity would suggest that budgetary contributions should be related to 'ability to pay'.

GDP per capita is a commonly-used measure of ability to pay. A means of incorporating it was suggested by Padoa-Schioppa (1987), namely that the funds available for net budgetary contributions to regions could be related to their GDP per capita. This would give us a target against which to judge the actual net contributions, which vary because of the complexity of the payments system and eligibility for funds and the shortfall in take-up of the funds available. This need not be an exact formula but could cover a range either side of it before extra payments were triggered to bring it within the range.

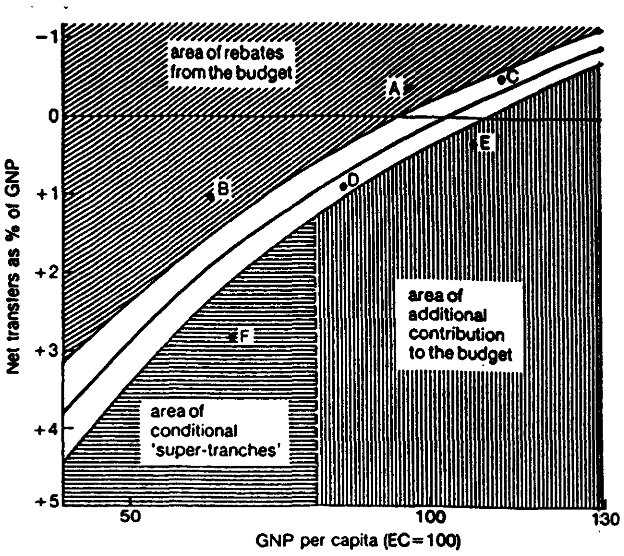
Padoa-Schioppa focuses on the Community budget as a whole at the level of the Member State. His specific formula is that the net contribution for a Member State should approximate to the following

$$N = ln\ (y^{\beta}) - c$$

where N is net contribution for a Member State as a proportion of its GDP, y is its average GDP per capita and c is a measure of the average capacity of the Member States to contribute. The parameter β represents the extent to which redistribution is desired among the Member States (Padoa-Schioppa experiments with values between 0.01 and 0.1), the greater β the greater the redistribution. His illustration of the result is shown in Figure 9. Member States like C and D lie within the proposed band before the system is applied, hence no change is required. Member States A and B however are having to pay too much (A is making a positive net contribution but B's net contribution is already negative although insufficiently so). By contrast E and F should pay more.

One advantage that this formulation has is that it deals simultaneously with net beneficiaries and net contributors. The same functional form prevents contributions rising ever faster and gives a slowly falling share of marginal incomes being paid as net contributions. Other functional forms are possible, even involving progressively rising payments, should that be felt desirable. Nevertheless, this smooth form of transition both for the receipt of benefits and the payment of net contributions has considerable attraction to it. The width of the band of tolerance can also be debated.

Figure 9: **An equity safeguard mechanism for the Community budget**



A difficulty with Padoa-Schioppa's schema, however, is that, since it relates to the entire Community budget, the equalizing method would tend to be a general transfer and not greater expenditure under a particular programme. This might be soluble if regional expenditure dominates the budget because if spending is assessed relative to regional needs then the equalization will tend to be realized *ex ante* and the inequities, which largely stem from the CAP, would not be so important.

4.6. Good and bad practice

Irrespective of budgets, there is an onus on the spending agencies to demonstrate that the limited resources available are used in the most efficient way. Satisfaction of donors that their contributions are being well spent requires that it be demonstrated not only that inputs have been efficiently spent, but also that they produce acceptable results in terms of enhancing growth potential, adding to income and thus furthering cohesion. To achieve this, Community institutions must develop their standards of financial management in line with their growing responsibilities and ambitions, and conduct convincing evaluations of the effectiveness of policy. In addition, they have to be sufficiently flexible to change policy and to adopt best-practice instruments.

Efficiency must be maximized because the opportunity cost of any expenditure, even with an increased budget, is alternative expenditure forgone on another project or region. The satisfaction of net donors is equally essential if taxpayers in better-off regions are to share the sense of cohesion, and to continue contributing. A particular challenge, with respect to the subsidiarity principle, is to strike a balance between the economies of scale and coordination achieved by a higher level of administration, and the local knowledge and flexibility of lower levels. Perceived inefficiency of local authorities may justify transferring their responsibilities to regional or national authorities. But it may equally reveal a need to reinforce the administrative capacity of the regional and local authorities themselves.

A key part of ensuring efficient delivery of policy will be to learn from experience. There must be cause for concern, for example, that the rate of take-up of structural Fund commitments is, at times, alarmingly low. In Italy, for example, bureaucratic delays appear to be a major problem in the administration of policy. Recent evidence from East Germany indicates that there is a pressing need for technical assistance in designing and implementing economic regeneration programmes.

The recent evolution of regions which have manifestly had successful transformation can provide insights into the types of policies that have been successful. Industrial South Wales, which has long been recognized as a problem region in the UK, is an interesting example of a region that has suddenly begun to exhibit dynamism. Its substantial inward investment has undoubtedly been encouraged by the presence of a coherent development agency which has been able to create appropriate packages for potential investors. The evidence suggests, however, that the quality of the labour force coupled with relatively favourable wage rates has also been a potent factor.

Experience in some Italian regions, on the contrary, suggests that where the delivery of policy is very politicized, its efficacy is much diminished. A separation of implementation from policy formulation would, consequently, make sense. This is a direction being taken in Greece, where it has been recognized that local political control had diminished the impact of policy interventions. Of course, where agencies or other bodies are involved it is important that there be adequate forms of accountability to elected authorities.

The mix of instruments used in economic development needs to be carefully judged. Major schemes that are ill-suited to the needs of the region or which cannot be justified on any reasonable cost-benefit appraisal – the Humber bridge in England or vast factories using inappropriate technologies in the South of Italy – not only waste resources, but can also be perceived as white elephants and can be anti-cohesive in the impression they convey. Some of the experts consulted have, nevertheless, stressed the importance of big projects able to make a mark on the recipient region and thus to demonstrate a commitment to cohesion. The celebrated Knock airport in the West of Ireland is, arguably, an example of a bold investment that can alter the direction of a local economy. Policy instruments also need to be complementary as far as possible. In Ireland, training programmes, though expensive, have been seen as needed to provide the 'soft' infrastructure to go along with physical infrastructure and incentives to productive investment.

The lack of coherence in policy can diminish overall effectiveness, even if individual schemes are well-judged. Scale of overall effort is also relevant. In Spain, for example, it is considered that too little has been expended on regional development policy to have made a meaningful difference. Equally, it is important to acknowledge the role of non-spatial policies. Professor Allen, who produces an annual inventory of regional policies in European countries (Yuill et al. 1991) sums this up in the following aphorism:

'Regional policy is part of regional economic development, but regional development is more than regional policy.'

4.7. Modifications to the EC institutional structure

One of the complications in achieving social and economic cohesion in the EC is that it is not just a matter of who pays how much to whom. Nor is it just assessable by the opportunity cost of the funds transferred and the use made of them by the recipients. The whole process of decision-making, administration and accountability forms part of the cohesive process and its acceptability. Thus the current moves towards what has been labelled 'political union' form part of the process of achieving cohesion.

There are several forces at work, some of which may conflict. The first is that major interest groups within society wish to feel part of the decision-making process and in the case of regional cohesion this naturally includes regional and local administrations. The problem in the structure of the European Community is that institutional structures are rather different from those of any State, whether federal or unitary. Decision-making in the Council is at one remove because it is conducted by the ministers of the Member States, not the constituent regions. In the cases where the whole Member State is eligible for a particular form of assistance, this may be less of a problem.

Quite radical solutions have been proposed to this, including adding a second regional chamber to the European Parliament, making it more similar to the US model. It has also been suggested that there should be a further regional committee related to the Economic and Social Committee whose opinion is sought on all regional matters. This has excited considerable debate, firstly on the grounds that the ESC has not thus far been a particularly influential body and its expansion could merely result in a nominal increase in the inclusion of regional interests without much practical effect. Furthermore, it might weaken the power of more effective routes to increased regional influence which already exist such as those through the European Parliament and its committees. It is not at present clear what might be decided by the intergovernmental conferences but some increase in direct influence from the regions may assist the process of cohesion.

The position of the Commission is rather different from any national administration and in many respects it is much more open to the lobbying process than is normally the case. However, exercising such opportunities for lobbying does depend on the level of resources available and the ease of getting to Brussels. Thus small, low-income and distant regions are likely to have less effective influence than their richer colleagues close to the core. This is certainly the pattern of current representation in Brussels although peripheral regions are to some extent offsetting this by combining their forces.

The regional voice is, of course, effectively heard in the Parliament but here the problem is of the strength of the Parliament in influencing the final decisions. Parliament's powers were considerably enhanced by the Single European Act and it seems likely that the new treaty will enhance them further, perhaps going as far as co-determination. The role of Parliament is particularly important, as far as policy for the regions is concerned, at the time when the policy is agreed and put into legislative instruments and when the success of the policy is reviewed. The role of parliamentary committees in making sure that the regional voice is heard should not be neglected and it is no surprise that the Parliament should have been making the running in the debate on the treatment of cohesion.

The intergovernmental conferences thus provide a crucial opportunity to determine how great the role of Parliament should be in the future. There are, however, other routes, not so much in this instance the Court of Justice but the Court of Auditors. As is clear from our study, the Court of Auditors has played a central role in pointing out the problems of previous use of the structural Funds and has made several clear recommendations for the way forward.

The principal function that the Court performs is to provide an opportunity for accountability and to see not just that the money was spent on the right projects but that these projects achieved their stated aims. Combined with the effects of the Committee for Budgetary Control in the Parliament, this institution could provide formidable assistance to improving the process of cohesion, especially from the point of view of the regions that are net contibutors to the structural Funds, as it would reassure them that their contributions are being used to their best advantage.

However, the other side of the coin is that the recipient regions themselves wish to have substantial control over the way that the funds are spent. Spending a particular sum of money on a project when the local region agrees that this is the right way to spend the funds is clearly more cohesive than having the decision imposed from above. This is one of the origins of the principle of subsidiarity (see Padoa-Schioppa (1987), for example) that responsibility should lie at the most local level possible consistent with efficiency. This exercise of subsidiarity lies at the centre of the success of regional policies. The problem is to find a good balance between the overall coherence of the programmes across the Community as a whole with the exercise of local power. The derivation of the CSFs and the switch to a programme rather than a project basis was intended to help achieve this. However, this process appears to have been only partly successful so far (although we may get a wider range of evidence when the mid-term review of the structural Funds appears).

In several instances, the new system has increased the bureaucratic load and has slowed down rather than sped up spending of the structural Funds. The fault does not lie merely with the system but also with local administrations. It is noticeable that there has been a considerable shortfall in take-up of the structural Funds, particularly in the most disadvantaged regions. Clearly there is little point in trying to spend more if the limits of absorptive capacity have already been reached. However, it appears that this limit is not because they are running out of suitable projects nor because there are insufficient local financial or building resources to carry through the programmes but often because it is not possible to put together adequate project appraisal, design and management resources.

This is something which can be solved both by an accelerated programme of training and development of local expertise and by the use of task forces from other regions. Such technical assistance is difficult to give without offending the sensibilities of authorities in recipient regions and without contravening the principle of subsidiarity; it has already been available to some extent but has frequently not been taken up. This emphasizes the delicacy of balance required. If the size or scope of the structural Funds is to be increased in the future, then the problem will be enhanced, but at least in this instance there are many examples round the world from countries at varying stages of development of how such competences can be acquired.

There are ways round the apparent conflict between the desires for accountability and subsidiarity. The process of accountability can of course be undertaken locally. All legal entities are normally subject to auditing requirements and local expenditures are no exception. The responsibility for keeping the local house in order can also be local. One problem that does arise, however, is ignorance on the part of the auditor of practices and progress elsewhere in the Community. In part this can be solved by exchange of information, but also by random audit from the centre.

The institutional structure of the EC has two further impacts on the effectiveness of cohesion. Not only is motivation increased by local involvement in decision-making and exercise of the principle of subsidiarity, but it is also likely that those local needs will be more accurately identified. Just because certain forms of infrastructure are more effective in achieving cohesion in one region, this does not entail that they will necessary be just as effective in another. Priorities will vary. Secondly, cohesion is a dynamic problem and involves the response to a rapidly changing economic and social environment. Improved decision-making throughout Community institutions can speed up the process considerably. At present, for example, the Court of Auditors reports about two years after the event on the success of Community programmes. These reports are then debated and responses given. It is, however, clear from the latest report (1989) that the Court finds that it has to repeat the message on a number of occasions on the subject of the structural Funds before action is taken.

One further change in structure which has been mooted is the idea that there should be wider involvement in the process of formulating and executing the programmes using the structural Funds. While this would prima facie run counter to the objective of streamlining the administrative arrangements, the particular suggestion is for involving the social partners. Since it is the private sector that will, in the main, take advantage of the new infrastructure, both hard and soft, in trying to increase the rate of local economic growth and employment, there is a clear argument why it should be involved in the decision-making process at the local level. If nothing else, this may reduce the chance of creating white elephants which are built at great expense but subsequently not used or at least not used to the full. On the other hand, it does increase the chance of capture of the Committees by particular interests, although scrutiny procedures should be efficient enough to pick this up.

This participation will tend to be more effective if the attraction of private sector funds forms part of the criteria for assessing the economic viability of projects. Such participation is a common requirement in the granting of loans. It might appear more important to get such commitment in cases of grants where the principal does not have to be paid nor interest payments made as the project develops.

5. Options for a new strategy for social and economic cohesion after 1992

The mix of instruments used in any new strategy to advance cohesion in the next decade needs to be chosen in the light of a number of conflicting constraints and priorities. On the one hand, in acting to improve cohesion, policymakers will not want to jeopardize potential gains from economic integration. This would imply that attempts to steer economic activity to less competitive areas should be reserved for emergencies rather than being a central plank of policy. On the other hand, cohesion policies need to ensure that potential losers from integration have the capacity to take opportunities that present themselves. This involves building up competences, and redressing shortcomings in specific elements of the supply side, for example, infrastructure, labour skills, or managerial talent.

The existing portfolio of Community policies can be revitalized in a way that makes them more effective in advancing cohesion, but there are pragmatic limits to what they can sensibly be expected to achieve. This means that either the demands placed on the policy agenda have to be scaled down, or radical departures are needed from current thinking on what to do to promote cohesion. This chapter looks at the instruments of policy that might be deployed to do so.

5.1. The current range of Community policies

In practice, the current armoury of Community policies to promote cohesion is limited. Although Article 130 c of the Single Act refers to the role of the structural Funds, the European Investment Bank and other Community policies in reducing disparities, there is little attempt in the formulation and implementation of other Community policies to address cohesion objectives. Thus, the structural Funds, due to reach ECU 14 billion per annum by 1993, are the principal form of expenditure on cohesion, while about half of EIB lending is directed to regional development projects. Both types of intervention are intended to boost investment rather than to support incomes (though critics of the way the Funds are administered maintain that the money from them is frequently dissipated as consumption).

The structural Funds are coordinated with Member States' social and regional policies, and complemented by national financial contributions, through Community support frameworks (CSFs) for the assisted regions. The 1988 reform, as well as doubling the structural Funds over the next five years, calls for CSF assistance to become more clearly focused on integrated programmes in more closely defined regions. Integrated Mediterranean programmes (IMPs) provide some additional funding and programme-management assistance to the Mediterranean regions of the Community.

The European Investment Bank makes commercial loans to development projects which in 1990 totalled ECU 13.4 billion (EIB, 1991). These are at market rates, but could be regarded as soft loans to the extent that the Bank is lending as though the borrower is triple-A credit-rated, so that borrowers in less favoured regions avoid risk premiums. In some cases, this could be a significant advantage. In the Mezzogiorno, for example, data reported by Svimez (1991) suggest that the interest rate paid by commercial entities is two percentage points higher than in the Centre-North of Italy. Before granting a loan, the EIB makes a three-pronged appraisal of the proposed project. This consists of a financial assessment, an investigation of the technical aspects of the scheme and an *ex ante* economic evaluation. The allocation between the main uses of EIB loans for the two most recent years is shown in Table 5.

Table 5: **EIB financing under the heading of regional development**

(million ECU)

	1988	%	1989	%
Industry, services, agriculture	1750.5	35.6	2561.0	36.5
Transport	854.2	17.4	1438.4	20.5
Energy	730.5	14.9	1102.6	15.7
Telecommunications	1003.3	20.4	1086.2	15.5
Water, sewerage	299.7	6.1	507.4	7.2
Other infrastructure	274.6	5.6	322.2	4.6
Total	**4912.8**	**100.0**	**7017.8**	**100.0**

Source: EIB Information 66, November 1990.

The EIB lends at market rates, so the main direction of finance is towards production activity yielding positive financial returns. Facilities exist within the structural Funds for assistance with payment of interest on loans, but this does not appear to be widely used. The Bank has largely assumed responsibility for special provision to small and medium-sized enterprises (SMEs), originally provided by the New Community Instrument. Its capital base has been progressively increased, with a 22% rise in resources in 1990 in preparation for the single market completion. The scope for further increase in lending activities was identified in the 1988 structural Fund review, which correctly points out that loans may be substituted for grants where a project is expected to yield commercial returns.

5.2. Changing the scope, role and administration of the structural Funds

The structural Funds are the principal form of Community expenditure aimed at enhancing productive capacity in the less favoured regions. Together with loans from the EIB, they have the role of boosting investment in infrastructure, productive assets and human capital. Considering how these Funds might be developed to improve their impact is bound to be a key part of any new cohesion strategy. The doubling in real terms of the structural Funds over the 1988 to 1993 period and their recasting within CSFs has meant that they have been able to lend support to a wider range of activities. However, there are serious doubts about how effective the fund outlays have been in meeting their aims. Three kinds of difficulties have been apparent:

(i) absorption of fund money has not been easy because national or regional authorities have either not been able to generate sufficient projects of quality which conform with Fund regulations or have been slow or excessively bureaucratic in implementing them;

(ii) co-financing rules have impeded those countries with weak budgetary positions from implementing projects;

(iii) additionality rules have been hard to enforce, with some countries using structural Fund money to reduce domestic expenditure (e.g. it has been suggested that national vocational training schemes in France and the UK are partly financed in this way).

Concern has also been expressed about the bureaucratic demands in the administration of the Funds which appear to have increased substantially. In addition, it is very difficult to trace a direct link from the incidence of structural Fund spending to desired outcomes in terms of employment creation, income generation or improvement in regional competitiveness.

These problems suggest that a review of the operation of the funds could be advantageous in enhancing their contribution to cohesion. This could go in several directions, depending on how the aim of facilitating structural adaptation is interpreted. In order to provide viable long-term competitiveness, the real need is for the basic resources of an economy – the skills of the workforce, the supply of capital, the factories and the offices, and the managerial talent – to be convincingly and permanently improved. This must be the central objective of economic development policies. At the same time, there is a need to ensure that physical infrastructure (transport and telecommunications) is kept up to scratch – particularly when the pull of Europe is liable to draw activity away from peripheral regions.

While retaining the present focus on investment, it would be possible to widen the scope of the structural Funds to put a greater emphasis on environmental objectives and social objectives, notably on building up human capital. This would ensure that their coverage extended to investment in improving *all* the factors of production, rather than being limited to capital. At the same time it is essential to recognize not only that different factors deserve priority in different regions, but that the priority in any region will shift through time. In many lagging regions, the need for basic infrastructure remains acute. The STAR programme, which has assisted the installation of telecommunications networks in Objective 1 regions, has patently helped to accelerate change in this respect, but it is clear that gaps remain to be filled. In a number of Objective 2 regions, a more pressing need is to upgrade the quality of business services which often fall short of the quality available in more favoured regions (IFO, 1990a).

Elsewhere, however, it is arguable that an altogether different mix of structural interventions is called for. Training schemes are a case in point. The IFO study (1990b) highlighted the importance of qualified labour as a factor businesses regard as crucial, but it is one which has to be approached with some subtlety, since skill needs can shift quite rapidly. Action on long-term unemployment or insertion of youths into the labour market plays a useful role in supporting disadvantaged groups and thus in improving social cohesion. This tends, however, to neglect the training needs of the employed workforce or shortcomings in managerial skills and entrepreneurial capability. The quality of social infrastructure – the residential environment, the quality of local services, etc. – is also worth attention as a factor in regional competitiveness. The implication is that policy needs to be able to adapt to shifting circumstances and that priorities are bound to differ from region to region.

How is this to be achieved? The first requirement is to establish an effective framework for the delivery of policy. In this regard, the CSFs obviously represent a fresh approach which could be extended. A lesson that comes from any appraisal of economic development strategies, however, is the importance of a flexible approach. There is little point in having grandiose, rigidly designed schemes which make it appear as though plenty is being done but which pay little heed to local circumstances and which do not adapt as problems evolve. Part of the answer may lie, therefore, in the application of the principle of subsidiarity to ensure that the various local public authorities and other local actors play a central part in determining and delivering policy. Yet there are also dangers in continuing to rely on local administrations which manifestly lack the necessary level of competence. It has been argued, for instance, that radical institutional change is needed in much of the Mezzogiorno to overcome shortcomings in administration that have hampered economic development policies.

A second improvement would be for assistance channelled through the structural Funds to be more explicitly linked with national and Community policies in fields other than the spatial. Some countries/regions achieve this through the medium of development agencies with broad remits. There is a case for Community-funded agencies to become involved at local levels in areas where failings of administrative competence can be shown to have detracted from the effectiveness of the structural Funds, although it would need to be recognized that this could offend political sensitivities.

As well as looking for improvements in the role of the funds in building up structures, it is worth asking whether some shift in emphasis towards incentives for producers or the encouragement of services is also warranted. This has been tried, if perhaps somewhat tentatively, in the STAR programme in relation to telecommunications services. More generally, the importance of the availability of business services to regional development merits examination as a target for the structural Funds.

With respect to additionality, three distinct points merit consideration. First, in those more favoured countries where the principle of additionality is not strictly adhered to, the recycling of money from national budgets via Brussels to national programmes is an evident absurdity. Second, the obligation on countries with weak budgetary positions to co-finance projects should not be allowed to obstruct worthwhile projects. Conditions would obviously need to be imposed to restrict any windfall gains from being used to boost consumption, but there should be scope for the investment to proceed without unnecessary hitches. Derogations from additionality rules might provide the answer, or a reserve fund to assist public authorities facing budgetary stress might be contemplated.

The third point regarding additionality is perhaps the most critical. The real test of the effectiveness of any policy instrument is the aggregate effect it has on the target economy. Much more attention needs, therefore, to be paid to the total investment, employment and activity stimulated by a project, as well as to the effects on innovation and entrepreneurial behaviour. To focus only on ensuring that public investment is additional neglects the contribution of complementary investment from the private sector. 'Leverage', the response of private investment to public is becoming acknowledged as an important test of the effectiveness of a scheme in fostering economic advancement. It ought to be brought into the equation for structural Fund interventions. Part of this will, of course, be foreign inward investment. External ownership of productive assets is open to the criticism that it creates dependency, though it is generally considered that this worry is overshadowed by benefits. It is important all the same not to overlook the significance of levering-in additional indigenous investment as well as seeking inward investment.

5.3. Intergovernmental and/or interregional transfers

On the face of it, a form of fiscal equalization system would seem to be a natural way forward for the Community. Virtually all nation-States have some sort of redistributive mechanism, whether it is direct interregional equalization or is implicit in the interaction of taxes and benefits. Yet it is clear from the research carried out for this study that any proposed scheme would face formidable obstacles. Indeed, the difficulty of extending Germany's extensive interregional redistribution system *(Länderfinanzausgleich)* to the Eastern *Länder* indicates the possible problems of attempting such a policy at the EC level.

It is important, for cohesion, to look at how income is raised as well as how it is spent. At present, most of the Community budget is raised from expenditure taxes, and thus tends to be regressive, although it is obviously equitable to the extent that countries with large per capita expenditure pay relatively more. When the GDP resource is called on (it has not been in the last two years), the link to ability to pay is more direct.

An ever-present danger with unhypothecated transfers is that they create a climate of dependency amongst recipients while being seen as handouts to scroungers by donors. A related risk is that transfers would favour consumption rather than investment and could lead to the Community as a whole investing too little. Although higher consumption may, in the short-term, be cohesive in its impact on recipients of assistance, the adverse effect on wealth creation would be damaging in the long term. The scheme proposed in the Spanish Government's submission to the intergovernmental conference for the creation of a fund which is financed by an automatic levy on regions with above-average incomes to pay for infrastructure projects in less prosperous regions is a clever mix of transfers and structural policies in so far as it would favour investment.

The MacDougall Report suggested that, using a mechanism similar to the German *Länderfinanzausgleich*, a 40 % reduction in inequalities between the nine Member States in 1975 could have been achieved by transfers to the national governments of the three poorer Member States from the six richer ones equivalent to 2% of Community GDP. In practice, however, a total Community budget of 5 to 7 % of GDP would be necessary to support a full EMU. Transfers on this scale are almost certainly beyond what is politically realistic at present. However, provided that the visibility of whatever tax is used to finance any transfers is low, it might be possible to go some way towards an automatic transfer mechanism. In this respect, a VAT levy, though less progressive than income tax, may have much to commend it.

5.4. R & TD dispersion or new forms of interregional R & D cooperation

The perception that the EC is losing ground to Japan and the USA in the race to develop and diffuse a range of emerging technologies – including microprocessors, optical fibres, robotics, new materials and biotechnology – has prompted a series of Community initiatives. However, the introduction of these technologies is a force for regional imbalance, since they tend to develop first in already-advanced industrial centres and to offer few initial linkages to the areas outside. Work by the FAST team (Hingel, 1991) identifies 10 major 'islands of innovation' in Northern Europe within which 80 % of science-based innovations have occurred. The Community's problem is to maximize its overall rate of technical progress while ensuring that the income and employment gains are equitably spread.

Progress has been made in raising the scale and productivity of European research and technical development (R & TD) by increasing the resources allocated to it and reducing the duplication of R & TD effort in different companies and countries. A combination of increased competition and corporate restructuring within the single market increases the ability and incentive for companies to develop and commercialize new product and process technologies. At the pre-competitive stage, the twin deterrents to private R & TD in major new technologies – external benefits from their development, and the large long-term costs of some research – have been successfully overcome with the help of Community research programmes such as Eureka, Sprint, RACE and Jessi.

The exchange of ideas among university researchers and between universities and industry, on which many current innovations depend, has been promoted, as has the industrial training on which introduction of advanced techniques often depends. There are also successful programmes for the diffusion of new technologies, such as STAR for telecommunications and Tedis for electronic data interchange. In Japan, R & TD joint ventures have achieved considerable technical advances, but those organized by private firms outperform those sponsored by the State. In the USA, successful firms still appear to go it alone, and government-backed initiatives (such as Sematech) have had few positive results. But for historical reasons, European firms still lack the close links that allow multilateral joint ventures, and the absolute scale or geographical clustering that assist large-scale R & TD within the firm. Community-organized initiatives therefore have an important role, and have already recorded positive results. The Community's FAST programme for technology forecasting and assessment has identified four priorities for future R & TD policy (FAST, 1989):

(i) Greater emphasis on basic research, to explore fundamental links between science, technology and society. New initiatives are suggested in microelectronics, photonics, new materials, cognition, nutrition, and alternative land uses.

(ii) The use of current Community R & TD programmes to promote social cohesion, especially through improved working conditions, public understanding of science and technology, and the diffusion of new technologies (especially in information and communication) to small firms.

(iii) Application of R & TD to education and training, and to the creation of networks among enterprises in lagging regions similar to those that now exist in more advanced regions.

(iv) Diffusion of R & TD discoveries to developing regions outside Europe. Current Community initiatives focus on leading-edge R & TD, and their benefits will go mainly to cities and regions which already support concentrations of advanced industries. R & TD breakthroughs will continue to occur predominantly in these urban centres, because these contain the advanced users from whom innovative ideas increasingly originate (FAST, 1989), and the clusters of enterprises, researchers and users within which they can best be developed. To maintain Europe's global competitiveness, particularly against America and Japan, it is vital that these R & TD centres continue to be promoted.

Thus, the R & TD of advanced technologies is necessarily regionally unbalanced. To maintain cohesion within the Community, it is equally important to assist R & TD within smaller enterprises outside the economic centres. The less favoured regions tend to have an above-average representation of small and medium-sized enterprises (SMEs) (Nam et al., 1991). These are often less well-equipped than larger enterprises to carry out the R & TD needed to remain competitive in fast-changing markets. At the same time, small enterprises can be an important vehicle for the introduction of innovations (Rothwell, 1986). The difficulty of forecasting which new technologies will become economically important makes it important to avoid overconcentration of R & TD either regionally or sectorally.

The diffusion-promoting programmes will help less favoured regions acquire new technologies developed elsewhere, as will inward investment by innovation-driven firms. However, there may be substantial additional benefits from creating R & TD capacity within these regions. This is, firstly, because technologies developed in advanced areas may not be appropriate to the factor conditions and consumption needs of developing areas (Schumacher, 1973); secondly, because imported techniques arrive only after a lag, with inward-investors usually waiting for technologies to mature before exporting them; and, thirdly, because, as with all income-generating activity, it is preferable to install indigenous capacity than to rely on continual transfers. New measures to promote R & TD in smaller enterprises outside urban centres could build on structural instruments already in place. The social and economic infrastructures supporting innovation can be strengthened by improved scientific and technical training; public provision of research funding and facilities; easier access to venture capital for investment in new or improved techniques; scientific and educational exchanges; better telecommunications; and provision of advice and information to small businesses. There is scope for promoting networks of small firms in peripheral and lagging regions, similar to those which have been identified linking technology-based firms in the leading regions (Hingel, 1991).

The Community would do well to continue to follow a two-pronged approach, promoting 'state of the art' R & TD to maintain its global competitive edge, but also ensuring a wider production and distribution of new technological opportunities.

5.5. Education and training

Many new industrial processes make additional demands on the skill and adaptability of the workforce. At the same time, rising competition in the world market for existing products requires adoption of new technologies and work practices for which a trained and motivated workforce is vital. The quality of the workforce is an increasingly important factor in deciding the location of new investment, and considerable evidence has been found linking inferior labour productivity to a shortfall in educational and vocational qualifications (Prais, 1990). Education and training are, consequently, central to cohesion, from the perspectives both of regional competitiveness and, through its influence on opportunities for individuals, on social cohesion.

The new skills required in the industrial and service sectors are often more analytical and less mechanical than in the past, requiring employees to understand their technology, and its place in the production process, rather than repeating a narrowly defined task. New techniques of organization, such as total quality management to eliminate separate quality checks and just-in-time scheduling to reduce stocks, place considerable new responsibilities on all levels of the workforce. New technologies, particularly computer-numerical control in manufacturing and information technology in services, must be adopted quickly if competitive advantage is to be maintained. Employees must increasingly combine a highly-developed technical skill with a broad-based understanding of the principles on which it is based, and of processes outside their specialism. In some occupations, where product and process technology is changing rapidly, they must be receptive to continual re-training.

Widespread reports of skill shortages in high-growth industries and regions have reinforced the perception of the availability of skilled labour as a limiting factor on industrial development. It is feared that if industries do not solve the problem by increasing the supply of skills, they will be forced to retreat into lower-skill, lower-productivity and ultimately lower-wage products and processes. The rapid increase in academic and vocational skills in the newly-industrializing countries, once regarded as cheap labour competitors, reinforces the economic need to upgrade European labour skills. There are also quite separate social advantages from giving workers additional training, in terms of higher wages, better employment prospects, more mobility and a sense of personal value which bear directly on social cohesion.

Another human resource deficiency often arises at the level of middle-management, both in private industry and public administration. Ambitious and fundamentally sound strategies often fail, or become submerged by short-term considerations, because of a lack of technical skills and experience at the implementation and project-management level. In some Community countries, employees typically rise into these positions after performing well in more junior posts in the commercial/administrative structure. Problems can arise when technical and craft skills are inadequately supplemented by planning and managerial abilities required in the new post. In some countries, academically successful employees are specially trained to fill managerial posts, but in others, both operational and managerial skills are generally lacking. The issue for policy to advance cohesion is that the market tends not to supply the necessary investment in training. Education and training therefore have the characteristics of a public good.

There are some important distinctions between the economic approach, of using training to enhance the skills of the entire workforce in an industry or region, and the social approach of using training to improve employment opportunities. The first will tend to target training at those who are already in work and possess some certified skill, while the second directs it at socially disadvantaged people, principally those out of work and lacking formal qualifications. The first will tend to emphasize broad-based, widely applicable skills which employers can supplement with specific training, while the second often targets specific skills which are believed to be highly employable. Success of the first approach is measured by the rise in attainments within the workforce, the flow of new inward and indigenous investment, and changes in overall growth and employment rates. Success of the second is measured by the attainments and subsequent employment success of individual trainees. To a degree this encapsulates the distinction between economic and social cohesion.

Budget constraints raise three important questions with regard to funding of education and training:

(i) First, what is the appropriate public contribution, relative to the contribution of private employers and employees?

(ii) Second, at the margin, is cohesion advanced more readily by training to improve the stock of skills in a region, or training to improve the employment opportunities of particular social groups?

(iii) Third, to what extent should education and training, traditionally the preserve of Member State, regional or local authorities, be addressed by the Community?

The first question is difficult to answer because levels of public funding to post-compulsory education and training differ substantially across the Community. The comprehensive system in Germany, for example, of a near-universal apprenticeship system is mainly funded by private employers, while in France a system with similar coverage receives State support through training colleges and technological universities. In some other Member States, provision is much more piecemeal. The extent of employee-financed training depends heavily on the availability of loans, and on the expected opportunities opened up by the acquisition of skills. The extent of employer-financed training depends heavily on rates of labour turnover and on the scale of training outlay by other employers, since widespread training and low turnover rates reduce the threat of poaching and refusal to train.

Within countries, educational expenditure is often fairly evenly spread (most localities have a school, and universities are often located outside main industrial centres), but private-sector vocational training will tend to be more readily available in urban regions supporting profitable enterprise, and some regions bemoan the lack of institutes of learning. Clearly, on-the-job training in new skills is most easily provided in regions housing the 'sunrise' industries that demand them. The output from education and training is more regionally unbalanced, since those with qualifications are more likely to migrate to more prosperous areas. Although an improved skills base makes a region better able to attract new enterprise, too long a lag in its arrival will cause the skills to go elsewhere. It is vital that programmes of industrial development and employment creation operate alongside assistance to education and training.

The second question has been the subject of long debate. It is quite possible that economic benefits are maximized by giving further training to those already qualified and in work, while social benefits are maximized by giving training to those without jobs or qualifications. However, it remains likely that the economic returns to human resource development remain higher when it is directed at those who are already relatively privileged. A different allocation of funds between the regional and social objectives, as noted above, could achieve this local variation.

Given regional differences in the commitment to education and training and the contributions of the private sector to funding it, the need for additional public input to human capital formation must be assessed separately for each assisted region. The answer to the third question is, consequently, linked to the fiscal capacity of regions. Whether structural Fund assistance should go towards this purpose also depends on the other uses available, and their expected social returns.

5.6. A common social security fund or similar automatic stabilizer

One of the crucial issues in achieving cohesion is whether actions should be aimed at improving the standard and quality of life of those most disadvantaged or at enhancing the resources of particular regions without specific concern for the distribution of benefits among the inhabitants of those regions. As Community policy stands at present it is largely in the second camp. Desirable objectives for expenditure have been derived principally in terms of hard and soft infrastructure. However, the further spending moves into the soft infrastructure (for example, training, education, health), the more likely it is that the funds will be spent on individuals and particularly on those individuals in greatest need. Thus, those who already have considerable skills are less likely to benefit from training programmes, while those who can afford health insurance will have less need for public schemes.

Several other Community policies are already directed at individuals. For example, the latest price support proposals for the CAP distinguish between categories of farmers according to the size of their holdings and hence their incomes. It is, therefore, worth exploring whether it might not be more appropriate to tackle these questions of individual or household need directly.

Such needs can either be met directly by providing the appropriate facilities – hospitals, doctors, training courses for which charges may or may not be made depending upon the Member State or region's decision – or by providing income support to enable the poorest households to improve their standard of living. The particular form of income support could be general – a social security payment – or dedicated to a particular service, e.g. a bus pass, a training voucher, or an electricity bill rebate. Various arguments are put forward for preferring one scheme to another, but the major justification for payments to the household is that they are better targeted. The more dedicated the payment/credit the more closely targeted it becomes.

In general, such payments would be an addition to the existing structural Funds as they tend to cover current spending rather than the investment to provide the service. However, they might be more successful in leveraging private-sector contributions towards cohesion than an increase in the availability of publicly owned and operated infrastructure. Thus, providing retired people with housing vouchers which they could use in retirement homes might bring forward investment from the private sector to set up such homes.

The establishment of a new fund aimed at individuals and households would be a way for the Community to demonstrate that it was concerned to address the problems of individuals as well as regions collectively. To dovetail neatly with the existing structural Funds, it could take the form of a new social security fund which tackles the problems of those who are disadvantaged in terms of income and unemployment. This has the advantage that it uses the same two principal criteria that are applied to the regions themselves.

This proposal has a second advantage in that it lies between the two categories of payments that can be made to less favoured regions. The first is specific grants, as are used at present for the structural Funds, which must be spent on agreed programmes currently specified in great detail, so that the distinction between them and individual projects is actually rather small and the second, unhypothecated transfers which regions can use to enhance their general level of spending. For the latter, the area of spending is laid down but not the specific allocation.

If this new fund is to be accepted and come into place in the course of the next few years, this set of transfers would have to be an addition to existing social security systems and not a new system. In any case, this proposal would have to respect the principle of subsidiarity and let each region/Member State decide what particular form of social security transfer suited it best. It would be important to permit different assessments of relative needs within the overall requirement that the funds go directly to less advantaged households.

Furthermore, by focusing on social security the spending requirement will vary with economic circumstances, rising as the economy turns down relative to trend, rising for areas experiencing problems of structural change, yet falling automatically as the problems are resolved. It would, thus, be a form of automatic stabilization for both problems of adjustment to the requirements of closer integration and for asymmetric responses to shocks to the system, payments tending to flow towards the areas of greatest need. This could be particularly useful as new strains appear in the run-up to economic and monetary union.

The specific form of the fund is obviously open to debate, but needs could be assessed in a similar way to that used for the structural Funds at present, with one criterion based on unemployment and the other on income per head. It would be possible to construct a needs formula which might, for example, give added weight to unemployment according to length of time out of work or age if it is thought that the emphasis should fall on a particular group such as the young. However, while unemployment measures directly identify the target population, measures of average GDP per capita do not. It is necessary to look at the distribution of incomes and not just the average level. Focusing on incomes rather than GDP would help overcome the problems of the net flows of income out of the region.

At first blush this sounds like a heavy additional requirement, but all the information is collected already for national tax and social security systems. As in the national cases, the relevant income would be that before tax. Clearly what would be required at the Community level to assess needs would be some measure of the nature of the income distribution. Such a measure might be a calculation of the proportion of the inhabitants of a region below a particular income level relative to the Community average or it could be the average income of the poorest x % in the region.

Requirements of additionality could be imposed on the regions in an attempt to prevent them cutting benefits paid from their own resources, although this would be just as difficult to enforce as it is for any other form of spending, as it is impossible to say what would otherwise have been spent. Even in the event of total failure to achieve such additionality, the payment would effectively take the form of an unhypothecated transfer – however, it would be possible for the nation to switch that transfer out of the particular region to the national budget if part of local expenditure is centrally financed as is universally the case. It is thus very difficult here, as in all other cases, to disprove the existence of additionality as there is no objective description of what would have been done otherwise to stand against the current spending plans.

Member States vary in the way they apply their social security systems, variously targeting individuals and households. Providing the calculations are universally on a similar basis from the point of view of assessing the per capita need, how the region chooses to allocate it need not be the same, thus preserving the principle of subsidiarity. While there may be externalities as a result of the differing systems and the way the regions choose to apply the new social security fund, the major reaction would have to be in terms of the labour force voting with its feet and moving to where the rules are more congenially interpreted.

Thus, for each region in the Community, it is possible to assess the numbers falling below given income or unemployment levels. It is up to the specific design whether all payments are focused on the worst off or whether a graded system is introduced, say a payment of one size for all those below 25 % of average income and half that for all those between 25 % and 50 %. The size of the fund can be based on a proportion of Community GDP so there is no danger of total spending rising above desired limits. The total size can be fixed in advance for the five-year spending programme of the Community, with the exact sums involved being estimated on an annual basis for the individual regions on the basis of their needs and the yield from Community GDP.

It is likely that all regions would benefit on this criterion as all have wide *ex ante* distributions of income. A second criterion would therefore have to be introduced if the fund did not need to be of enormous size, based on the ability of the region to meet its own needs. This could be on exactly the same basis as at present in terms of average per capita GDP, compared with the Community average, adjusted for abnormal costs stemming from low density of population, rapidity of structural change or need for urban renewal. It is also a choice whether the eligibility for funding varies across a range or whether it is a simple absolute criterion as at present. Under a variable regime, eligibility could be assessed according to the extent to which GDP fell short of the Community average as is discussed in more detail in Section 6.1. For example, those with GDP per capita less than 60 % of the average could receive 100 % funding, while those above 80 % would receive nothing. Using a straight line proportion would give those with

70 % of the average GDP 50 % funding. Padoa-Schioppa (1987) suggests a logarithmic approach whereby the poorer regions get progressively more.

Other forms of fund for dealing with individual deprivation and stabilization have also been advocated, the most widely canvassed of which is an unemployment fund (see the MacDougall Report (1977), for example). The advantage of such a fund is that it is directly stabilizing in character, making transfers to those regions experiencing problems, although in view of the low unemployment rates in some of the least favoured regions, the targeting would miss some important objectives. Again, it is possible to restrict the range of spending on which the funds should be used. Such a fund can operate on a self-financing basis with those who are in employment in effect making the contributions and those who are out of work receiving the benefits. However, most proposals for unemployment funds are for funds which are used to try to increase employment in areas of high unemployment, rather than transfers to individuals who are unemployed. Nevertheless, even with a rather more broadly based stabilization instrument like a social security fund, there is no reason why the means of equalization should not take the form of the German *Länderfinanzausgleich* if so desired. Such transfers do not have to be unhypothecated and can be paid into a specific fund.

Stabilization funds could therefore take the form of assisting households or the unemployed directly or of providing regional assistance towards business activity during short-run difficulties. Just as with any State, it is difficult to forecast whether any current downturn is a cyclical movement requiring temporary assistance to prevent unnecessary hardship and costly changes, which would soon be shown to have been unnecessary, or whether it reflects an enduring change in competitiveness requiring longer-term funding. Beginning with short-term funding and then making a transition to longer-term funding is not the right response as the short-term funds are aimed at preventing unnecessary change not encouraging regions to undertake longer-term restructuring.

5.7. State aids and cohesion

There will always be conflicts between regional, national and pan-European cohesion objectives, a point exemplified by the debate on State aids. These are defined in the *Second survey of State aids* (Commission of the European Communities, 1990c) to be incentives or other forms of assistance which confer competitive advantages on the undertakings receiving them (distinguishing them from general measures, which do not explicitly discriminate between different sectors or undertakings). All tiers of government adopt policies to promote economic activity either generally in their territories or in localities which are judged to be relatively disadvantaged. Thus it is that rural areas of a prosperous region such as Baden-Württemberg have been eligible for assistance from the *Land* government on the reasonable grounds that they compare unfavourably with the main urban centres. As the Commission's *Second survey of State aids* shows, there is a wide range of different sorts of State aids, a sizeable proportion of which is not readily visible.

Aids have been concentrated on the manufacturing sector and appear to have been highest (as a proportion of gross output) in Greece, Portugal, Ireland and Italy. However, when aids are expressed in terms of outlays per employee, it is Italy, with double the Community average, which gives most assistance. These aids are on offer throughout Italy, though at a higher rate in the Mezzogiorno. In those countries with acute budgetary difficulties, State aids account for big shares of public expenditure: 6 % in Italy, Greece and Belgium, compared with 2 % in the Netherlands and Denmark.

State aids in relatively favoured regions or Member States can be contrary to cohesion if they conflict with wider spatial objectives, be it less favoured parts of Germany, or Objective 1 regions where there are companies which compete in the same markets as the assisted firms. A second dimension of this is fiscal capacity. In general, less favoured regions of the Community are less able to finance aids to industry, because of other demands on public expenditure and a lesser tax base.[1]) This is exacerbated where the public administration in question is in budgetary deficit, as in Greece or Italy. As a result, weaker regions are not able to offer incentives on a sufficient scale to compete with those available in more prosperous regions, let alone at levels that would yield competitive advantages, so that the effect of State aids tends to act counter to cohesion.

DG IV of the Commission is already active in trying to curb State aids (in pursuance of Article 92 of the Single Act) in favoured regions, but it is plain that this has some way to go. The Commission survey shows that most of the State aids are not regionally targeted. Over

[1] It might be argued, of course, that if expenditure on State aids is cut back, administrations in favoured regions would *ceteris paribus* be able to cut taxes across the board, thereby improving competitiveness by a different route. However, as this replaces a targeted by an untargeted policy, the impact on the most sensitive industries is likely to be smaller.

the period 1986 to 1988, it is estimated that the volume of State aids was three times as great as Community resources spent to support activity (and most of that, of course, was in agriculture). Derogations from Article 92 are allowed for regional aid under the provisions of Section 3 to the article which covers 'aid to promote the economic development of areas where the standard of living is abnormally low or where there is serious underemployment'.

Although there are large differences in the cohesion impact of different sorts of State aids, it is plain that a greater stress on Community rather than national or regional objectives in the way State aids are granted is necessary as part of a strategy to achieve cohesion. The whole question of State aids is one that provokes heated debate. From the point of view of completing the internal market, any State aids can be regarded as an impediment. On the other hand, there is widespread support for interventionist industrial policy, with differences in political ideology central to the question of whether or not such policies are regarded as worthwhile.

From the perspective of cohesion, the key question is how to regulate the use of State aids so that the broad aims of structural policy are met. Under Article 92, the answer has been to impose a threshold favouring the least favoured regions. This is regarded by many experts as being too rigid an approach, suggesting that a more graduated schedule would be more appropriate. Sectoral coverage, assistance to SMEs and the encouragement of entrepreneurial activity are additional points at issue. It could, for example, be argued that State aids which assisted the build-up of subcontracting networks, increased the rate of formation of new company starts or improved the supply of venture capital would all be desirable. Similarly, intervention which improved the availability and quality of complementary business services while posing no real challenge to undertakings outside the region would be seen as an improvement in productive potential. On the other hand, regions will want to avoid an auction to attract inward investors. Although devising operational guidelines will be far from easy, the guiding principle ought to be that State aids with the prospect of a positive sum game should be admissible, and the present over-rigid income thresholds should be relaxed or even abandoned.

Perhaps the most obvious way out of this dilemma is to replace the system of various regional and national aids to industry with a Community-wide industrial policy. To an extent, this exists at present with support for various industrial developments like Esprit and Brite. Such spending can have an explicitly regional dimension as with Star, but it is then arguable whether support should be focused on those best able to use it rather than on an extension of regional policy. Whichever route is chosen it is clear than the two aims have to be put together, otherwise they stand a good chance of being contradictory, with regional policy trying to encourage one form of industrial development in one part of the Community and industrial policy trying to encourage another in a different set of regions, thereby cancelling each other out and spending public money in the process. This is thus not just a zero-sum game but a negative sum. Clearly this can be run either way round, either insisting that industrial policy has a regional dimension or that regional policy takes account of the wider industrial requirements. In either event a substantial increase in coordination would be required.

5.8. Improving administrative competences

The difficulties apparent in many regions in making use of the structural Funds indicate that administrative capacity has to be regarded as an important ingredient in cohesion policy. If public authorities lack the competences to use resources effectively, the chances of achieving cohesion are bound to be diminished. In addition, where it appears that resources are being poorly used, the confidence of donors in the value of the assistance is undermined. This suggests that while application of the principle of subsidiarity means that control of policy should remain with as low a tier of government as possible, there is a strong case for making improvements in administrative competences a component of cohesion policy. In order to achieve this aim yet avoid upsetting political sensitivities in regional or local administrations, a number of possible approaches can be contemplated.

A first imperative is to draw a clear distinction between the technical demands of programme implementation and project management on the one hand, and the political decision-making process on the other. For most major structural programmes and operations, the regional tier of government is probably the most appropriate level for the formulation of policy and the setting of economic development objectives. This requires not merely administrative skills and political judgement, but also economic development expertise, which is often deficient. For individual projects, local knowledge and judgement is more critical.

At both levels, however, international experience of economic development suggests that the role of project executives and development specialists is often crucial in the success of initiatives. This suggests that an important part in stimulating economic development could be played by the Community in assisting the training of such individuals and in supporting their work. This assistance could function in a number of ways. Within the present arrangements for the provision of technical assistance, there is allowance for training and briefing of officials, business leaders and workers, including the opportunity for exchange visits. This appears to be geared mainly to the preparation and monitoring of CSFs. However, a key long-term need is the building up of a cadre of experienced economic development specialists.

It is important to recognize, though, that it is not so much at strategic levels that such expertise is needed – the opinions of respondents indicated that top-level administrators with suitable training and track-record could, generally, be found. Rather, it is at the intermediate level that additional skills are needed. To fill this gap, a combination of the following options would be helpful:

(a) Creation of a Community-funded training programme for economic development specialists. This could, in principle, raise a proportion of its costs from regional authorities, perhaps on a means-tested sliding scale.

(b) More extensive and elaborate exchange programmes for relevant public officials. It is established that innovation in economic development requires flexibility and the ability to experiment with new approaches. One way to obtain information on which to base such innovation is through practical experience of what is effective elsewhere.

(c) Secondments either of staff from other tiers of government or from specialist agencies, including those in the private sector.

(d) Regional cooperation on economic development issues. It emerged in research carried out for this study in the new German *Länder*, for example, that information gleaned through regional conferences and contacts with Western *Länder* had been useful in influencing policy choices.

At the technical level, the principle of subsidiarity notwithstanding, the case for employing experts is compelling. In several of the Objective 1 regions, especially, local political control of the implementation of programmes and projects has been identified as a substantial obstacle. 'Clientilism' – the use of political favours – in the awarding of contracts has been endemic and has greatly reduced the efficiency of policy delivery.

Possible solutions may be to build up task forces for the purpose of technical execution of projects, an approach that is now being experimented with in Italy. The French system of agreeing contracts between sponsoring agencies and recipient authorities may also be a way of introducing higher standards of implementation. It has to be recognized, however, that such changes in certain regions, such as parts of the Mezzogiorno or Greece, are not just administrative tinkering, but would involve major changes in the social and political environment. For this reason, they must be expected to face real difficulties.

A means of pushing the pace of reform in this respect might bé the imposition of explicit conditions attached to the allocation of funds. This is sure to be a vexed question, since any attempt by the Community to dictate to regions would encounter hostility. On the other hand, many of those consulted in the course of the research indicated that external pressure of this sort may be necessary to achieve change.

5.9. Credit arrangements within EMU

There is a tendency for attention to focus on the use of grants as a means of achieving cohesion. However, as noted earlier and brought out clearly by Franzmeyer et al., loans can be an equally important source of funding for projects and, since they have to be repaid, they tend to be focused rather more explicitly on projects with good real or social rates of return. In 1986-87, EIB loans amounted to almost exactly the same as the structural Fund grants for Europe of the Ten; the two new members were rather more dependent on grants. In practice, of course, while individual loans may have to be repaid, it is normal to roll the general bulk of the debt forward and indeed to allow it to increase in parallel with the ability to pay the interest through current incomes.

However, regional and national governments have always been able to borrow. Borrowing via the European Communities is only of interest if it offers better terms than are otherwise available. Since the European Investment Bank is itself able to borrow at the best terms available, it is able to pass these rates on to borrowers in the regions. This may give some advantage to higher risk borrowers, although the EIB is itself very risk averse and has sought to avoid building up the sorts of debts that have troubled the commercial banks in their dealings with the less developed world in the 1980s. It is loans for eventualities that are not otherwise covered which will tend to be rather more important than the small differences in rates which can be obtained.

In previous sections, we distinguished between policies primarily aimed at the longer-term issues of cohesion and prepared to provide transfers between regions on a continuing basis from those which are aimed at reducing the adverse impact of short-term fluctuations. To this we can add policies which are aimed at overcoming transition problems arising during progress towards closer integration such as the moves towards nominal convergence and reduction in fiscal deficits and debt ratios. Although these latter may not be aimed at cohesion as it is usually defined, they do in fact affect it if the policies required by Member States to adjust result in a reduction of cohesion.

It is appropriate that these problems should be dealt with in their own right rather than trying to fall back on regional policy to make up for the deficiencies elsewhere. In general, these short-term problems are often best dealt with by loans or short-term credits as they reflect a problem of timing rather than permanent need. Thus, for example, if monetary union is likely to benefit a region in the long term but considerable expenditure is necessary in the short term to overcome the problems of transition, a loan to tide it over may be appropriate.

The simplest example of this approach is the system within the EMS for providing levels of credits to offset short-term fluctuations. The conditions applied to the use of these funds increase in harshness according to the length of their use. When central banks in the EMS reach the point at which they should intervene to keep their currencies within the permitted bounds they may not have the appropriate quantity or mix of reserves. The very short-term financing facility (VSTF) was set up to cover the obligation to intervene at the margin (there are also more limited credits to assist infra-marginal interventions). This facility is of unlimited size. However, the credits have to be repaid within three months with a limited ability to extend them for a further three months. The system also contains a medium-term financial assistance facility to help smooth temporary balance of payments problems. To this can be added the special loans to Greece to assist its adjustment into the EC. The major circumstances under which this extra form of support is required at present is in the transition to monetary union, although it is easy to envisage that the accession of new members in Central and Eastern Europe might pose some special, additional problems of transition which would require similar steps.

Three forms of support for countries are available in the international system:

(i) outright grants;

(ii) medium- to long-term loans, such as those administered by the World Bank, for programmes and projects;

(iii) drawing rights on the IMF.

Within the EC, the third option – drawing rights – is not currently available to regions. It might, however, be possible to develop a suitable credit mechanism similar to the international regime. Once the EMU is operating, these credits would not make sense in the same framework, as we would be dealing with the internal operations of the European central bank. In the transition such a role would be possible. However, it would, on the whole, need to be directed towards governments which have the appropriate monetary authorities, rather than to regions. Such loans would therefore be conditional on various actions being taken to transform the regional economies in question, in line with the sorts of conditions that the IMF places on Member States.

In both the transition towards EMU and (assuming it proceeds) full EMU, the scope for public authorities to borrow from whatever form of central bank is created will affect cohesion. The present position is that national governments do have access to privileged borrowing through printing money, whereas neither the regional nor the supra-national tier of government can. Once EMU is established, on present proposals, Member States will no longer be able to borrow in this way and during stage two of the transition they will be discouraged from doing so. Since budgetary policy is also likely to be subject to constraint the scope for funding will also be limited. Credit mechanisms can, however, be an important means of achieving transfers and consequently deserve consideration as part of a cohesion strategy. There will have to be some arrangement for relating European money creation to its distribution and there may be scope in this respect to favour regions or countries facing difficulties. Such a system could work in a variety of ways, depending on whether the aim is to provide permanent or temporary real resource transfers and the time profile over which net resource flows are to occur.

A possible model is the special drawing right instrument (SDR) of the IMF. In a recent paper, Coats, Furstenberg and Isard (Princeton Essay in International Finance, 1990) discuss the extent to which the exercise of SDRs gives rise to permanent as opposed to temporary resource transfers. The outcome is affected by the terms on which a country can obtain a 'loan' via an SDR-type system, and the rate of interest charged on it. For example, countries or regions which would otherwise face risk premiums would gain even if an allocation of funds (and thus the capacity to purchase real resources) was made at a competitive ecu rate, since that country would avoid the risk premium. Of course, it would also be open to a central monetary authority to issue debt to target countries at less than market rates or on soft repayment terms, adding to the resource transfer element.

It is important to distinguish between the possible operation of an unhypothecated financial instrument modelled on the SDR and loans made through an institution such as the EIB which relate to specific projects and which are subject to a rate of return target. Both can play a part in advancing cohesion, but the former would operate mainly by relaxing macroeconomic constraints, whereas the effect of the latter depends much more (though not exclusively) on its microeconomic impact. On the whole, the scope for loan finance, whether through the EIB or some new mechanism, receives less attention than it deserves in the debate on cohesion. In widening that debate it might be worth considering the use of soft loans by the EIB in the same way that the conditions for use of the structural Funds might be eased for countries experiencing difficulties in absorption.

The loans through the EIB involve industry in a way which is not true of the structural Funds. It might be possible to extend this relationship further and make it closer if the extent of participation in the enterprise were to be expanded. One direction this might go is in the use of venture capital. One of the problems for the less favoured regions is that the average size of enterprise tends to be smaller and hence use of official or other funding routes may be particularly difficult. This can be offset by specific lending institutions focusing on SMEs, such as exist in some Member States. This specialization can extend further to the most appropriate form that the lending might take and for many small companies that route is venture capital. For venture capital to be a successful if relatively high-risk form of activity, sheer lending needs to be augmented by managerial and technical advice. To undertake this work, specialist institutions would be required even if the original funds were to be subscribed by the EIB.

5.10. Modifying other Community policies

Although the Community's agricultural policies, given their large share in the Community budget, are seen as a prime target for reform in order to advance cohesion, the underlying politics will make major change hard to achieve. The most likely scenario is that the various pressures for reform described in Section 3.2.8 in conjunction with the Mac Sharry package will ensure that agricultural spending is held in check, with rather more support flowing to the southern European countries than hitherto.

As regards Community expenditure other than the structural Funds or agricultural spending, its potential impact on cohesion is not great. It is true that certain Community institutions could be relocated in order to serve cohesion objectives, but this could prove counterproductive if it raised administrative costs. Nevertheless, it would be useful to know what the territorial incidence of such expenditure is.

There may, almost paradoxically, be greater scope for policies that do not directly involve public expenditure to be refashioned for cohesion purposes. Competition policy or measures to support industrial development could be given explicit cohesion aims. In adjudication of mergers, for example, competition criteria are quite properly dominant, but there ought to be some grounds for influencing a decision if the effect on cohesion would be adverse.

Transport or telecommunications developments in one country can both complement and compete with those in others, and there may be a role for Community institutions to play in ensuring that the direction of change does not threaten cohesion.

The Community's position in the Uruguay Round trade negotiations is a good example. If the outcome were, broadly, a deal in which the *quid pro quo* for an opening-up of world markets for financial services would be a relaxation of Community restrictions on textile and food imports, the regional incidence of these changes would almost certainly be uneven. Major financial centres, most of which are in favoured regions, would stand to gain most, whereas textile regions, notably those in low wage areas, would be threatened. While it would be difficult to argue that this should prevent a deal being struck, it would make sense to implement the changes in a way that minimized the damage to cohesion, perhaps by phasing the implementation. At the very least, it is important to place the question of cohesion on the agenda so that, if a particular decision is taken, it is with the knowledge of what effect the decision is likely to have on cohesion.

6. Operational questions

Implementation of any new strategy will require decisions on a range of matters. These in turn have a bearing on the feasibility of the strategy, since they affect its total cost and thus its potential for success. Some of the relevant issues are discussed in this section of the report.

6.1. Determining eligibility

In the light of the earlier discussion of new factors affecting cohesion, an important issue is which indicators to use to measure eligibility for any form of assistance. The tendency in recent years to simplify and to concentrate on GDP per capita and unemployment has an obvious appeal, especially when the problem is so obvious and there are so many projects on which to spend the money that further sophistication might seem unnecessary. However, because eligibility of a region as a whole depends to a great extent on the narrow question of whether one or two indicators reach a threshold level, it is necessary for the indicators to be very robust if misclassification is to be avoided.

There are four aspects which can be explored to try to improve this determination. The first is the choice of the indicators themselves, which depends in turn on our understanding of what constitutes a lack of cohesion. The second is how regions should be delimited, the third is the question of whether eligibility could be more graduated and the last is whether, in fact, spatial measures encompass all the categories of economic and social disparities that we wish to consider.

The case for using GDP per capita is that it is a reasonable proxy for most other characteristics of a region, although what determines the standard of living is post-tax incomes (including any transfers) rather than the value of output. However, it is not a direct measure either of the wealth of individuals or of the region in which they live. Private wealth, particularly financial wealth, can be expected to generate an income which is picked up by monetized indicators like GDP. Such measures cannot, however, provide useful information on the built environment and the quality of social infrastructure or indeed, on factors which affect the quality of life in a region. Although income per capita (calculated in terms of disposable income rather than GDP) is bound to be crucial, there may be a case for using differing criteria for different aspects of cohesion. The main statistical problem is the inadequacy of indicators of social cohesion, as they tend to be less well correlated with basic economic indicators.

In designating regions for assistance, we might, thus, wish to consider a range of indicators of the stock of infrastructure and its condition; some might be volumetric like:

- miles of motorways per inhabitant and per square mile;
- number of patients per doctor;
- proportion of dwellings without facilities, such as inside toilet, running water, bathroom;
- number of reported faults per phone line, or waiting-time for installation (as high as seven years in Greece);
- ownership/use of consumer durables;
- number of phones/cars/TVs per 1 000 inhabitants;
- life expectancy;
- proportion of population with various educational/skill qualification.

Other components of infrastructure might actually have been valued. Water, gas and electricity industries, for example, may have had their assets assessed as part of Member State scrutiny of performance, or where the industries in question have been considered either for privatization, or to appraise eligibility for further loan finance.

However, this is a view of cohesion as a static condition. We have for example already noted the importance of considering rates of change as well as absolute differences in levels of disparities. A relatively well-off region may be in need of structural assistance if it is in rapid decline because the level of resources required to counter such a dramatic change exceeds that usually available, even though the Member State may not be less favoured. A society may be able to adapt to a particular level of unemployment, for example, but a rapid rise in that level may be socially highly disruptive, even though the numbers becoming unemployed are still relatively small compared with those already out of work.

Similarly we might wish to consider what is already being done to address the problem of social cohesion – either on an input basis:

(i) spending on health, education;

(ii) number of training places, hospital bed nights;

or on an output basis:

(i) number attaining particular qualifications (with the two measures being necessary to indicate efficiency). Changes in the stock are also important as an indicator of new problems that ought to be tackled;

(ii) proportion of population illiterate;

(iii) infant mortality.

A second question is whether regions should be designated purely within national boundaries or whether cross-border definitions would be preferable. Taking a pan-European approach, it would be most equitable to concentrate assistance on areas or social groups manifestly lagging behind the rest of the Community. In practice, there are bound to be disparities within countries and/or regions that demand a political response but not at the European level, so that it is almost inevitable that cohesion policies will be required at different spatial levels. This will entail compromise, since it could be argued, as with State aids, that help to poorer parts of richer regions or countries undermines that given to less prosperous regions. There will also need to be a review of who decides eligibility. Boundaries designated for ERDF purposes do not always accord with those applied by national governments for regional assistance. Some State aids can, moreover, be said to promote vital national interests, yet can affect EC cohesion adversely.

A third question affecting these decisions is that currently areas are either eligible for aid from the structural Funds or they are not; there is no question of partial eligibility, yet in practice there is a continuum of problems from the severe to the minor. While severe problems should be the main focus, this should not entail the neglect of lesser problems. Thus a whole range of partial eligibility could be considered, attracting a proportion of the support available to those regions in greatest need. To a degree, boundaries are arbitrary. For administrative reasons, a rural area may need to incorporate a major town in its region in order to provide some of the basic services, yet that town may be either separated from the region as a whole or right on the edge of it. A small spatial displacement of the boundary may have a major impact on a large range of the indicators of disparities. Similarly, there are minimum and maximum limits to the size and population of regions for administrative cost and convenience which may have little to do with behavioural definitions of regions or any feeling of regional identity.

These problems can be overcome by targeting groups within regions, such as the poor, by looking at the distribution of indicators – percentage of population within 20 miles of a hospital – and by making the extent of assistance provided related to the extent of the disparities. This artificiality of boundaries was particularly remarked upon in our interviews in Italy, probably in part because of the length of Italian experience in handling these policies and hence the ability to observe the impact of distortions on the flow of people and funds and on national cohesion.

In a sense we can invert the problem by listing social aspects where cohesion appears to be lacking and see if they are picked up by existing indicators. There are some obvious examples where this is not the case. The first is in the case of ethnic minorities (even where those minorities are major groups). This is exacerbated when the minorities are also recent immigrants. Their social requirements may be greater than for the existing population, not just because they do not know the language or demand different mixes of consumer goods which are likely to cost more, but because they lack all the asset and network benefits of having lived in an area for generations.

A second is urban problems, which can be caused both by excessive growth or decline. In less favoured rural regions, the problem comes from people arriving in the towns in advance of the jobs and the building of the infrastructure. But in the older cities it is a problem of decay. A fabric built a long time ago is now in need of massive repair. As the quality of the housing stock deteriorates the wealth and income of those in the area falls as does its ability to put the problems right. The process can therefore be cumulative and exceed the resources of the region to correct it. Incomes required for survival in urban areas may be greater than in the country and costs for the poor escalate rapidly when heating becomes a problem. In many respects this problem has best been illustrated in the USA where, in the absence of public intervention, extreme decline was permitted, leading to major dereliction. The ability of the market to correct this has proved to be slow-working and in many cases still ineffective. It would not be an attractive model for Europe to follow.

6.2. Competences and responsibilities of different tiers of government

That there will be disagreement on the extent to which different tiers of government should be involved in formulating, financing and implementing policy towards cohesion is inevitable. Although it is accepted that the principle of subsidiarity should prevail, it is typically quite hard to determine how to apply the principle. Land-use is an interesting case in point. The Commission's recent document *Europe 2000* (Commission of the European Communities, 1991a) shows that there is a Community dimension to such questions, yet such policies have traditionally been the preserve of lower tiers of government. The current approach with respect to the structural Funds is to try to achieve a balance by developing a partnership between the Commission, national, regional and local governments, with the lower tiers being primarily responsible for execution and the higher tiers providing guidelines, frameworks and rules for operation. In the main it is accepted that funds will be better targeted by the lower tier authorities as they have the detailed knowledge of local needs and ways of behaving. However, it is unlikely that the lowest levels of government will have much experience in establishing the effectiveness of the various instruments and technical help will be required. To some extent this can be provided by higher level authorities, but the sensitivities may be better handled by having task forces which are not part of the higher tiers of government themselves but are recognized by them as possessing the necessary competences.

Administrative competence raises similar issues. Even though there is a compelling case for the local tier of government to have a primary role, there may be circumstances where a lack of capacity weakens the delivery of policy. Such problems occur, for example, in parts of the Mezzogiorno, prompting demands for a fresh administrative approach. Obviously, any such intervention is bound to offend local political sensitivities, but if the alternative is persistently ineffective policy, difficult decisions may have to be taken. One aspect of administrative competence which tends to be stressed is financial competence – the fear that money is not being spent wisely, efficiently or indeed in some cases fairly. There are a number of ways out of this. The most obvious is to strengthen the accounting and policing functions. A second is to provide Community-wide training programmes to improve administrative competences. Some argue that a new Community institution should be set up to achieve this, perhaps in one of the regions where the administrative difficulties appear to be greatest. An alternative route might be an expansion in the role of the European Institute of Public Administration or similar existing institutions.

6.3. Monitoring and evaluation

Policies to achieve cohesion are bound to create tensions. Whatever strategy is adopted, net contributors of resources will need to be persuaded, first, that there is a convincing case for providing assistance, and, second, that the resulting policies are effective. This is partly to do with establishing a suitable monitoring framework. Criticisms have been expressed about a lack of information on how structural Fund money is used and an absence of transparency in accounting systems. This clearly needs to be improved. But checking policy effectiveness means more than verifying that money is spent as intended. It is also necessary to ensure that the outcome of the policy conforms to expectations. Does a specific infrastructure project lead to higher than expected investment, are there more jobs in an area as a result of training programmes, or do incomes actually rise in line with transfers? These are the sorts of questions to be answered if a genuine evaluation of policy is to be conducted.

Evaluation can occur at three levels within the Community. There is a clear role for the Court of Auditors, which acts in much the same way as public auditors in the Member States. Similarly, in the Member States, the legislature has considerable powers of accountability over the actions of the executive, although there are manifest variations between countries in the extent of these powers. At the Community level, the European Parliament's Committee on Budgetary Control is able to conduct its own investigations into the implementation of the Community budget.

However, subsidiarity has been stressed as a key concept in the flexible and effective use of the structural Funds to meet regional needs. This would imply the use of satisfactory systems of local accountability. The monitoring function built into the Community support frameworks falls a long way short of such accountability and hence would either need to be reinforced or supplemented by a secondary mechanism if both subsidiarity and accountability are to be fulfilled simultaneously.

A third mechanism already exists in that a minimum level of public funding from each Member State is required for projects using the structural Funds. Such public funds are subject to the normal scrutiny of the

Member State concerned. A simple extension is to subject the Community element to exactly the same process thus providing a measure of devolved responsibility.

Where direct redistribution from the Community budget to households is involved, here again there is an opportunity to consolidate this with the public accounting procedures of the Member States concerned, which may operate through agencies, central or local government departments.

Taken together, therefore, a new strategy could involve a balanced package of expanded resources matched by greater emphasis on the efficiency of their use, a wider range of objectives and instruments, greater local responsibility and accountability and a stronger role for scrutiny by the Court of Auditors and the European Parliament.

6.3.1. Managing the budget

It is normally argued that three basic criteria need to be met in budgetary management of programmes such as those covered by the structural Funds. First, there must be proper *ex ante* appraisal of the spending, requiring a precise statement of objectives and a review of the alternative means for achieving them; this should include scrutiny of their anticipated costs and benefits (not all of which will be quantifiable) and of the robustness of the proposed management of the expenditure. Second, there must be mechanisms for monitoring the progress of the programmes/projects thus funded, in terms of tangible progress as well as in financial terms. Finally *ex post* evaluation is needed to establish both the legality of the actual spending and of its efficiency and effectiveness in relation to its objectives (value for money).

In the past, management of Community spending in all these respects has been weak, although improvements are in hand. *Ex ante* appraisal has tended to be largely left to the recipient Member States although more is now being done within the Commission, particularly to ensure that proposed expenditures are consistent with the broad planning represented by the Community support frameworks. More might be done, though, possibly along the lines adopted by the EIB. However, according to the 1988 report from the Court of Auditors: 'Weaknesses at the national level are not compensated for by sound controls at Commission level' (Court of Auditors, 1989). Both the 1988 and 1989 (Court of Auditors, 1990a) audit reports provide several examples where the information supplied to the Commission was inadequate to enable its officials to make a fully reasoned judgement either on such matters as the eligibility of certain projects, or on their likely chances of success, taking into account such matters as anticipated demand for output or supplies of raw materials, inadequate quantification of their expected costs and effects. These weaknesses revealed a lack of rigorous *ex ante* appraisal procedures; although standardized information has to be provided and is reviewed, the Court of Auditors' reports suggest that the processes have been excessively formalized with inadequate testing of the robustness of the underlying assumptions or expectations.

Ex ante appraisal procedures have been strengthened since 1988, but Commission officials suggested to us that the procedures and spirit of the matter are still rather formal and fall short of best practice in the private and public sectors elsewhere. The lack of vigorous probing of Member States' submissions is usually justified on the grounds of subsidiarity i.e. it is not for the Commission to behave as a kind of neo-colonial power with respect to sovereign Member States. However, while matters of high policy may not be for criticism or review by the Commission, a careful analysis of the expected economic effects, costs and project management arrangements of developments financed with Community funds are entirely legitimate areas for concern, and should include constructive suggestions and cooperation with the national authorities on the ground.

A more rigorous approach to appraisal could embrace such matters as:

- The precise objectives of the proposed spending, in a quantified form, e.g. number of jobs to be created over what period.
- The options considered.
- The constraints involved.
- The costs and benefits of the options.
- Important unquantifiable factors.
- An economic/industrial analysis to provide a basis for judging such matters and likely levels of demand, utilization, availability of supplies and raw materials, etc. wherever appropriate.
- The preferred option and its justification.

- The precise timetable of the operation in terms of financial developments (e.g. a programme of expenditure on equipment, labour and other supplies and physical milestones relating to stages in the completion of the development).
- The monitoring information to be provided and when.
- Arrangements for project management and control.
- Sensitivity of the operation to altered assumptions, e.g. changes in the economic environment.
- Arrangements within the sponsoring Directorate-General for managing and monitoring projects to ensure the above criteria are met.

It has been argued that the main basis of *ex ante* appraisal is to see whether proposed developments are consistent with Community support frameworks which were put together somewhat hastily in response to political imperatives and without the benefit of independent economic analyses of the regions and developments concerned. This does represent a significant development in the Commission's efforts to improve the quality of its financial management and these are still somewhat early days. None the less, it would be desirable if the results of any analyses currently being undertaken of the quality of the CSFs and of *ex ante* appraisal experiments were to be made available to the Parliament, particularly the Committee for Budgetary Control.

The Court of Auditors' reports suggest that organized monitoring of projects – in terms of both financial progress or the use actually made of funds, and of physical developments of the project with respect to previously agreed milestones – is largely absent; where several agencies in the recipient country are concerned, liaison can be poor and in many cases monitoring reports are not submitted on time or in sufficient detail. Projects are frequently abandoned and in some cases it has taken the Court of Auditors to identify this, to the surprise of higher-tier national authorities in the country concerned and the Commission: abandonment reflects weak *ex ante* appraisal and – when it comes as a surprise – weak monitoring procedures. Putting Community taxpayers' financial resources into projects which have not been rigorously appraised and then only sporadically monitored does not represent respect for the principle of subsidiarity: it is simply acceptance of waste and mismanagement, and possibly fraud.

Although monitoring committees exist, they vary with respect to the quality of the work and the frequency with which they meet: it is not unknown for such a committee virtually to suspend its activities if it does not receive the necessary monitoring information. Monitoring in both tangible and financial terms has been weak while failure to obtain necessary financial and other reports from Member States has been endemic. Information needed for monitoring purposes is, according to the Court of Auditors' reports, frequently late and incomplete; sometimes, problems arise because of inadequate coordination in Member States where several government departments or agencies are involved. In the circumstances, the ability of the Commission to monitor and control its own cash disbursements, to monitor progress of projects financed with Community funds and to get early warning of difficulties faces severe problems and might even be impossible.

Ex post evaluation has been sparse, although studies are now under way (often they will need to infer what the precise objectives were and will face difficulties if no information system for facilitating *ex post* evaluation was put in place). *Ex post* evaluation cannot be undertaken effectively if there was no *ex ante* precise specification of objectives, costs, milestones and outcomes and if there was no prior provision for an information system to supply data needed for *ex post* evaluation. It is also the case that good practice in the private sector involves an evaluation team quite separate from the *ex ante* appraisal group: this acts as a strong discipline on the ex-ante appraisal. In all these respects, evaluation of the impact and effectiveness of Community spending programmes reveals immense scope for improvement.

Reports by the Court of Auditors have often tended to focus on matters of regularity, i.e. was the money legally spent? rather than value for money, i.e.

(i) Economy – were resources of the lowest cost needed to do the job sought and budgeted?

(ii) Efficiency – was the mix and volume of inputs minimized for the given desired outcome or, to put it another way, was the greatest possible impact achieved for the given expenditure of resources?

(iii) Effectiveness – were precise, desired, objectives attained? There is no point in doing something well if it is of less value than something else requiring the same expenditure of resources.

There is a feeling in many quarters that the needs of the weaker regions of the Community are of such magnitude that attention to the matters outlined above are mere unnecessary details. 'After all, their needs for improved infrastructure in such matters as telecommunications and roads are so great that any money put in by the Community must be a good thing', as one senior official put it. But resources are limited so we need to consider, even in the case of a road in an area lacking good roads:

(a) What is the best route for this road?

(b) What is the anticipated volume of traffic and why do we claim this?

(c) What is the most efficient way of constructing this road in terms of the mix of materials, the depth and cost of its foundations, the trade-off between a more expensive initial outlay on a first-class road with low subsequent maintenance costs (i.e. one having a high cost in present value terms at any positive rate of interest) and one which is cheaper to construct but which will create higher running costs in later years (i.e. one where the present value of costs is lower)?

One might go on but the attitude displayed in the quotation above is one which, if it were at all widespread, creates the risk that slackness in budgeting and management, waste and mismanagement – all, perhaps, of less importance when the Community budget was smaller and had lower ambitions – become endemic and irreversible. Sadly, the impact of the Court of Auditors' reports in the European Parliament has been much less than that of comparable reports in the parliaments of the Member States.

Commission officials, while acknowledging past weaknesses, emphasize:

- the unwillingness of Member States to accept advice including (and sometimes especially) those with pressing needs for technical assistance;
- that, as EC funds have been relatively small and only part of the project finance, the recipient Member State has been relied upon to minimize waste, fraud and mismanagement;
- shortage of staff with appropriate skills;
- that technical assistance is available to help Member States;
- political imperatives to spend more and not worry too much about how it is spent, provided it is not fraudulently spent;
- current efforts to improve the quality of *ex ante* appraisal, monitoring and *ex post* evaluation;
- efforts to mount training programmes in the necessary skills.

Critics claim that:

- sound financial management has been a low priority in the Community institutions, emphasis having been on increasing the quantity of Community budgetary resources, in response to intense political pressures, with insufficient attention having been paid to its quality;
- skills, accountability and systems should be radically improved; they do not command sufficiently high priority and skill training is sporadic, unsympathetic and not a high priority. Thus in contrast to some Member States, regular, centrally determined training on financial management intended to ensure standards of best practice throughout the services of the Commission does not appear to be systematically provided;
- technical assistance budgets are underutilized and their provision should be mandatory and not a voluntary matter;
- the Community institutions should be much more pro-active in encouraging improvements to administrative capacity and skills in the weaker regions;
- that a significant percentage of any existing funds are not spent because of weak project planning capacity in intended recipient areas;
- that things would not be even as good as they are but for the commitment of individual officials.

6.4. Timescale and targets

Constrained resources impose limits on what can be achieved and make it clear that the Community ultimately has to be clear about how committed it is to attaining cohesion. Some policy initiatives necessarily require more expenditure; others might imply compromise on other objectives such as the speed of integration. The timescale according to which cohesion advances, and the degree to which it is achieved must, therefore, be seen as involving difficult political choices, as well as being technical problems to be solved by economic and social analysis. In practice, progress towards cohesion will probably have to be confined to realizable targets, rather than full attainment of objectives. Any new strategy must also be set out on a realistic timetable and have the flexibility to adapt to changes in circumstances.

There are three obvious elements to the timescale. First, a number of improvements can be implemented immediately as they relate to the better operation of existing Community systems and require procedural changes rather than any elaborate changes in legislation or budgetary ramifications. These include most of the planning, monitoring and evaluation procedures discussed in the previous section. The Community is out of step with best practice and should move without delay. The second clear stage in the timetable is that planning is already afoot for the next budget financial perspective for the years 1993-98.

This timetable is also relevant to the structural Funds, which will have completed the process of being doubled by 1993, and will be due to be renegotiated. The starting date matches the coming into force of many of the remaining measures relating to the completion of the internal market and it also embraces what is anticipated to be stage two of the progress towards EMU. It is therefore essential that proposals are put forward which involve achievement of targets related to these major issues over that period.

However, the major question is what form such targets should take. There have been two major successes in recent years in attracting public attention, the first and most outstanding being the 1992 programme. The idea of setting a target date for an ambitious programme of legislation galvanized activities and expectations. No doubt the intergovernmental conference on economic and monetary union is strongly concerned about how to retain the momentum. The other successful concept has been the doubling of the structural Funds. These are simple concepts and quite probably misleading in their importance but effective in capturing the imagination and therefore in actually getting firms and public authorities to act and to overcome the inertia which has surrounded some previous moves towards closer integration.

However, there are many forms of targets. Completing a legislative programme or spending given sums of money are input targets. In some respects they are much easier to achieve than the output targets that are the real objectives of the actions. Thus, in the case of the single market, it is still very much open to question how far the effective barriers will have been broken down by 1993. With respect to the structural Funds it will be difficult to ascertain how effective they have been in reducing disparities. The simplest reason is that they are not being measured. No serious evaluation is being undertaken of what will be achieved (compared with what would have happened without them) either in aggregate or in terms of specific instruments.

It is, therefore, arguable that the next five years should have real, not just financial objectives; indeed it is arguable that the continuing size of the budget should depend upon what could be achieved. Part of the problem is simply the difficulty of measuring jobs created or extra output. This does not mean that the process should not be attempted. The simplest form of target would be to reduce disparities for various groups, e.g. that by 1998 no region should have a GDP less than 60 % of the EC average or that no region should have an unemployment rate more than double the EC average. Alternatively, one could have targets which relate to disparities for the Community as a whole. Thus one could argue for a reduction of 10 % in the variance of regional GDP in the Community (as measured by the weighted coefficient of variation). Cohesion is also affected by adverse change, so that there may be a role for policy in trying to diminish any detrimental effects of integration.

In the foregoing, we have argued that a framework should be set up for the choice of how money should be spent, that the allocation of expenditure to regions and the framework for net contributions by Member States should be agreed in advance so that the financial dimension ceases to be controversial. This does not mean that there need not be any financial targets, such as adding 50 % in real terms to the structural Funds over the next five years, but these might be limits as either minima or maxima, with the outturn dependent upon real achievements. This then enables a focus on real objectives as the point of the programmes. Such objectives can be absolute or relative but, as suggested in the previous section, they need to be continuously monitored and the programme modified as it develops in the light of experience. The whole point of having grants for specific programmes is that they should achieve specific results. If the form of spending and its use is not important then the transfer should not be linked to any objective.

6.5. Costing a strategy

The budgetary cost of a strategy to improve the economic and social cohesion of the Community is, inevitably, contingent on the targets selected. To raise living standards in less favoured regions rapidly obviously requires a bigger effort than if a longer timescale is allowed. Similarly, aiming for a higher target will cost more. The test of cohesion is political or social acceptance, either of which will be liable to fluctuate from time to time, rather than the value of a supposedly objective indicator such as GDP per capita. An outcome acceptable to some people may be rejected as hopelessly inadequate by others. This means that it is impossible to give a single figure that constitutes a best estimate of the cost of achieving cohesion.

Instead, an appreciation of the magnitudes involved can be obtained by considering a range of options. In Table 4.1.1. of the fourth periodic report (Commission of the European Communities, 1991b), the Commission presented indicative figures showing the differentials in growth rates that would be required to ensure that regional convergence occurs. These figures are purely hypothetical rather than relating to identified regions. To give an idea of what might be needed in practice, a similar exercise has been carried out to show the cost of increasing GDP per capita in the Objective 1 regions. It has to be stressed that these are illustrative, broad-brush figures and that the outcomes shown depend on assumptions that may be open to question.

The Objective 1 regions, according to data in the periodic report, had a GDP per capita measured in purchasing power standards of 66.9 % of the Community average in 1988, ranging from 39.9 % of the EC average in Voreio Aigaio (Greece) to 89 % in Abruzzi (Italy). These regions, in aggregate, contained 21.7 % of the Community population in 1987 and produced 14. 5% of Community GDP, measured in PPS. For the Objective 1 regions to increase their GDP per capita relative to the rest of the Community, they have to grow faster. Although this has happened in some time periods, in others the gap has widened. In the calculations which follow, it is assumed that in the absence of policy assistance, the Objective 1 regions would grow at the Community average rate. For real convergence to occur, therefore, there would have to be a flow of resources from the rest of the Community to the Objective 1 regions.

Table 6 shows the results of an exercise to determine the resource transfers required to attain real convergence. In these simulations, the Community growth rate is assumed to be a steady 2.5 % per annum. It is then assumed that flows of structural assistance from the rest of the Community enable GDP per capita in the Objective 1 regions to rise by the amount of the transfer. This is, of course, a questionable assumption. If the transfers are used inefficiently, or if the recipient region lacks complementary resources needed to make optimal use of the assistance, considerably more would be needed to attain the targets. Evidence presented in Appendix E of the Padoa-Schioppa Report suggests that the marginal efficiency of capital – a measure of the growth impact of investment – is substantially lower in less favoured regions. Conversely, if structural measures engender a leap forward the cost may be exaggerated. Interested readers can make their own adjustments by scaling the figures up or down. The figures in the table show the costs of combinations of pace and scale of convergence: to bring the Objective 1 regions up to 90 % of the Community average GDP per capita in five years, 1.16 % per annum of the GDP of the rest of the Community would have to be transferred. This is virtually the same as the entire Community budget today. By contrast, if the target is 80 % in 15 years, the annual cost would be 0.26 % of the GDP of the rest of the Community.

The estimates have been calculated to take account of the projection that population in the Objective 1 regions will grow slightly faster than in the rest of the Community, although the difference is so small that it does not make much impact. Manifestly, if more regions are designated for assistance (as would be the case if regions currently designated as Objective 2 or 5b were to continue to receive assistance), the volume of assistance will be greater, while the donor base would shrink. As a result, the numerator of the ratio of assistance provided to designated regions to GDP in the rest of the Community would rise at the same time as the denominator fell. Spreading eligibility for assistance would, therefore, cause a sharp increase in the ratios.

For short-term targets to be attained, the pace of economic growth in the Objective 1 regions would have to rise substantially. Thus, for the target of 80 % to be attained in 10 years, the growth would have to be 3.9 percentage points faster than the Community average – meaning a rate of growth of 6.4 % which has rarely been achieved in any single year, and certainly not over a prolonged period. It should be noted, moreover, that the figures shown relate to the Objective 1 regions as an aggregate, implying that the regions where GDP per capita is lowest would remain below the target.

Table 6: **Illustrative costs of reducing disparities of Objective 1 regions**

	% of EC average GDP per capita to attain:			
	75	80	85	90
Number of years to achieve target	% of GDP of rest of EC per annum			
5	0.46	0.71	0.94	1.16
8	0.30	0.45	0.60	0.73
10	0.25	0.37	0.48	0.59
15	0.18	0.26	0.33	0.40
20	0.14	0.20	0.26	0.31

Note: The figures in the body of this table show the percentage of GDP that has to be transferred from the rest of the Community to the Objective 1 regions to raise GDP per capita to the levels shown in the columns over the number of years shown in the rows. Thus, for the Objective 1 regions to be brought up to 80 % of the EC average in eight years (i.e. by the end of the century), the required transfer is 0.45 percentage points of the GDP of the regions not designated as Objective 1.

These calculations also need to be treated with caution in the light of some of the assumptions. If, as has been argued earlier, the impact of economic integration is to tilt the balance of growth in favour of the more prosperous regions, assistance would be needed simply to avoid the widening of existing disparities. This would add to the costs shown in the table. By the same token, if the transferred resources are squandered, the outcome would fall short of the growth target. Nevertheless, these illustrative numbers suggest that manageable increases in the EC budget would be sufficient to make progress if targets are sufficiently focused.

7. Conclusions and preferred strategy options

7.1. The policy mix

The European Community has a wide range of options in forming a new strategy for social and economic cohesion after 1992. However, the experience of the past and the new demands from developments anticipated during the next decade (including completion of the internal market, progress towards economic and monetary union, the probable widening of the Community to include new full members and closer relations to assist the liberalizing economies of Eastern Europe) mean that the suitability of past policies has to be questioned and major changes introduced. The importance of cohesion was recognized in Article 130a in the Single European Act and is likely to be given even greater prominence in the new treaty which is being negotiated in the two intergovernmental conferences at present. In the view of the President of the Commission, cohesion is crucial if the next stages of closer integration are to succeed. Indeed, if the problem is not addressed properly, it could jeopardize agreement on a new Treaty and could even result in disintegration.

We are persuaded by the report of Nam et al. to the Parliament (on the regional impact of the completion of the internal market) and the results of the wider debate about the impact of the transition to EMU that the pressures in the 1990s will tend to exacerbate disparities in the Community. A better allocation of resources will improve the competitive position of Community industry and thus engender a faster rate of growth in the EC as a whole. But it is inherent in the successful achievement of economic integration that growth will be unbalanced, as more competitive regions exploit their advantages, at least partly at the expense of the less competitive. A successful policy towards cohesion has to ensure that these benefits are redistributed to the disadvantaged in a way which is viewed as equitable, offers an equal opportunity to all regions to compete and yet does not destroy the source of the growth process.

The report by Franzmeyer et al. to the Parliament shows that although the structural Funds make a major contribution to trying to improve cohesion, the Communities' budget as a whole makes a relatively limited contribution towards redistributing resources to the less favoured regions. There is thus the potential for a major increase in the effort that can be made to improve social and economic cohesion in the 1990s within the existing budget, before considering whether an expansion of resources over the next decade might be necessary.

Thus far in this report, we have attempted to set out the objectives of policy for cohesion and the instruments that can be used to achieve them in the context of the requirements of the 1990s. We have also tried to set out the process which needs to be followed in deciding upon a new strategy. Many options could be followed, but in this section we draw our conclusions from the foregoing analysis by setting out the major decisions which have to be made and our views on what would constitute a suitable package.

Our proposals have six elements to them:

(1) an evaluation of the success of existing policies;

(2) a development of the current structural Funds to make them more effective and better targeted;

(3) a broadening of the range of current objectives to increase social cohesion;

(4) a tightening of the administration, evaluation and monitoring procedures to improve accountability on the one hand and the operation of subsidiarity on the other;

(5) the introduction of a new instrument to assist the poorest households in the Community;

(6) a reappraisal of the Community's budget with a view to reforming its structure towards a greater emphasis on cohesion.

7.1.1. An evaluation of the success of existing policies

The success of present policies in achieving the objective of increasing cohesion and, in particular, in diminishing social and economic disparities among the regions of the Community has not been assessed. The emphasis has been on spending the allocated funds in the eligible regions. Before proceeding to the formulation of a new strategy for the next five-year budget perspective, the Commission should, as a matter of urgency, establish the effectiveness of existing policy instruments in achieving their objectives. In future, expenditure should be based on the principle of achieving the greatest improvement in cohesion. In part, the problem has arisen because of the vagueness of the definition of cohesion in the first place. We have offered our interpretation and set out principles for understanding cohesion, but a robust definition needs to be agreed so that it becomes a shared objective. One clear feature, however, is that the components of cohesion change as time passes. In particular, during the 1990s, it seems probable that social and environmental concerns will increase in importance.

7.1.2. A development of the current structural Funds

The thrust of current policy in seeking improvements in the structure of the economies of the less favoured regions is an eminently sensible basis for seeking to reduce the disparities among the regions. In practice, this should enhance equality of opportunity which we regard as a core element in cohesion. However, to achieve this equality, a proper assessment needs to be made of the needs of the various regions while the funds should be allocated on a more flexible basis. Existing indicators in the form of GDP per capita and unemployment are, at best, inaccurate measures of need and should be supplemented by a more specific range of indicators relating to the extent and quality of the built infrastructure and the public services stemming from it, the education and skills of the labour force, and the quality of life of the population.

These broad economic indicators clearly do not pick up some disadvantaged groups and areas, such as urban ghettoes, ethnic minorities and immigrants. The level of disparity is only one facet of cohesion, rapid unfavourable movements in a region's relative position also require action. Official boundaries of regions in many cases do not delimit the groups in need. Specific attention should be given to cases which run across existing national borders, but in general there should be concern not just for the average value of indicators but for their distribution. Use of GDP per capita, for example, in regions with a number of major high value-added production activities may disguise both the extent of poverty and low quality of the social as opposed to the purely economic infrastructure.

Collecting information on this wider range of indicators is not as daunting a task as it might appear, since much is available publicly and that which is not widely available through local surveys and their collation could be collected and compiled readily by Eurostat. Most of the additional information needed would not be expressed in monetary values which could be misleading, so that it would not present too serious a problem of comparison.

A persistent problem for the structural Funds has been the vexed question of additionality. Although the principle of ensuring that money from the Funds does in fact add to what would have been spent anyway, there are problems of both administration and identification. Certainly, the underlying purpose of intervention through the Funds should be to enhance investment so that resources are not dissipated in increased consumption (even though the latter may have short-term attractions). Our preference would, however, be to shift the emphasis towards the aggregate investment impact of intervention, rather than too narrow a concept of project or programme additionality. This implies not only ascertaining the response of private investment, but also taking a wider view of what is needed to attain that investment. For example, if the Fund rules, as at present, demand co-financing from the regional or Member State authorities, projects which might be strategic may founder because of a lack of fiscal capacity in the Member State or region. In the same vein, it is vital to identify binding constraints on economic development and to use the Funds to address these. A way forward in this respect might be for the Funds to assist regional authorities in conducting economic development audits in order to devise a strategic development plan which sets out priorities. This would be altogether wider in scope than the existing CSFs which have the more limited aim of coordinating diverse sources of intervention.

7.1.3. A broadening of the range of objectives

The emphasis on the built infrastructure can have only a limited impact in providing a competitive basis for less favoured regions and an attractive location for domestic and inward investment. Although existing Community policy also includes investment in training to try to improve the quality of the labour force, this is only one step in improving social cohesion. Vocational training has to build on the framework of a good education system, indeed for young people it needs to develop directly out of it. When dealing with an existing society, the problem of transforming the skills of the labour force is much more difficult if that missing education cannot readily be replaced. It is therefore necessary to do more than support training; structural support should be offered for the educational system. More than this, for a region to offer a full range of facilities and attractions for labour, it needs investment in health and other aspects of the social infrastructure. These social aspects are often most important not in Objective 1 but in Objective 2 regions where a decline in traditional industries threatens the existing social structure. That structure needs to be kept alive during the period of transition. Deficiencies in social infrastructure and the quality of life are also a characteristic of some declining urban areas and areas populated by ethnic minorities, particularly recent immigrants.

The priorities of cohesion tend to alter as time passes. Social and environmental concerns are in the ascendant at present with the avoidance of social and eco-dumping being on the agenda for both favoured and less favoured regions. During the next budgetary perspective the structural Funds programme will need to reflect that change in emphasis. It might also be thought desirable to follow up the increasing emphasis being placed on innovation and the speedy development of modern technologies as sources of regional growth.

However, the priorities of cohesion extend outside the structural Funds. In trying to dynamize the regional economies, recourse might usefully be made to methods of public-sector support which are currently being outlawed as part of the single market programme because they discriminate in favour of local industry. But this discrimination in favour of regions otherwise less favoured is the point of the policy. Hence their controlled use might well form a useful component of achieving equality of opportunity. As we point out, for a less favoured region to be able to compete on an equal basis, it may actually require a greater infrastructure and support framework than a favoured region, purely because of what causes the region to be less favoured in the first place, such as geographical peripherality or inherited characteristics.

7.1.4. Tightening of administration, evaluation and monitoring

As the Community budget expands and the operation of the principle of subsidiarity increases the disaggregation of its administration, it becomes increasingly important to have straightforward and effective procedures for the administration of funds, for evaluation and for monitoring of programmes and for a speedy response to efficient auditing. In most areas, the Community has prided itself in trying to adopt best practice in its policies. This unfortunately does not seem to apply to these issues. Poor administration and an apparent inability to provide adequate *ex ante* appraisal of projects in some of the less favoured regions has meant that they have been unable to take up the full amount of funds available. Increasing the ability to absorb funds must be an immediate priority otherwise it will be pointless to try to increase either their size or scope. This could be achieved by setting up a new Community institution to provide the relevant training and in the interim by providing task forces for the affected regions.

However, this tightening up of procedures needs to be applied at all levels: within the Commission in the administration of programmes, through strengthening the role of the Court of Auditors in monitoring progress and pointing out deficiences over which action must be taken; in increasing the role of the Parliament in being able to scrutinize budgetary actions and in insisting on the implementation of recommendations from the Court of Auditors; by national, regional and local administrations in ensuring that the Community programmes are subjected to rigorous scrutiny. But above all, the problem is one of cooperation across the boundaries of responsibility. The planning and monitoring functions within Community support frameworks are vital and continuing activities to ensure that administration of the operational programmes respond quickly and effectively to the lessons of experience and changes in opportunities.

We think it particularly important that the private sector be involved directly in the implementation of regional development as it is primarily the vehicle by which cohesion will be improved using the new resources created by the structural Funds. Inadequate coordination and commitment by the two sectors has led to major waste in some infrastructure projects. Indeed, to try to ensure that commitment, we suggest that leverage of private-sector funds be an explicit objective of the CSFs. In social and economic affairs generally in the Community, the involvement of the social partners has been welcomed; a similar case can be made here for the establishment of powerful monitoring committees which include both employers and representatives of the work force.

7.1.5. A new instrument for social cohesion

Providing equal opportunities does not ensure that disparities will be reduced, even despite the best efforts of the Commission and national, regional and local governments. Indeed in no other State has it been found possible to achieve adequate cohesion without substantial redistribution. The same will be true for the Community. At present, there is limited enthusiasm for any substantial increase in the EC budget or for unhypothecated transfers between regions, as the lukewarm response to the Spanish proposals for a system of transfers as in Germany shows. So any attempt to deal with the disparities that remain will need to be more specific. A simple solution is to target the worst-off residents in regions across the Community and support their incomes.

7.1.6. A reappraisal of the Community budget

It is not enough to focus purely on structural policy to achieve cohesion. As Franzmeyer et al. show, some other Community policies, particularly price support under the CAP, are anti-cohesive. In our view, therefore, the whole structure of the budget (and, indeed, of other Community polices which do not have expenditure implications, such as adjudication of mergers) needs to be further appraised to look at its impact on cohesion. Even if little is then done, it is important to know how policy affects cohesion. Agriculture being the largest heading needs the most detailed consideration of its regional impact. Because of the size of the agricultural budget, small reductions could result in large increases for expenditure on cohesion. In our view, the structure of price support has not only outgrown its original purpose, but is showing very considerable internal and external strains. The latest proposals for change by the Commission are trying to switch spending away from its current bias favouring wealthy farmers, an emphasis on the better-off, towards smaller-scale farmers in less favoured areas. However, the proposed means of achieving this would encourage inefficiency. We consider that attempts at income support should be explicit. The social security fund we have proposed should be used to support all those in the less favoured regions, including farmers.

7.2. Budgetary implications

It is clear from the foregoing analysis that the major problem in the short run is not shortage of funds for structural adjustment: in fact, under the present rules, the limits of absorptive capacity have already been reached in some regions. A tightening up of existing monitoring procedures and a refocusing on the greatest needs and the most effective routes to achieving cohesion, together with the likely continuing real increases in the funds available as the Community expands in size and grows in income, should result in a considerable improvement in the impact of the planned budget. Instead it is the use and allocation of the prospective budget that requires attention.

The current Community budget as a whole shows considerable inequity compared with a pattern that would engender cohesion, say along the lines suggested by the Padoa-Schioppa Report in 1987. These would ensure that the least favoured would be net beneficiaries, with the benefit increasing more than proportionately, the greater the need, while regions with above average resources would make net contributions which increased in line with their relative advantage. In particular, while the three lowest income Member States are the greatest beneficiaries, Spain gains relatively little and two of the richest countries, Denmark and the Netherlands, are also substantial net beneficiaries instead of being net contributors. More minor adjustments might be called for in the case of other Member States if the bands of tolerance within this framework of equity were drawn relatively tightly, but taken together, this would have a further important impact on the funds available to the less favoured regions.

By focusing narrowly in this way, it is possible to reduce the net redistribution budget below the figures suggested in the MacDougall Report. There, in the transitional phase, it was thought possible to operate with a total Community budget of 2 to 2.5 % of GDP, rising to 5 to 7 % in a federal system. A net transfer system in the Community, as it stood in 1975, with transfers from richer to poorer countries, would have required 2 % of GDP to reduce disparities in income per head by 40 %. Today, assuming some reductions in agricultural support, a real increase in the total budget of the same magnitude recorded over the last financial perspective (4 % a year) would be able to fund a significant programme of redistribution, within the current own-resource limit of 1.4 % of Community GDP.

7.3. Political and institutional issues

Although cohesion is usually measured in economic and social terms, it is ultimately a politically determined concept. Cohesion requires the acceptability not just of actual and prospective disparities but of the mechanisms being used to try to reduce them. Our proposals need, on the one hand, efficient planning, execution, monitoring and control of programmes, and on the other, the enthusiasm and commitment which comes from identification with the objectives of the work. In general, the principle of subsidiarity is intended to help determine the level of government at which the various functions should be undertaken. Effective structural change involves detailed local knowledge and commitment of the public and private sectors, including not just firms and local authorities, but the whole network of education, training, finance and business services and public utilities. It depends very much on the structure of the Member State as to whether these are local, regional or national responsibilities. However, even though the programmes may be put together at the higher levels there is clearly a strong need for local and regional involvement.

Equally, planning, evaluation, administration and monitoring often require a wide range of technical skills not available at the lower levels of government. In our view, this should be dealt with by a three-pronged approach. In the first place, a major effort should be made to increase the general run of technical competence in these aspects of structural projects, principally at the intermediate level. The top echelons are already well-qualified throughout the Community, while there is less of a requirement for skills at the lowest levels. Secondly, to overcome current bottlenecks and to make faster progress in the short term, teams of experts should be put together to act as temporary task forces, moving from one region to another as the need arises, as has always been the case with most intercountry assistance programmes.

The greatest difficulty and hence the gravest need requiring attention from the Community institutions lies in the links between different agencies, both vertically and horizontally, in the system of administration. There is a series of improvements which need to be made at Community level, with regard to liaison between parts of the Commission, to enhancing the power of the Court of Auditors and to the impact of scrutiny by the Parliament. One idea which we think has a lot to commend it is the French arrangement of a contract between the government and the regional administrations to manage their area in such a manner as to achieve the central objectives. This sort of performance contract has resulted in considerable improvements in the efficiency of public purchasing in parts of the Community so that its extension to local development programmes financed in part by the Community budget would be logical.

8. Action programme

In considering how a new strategy might evolve, it is useful to distinguish between what can be done immediately to bolster the impact of existing measures, reforms that can significantly improve cohesion in the medium term, and lastly, how the Community should approach the question of cohesion in the next century on the assumption that EMU has been achieved and that the European economy has become a much more integrated economic, social and political entity. This section sets out a sequence of possible initiatives in each of these three phases.

I – Immediate changes

(1) There should be an immediate strengthening of assessment procedures on the use of existing funds: in particular programmes should be evaluated for their effectiveness in achieving the real objectives of the expenditures, namely, reducing disparities in GDP per capita, in unemployment; the focus should go beyond the immediate use of the funds to what stemmed from them:

(i) What private sector investment was attracted?

(ii) What new enterprises have been set up?

(2) Representatives from the social partners should be invited to participate in the decision-making on developing and monitoring the use of the structural Funds through the CSFs.

(3) Leverage of private-sector funds should be an objective for the structural Funds.

(4) In undertaking its review of the structural Funds, the Commission should make a comprehensive examination of the effectiveness of the various forms of structural Fund support in achieving their objectives. It is important, then, that there should be extensive discussion of the results for use in forming the next structural Fund plan for 1993-98.

(5) A crash programme of expanding administrative capacity for project evaluation, programme management and monitoring should be implemented throughout the less favoured regions with a view to improving the management of Community-funded programmes and allowing funds available to be fully used. In the short run, conditionality and co-funding rules might be eased to increase absorption.

(6) There should be an immediate improvement in the budgetary control, monitoring and evaluation procedures for the structural Funds. In particular, the Court of Auditors should have increased powers and should add the achievement of value for money to financial regularity as a principal objective of its assessments.

(7) The role of the Parliament's Committee on Budgetary Control should be increased to provide effective accountability for the spending of the Communities' funds.

II – Issues to be sorted out for 1993

(1) A new set of specific objectives for use of the structural Funds should be agreed, including new competences for education, health and the environment. The size of the funds available for each region should be on the basis of need – shortfall of hard and soft infrastructure compared with targets which take into account a variety of factors including population density, age structure, industrial structure, compared with the fiscal resources available. Consideration should be given to making receipt of structural Fund assistance conditional on respect of certain strategic objectives to be agreed between the Commission and the region in a contract.

(2) The definition of eligibility should be broadened to include disadvantaged groups such as migrants without regard to spatial boundaries.

(3) A new welfare fund should be set up to provide income support for less favoured households. Where possible these funds should be administered at regional rather than Member State level. Allocation should be assessed on the basis of need versus fiscal capacity.

(4) A new budgetary framework should be set out for the years 1993-98 along the lines suggested in the Padoa-Schioppa Report of 1987.

(5) Future spending programmes under other headings, as well as other Community policies, should take account of their impact on the regions.

(6) There should be an easily identifiable target for spending on cohesion during the budgetary period 1993-98. A real increase of 50 % is an example (subject to the constraint that the total Community budget does not exceed its real growth rate in the previous five years (4 %)).

III – Issues for later in the decade

(1) The prospective widening of the Community to include new members needs to take account of their fiscal impact if they are to be equally treated. It is particularly important to establish an appropriate transition mechanism for the countries of Eastern Europe.

(2) The costs of structural adjustments to prepare for EMU, which involve the changing of deficit and debt structures of Member States, should be treated as a different issue from regional policy and should be dealt with from separate adjustment funds.

(3) New credit mechanisms to enable regions to cope with macroeconomic imbalance should be established.

(4) Since reforming the structural Funds and establishing a social security fund will only go part of the way to achieving cohesion, a thorough examination of possible mechanisms for more substantial interregional redistribution should be carried out (as explored in the MacDougall Report of 1977, and discussed again in this report) and the preferred scheme adopted.

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