Open Europe submission to the UK Government's Balance of Competence Review: Cohesion Policy

January 2014

This submission below has drawn on the following publications:

Open Europe, 'Off Target: The case for bringing regional policy back home', January 2012; http://www.openeurope.org.uk/Content/Documents/Pdfs/2012EUstructuralfunds.pdf

Questions

1. How effective in your view have the structural funds been in addressing the tasks given to them under the various Treaties and what might be done to improve this?

The Treaties commit the EU member states to "promote economic, social and territorial cohesion". While this is a broad remit, there are three criteria on which the success or otherwise of the structural funds can be assessed; growth, jobs and regional convergence. There already exists a vast body of academic literature on this subject which Open Europe has reviewed. In short there is no definitive answer; different studies have produced mixed results and at times reached radically different conclusions. Overall, there is no conclusive evidence showing that the structural funds have had an overall positive economic impact on the EU economy, or the individual measures of growth, jobs and regional convergence. For the full literature review see Annex I of 'Off Target' but below are a few key points:

- In the short-term, the structural funds can lead "to crowding out of private spending", which can have a negative impact on short-term growth rates.
- Ireland was able to use the structural funds to successfully boost its growth rate and to meet (and subsequently overtake) the average EU GDP, it did so by combining the funds with other pro-growth measures such as structural reforms, while the evidence for countries like Spain and Italy is conflicting and therefore inconclusive.
- In terms of job creation, the evidence is likewise inconclusive, and due to methodological limitations, claims made by the Commission that "x amount of jobs were created" need to be treated with caution. One ECB study found that the structural funds could even be damaging for job-creation in low-skilled settings due to their tendency to subsidise the cost of capital.
- As with growth effects, evidence on the impact on convergence is mixed, although there is a broad consensus that while income disparities have narrowed between member states, they have increased both across and within regions.

One of the problems with trying to get a more definitive answer on the effectiveness or otherwise of the structural funds is the difficulty in differentiating the impact of the funds from other investment, governmental economic policies and wider macroeconomic trends. In addition, many of the models used to asses them – in particular the QUEST models used frequently by the Commission – are built on the assumptions of rational actors and efficient markets. As the Commission has admitted, "They [the QUEST models] assume no money is wasted on sub-optimal projects", which is not the case given the widely acknowledged deadweight costs and wasted funds. Neither can these models fully account for the opportunity costs which need to be factored in. See page 13, 'Off Target' for a more detailed discussion on this topic.

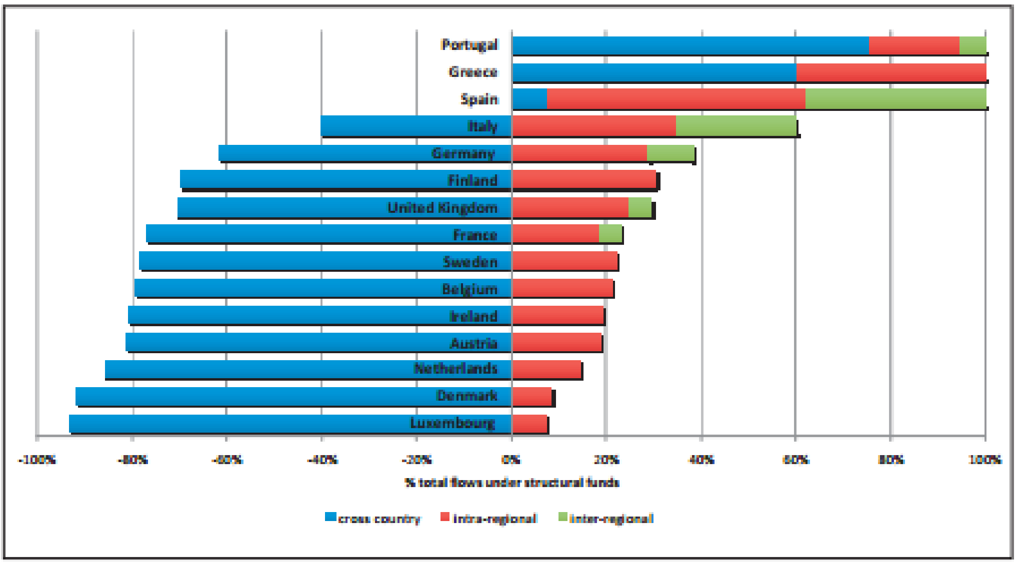
In terms of improving the situation, Open Europe recommends limiting the structural funds to less wealthy member states where they can have the biggest comparative impact and which would struggle the raise the necessary capital themselves (see answer to question 3 for more details).

2. To what extent have UK places, companies and workers benefited or not benefited from EU structural funds?

From a purely financial perspective, UK regions, companies and workers have benefited from the money made available under the structural funds. Upon joining the EU the UK pushed for regional development funds as a means of offsetting its substantial net contribution to the CAP, but as a result of EU enlargement and the development of the UK economy since then, the UK is now a large net contributor to the structural funds – approximately £20.8bn over the 2007-13 MFF – meaning that there is no added value in having these funds flowing via the EU budget.

Moreover, according to our calculations, the majority of the money that the UK receives from the structural funds goes to the same region in which it was originally raised via general taxation – only a small percentage is redistributed across the UK from richer regions to poorer regions. As a redistribute mechanism, the structural funds are therefore highly inefficient:

Figure 1: Structural Fund flows within and between countries



Sources: Santos (2008) dataset, Open Europe Calculations

The graph shows that 70% of the UK's structural fund flows over the 2007-13 MFF were in the form of subsidies to other countries, which is unsurprising given that it is a big net contributor overall. However, only 5% of its flows actually comprised re-distribution across regions, meaning that of the remainder, local taxpayers financed their own region, albeit via the EU.

The redistribution patterns we have highlighted above also raise questions over how many UK regions actually come out net beneficiaries from the structural funds; the answer is only two out of 37 in total; Cornwall and West Wales and the Valleys.

The relative wealth of a region can change radically depending on which measurement is used. The EU tends to use GDP or GVA per capita to measure wealth. However, an equally good, if not better, measurement is disposable income per capita, as this better reflects relative wealth levels of individuals, including spending power and ability to meet living costs.

When taking into account the net contributions of UK regions to the structural funds[1] and setting them alongside disposable income per capita, it becomes evident how little correlation there actually is between a region's relative wealth levels and how much it gets from the funds. When looking at the contribution ratios for each UK region; i.e. how much they have to contribute in taxation order to receive £1 back via the funds, we see that over the 2007-13 MFF period:

- The West Midlands, a region containing many pockets of urban deprivation following the decline of its traditional industries, and which has the lowest disposable income per capita in the UK, paid £3.55 for every £1 it got back.
- Other less advantaged English regions that are nonetheless net contributors include Merseyside, which effectively paid £2.88 for every £1 it got back, Manchester, which paid £2.99, Lincolnshire, which paid £4.55, and Derbyshire and Nottinghamshire which paid £4.39.
- Some regions that are under the UK average for disposable income per capita paid far higher contribution ratios than those over it; for example Devon (94%) pays £6.58 for every £1 it gets back while Herefordshire, Worcestershire and Warwickshire (105%) pays £4.49.

See Table 1 on page 16 of 'Off Target' for full list of regional contributions.

Finally, having a regional development policy funded and co-ordinated at the EU level carries with it a heavier administrative burden than a national development scheme. Moreover, the funds come with EU wide conditions attached which may not be completely appropriate for national/regional circumstances. For example, Cornwall receives significant EU funding but the funds are directed towards developing its high-skills sector (for example via the establishment of business parks), yet there is limited demands for these. On the other hand Cornwall does have a competitive advantage in niche foodstuffs but these are ineligible for support from the structural funds (or the EU's separate agricultural funds), meaning that these companies fall into a 'funding black hole' despite the fact that they have a good business case and create viable local jobs. Capital is not geared towards a sector in which the region has a comparative advantage

3. Are the types of activity covered by the structural funds and the other funds outlined in this paper more appropriately funded at EU, national or regional/local level? Should all Member States or regions receive structural funds in future? If not, what should be the criterion?

[1] See Methodology section of 'Off Target' for an explanation of how these were calculated

The rationale of having regional development funded at the EU level is that poorer member states – those who need funding the most and yet would struggle to raise sufficient capital themselves – can be helped out by the wealthier member states. For wealthier member states such as the UK there are good political and economic reasons for contributing to the development of poorer states whose economic development stalled under communist rule. By helping to boost these countries' development and the prosperity of their citizens, they in turn will demand more goods and services from the UK, and there will also be increased opportunities for UK based companies to win contracts abroad.

There is some evidence to support this view - among the new member states Poland's GDP per capita as a percentage of the EU average has increased from 51% in 2004 to 67% in 2013 while Slovakia's has increased from 57% to 76% over the same period.[2] Of course the structural funds are only one of many factors at play; access to the single market and structural reforms have also contributed to growth while the impact of the economic crisis on the EU's wealthier states and the accession of even poorer member states have made these figures appear more favourable.

However, having accepted there is a justification for providing funding to poorer member states to enable them to catch up with the rest of the EU, there is no reason why every single member state should be involved in the process. Indeed this is economically irrational as it can channel funds away from where they can have the most comparative impact, as richer member states already attract investment, which, at worst, can be crowded out by the structural funds. Even the Commission itself has admitted that this results in "considerable administrative and opportunity costs".[3]

Open Europe has therefore proposed to limit the structural funds to member states with a GDP per capita of 90% or below the EU average, the same eligibility threshold which currently applies to the Cohesion Fund. This was also the policy pursued by the previous Labour government in the long term EU budget negotiations when Gordon Brown was Chancellor, but not re-adopted by the Coalition. According to our calculations, cutting out payments to wealthier member states over the 2007-13 MFF period, 23 of the then 27 member states would have saved money on their contributions the EU budget. France would have been the biggest beneficiary followed by the UK which would have saved £12.6bn gross and £3.8bn net on its contribution to the EU budget. See Annex V on page 42 of 'Off Target' for a breakdown of savings for every EU27 member state.

The countries that would have lost under such an arrangement would have been Greece, Cyprus, Spain and Italy. The only member of the old EU15 group of countries to continue receiving funds under this model would be Portugal (although since Open Europe's initial calculations, Greece's GDP per capita has fallen to below 90%). However, there are serious questions to be asked over whether any of the old member states should continue to receive money from the structural funds given that they are not the most appropriate tool to assist these countries in overcoming the grave economic challenges they face – indeed in some ways, the funds actually contributed to their problems, for

[2] Eurostat figures
http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&language=en&pcode=tec00114&plugin=0

[3] European Commission, (2009) A reform agenda for a Global Europe [Reforming the budget changing Europe] 2008/9 budget review

example their pro-cyclical nature helped to stoke the construction bubble in Spain (for a more detailed discussion of this phenomenon see pages 18-19 'Off Target').

For this reason, another condition could be length of EU membership, with older members no longer qualifying for structural funds. Of course they would require some form of transitional support specifically targeted at helping them to overcome their specific economic problems, not least with labour inactivity (this is the rationale of the ESF but in its current form it has clearly not been successful on a macro level).

4. What is the right balance between strategic guidance at EU level, Member States management and control of the funds and regional or local identification of needs?

As explained above, only less developed member states should be eligible for the structural funds. Under such a system, wealthier member states would be responsible for their own regional development policies with the EU maintaining a supervisory role to ensure that member states do not use their own funds to provide state aid to domestic firms in contravention of state aid rules. For the poorer member states, the current system whereby local and national authorities agree policy priorities with the EU would remain in place albeit it with reforms to ensure a clearer link between funding and performance (see answer to question 7).

5. Do all parts of cohesion policy provide equal value for money? Are different approaches required for different funds and different geographies?

As demonstrated above, value for money in Cohesion policy is represented by providing funding for regions and member states that are not able to raise the necessary capital themselves. Money that is recycled around the wealthier member states (for example between the UK and Sweden), via Brussels, therefore fails that test.

As regards the question of different approaches for different funds, part of the problem is that they already have numerous objectives, and at times these can contradict one another (such as boosting growth and employment yet also reducing emissions and other environmental objectives). This adds to the underlying problems of poor targeting, evaluation and complexity. Instead, the funds should be focussed on one single objective: convergence. This means channelling funds to economically viable projects in areas that otherwise would find it difficult to attract investment.

It makes sense to have two distinct funds – a Cohesion/Regional Development fund which could fund larger infrastructure projects where needed and a Social Fund which could target skills. The latter could come in the form of a revamped European Social Fund or the Globalisation Adjustment Fund but there is no rationale for keeping both of these funds operational. Spending on research and innovation - which it makes sense to continue funding at the EU level - should be increased but kept separate from regional development spending per se.

6. To what extent should the funds be targeted at less developed areas and disadvantaged groups of society rather than being available as sources of investment for economic development across all areas?

This question addresses one of the inherent contradictions in the structural funds – Is their purpose to channel funds to where they can generate the most return, or is to foster convergence between regions? Under the current set-up, there is a clear conflict between the two, which leads to a wasteful allocation of resources. If their aim is to foster growth, then funds should be channelled to areas where each invested pound/euro can generate the greatest absolute return – where the so-called Marginal Product of Capital (MPK) is the highest. If it is to foster "regional convergence", then the funds need to go to areas which struggle to attract private investment, often areas where MPK is relatively low. The areas with the highest growth prospects tend to be in richer member states and regions which benefit from good administration, developed infrastructure and a range of other factors. However, targeting such areas runs in direct conflict to the aims of convergence and cohesion, as this would allow them to soar further ahead of poorer regions.

In our view the funds should indeed be targeted at less developed areas but wealthier member states should be put in charge of trying to develop their own less advantaged regions. As noted above, if an eligibility threshold of 90% or below average EU GDP per capita had been in place over the 2007-13 MFF period, the UK would have an additional £3.8bn to invest in its less advantaged regions in addition to the money it received under the structural funds. Moreover, due to the flawed targeting inherent in the current distribution of funding in the UK, under a UK run regional development programme it would be easier to target pockets of depravation in otherwise relatively wealthy areas (for example, seaside towns such as Clacton-on-Sea in Essex).

7. How effective in your view is accountability and financial management of the funds outlined in the paper? What further steps if any might be taken to provide increased assurance for EU taxpayers?

One of the main flaws of EU Cohesion Policy is the absence of strong conditionality and performance criteria in the allocation of funds. A range of reports have pointed this problem out, including the European Court of Auditors who in a 2011 report noted that "Despite the claimed focus on results, the scheme remains fundamentally input-based, and therefore orientated towards compliance rather than performance".[4]

At the moment, countries and regions can consistently fail to meet set targets and continue to receive funding year on year. For example, Sicily failed to meet a whole range of targets under a €8.5bn programme (of which €6.6bn came from the ERDF and ESF) running between 2000 and 2007 – despite spending all the allocated funds. And yet, it received €6.6bn for a successor programme running through the 2007-13 MFF, although not all of it from the structural funds (see page 19 'Off Target' for more details).

The problem is that despite the checks and balances, there has developed a 'getting the money out of the door' mentality as funding gets distributed 'far and wide', instead of being targeted at the areas where it can provide the most added value. The result is that the Court of Auditors

[4] European Court of Auditors - Opinion No 7/2011
http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2012:047:0001:0013:EN:PDF

consistently finds that the structural funds have among the highest rate of erroneous spending in the whole EU budget; in 2012, the COA estimated the error rate in the Regional Policy, Energy and Transport area at 6.8% compared to 4.8% across the budget on average.[5]

The final responsibility for ensuring that the money is spent effectively and within the rules lies with member states, although the 'getting the money out of the door' mentality mentioned above does not encourage the best possible housekeeping. The Commission has indicated that from next year member states that fail to address irregularities on time risk losing EU funds for programmes definitively, although it remains to be seen how strictly this will be enforced. Other measures that could improve assurances for EU taxpayers include by establishing a clearer link between funding and performance include:

- *Inject more competition*: In order to avoid channelling public money towards economically unviable projects, disbursement of the structural funds could be made far more oriented around business and competition. Success would be gauged less on the completion of a programme (for example a ERDF-funded construction project or an ESF-funded training scheme) and more on the meeting of an underlying business case.
- *Disbursement conditional on met targets*: Recipient governments and/or regions could be given full discretion as to which investment projects they would like to see financed (subject to state aid restrictions), but they would be obliged to declare beforehand the expected results of the project. Disbursement of the funds could then be made in lump sums, and would depend upon results being reached. This would have the added benefit of improving accountability by putting member states firmly in charge of ensuring targets are met.
- *Greater performance reserves*: The Commission has introduced so-called 'performance reserves' for structural funds in the new MFF whereby extra funding is allocated to those regions that have achieved the best results. This is a step in the right direction, although the Commission's proposed reserve will only cover 5% of overall funding for the 2014-2020 budget period, not nearly enough to have a significant impact.
- *Sunset clauses*: These would reduce support for member states which have failed to display sufficient progress and to limit the expectation of continued support.

8. What are the main barriers to accessing EU funds? What might be done to overcome these?

The most commonly experienced barrier to accessing the structural funds is the administrative workload which is particularly burdensome for small businesses and organisations. To its credit, the Commission has introduced a number of simplifications for the new MFF period including exempting smaller projects from some auditing requirements, allowing for more electronic submissions and reducing the length of time during which projects have to save records. This is welcome, although it remains to be seen how effective these will prove in reality; there is evidence that previous reforms have actually increased rather than decreased the workload associated with accessing the funds.[6]

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[5] European Court of Auditors - Annual report on the implementation of the 2012 Budget http://www.eca.europa.eu/Lists/ECADocuments/AR12/AR12_EN.pdf

[6] For example, the Chief Executive of Co-ordinating European Funding for the East Midlands Third Sector (CEFET) told a House of Lords inquiry that "the administrative burden on the delivery bodies has roughly

Ultimately, we suspect that much of the complexity and administrative burden stem from the very existence of such a large redistribution scheme, crossing a range of very divergent countries and regions. Even the Commission itself has admitted that "it has become clear that due to the variety of experiences and differences in national administrative set-up, what in some member states may be considered simplification, can be viewed as complicating things in another."[7]

This in turn brings us back to limiting the funds to the poorest member states which would have the additional advantage of applying them to a group of countries which as post-Communist transitional economies (albeit at various stages of that process) share many common economic and administrative features, making it easier to tailor the rules to their circumstances which are different to those of the Mediterranean or North-Western Europe.

9. What practical steps could be taken to reduce the administrative burdens in getting funding from EU programmes?

See answer to question 8.

10. How can the local or regional dimension best be reflected in EU policy-making?

By limiting the structural funds to the poorer member states, this would allow the UK and other wealthier member states to tailor their regional development policies to better suit regional and local conditions as opposed to having to conform to a one size fits all EU framework. In terms of the EU as a whole, the local and regional dimension is already represented by MEPs, while there is also scope for national parliaments to have a much bigger say in EU affairs which would in turn further reflect local and regional priorities.

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quadrupled [since the previous EU budget period] in terms of the staff time needed to fill in the returns and draw down the money" http://www.publications.parliament.uk/pa/ld200910/ldselect/ldeucom/92/92i.pdf

[7] European Commission – Simplifying Cohesion Policy for 2014-2020 http://ec.europa.eu/regional_policy/sources/docgener/informat/2014/simplification_en.pdf