



ADAM SMITH
INSTITUTE

Good money after bad?

An analysis of EU regional aid

By Keith Boyfield

Why this study was written

Brussels has been described as the lobbying capital of Europe, generating £1bn in sales turnover and employing well over 20,000 people, who occupy more than 2.5 million sq ft of prestigious office space in the Belgian capital.¹ Significantly, a substantial proportion of these lobbyists are promoting the interests of regional governments. The reason for this considerable investment is clear once one analyses the EU's budget. Over 35 percent of the Commission's annual expenditure is allocated to regional development grants of one sort and another.

Given the incentive to do so, this can be seen as entirely rational behaviour. Essentially, the profusion of regional representative offices – promoting everywhere from Catalonia to Scotland – are all pursuing the same goal, namely to extract as large a share as possible of the regional development budget. This brings to mind the story of Willie Sutton, a notorious American bank robber who, when asked why he kept stealing from banks, replied 'that is where the money is!'

Each year sees the competition for regional development support become more intense. In the last few years the rivalry has strengthened following the expansion of the EU from 15 member states to 27. Looking ahead, the contention is likely to exacerbate, particularly when one takes into account the current fierce debate over whether to allow a number of other countries to join the EU, notably Serbia and, more controversially, Kosovo, the former regional entity that was previously part of Serbia. Now established as a separate country, it was significant that a number of EU Member States, including Spain and Romania, refused to recognise it.

Increased competition for funding has led to a ratcheting up of tensions as regions vie for money from the EU. These

tensions are likely to become more pronounced over the course of the next decade as regions argue their case for further financial support.

This report argues that in an increasingly globalised world, the EU's regional policy is encouraging the fracturing of the familiar nation state model. Clearly, a large proportion of the citizens of certain member states feel little if any loyalty to the nation in which they live. Examples are not hard to find. The Flemish population of Belgium want less and less to do with their Walloon neighbours in the south; in Spain there are strong movements for greater autonomy in the Basque country and Catalonia; and in the UK, Ulster already enjoys a considerable degree of autonomy, as does Wales. Meanwhile, Alex Salmond's SNP government loses no opportunity to put the case for an independent Scotland.

As a political entity the EU is emerging as a continent of winners and losers. Increasingly, one notices a clustering effect whereby certain industries attract more and more players who focus on offering a specialised set of products or services. Hence, the Bologna area of Italy boasts a wide range of advanced engineering and design skills; the region is home to many illustrious car marques including Ferrari, Maserati and Lamborghini. Similarly, the Munich area has attracted many IT companies to the region; and London remains the dominant financial centre for Europe with a wide raft of banking, legal and other professional skills, although this pre-eminence is under increasing threat from regulatory and tax initiatives. In contrast, there are other peripheral regions of Europe that have failed for one reason or another to match the average level of economic growth across the EU. The North East of England is a good example, while Calabria in the south of Italy is another.

The European Commission is seeking to raise average GDP per capita in these economically challenged regions.

How far this is sensible and achievable is the theme of this study. The report also examines whether the money that goes on regional development funding represents value for money and whether there is proper accountability for this spending, which totals tens of billions of euros a year.

In June 2009 people across the 27 Member States voted for a new European Parliament. Significantly, turnout was down yet again and, at an average figure of only 43 percent, it ranked as the lowest recorded since 1979. However, right of centre parties did better than expected and in the new Parliament they will have a strong majority. This means they will have a large say in the strategy and policies pursued by the new Commission to be appointed this autumn.

While the EU's total regional funding budget has already been largely decided for the period 2007 – 13 the new Commission, together with the Parliament and the Council of Ministers, will play a pivotal role in determining how to allocate regional spending across the EU, particularly as it relates to infrastructure spending, redevelopment of rundown areas and employment training schemes. With Europe facing the worst recession it has experienced in the last sixty years, the strategy adopted by the Commission to spur enterprise and innovation will be more important than ever; and, with money tight in all Member States, the way in which taxpayers' funds are spent on regional programmes (or misspent due to endemic corruption) is of greater concern than at any time since the EU was established.

1. A short introduction to EU regional policy

Spending on regional development constitutes the second largest item of expenditure by the European Commission after the Common Agricultural Policy (CAP). Over the next five years 35.7 percent of Commission spending will be channelled into regional support of one type or another. Over the seven year period 2007-2013 the combined total will amount to € 347.41 billion. This contrasts with the position in 1988 when it accounted for only 17 percent of spending.

Regional support was one of the original goals of the EU. Article 158 of the EU Treaty states that the Community will aim to reduce “disparities between the levels of development of the various regions and the backwardness of the least favoured regions or islands, including rural areas”.² For many years not much was spent on it but this

strategy changed during the negotiations in the lead up to the passing of the 1986 Single European Act. At the time politicians sympathetic to the goals of the EU were fond of talking about the concept of ‘social and economic cohesion’. Paradoxically, the problem confronting advocates of a single European market was a fear that the realisation of their goal would inevitably generate winners and losers. Regional funding by the Commission was seen as a means of protecting the worse off areas on the extremities of the EU, notably Ireland, Greece, Spain and Portugal – all relatively new member states and noticeably poorer than original members such as France and Germany. In practice, this translated into the Commission acting as a ‘visible hand’ apportioning grants and other handouts to the laggards. Politicians welcome this development as it gave them plenty of opportunities to claim they had ‘won’ money from Brussels on behalf of their constituents.

How EU regional funding is allocated

EU regional development aid, in the view of Dirk Ahner, the Director General of DG Regional Policy (the Commission Directorate charged with implementing EU regional aid) is focused on three objectives. First, it aims to generate growth and jobs across Europe in line with the principles of the Lisbon Strategy. Secondly, it aims to achieve this goal in a sustainable way. And thirdly, regional assistance should be deployed with the idea of promoting an “overall balanced development in your territory”.

The parcelling out of EU regional support is labyrinthine in its complexity. Few people understand it, let alone the acronyms involved. As Lord Teverson admitted in a recent House of Lords debate on EU regional aid, “One of the big challenges is understanding anything about it, what with the nomenclature, the acronyms and the things you expect to mean one thing that actually mean something completely different”. Given the fact that Robin Teverson was previously a Liberal Democrat Member of the European Parliament for Cornwall, thereby having many an opportunity to study the system in operation, ordinary members of the public have little hope of understanding the complexities of the EU regional funding machine.

In a nutshell, EU aid is allocated by Commission officials who proceed by apportioning ‘indicative’ annual sums for each Member State according to four key criteria, namely (1) eligible population, (2) national wealth, (3) regional wealth and (4) unemployment rate. Having worked out a sum for each Member State, officials in a national “managing authority” – i.e. a government department – then allocate total amounts for a range of programmes,

such as infrastructure, vocational education, capital investments, which all in turn compete for funding. The officials closest to the ground then determine the specific weighting given to each individual project. The crucial point to note is that this system places considerable power in the hands of these national officials.

The total budget allocated to regional development – not far short of €350 billion over seven years – is divided three ways by the European Commission, namely:

1. **The European Regional Development Fund (ERDF)** was set up to encourage regional development, promote economic change and enhance competitiveness and territorial co-operation throughout the EU. This fund provides direct finance for companies, infrastructure and financial instruments.
2. **The European Social Fund (ESF)** was established and designed to focus on employment, social inclusion and projects aimed at tackling discrimination. This money is directed at projects aimed at improving skills and access to employment opportunities.
3. **The Cohesion Fund** is restricted to member states with a Gross National Income (GNI) of less than 90 percent of the EU average. The Cohesion Fund concentrates on investment on environmental and energy projects and on trans-European transport networks.

In the past, a number of countries along the southern fringe of the EU, such as Greece, Spain and Portugal, have done very well out of the Cohesion Fund. However, with the accession of a number of relatively poor countries in Central and Eastern Europe, they stood to lose out, not least because regions in southern Europe have grown richer. In order to win their political support for the overall EU budget, these countries have managed to qualify for Cohesion Fund support on a transitional basis.

In spending almost €350m or €50bn a year in regional development support, this EU taxpayers' money is meant to achieve three cherished objectives, namely:

1. **EU Convergence**, the idea that regions throughout Europe should come closer together in terms of the dynamism and wealth creation capabilities of their economies. This policy goal accounts for 81.5 percent of total EU spending on regional policy.
2. **Regional Competitiveness and Employment**, which accounts for around 16 percent of total expenditure on regional development and is spent on initiatives in regions that do not qualify for convergence funds.

3. **European Territorial Co-operation**, which accounts for a relatively modest 2.5 percent of the total budget, is supposed to strengthen cross border co-operation through joint projects, such as rail links.

2. EU regional development aid fails to meet its promise

The first chapter of this study rehearsed the apparently laudable reasons why the European Commission spent billions of taxpayers' money on regional support. Yet while invariably well intentioned, this EU spending appears to deliver relatively modest benefits considering the sums spent. A range of well-respected independent observers have questioned whether regional development spending fulfils its objectives.

The World Bank, for example, judges that EU regional structural funds are "ineffective subsidies based on incorrect and at least unsubstantiated economic theory, badly designed, poorly carried out and, in most cases, a source of wrong incentives".³

Commenting on the EU's regional development cohesion policy in its *Economic Survey of the EU* the Paris-based **OECD** points out, "Its record so far has been patchy: regional disparities are not falling or at best are declining very slowly. The budget is too small to make a real dent in income gaps, so the challenge is to get the maximum benefit from the available funds by making sure Member States focus on activities that will spark sustainable growth, such as education, research and important infrastructure projects".

The **Centre for European Policy Studies (CEPS)**, a think tank based in Brussels that is sympathetic to the aims of the EU, has published a detailed analysis of the EU Budget which concludes that the empirical evidence suggesting that EU Structural Funds have, on average, accelerated the economic convergence of poor regions is weak.

As currently implemented, the Commission's Structural and Cohesion spending appears to be making only a marginal impact on regional convergence within the EU. The academic evidence suggests that contrary to the claims made by the European Commission, regional development assistance has achieved only a negligible effect on the goal of convergence. Indeed, regional disparities have tended to widen rather than narrow in a number of cases.

This trend is highlighted by some academic work undertaken on the impact of EU regional development aid by Ben Gardiner and his fellow authors based at Cambridge University. In a detailed article published in the specialist journal *Regional Studies* the authors conclude that “regional convergence in the EU is at best a very slow process, typically only 1-2 percent per annum, implying that it would take several decades for any significant narrowing of regional disparities in per capita GDP to occur.”

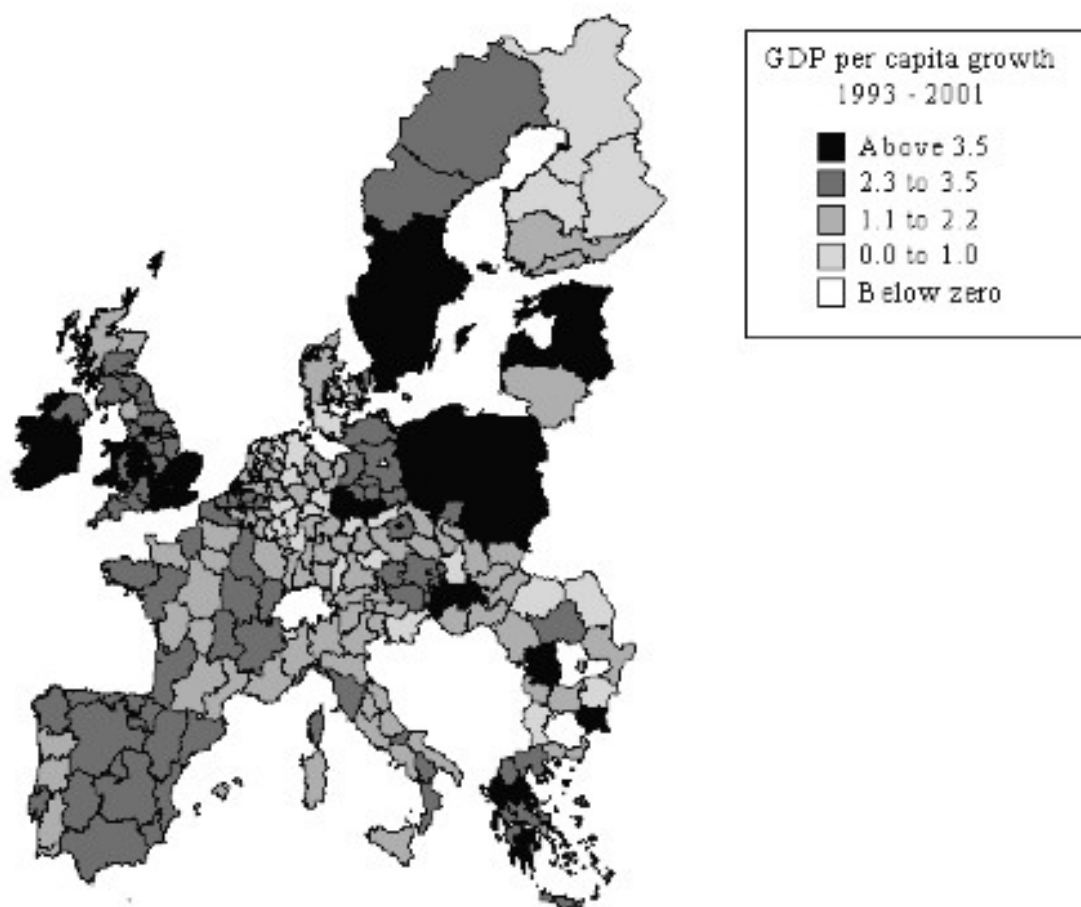
Measures of regional wealth – expressed as real rates of GDP per capita – across the EU have not changed very much. The pattern in 2001 bore a strong similarity with the picture identified in 1980. This is further reflected in the map of Europe reproduced below which illustrates the persistent wide divergence in GDP per capita growth rates achieved by the regions of the EU in the period 1993-2001.

Furthermore, it is worth stressing that the regional differences in productivity have not narrowed, indeed, in a number of countries, namely the UK, Italy, the

Netherlands, Austria and Germany, they have increased. As Gardiner and his colleagues note, “In effect, the rate of convergence in regional productivity across the EU has been falling since the late-1980s, precisely the time when EU economic integration has accelerated”.

While the EU’s total budget for regional development funding is substantial – it totals nearly €50bn a year – it is nevertheless relatively small when one considers the ambitious goals it is meant to fulfil. Spread across 27 member states, the sums involved tend to exert only a modest impact on regional development.

Where GDP per capita has shown strong growth, along with productivity, the causal reasons have been attributable to a range of other factors as well as EU support. In the case of Ireland, for example, other factors such as demographics, fiscal policies aimed at encouraging entrepreneurial activity, and the removal of trade barriers have played a more influential role on economic development than EU grants. As *The Economist* magazine observes, based on



Source: ‘Competitiveness, Productivity and Economic Growth across the EU Regions’, by Ben Gardiner, Ron Martin and Peter Tyler, *op cit*, page 13.

authoritative studies, EU development aid probably raised annual GDP growth in Ireland in the 1990s by around half a point.

In recent years the soaring cost of regional development support, combined with the limited evidence that it actually achieves much, has triggered mounting dissatisfaction and criticism of the EU budget by the member states left to foot the bill, notably the UK, Austria, Germany, Sweden and the Netherlands. The chart below ranks the 27 member states of the EU in terms of net EU spending per head. According to the bar chart above, Britain received less back in EU funding per head than any other member state. Indeed, the UK receives half of what France will gain and a quarter of the funds flowing to Ireland.

It is worth emphasising that if EU regional development aid were really the main cause of economic prosperity, one would expect to see other relatively poorer member states record rapid rates of growth as a result of EU fund transfers. But this is not the case. Looking back on the way in which EU regional development support was spent one finds that in 1990 EU Structural and Cohesion Funding represented three percent of Irish GDP. This is broadly in line with the percentage figure in other recipient countries. In Greece, for example, EU fund transfer amounted to four percent of GDP in 1990 while in Spain the figure was 2.3 percent; in Portugal the proportion was 3.8 percent. Yet the crucial point to notice is that none of these countries came close to matching Ireland's economic vitality. Whereas Ireland's growth rates ranged from seven to over ten percent in the second half of the 1990s, growth rates between 1990 and 2000 in Greece averaged 2.2 percent, 2.5 percent in Spain and 2.6 percent in Portugal. These figures indicate that the justification for EU regional development funding is not as convincing as its proponents claim.

3. EU regional funding's downsides – rent seeking, corruption and regional separatism

Critics of the way in which the EU currently operates have highlighted a myriad number of corrupt funding cases and some projects that were clearly a total waste of money.

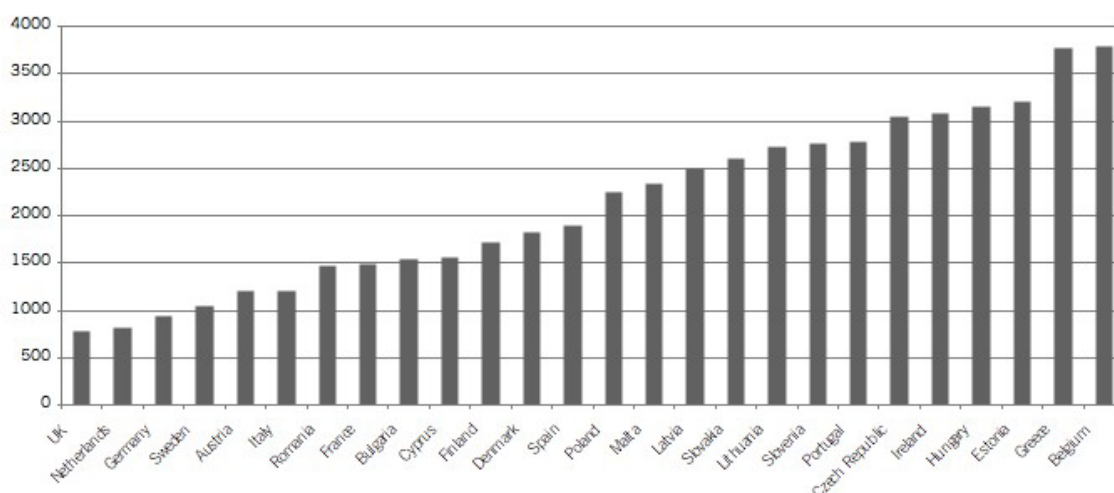
Matthew Elliott and Dr Lee Rotherham of the Taxpayers' Alliance reckon that in relation to Structural Funds expenditure, discrepancies in the bookkeeping undertaken by two Member States countries comes to a staggering €11.5 billion. Reviewing the sorry history of the European Court of Auditors (ECA) investigations into EU spending, the authors point out that management accounting systems were deemed to be inadequate in just over half of the eligible Member States.

Italy's tax and fraud investigator, Guardia di Finanza, noted in its annual report that €433 million worth of EU money was subject to outright fraud in Italy alone in 2006. Meanwhile, Open Europe suggest that some reports claim that up to 13 percent of regional development aid to Poland is affected by fraud.

A European Court of Auditors report in 2006 found that over half of EU funded projects in Romania and Bulgaria "are not operating as intended". More recently, in July 2008 the European Commission suspended €487m of aid to Bulgaria because of concerns about corruption, particularly with regard to public procurement procedures.

A year later the position appears not to have improved significantly. Simeon Diankov, a senior World Bank economist and policy adviser to the Gerb Opposition party in Parliament, told the *Financial Times* in June 2009 that:

Spending per head (€) by the European Union, 2007-13



“The level of corruption here is mind-boggling. I have worked for the Bank in more than 90 countries and I have never seen anything like it.”⁴

Even Commission officials admit that accountability for regional development spending leaves a lot to be desired. The most senior official within the Regional Policy Directorate, Dirk Ahner, recognises that the accountability and control functions in some member states, notably Romania and Bulgaria is still being, as he diplomatically puts it, “built up”.

Matters have deteriorated to such an extent that Bulgaria may now lose access to several hundred million euros of EU regional support because corruption is so endemic. The Socialist government, unable to crack down on crime and corruption, has missed the opportunity to benefit from EU fundings aimed at upgrading infrastructure, modernise agriculture and improve competitiveness.

Nor for that matter is the UK blameless, since EU management systems have revealed that no less than six English regions were found to have “poor standards” of monitoring the spending of £500m in EU aid grants. BBC Radio 4’s *File on 4* broadcast a programme on 16th October 2007 suggesting the North West region could be fined tens of millions of pounds. A spokeswoman for the Commission’s Regional Policy Directorate, Eva Kaluzynska, explained to the BBC that the ECA had identified a number of weaknesses in the English region’s management and control systems relating to £4bn in regeneration funding received since 2001.

Regions as lobbyists for regional separatism

Over the last decade or more there has been a noticeable and quite understandable trend among the 268 regions of the EU, as categorised by the European Commission, to promote their case for increased EU spending. As noted in the Foreword to this study they have done so through opening some highly visible and grandiose offices in Brussels expressly to lobby directly the various EU institutions that are clustered in and around the Belgian capital.

The Commission’s own staff acknowledge this accelerating trend. Indeed, Dr Jorgen Gren, a member of Commissioner Hubner’s cabinet, points out European regions are remorselessly active in terms of influencing EU policy making and searching for funding from the European Community. In his book on *The New Regionalism in*

the EU Dr Gren notes this is “often the main function of representation offices and representational officers in the regional administrations”. He adds, “The creation in the mid 1980s of organisations such as the Assembly of European Regions (AER) or the Council of Communes and Regions of Europe (CCRE), both present in Brussels, are features of the regional representation network that were either almost completely absent in the 1970s or were concentrated at the national level only”.

Constitutional changes in certain member states have also encouraged this paradigm shift. For instance, in Spain a ruling by the Constitutional Court in 1994 enabled regions such as Catalonia and the Basque Country to establish direct contacts with supranational authorities, notably the European Commission in Brussels. In the case of Catalonia, the Spanish government has conceded that the regional authority can deal directly with the Commission in matters relating to Structural funding. The Spanish Constitutional Court’s decision has led to a substantial boost in the representative profile and presence of Spanish regions. The office of the Region for Valencia, for example, currently has a staff of 45 people in its Brussels office.

Regions have become increasingly adept at working the system. The Rhone-Alpes region, for example, managed to persuade the Commission to categorise it as a region entitled to benefit from the Integrated Mediterranean Programme (IMP), even though the Rhone-Alpes *departements* were no where near the Mediterranean. Despite this geographical fact the region’s representative office in Brussels, together with the region’s MEPs, lobbied hard for inclusion on the basis that they grew at least some of the agricultural products more generally associated with Greece, Italy and its southern neighbour, Provence.

Regions have also co-operated with one another in a bid to exert more influence within the Commission and in other EU institutions. Hence, the ‘Four Motors’ initiative between Rhone-Alpes, Lombardy, Catalonia and Baden-Wurttemberg, was recognised by the Commission as “the most far reaching model of interregional co-operation in Europe”. Indeed, Jacques Delors, who was then President of the European Commission, observed that “without waiting for a European Union, these four regions have taken the co-operation into their own hands and shown the direction for Europe”. Commenting on these developments Jorgen Gren concludes that “the regions have... increased their involvement in para diplomatic and cross-border activities. It is also clear that the regions initiate these

types of co-operation schemes without the involvement of the national authorities, often with direct support from the Commission”.

Regionalism is growing stronger. More and more, people feel a loyalty to a culture, lifestyle and, in an increasing number of cases, religion. This sense of belonging is not necessarily national in character; it tends to focus around a region or major city, as the urban geographer, Jane Jacobs observed. But greater regional autonomy will inevitably lead to heightened tensions as regions such as the Flemish speaking part of Belgium, the Basque country and Catalonia in Spain, and the northern provinces of Italy, clamour for greater autonomy.

In the UK there has been a trend towards greater devolved government in Scotland, Wales and Northern Ireland, although the recent financial upheavals appear to have tempered the Scots’ keenness for self- government. Many of them have looked north towards Iceland and worry about the risks of going it alone without the support of 50 million taxpayers south of the border.

But judged overall, as a continent, it would appear that Europe is already reshaping itself along more regional lines. Continued regional development assistance from Brussels to the richer countries merely raises the suspicion that the EU bureaucracy is seeking to undermine the national tier of government in favour of a single European superstate.

4. EU regional aid is tantamount to bribing people with their own money

The fundamental problem with EU regional development aid is that it involves bribing people with their own money, albeit with Brussels bureaucracy retaining a sizeable chunk.

The recycling of Social & Cohesion Funds money necessitates multiple layers of administration, which creates substantial additional costs. Moreover, significant sums should not have been spent at all, as the ECA has shown. For example, in its 2006 annual report the ECA pointed out that 12 percent of the expenditure reimbursed to member states from the Structural Actions Budget in 2006 – around €4bn – should not have been reimbursed because there were doubts over how it was calculated. As a result of the Commission’s audit work on EU regional development funding financial corrections of €500 m and €360 m were made in 2006 and 2007 respectively.

Looking ahead, Commissioner Hubner points out that “For ERDF and Cohesion Fund there are 11 formal procedures for suspension of payments and corrections which have been launched with an estimated amount of corrections of over € 2 billion”. As was highlighted in chapter three, certain accession states, notably Bulgaria and Romania, have triggered considerable cause for concern and a range of programmes have been suspended because of embezzlement and fraud. Transparency International point out that in both countries, “hardly any concrete, irreversible measures to prevent and combat corruption have been implemented. Their judicial systems remain non-transparent and often ineffective”.⁵ The fact that Bulgaria’s judicial system is seen as its most corrupt institution, closely followed by parliament and the political parties with seats in the legislature, does little to suggest that the situation will be radically improved in the foreseeable future.⁶

The key question that must be asked is why should the EU Commission get involved in the first place with regional development? In practice, there is no real compelling justification for regional aid to be channelled by the European Commission. In *EUtopia* the author and Tim Ambler argued that:

A great deal of waste and fraud could be saved if funds were not being sent to Brussels and back again. This is little more than bribing citizens with their own money – the worst form of pork-barrel politics. Member states should apply their own funds to agreed EU programmes, with only surpluses or shortfalls moving into and out of Brussels. Richer countries should look after their own poorer regions as proposed by Sweden. The EU should continue to support economic development of poorer countries such as the accession countries.

Critics of EU regional support suggest that a considerable proportion is actually spent in the richer Member States. Open Europe, the London based think tank, points out that a total of 48 percent of the Social & Cohesion Funds budgets - equivalent to nearly €150 billion for the 2007-2013 period – is spent in the Community’s 15 richest Member States.

Since every single region of the EU receives some funding from Brussels, there is less to be channelled into the really poor regions of Central and Eastern Europe. As Lord Woolmer, the Labour peer points out, “If there was a single country with a population of 470 million and there were 268 sub-units of government, and you were considering

how best to use less than half a percent of overall income to help development and do other things... [you] would be very, very selective across that kind of population and that number of regions, yet the programmes are not very selective: every region gets something”.⁷

The wealthier Member States can look after their own interests: there is no real value added provided by the Commission. In economically advanced Member States such as the UK, Netherlands and Sweden, there seems little justification in the EU being involved in regional development programmes. The Commission’s repository of experience and expertise makes only a modest contribution to any development projects, nor should there be any significant corruption problem with national funding in these mature political democracies. The main function of the EU in these projects is simply as a ‘cash cow’.

Surprisingly for politicians, when it comes to distributing taxpayers’ money some EU member states cannot spend the money they have in an effective manner, including Britain. The *Financial Times* reported that the Treasury has decided not to draw on £671 million of EU money allocated for regional funding in England, preferring instead to deduct the same sum from future contributions by the UK to the European Union budget.⁸ This decision is bad news for the regional bureaucracies that had planned to spend this EU money but is better news for the taxpayer, now faced with a lower bill for future EU support.

Other Member States simply find it impossible to spend the money assigned by Commission officials, a point acknowledged by Commission officials themselves. When interviewed by a recent House of Lords inquiry, the Commission’s Dirk Ahner conceded that it would be foolish for the EU to spend more on regional aid since “the poorer regions cannot cope with what they are getting”.⁹

This evidence – provided by the Commission itself – reinforces the case for an overall cut in regional development aid, which in turn would lead to a corresponding fall in Member State contributions. The savings could be considerable when one remembers that regional support represents over a third of the Commission’s total budget.

To restate things very simply, wealthier Member States should handle their own regional development, while the EU should focus its resources on poorer Member States. However, increasing the amount of funding directed towards these states would be a mistake, since the evidence suggests that they are already struggling to effectively handle the funding they receive. In some cases

– even for those poorer areas of the EU – cuts in regional development aid may be the most appropriate policy.

5. Regional aid is no substitute for liberalisation and market orientated policy reform

Recent European Commission initiatives

It must be appreciated that from the Commission’s point of view, regional development aid, particularly as it applies to high profile infrastructure projects such as roads and bridges, reinforces the idea that the EU is a benevolent body offering local citizens a multitude of benefits. It is therefore no surprise to discover that there are strict rules relating to the way in which major projects such as roads and transport systems must publicise the fact that the schemes have received funding from the EU. Accordingly, if one drives round the Isle of Skye one will notice prominent signs highlighting the fact that the road improvements were funded by the EU regional development programme. Similar notices indicating the largesse of the EU bedeck the West Coast of Ireland. And in Spain the support is equally highly visible. As Mr Eric Dufeil, an official within the Commission’s Regional Policy Directorate points out, “If you travel to Spain you can see big panels everywhere with the blue flag and the 12 star ‘Co-financed with ERDF’”.

Following the financial traumas that have hit European economies sharply as a result of the credit crunch, the European Commission has accelerated some of the regional aid programmes centred on public infrastructure initiatives and employment training programmes. A key element of the European Commission’s fiscal stimulus plan is an acceleration of at least €6bn in structural funding payments to the poorer regions within Europe. A major slice of this funding will be spent on infrastructure improvement of one type and another, ranging from fibre optic cabling in South Yorkshire to road and rail improvements in Poland. Public infrastructure investment was also one of the main themes of the European Socialist Group’s manifesto for the European elections held in June 2009.

However, while this accelerated spending is well intentioned, there is a real danger that such ‘public works’ programmes will experience considerable delays, budget overshoots, and fall far short of the ambitious goals set for them. Indeed, many regions already have considerable difficulties in spending the money they have been allocated. The region of Lubelskie in Poland, for example, was only able to spend 80 percent of EU regional funding

grants between 2004 and 2006. As Baroness Cohen of Pimlico, the chair of the House of Lords EU Regional policy Sub-Committee notes, “pumping money into a system that is unable to spend its current allocation will not achieve a proportionate benefit in the economy”.¹⁰

Instead, if Eastern European countries want to boost economic growth they would be well advised to implement policies aimed at removing barriers to efficient markets, free up the labour market, eliminate unnecessary regulation and establish attractive ‘flat tax’ regimes.

Similarly, European governments wishing to employ a more targeted regional development policy should learn from the Thatcher government’s imaginative ‘enterprise zones’ and ‘urban development corporations’. The successful regeneration of London’s Docklands demonstrates what can be done if government withdraws from micro-managing regeneration and leaves it to the dynamism inherent in the market. Government’s role should be focused on setting an attractive tax regime along with establishing good transport links, funded from private and public resources.

London Docklands case study

In the case of the former docklands in London, the Conservative government carved out a fresh approach when it lifted many planning controls in order to encourage the private sector to build and create a whole new business district, namely Canary Wharf.

The process began with the passing of the Local Government, Planning & Land Act in 1980. This legislation created enterprise zones and urban development corporations, aimed at involving the private sector. The Isle of Dogs was then made an Enterprise Zone, a government scheme which offered tax allowances to both investors and developers. The enterprise zone designation lasted for ten years.

The UK government then created the London Docklands Development Corporation (a similar Urban Development Corporation was created for Merseyside), which was responsible for promoting the regeneration of 5120 acres of land east of Tower Bridge. The experiment proved highly successful, not least because it avoided strict planning regulations. The LDDC’s first chief executive, Reginald Ward, refreshingly observed that “planners presume that they can regulate the market place, - and they can’t... the need is to be responsive to development pressure... which requires a very flexible planning framework”.

This radical new approach to infrastructure development, coupled with changes to the tax system, notably the indexation of capital gains tax so that the tax was levied in line with the rate of inflation, greatly improved the attraction of investing in commercial property. The third essential dynamic was the development of adequate transport links so that people could access London’s new business area.

Freeing up the market to deliver economic growth

In offering regional development aid to the new Member States the European Commission must appreciate that subsidies can be counter-productive. Indeed, reliance on EU agricultural and regional development subsidies could hinder economic advancement since such subsidies will tend to sustain employment on farms in rural areas that have no long term viable future, and deter people from moving to town and cities, where they are more likely to be able to earn higher wages producing goods and services for which there is a growing demand.

Chasing after subsidies and grants detracts from the time and resources that entrepreneurs should be devoting to developing new products and services that satisfy a market opportunity. Rather than concentrate on allocating various forms of regional development assistance, the EU would be better advised to focus on removing barriers to trade.

Although substantial amounts of money have been pumped into the Spanish and Portuguese economies over the course of the last two decades, these countries are still shackled by a range of supply side rigidities. Since 1990 Spain has managed to improve its economic competitiveness but this success has again probably owed far more to the wider market made available by EU membership and the liberalising, market-orientated policies of the Aznar government (1996-2004) than any direct causal link associated with EU subsidies.¹¹ The *2009 Index of Economic Freedom* published by *The Wall Street Journal* in association with the Heritage Foundation and other leading think tanks notes: “The government has tried to streamline red tape and improve licensing procedures”. Yet Spain retains a raft of restrictions on hiring, firing and hours worked, which deters employers from recruiting additional staff and growing their business. Spain currently has one of the highest unemployment rates (over 18 percent in April 2009) within the EU and the Socialist government is unpopular, as reflected in the European elections held in June 2009.

In the case of Portugal, while substantial amounts of EU regional assistance has been channelled into the country over the last 20 years, only modest improvements in economic competitiveness have been observed. Portugal continues to maintain a bloated public sector (total government spending is close to 50 percent of GDP) and employment regulations, including limits on hours that can be worked, have severely constrained employers' wish to hire labour. Significantly, the Socialist party now in government lost a considerable share of its overall vote to centre right parties in the latest European Parliamentary elections.

When Greece joined the EU in 1981 its GDP per capita was only 58 percent of the EU average (measured in terms of purchasing power parity). Yet despite considerable sums of EU regional development aid, Greece's income per head actually fell relative to other member states in the first ten years of its membership of the EU.¹²

As Yannis Stournaras, a professor of economics at Athens University observes, "red tape discourages entrepreneurship, innovation and foreign direct investment". Greece follows some way behind other EU member states such as Ireland and Portugal in its ability to attract foreign direct investment. In 2007 foreign direct investment totalled a mere €1.4bn.¹³ This poor record is linked to politicians' reluctance to cede control of publicly owned enterprises and an endemic problem associated with deep-rooted corruption.

In contrast, Ireland is the probably the best example of a country where radical policies aimed at reducing taxation on business and spurring entrepreneurial activity, were shown to work. Unfortunately Eurozone interest rates, which were far too low for Ireland, subsequently fuelled a massive credit boom that has now burst with predictable consequences. The country has accumulated considerable debts due to the banks' misdirected lending policies, most notably to the construction and property development sectors. However, this credit boom and slump, mirrored in the UK and US, should not obscure the very real progress the country made in the 1990s under the enlightened guidance of the Irish Finance Minister, Charlie McCreevy.

As Charlie McCreevy points out, "Back in the late 1990s when, as Ireland's Minister of Finance, I started cutting taxes, many people feared that the loss of revenue to the Exchequer would be massive and that the policy would have to be abandoned. But the opposite happened. Far from the policy causing an erosion of the Exchequer's revenue

stream, reduced tax rates generated higher economic activity, greater taxpayer compliance and a surge in the tax take for the Exchequer".

Summing up, McCreevy says, "Looking at the results, we can see the policy was an essential part of Ireland's economic boom". He recommends, "Europe can be greater still with more tax competition and lower business taxes".

Recommendations

This study recommends that the EU make the following radical changes to its policy programmes focusing on regional development assistance.

1. The current system for allocating EU structural funds to the regions of the EU is fundamentally flawed. In the shorter term, a radical review should be undertaken of the current programme of regional development aid as an integral part of the overall review of the EU budget 2007 – 2013.
2. The EU 15 Member States should take over responsibility for managing any regional development initiatives. The circular system of sending money to Brussels only to see a portion of the sum returned is neither sensible nor effective. National governments in these countries are best placed to allocate resources and remove barriers to economic development. The European Commission does not appear to add much by way of additional value, as demonstrated by studies undertaken by the OECD, Cambridge Econometrics and the Cato Institute among others. It is worth pointing out that a leading proponent of such an approach is Gordon Brown, Britain's Prime Minister. In an article in *The Times* he argued that "when the economic and social, as well as democratic, arguments on structural funds now and for the future so clearly favour subsidiarity in action, there is no better place to start than by bringing regional policy back to Britain".¹⁴
3. Some carefully targeted EU regional development assistance is arguably worth continuing. In poorer, less well-governed countries, notably Romania and Bulgaria, EU funding can help attract private sector investment, particularly among the major global multinationals. But such funding needs to be properly accountable. Based on past experience, the European Commission is facing serious difficulties ensuring that

EU regional development aid is being appropriately spent. If regional development expenditure is focused on the poorer Member States, it should be easier to design and tailor programmes that address the most pressing needs, while at the same time reducing fraud and cutting administrative costs.

4. EU funding for the poorest Member States should primarily aim to improve their economic competitiveness and growth prospects. The stronger and more competitive the EU economy as a whole, the better it is for all concerned. This goal should be achieved by focusing on enterprise and innovation, infrastructure, and skills and employment. Some Accession States suffer from serious environmental pollution and EU aid should seek to address these glaring problems.
5. If poorer European Member States want to boost economic growth they would be well advised to implement policies aimed at removing barriers to efficient markets, free up the labour market, eliminate unnecessary regulation and establish attractive 'flat tax' regimes. Moreover, the successful regeneration of London's Docklands demonstrates what can be done if government withdraws from micro-managing regeneration and leaves it to the dynamism inherent in the market. Government's role in regional development should be focused on setting an attractive tax regime, along with establishing good transport links, funded from private and public resources.
6. In the longer term, unless action is taken to concentrate EU taxpayers' support on the poorer Accession States, in line with the goals of establishing a single European market, there is likely to be further dissension and argument over the allocation of funding. With the EU planning to invite a number of countries in the Balkans as new member states, there is bound to be even greater rivalry and conflict for regional development spending.

About the author

Keith Boyfield is a Senior Fellow of the Adam Smith Institute. He is also a consultant economist specialising in competition and regulatory issues. He advises a range of multinational companies, trade associations and non-profits and has acted as a consultant to some of the world's largest companies and professional advisers including Aon, the Association of Consulting Actuaries, the BBC, BNFL plc, British Sky Broadcasting Ltd, KPMG, Mott MacDonald Ltd. and Thomson Reuters plc. He has also acted as a consultant to the European Commission's Competition and Energy & Transport Directorates.

Keith is a regular contributor to the press, television and radio. He has written for *The Wall Street Journal*, *The Financial Times*, *The Business*, *The Daily Telegraph* and *The Independent*. He also writes for a number of specialist journals and magazines, most notably *Acquisitions Monthly*, *The Financial Regulator* and *Utility Week*. His in-depth study of the rapidly changing relationship between the banking and insurance sectors - *Global Insurance and the Capital Markets* - was published last year by International Financing Review (IFR) Marketing Intelligence, a division of Thomson Reuters.

Endnotes

- 1 *Evening Standard*, 11 February 2008.
- 2 Consolidated Version of the Treaty Establishing the European Community, Part 3, Title XVII, Article 158.
- 3 'Charlemagne', *The Economist*, 24 January 2004.
- 4 'Frustration at slow progress in EU', *Financial Times*, 19 June 2009.
- 5 Bulgaria and Romania must produce concrete and irreversible anti-corruption results, Transparency International press release, 12 February 2009.
- 6 Survey of Bulgarian public opinion, Transparency International. Reported in *Financial Times*, 19 June 2009.
- 7 House of Lords oral evidence, session 2007 – 8, held in April 2008 with European Commission officials, Brussels, page 10.
- 8 9 February 2009.
- 9 Op cit.
- 10 House of Lords debate, 9 February 2009.
- 11 The Socialist government led by Jose Luis Rodriguez Zapatero has largely maintained and built on the structural reforms pushed through by Jose Maria Aznar's administration.
- 12 'A special report on EU enlargement', *The Economist*, 31 May 2008, page 10.
- 13 'Greece', *Financial Times* special report, 2 June 2008.
- 14 *The Times*, 6 March 2003.