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How Small are the Regional Gaps? How Small is the Impact of Cohesion Policy?

A Commentary on the Fifth Report on Cohesion Policy

Abstract

The Fifth Cohesion Report presented by the European Commission in November 2010 provides a wealth of new data on social, economic and territorial trends in Europe. This commentary makes five principal points:

1. The economic gaps between European regions are *much smaller* than is normally reported if we look at per capita net adjusted income, which is a more relevant measure than per capita GDP.
2. The disparities between metropolitan areas and other regions move in different directions at various stages of economic development. Which corrective measures should be taken to affect this balance is a politically sensitive issue that is best left to national policy processes. There is *no generally desirable European span* of intra-national regional disparities.
3. The lion's share of inter-regional equalisation and development promotion is achieved not through EU cohesion policy but through *domestic policies*, incl. taxation, social insurance and public services.
4. In cohesion policy, the *quantity of evaluation is high but its overall quality is low*. Many studies of specific interventions compare the performance of support recipients with that of control groups of comparable non-recipients. A truly counterfactual analysis would address a further crucial question: what volume of economic activity was suppressed through the funding of these interventions?
5. The report presents cohesion policy as an area of win-win interventions, playing down the trade-offs between support for lagging regions and the pursuit of aggregate economic growth. This is not convincing. A fatal misunderstanding also leads the Commission to overstate the macro-economic effects in all countries. This impact is unfortunately *much smaller* than claimed in the report.

Introduction

Reducing the disparities between the levels of development of the various regions and the backwardness of the least-favoured regions is a cardinal task of the European Union (art. 174). For this purpose, a European Regional Development Fund has been established to help redress the main regional imbalances (art. 176). Other instruments with related purposes include the Social Fund (art. 162) and the Cohesion Fund (art. 175). The progress made towards economic, social and territorial cohesion shall be presented by the Commission every three years (art. 175).

The Fifth Cohesion Report, entitled *Investing in Europe's Future*, was submitted on 19 November 2010. Besides presenting a wide array of accomplishments, it offers an unprecedented wealth of data about vari-

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ous national and regional disparities in Europe. It also contains valuable summaries of recent research on social, economic and environmental trends. This mine of information provides an excellent basis for a thorough discussion of the future of cohesion policy.

From this perspective, the questionnaire attached to the report is a little limited. While raising important issues about possible modifications to allocation criteria and modalities, it circumvents the more fundamental or even existential questions about cohesion policy. Which gaps are most important? Which disparities are particularly amenable to EU policy interventions, and which evolve more in response to other independent variables such as market forces or domestic policies? Which objectives of cohesion policy have already been attained, and which success stories are likely to be repeated in the future? Without addressing such issues we can hardly assess the relative merits of cohesion policy in comparison with other pressing claims on the EU budget.

1. Which gaps matter most: disparities in production or disparities in consumption?

"He who does not work, neither shall he eat", was St Paul's message to the Thessalonians. This stern tenet has since been repeated in many political sermons, from the founders of the American colonies to Lenin and the early leaders of the labour movement, but it is of course utter nonsense: only one-half or so of mankind is actually working while the others – young, sick, infirm and old – are fed through transfers within families or welfare states. The work ethic remains strong, however, and is also reflected in the persistent primacy of production figures in spatial comparisons of wealth.

To boost the development of the least-favoured areas, we must first know where they are. In the EU, structural policy transfers are based on disparities in production, with a GDP per capita of less than 75 per cent of the EU average qualifying a region for "convergence" support and a GDP per capita below 90 per cent of the EU average for "competitiveness" support. Cohesion Fund contributions, however, are based on differences in gross national income, with countries having a GNI of less than 90 per cent of the EU average qualifying for inclusion among the recipients.

In cross-country league tables the difference between production and consumption may not be so great, with some exceptions (in the EU notably Luxembourg, Ireland and Bulgaria), but this changes when we come to very poor countries (receiving many remittances) and to the regional level. Here, production is not such a reliable indicator of wealth or welfare. In many metropolitan areas the GDP is inflated because of commuting and correspondingly deflated in the surrounding areas. This upsets the relationship between adjacent regions. The balance may also be affected by the under-reporting of actual production and earnings in areas with a sizable informal economy.

When the GDP is translated from production into utilisation, the original differences in wealth between individuals are reduced in several ways: first of all by sharing within households – the productive members of a family ("the breadwinners") regularly cover the living expenses of members who are not active in the labour market, such as children, non-working spouses and other dependents; second, through taxes and public transfers, some constructed as redistribution of purchasing power and others as provision of distinct goods and services. Accordingly, consumption opportunities are much more evenly distributed than the original results of production.

This is true not only for individuals but also for regions. The Fifth Report provides many different measures of income and the quality of life. We first learn that what is called *primary income* is about *8 per cent* less dispersed in the EU than GDP per capita because of such flows as commuting, profit extraction and remittances.

This is before taxes and various cash benefits have affected the distribution of net income. It is reported that regional disparities in *disposable income* are about *18 per cent* less than disparities in GDP. Since both property values and incomes are much higher in urban areas, a significant redistribution takes place at the national level between different parts of every country through the fiscal system. This tendency is further accentuated through social insurance mechanisms as rural areas often have higher unemployment and a skewed demographic structure.

In addition to these shifts in disposable income we should take into account the redistribution in kind produced through the various forms of public consumption (education, health care and other forms of infrastructure). This is called *net adjusted income* and its distance from GDP per capita may vary significantly between different countries. According to the Fifth Report:

> Net adjusted disposable household income (Map 1.67) corrects for these differences in transfers in kind as recommended by the Stiglitz-Sen-Fitoussi report. This is critical since it adds an estimated 43% and 39% to net disposable household income in Denmark and Sweden, compared to only 3% in Slovenia and 11% in Greece. In most Member States transfers in kind are estimated to add between 15% and 25% to net disposable household income (p. 104).

If this adjustment is supposed to cover public expenditures in kind, the figures given for Sweden and Denmark seem a little high and those for Greece and Slovenia correspondingly a little low, but the exact magnitude is less important than the recognition that this increment must be made to arrive at a realistic picture of economic disparities. According to the Fifth Report, the differences in GDP per capita explain only 60 per cent of the variation in net adjusted disposable household income (p. 104). The implications of this statement are not fully explained, but we know from many other studies that taxes and public expenditures go a long way towards narrowing the intra-national gaps between regions.

Many other factors than income affect our quality of life. The Fifth Report gives a rich coverage of both objective variations (such as life expectancy at birth, traffic fatalities and suicides, unemployment, migration, access to services, reported crime, violence and vandalism and differences in unemployment between immigrants and people born inside the EU) and disparities in subjective measures of well-being (such as safety, trust, difficulties in balancing family and work life and self-perceived personal state of health). Apart from separate indicators, several composite measures have been developed, such as the proportion of people at risk of poverty and the level of satisfaction with aspects of the quality of life in selected cities (the Urban Audit Perception Study). Some indicators presented in the Fifth Report offer surprises, such as the share of the population living in workless or low work intensity households, which turns out to be higher in the UK than in any other member state.

A well-established league table often diverging from the rank order of countries with regard to GDP per capita is the UNDP Human Development Index (HDI), also integrating life expectancy, literacy and enrolment in education. Within the EU, however, this indicator is highly correlated with GDP per capita. To gain a better perspective on human development diversity within the EU, an EU regional HDI has been calculated, including healthy life expectancy, net adjusted household income and the educational attainment for people aged 25–64. This indicator is less closely correlated with GDP than the UN one and provides a complementary perspective. A third instrument to measure disparities in well-being is the perception-based "happiness index", according to which the "number of happy years" varies between 63 in Denmark and Sweden and 37 in Bulgaria and Romania. The answers to the question "taking all things together on a scale of 1 to 10, how happy would you say you are?" range from 8.3 for Denmark and Sweden to 5.8 for Bulgaria.

In the first chapter of the report, we find 42 figures and 88 maps dealing with regional distribution. A few of these refer to conditions outside Europe, but the bulk of the evidence sheds light on various gaps within the Union. That such a many-faceted picture of the European economy and society can now be compiled is an important achievement in itself. The Commission has made ample use of materials from Eurostat, ESPON and a great many other sources. Recent scholarship has significantly amplified the information available about variations over time and across boundaries.

A key question in the formulation of cohesion policy is the determination of *relative needs of support*. If we divide the many measures in the report into (i) production-based, (ii) income-based and (iii) others, it seems clear that the large final group provides very important information about significant gaps within the European Union. However, given the partial character of some of these indicators and the softness of the perception data, they may not be easy to build into distribution keys for the allocation of cohesion funds. The indicators in the two former groups are harder and therefore more likely to qualify in this respect.

The use of an income measure (the country's GNI per capita) to determine the cohesion fund allocations seems well justified, but the same cannot be said about the use of a production measure (GDP per capita) to divide the regions into different classes (with the odd names "competitiveness" and "convergence") for the allocation of resources from the other structural funds.

This latter base is highly questionable. It seems grounded in the assumption that an equal level of production in all regions is a desirable objective to strive for, but this is by no means self-evident. Given the differences in natural endowments and locational advantages, why should we aim for the same gross regional product everywhere? This can never produce maximum efficiency and does not meet the key equity demand either, since equality in production is a very odd ideal.

Consider again the relation between individuals: nobody would expect all family members aged from 0 to 100 years to be equally active in the formal economy. What matters for our common well-being is a reasonable level of sharing when it comes to consumption and good life chances for everyone. Differences between the regions of a country should be seen in a similar light. Supporting regions to develop their potential may certainly be worthwhile and there is also a strong case for intra-national equalisation and solidarity, but why should the target for such efforts be an even level of production? The case for a comparable level of consumption is much stronger.

Another reason why GDP figures should not qualify as a basis for allocating structural fund support is the principle of additionality. According to this idea EU contributions should not replace but come on top of national contributions. This rule is not respected if national allocative and redistributive flows are disregarded and the EU money is distributed to the regions on the basis of their unadjusted production results, before these are modified through national taxation and public policy.

Again, the purpose of cohesion policy is not redistribution but regional development, but some basis must be established for dividing up the funds.

To this end consumption gaps seem much more relevant than production gaps. Taking into account the significant transfers that are constantly achieved through domestic mechanisms (taxation, social insurance systems, investments and provision of public services), the EU should not try to duplicate these forms of equalisation by basing *any* part of cohesion policy on GDP measures. A much better distribution key would be disparities in income, preferably net adjusted disposable income, which captures both private and public consumption and is a reasonably "hard" monetary measure in comparison with such constructs as the indicators of "happiness" or "human development".

2. Metropolitan areas vs. the rest

Regional convergence is a tricky phenomenon. When it occurs we do not know exactly the extent to which it is due to specific policy interventions or to broader market developments. In the United States there has been a long-term process of inter-state equalisation over the last century, and in Greece there was already noteworthy regional convergence in the decades preceding EU membership. On the other hand it is very probable that the common market and cohesion policy in combination have promoted the reduction of GDP disparities in Europe, and a wide range of other positive effects can also be ascribed to structural policy programmes.

Whereas the overall tendency in the EU is slowly decreasing the disparities between countries and regions, some gaps within member states are moving in the opposite direction. The metropolitan areas remain economically stronger than other regions. In 2007 they accounted for 60 per cent of the population but 68 per cent of the GDP. In most EU-15 countries the gaps have narrowed somewhat in recent years, but not in the EU-12, where the capitals in particular have seen vigorous growth.

Should we worry about these widening disparities? There are two reasons not to: first of all because of the point made in the previous section about production and consumption – per capita GDP provides no adequate measure of genuine living standards; second because of emerging insights into the evolution of interregional differentials. Recent research within a new sub-discipline called New Economic Geography and Growth (NEGG) has deepened our understanding of spatial variations over time. Where previous paradigms often projected a uni-directional diffusion model of growth through various forms of trickle-down effects, the new theories give more complex and nuanced explanations of the interplay between metropolitan and surrounding areas. The Fifth Report summarises this lesson as follows:

> …as countries become more developed, the advantages of agglomeration become more widely spread throughout the country due to improvements in the business environment, communication and transport infrastructure and the education of the labour force outside the main urban centers. At the same time, some of the benefits of agglomeration are offset by congestion costs and high rents. As a result, economic activity will start to spread to less developed regions, often rural, and the gap between these and urban areas will start to close, leading to a more balanced development, This seems to have occurred in the EU-15 (p. 23).

Such an evolutionary perspective on the relationship between metropolitan areas and the rest is not likely to satisfy the advocates of rural areas and peripheral towns. Ever since the publication of Jean-François Gravier's *Paris et le désert français* (1947), similar voices have been heard all over Europe. Spatial equity remains a sensitive political field where every government and every political party must make its own arbitrage between conflicting claims.

Different answers to this question will be found in different countries, but an answer that is valid for all times and all of Europe is hardly conceivable. The disparities between metropolitan areas and the rest is a matter best left to the national political process.

3. Domestic policies and the spectre of "renationalisation"

"EU Cohesion Policy operates alongside an array of national and regional policies devised and implemented in many different places and under widely differing circumstances", says the report (p. 145). Since the reduction of disparities is a "joint task" between the Union and its member states, the Commission recognises the "national contributions" towards this end. In so doing, however, it is often drawn to an overly centralistic vision of the policy process.

A threat often invoked in European institutions is that of the "renationalisation" of EU policies. This option is met with visceral abhorrence by committed Europeans, as a fateful step backwards in the process of integration. The concept has its reasonable place in discussions on CAP and trade policy where the EU mandate is wide-ranging, but it is much more contestable when applied to cohesion policy.

Here, member states and regions have always played the first fiddle, and the role of the EU is mainly supportive, whatever the report may say about disparity reduction as a joint task. Even in the poorer member states where cohesion policy plays a crucial part in institutional development and public investments, much more regional equalisation and development is achieved through nationally funded interventions than through EU support. In net contributor countries the overweight is striking and, however welcome the cohesion policy contributions to their beneficiaries, they do not add much to the fundamental orientation of national policy. The agencies involved in receiving structural fund allocations are of course well aware of the EU transfers, but for the general public these contributions blend easily with investments from domestic sources. As for taking political credit, there is no lack of regional and local volunteers.

Whether called the Rhineland model, *der Sozialstaat*, the welfare state, *l'état-providence* or something else, the national systems of social protection and public services have a long history and can hardly be portrayed as outgrowths of European integration. In reading Commission texts about "social Europe", however, one is often left with a different impression. It seems as if political decisions are principally made at the centre by assembled European leaders and then move out to the periphery. Member state actions do not stem from national and local political processes but derive from the Treaties, the Lisbon Agenda, the Europe 2020 Platform and other such strategies. Member states' agencies are relegated to the role of implementing guidelines laid down through European agreements. A similar assumption is expressed in the assertion that EU funds "mobilise" national and private sector contributions.

4. Easy victories through easy evaluation

The report gives a good overview of the many factors influencing convergence: domestic policies, other EU policies and elements outside the sphere of governance. Nevertheless, it also oscillates between an analytical line of reasoning and a more salesman-like approach, often hinting at causal relationships where such linkages seem improbable or uncertain.

The attitude to evaluation seems strangely ambivalent. On the one hand, the Commission has initiated some very ambitious studies, and in its best moments it presents a nuanced reasoning about what we know and cannot know about the results and impacts of cohesion policy. A few pages later, however, we are served the most encouraging good tidings from national evaluation reports that do not seem to meet particularly rigorous standards. A favourite model in the cohesion evaluation industry is presented as "counter-factual" analysis but is in effect a very light version of counter-factualism: the performance of support recipients is compared with that of control groups of comparable non-recipients.

This type of analysis may provide interesting information about the comparative efficiency of various types of intervention, but it does not reveal whether the money was well spent. A genuinely counter-factual analysis must relate the results to the zero option, i.e. the money remaining where it was without the EU transfer. What economic activity was suppressed through the funding of cohesion policy, and how many jobs were destroyed? Shaving off some 0.3 per cent of EU GDP cannot be achieved without a significant economic impact, and even if some of this money comes back the net impact will still be negative in a number of countries.

Future evaluation strategies deserve careful consideration. A persistent problem is that the effects that are detectable in the short term are not necessarily the most important results of cohesion policy. The more we go for "sustainable growth", the less interest there should be in quick returns. How many of the "jobs created" now proudly reported were linked to housing bubbles in recipient regions?

The recent financial problems of the longest-serving recipients of cohesion support are bound to raise the question of whether and to what extent these flows promoted structural reforms – or whether they provided a breathing space that, at least partially, may have delayed such reforms. This issue is not addressed in the report.

5. Macro-economic impact: gross figures, gross exaggerations

In the Synthesis Report (April 2010), the Communication on the Budget Review (October 2010) and the Fifth Cohesion Report (November 2010), the Commission has presented quite cheerful estimates of the macroeconomic impact of cohesion policy:

> In all the countries, the estimated effect of cohesion policy on GDP by 2009 is still larger than the amount of funding involved.
>
> *Synthesis Report, p. 117*

> GDP in the EU-25 as a whole is estimated to have been 0.7% higher in 2009 as a result of cohesion policy over the 2000/2006 period – meaning a good return for spending accounting for less than 0.5% of EU GDP over the same period.
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> *The Communication on the Budget Review COM(2010) 700 (19.10.2010), p. 6*

> According to QUEST, the return in 2009 is the equivalent of EUR 1.2 per euro invested. However, by 2020, the return is estimated at EUR 4.2 per euro invested.
>
> *Fifth Cohesion Report, p. 253*

> The QUEST model has been used to estimate the net effects of Cohesion Policy on the EU economy as a whole. The cumulative net effect on the GDP of the EU 25 of the 2000–2006 programmes expenditure is estimated at 0.7% in 2009 (i.e. GDP was higher to this extent as a result of policy). This was estimated to rise to 4% by 2020. In the EU 15 alone, the estimate is a cumulative net effect on GDP of just over 3% by 2020.
>
> *Fifth Cohesion Report, p. 254*

> In terms of the regional economy, the funding provided by Cohesion Policy over the period 2000-2006 created some 1 million jobs in enterprises across the EU, as well as perhaps adding as much as 10% to GDP in Objective 1 regions in the EU-15. As various studies indicate, this tended to boost the trade and exports of net contributor countries, which helps to off-set their contribution to funding the policy. Accordingly, macroeconomic model simulations indicate that Cohesion Policy had the net effect of raising the level of GDP in the EU as a whole.
>
> *Summary of Fifth Cohesion Report, p. 15*

The problem with these claims is that they lack any foundation in the Commission's own econometric analysis, to which the documents refer. Some of the above statements are just mysterious; others can be traced back to concrete misunderstandings. In the preparation of the Commission's texts, three crucial aspects seem to have been "lost in translation":

1. QUEST III is an econometric model that does not pretend to measure the positive output effects of cohesion policy but merely to shed light on its *potential* impact. Such estimates are based on the assumption "that all the money is directed towards productive projects and none is wasted".[1] The authors of the Fifth Cohesion Report take note of this, underlining that "it must be borne in mind that both HERMIN and QUEST do not measure the impact of policy, they model it" (p. 248), but no sooner have they served this reminder than they forget it entirely, landing a few pages later in the categorical conclusions about actual growth cited above.

2. The model results rely heavily on a series of assumptions about linkages between various parameters, especially the output elasticity of public capital (investments in infrastructure). The modelling problems hampering the proper identification of this elasticity include common trends, missing variables, simultaneity bias and reverse causation. The sensitivity analyses carried out to deal with these forms of uncertainty are conscientiously presented by the QUEST III researchers, but they then disappear in the Commission's presentations to the general public.

3. Finally, and perhaps most fatally, the authors of the key documents seem to have misunderstood the meaning of "cumulative gains" in both HERMIN and QUEST III. The +0.7 presented as an aggregate gain in GDP growth in 2009 is in fact not a figure relating to that particular year only, but to the *sum total* of all gains made during the years 2000–2009, compared with the GDP of each year. In other words, if we piece together all the small increments and decrements during the decade we will arrive at +0.7 per cent of one single year. That, unfortunately, does not mean a 0.7 per cent higher GDP in 2009.

The misunderstanding then grows cumulatively. When the increment in GDP for the EU-25 in 2020 is presented as +4.0 per cent, this claim exaggerates the results of the QUEST III analysis by a factor of 12; the actual QUEST III model prediction for this year is +0.33 per cent, again provided that all the cohesion money has been spent wisely and productively and that the investment elasticities correspond to the main assumptions of the model.[2]

For most contributor countries, the model's macroeconomic impact is negative throughout the 20-year period, especially for France but also for Austria, Belgium, Denmark, Finland, the Netherlands, Sweden and the UK. It is not particularly flattering for the Commission that this piece of information is entirely absent from the Fifth Cohesion Report. The only exact data offered about the contributor countries relate to their export shares to countries receiving cohesion support. Some (but only some) of this trade is due to cohesion policy. In contrast, the report presents no figures at all relating the much more important aspect of the financing burden.

Equally lopsided is the treatment of employment effects. Scattered throughout the Fifth Report is a variety of more or less precise indications of "jobs created" through cohesion policy, as in the final quote above. It is seldom spelled out that these data refer to gross increments only or made clear whether they reflect the end results or the cumulative impact. That the funding of cohesion policy inevitably shaves off a slice of employment every year in every member state is a point never made, nor is there any attempt to estimate the size of this job loss.

There may, in conclusion, be place for some added caution and some added candour in subsequent cohesion reports. Overstating the problems and pushing the costs under the carpet are not the best way of promoting sound policy choices. As for the future of cohesion policy, the discussion on this important topic should not be circumscribed by the 13 questions now asked by the Commission. Many others call for attention.

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[1] Janos Varga & Jan in 't Veld (2010) Cohesion Policy Spending in the New Member States of the EU: A DGE Model Based Analysis. DG Economic and Financial Affairs. European Commission, p. 2.

[2] Janos Varga & Jan in 't Veld (2011) "A Model Based Analysis of the Impact of Cohesion Policy Expenditure 2000-06: Simulations with the QUEST III Endogenous R&D Model", table 5. *Economic Modelling*, forthcoming.