

Executive summary

Introduction: the policy context and cohesion objectives

Economic growth in the EU has slowed appreciably over the three years since the publication of the last Cohesion Report. As a result, unemployment has risen again in many parts of the Union with all the social implications which this entails. The sluggish performance of the EU economy over the long-term, however, suggests that there are more fundamental problems that need to be overcome if growth is to be sustained at an acceptable rate in future years.

These problems are reflected in the low growth of productivity in the EU in recent years, especially as compared with the US. Unlike in the Union, growth in the US has accelerated as innovation has increased and the use of information and communication technologies (ICT) widened. At the same time, up until the 2001 recession, employment growth was generally higher than in the EU and a large number of people of working age were in employment. In consequence, income per head in the US has remained some 30% above the EU level.

If growth in the EU is to be sustained once recovery gets underway, investment in physical and human capital needs to be increased, innovation needs to be stepped up and ICT more widely used to boost productivity and employment. This, however, needs to happen not just in central parts where productivity and employment are highest and innovative capacity most developed but throughout the Union.

While it is instructive to consider the performance of the EU economy overall, it is important not to ignore

the wide disparities in output, productivity and employment which persist between countries and regions. These disparities stem from structural deficiencies in key factors of competitiveness — inadequate endowment of physical and human capital (of infrastructure and work force skills), a lack of innovative capacity, of effective business support and a low level of environmental capital (a blighted natural and/or urban environment).

Countries and regions need assistance in overcoming these structural deficiencies and in developing their comparative advantages in order to be able to compete both in the internal market and outside¹. Equally, people need to be able to access education and training in order to develop their capabilities wherever they live. EU cohesion policy was strengthened some 15 years ago at the time the single market project was initiated precisely to meet these parallel needs. Such assistance is even more important now in the face of the widening of disparities which enlargement entails.

The contribution of cohesion policy to EU growth

If the EU is to realise its economic potential, then all regions wherever they are located, whether in existing Member States or in the new countries about to join, need to be involved in the growth effort and all people living in the Union given the chance to contribute. The cost of not pursuing a vigorous cohesion policy to tackle disparities is, therefore, measured not only in terms of a loss of personal and social well-being but also in economic terms, in a loss of the potential real

income and higher living standards. Given the interdependencies inherent in an integrated economy, these losses are not confined to the less competitive regions or to individuals who are not working or who are in unproductive jobs but affect everyone in the Union.

Strengthening regional competitiveness throughout the Union and helping people fulfil their capabilities will boost the growth potential of the EU economy as a whole to the common benefit of all. And, by securing a more balanced spread of economic activity across the Union, it will reduce the risk of bottlenecks as growth occurs and lessen the likelihood of inflationary pressure bringing growth to a premature end. It will equally make it easier to sustain the European model of society and to cope with the growing number of people above retirement age and so maintain social cohesion².

Situation and trends

A narrowing of disparities between EU Member States but major challenges remain

Disparities in income and employment across the European Union have narrowed over the past decade, especially since the mid-1990s. Between 1994 and 2001, growth of GDP per head in the Cohesion countries, even excluding Ireland, was 1% a year above the EU average, and the proportion of working-age population in employment in all apart from Greece increased by much more than the average.

In Greece, on the other hand, as in Ireland, growth of labour productivity was over twice the EU average over this period and it was also well above average in Portugal. In these two countries, therefore, the productive base seems to have been strengthened, increasing the potential for continued convergence in income in future years.

Despite the narrowing of disparities, large differences remain. In Greece and Portugal, GDP per head is still only around 70% of the EU average and in Greece and

Spain, some 6–8% fewer people of working age are employed than the average.

Disparities in both income and employment will widen much further when the new Member States join the EU in the coming months. Average GDP per head in these 10 countries is under half the average in the present EU and only 56% of those of working age are in jobs as against 64% in the EU15.

Although growth in these countries taken together has been around 1½% a year above the EU average since the mid-1990s, it has slowed since 2001 as markets in the Union on which they are dependent have been depressed. Achieving the high rates of growth in future years which they require for development depends on growth being sustained in the present Member States. Equally, however, given the interdependencies, high growth in the new countries can be a significant boost to the rest of the enlarged EU economy. But to attain this, they will need substantial help over the coming years to tackle their wide-ranging structural problems and realise their growth potential.

Disparities at regional level

Regions suffering from structural weaknesses which limit their competitiveness and prevent them from contributing fully to sustainable economic growth in the EU tend to be those which suffer from low productivity, low employment and social exclusion.

Regions with problems of competitiveness, however, are not confined to the Cohesion countries in the present EU and the new Member States. A number of regions, despite adequate endowment of infrastructure and human capital, have deficient innovative capacity and difficulty in sustaining economic growth.

Increasing convergence of lagging regions in the EU

Development problems are more acute in lagging regions which lack the necessary infrastructure, labour

skills and social capital to be able to compete on equitable terms with other parts of the Union. These regions, which either receive assistance under Objective 1 of the Structural Funds or will do so in the near future, are largely concentrated in the Cohesion countries and the new Member States.

Since 1994 when the Structural Funds were strengthened, GDP per head in Objective 1 regions has converged towards the EU average. Between 1994 and 2001, growth of GDP per head in these regions taken together averaged almost 3% a year in real terms as against just over 2% a year in the rest of the EU

The extent of convergence, however, has varied markedly between regions, in large part reflecting their relative importance in the Member States in which they are situated. In those in the four Cohesion countries, which benefited from both substantial assistance and growth-oriented policies at national level, growth of GDP per head was much higher than in the rest of the EU.

The number of people in employment has also risen markedly in the Cohesion countries since the mid-1990s. The increase was particularly large in Ireland and was even larger in Spain, although the employment rate remains well below the EU average. The increase was more modest in Portugal and in Greece.

Outside of the Cohesion countries, growth in Objective 1 regions has been less impressive, dragged down in part by slow national growth. In the German new Länder, GDP per head increased by much the same as the EU average between 1994 and 2001, but in the Italian Mezzogiorno, it was below average. In both cases, however, productivity rose by more than in the rest of the EU, implying perhaps an improvement in competitiveness, but little if any employment growth. Only 43% of working-age population in southern Italy were, therefore, in jobs in 2002, well below anywhere else in the Union, while unemployment remains high in the new Länder.

Strengthening competitiveness and employment creation

There are a number of areas in the EU in which structural problems deter investors and inhibit the growth of new economic activities despite reasonable levels of infrastructure and work force skills. These tend to be old industrial regions or those with permanent geographical and other characteristics which constrain development.

There are, for example, 11 NUTS 2 regions in the EU15 in which growth of GDP between 1994 and 2001 was around half the average or less (at only 1% a year or so) and in which GDP per head in PPS terms was above the 75% threshold for Objective 1 support but significantly below the EU average. These regions are spread across the Union, in the north-east of England, in northern parts of Germany and in sparsely populated-areas in the north of Sweden. In each case, they had low growth of productivity as well as of GDP per head. Many contain areas in which GDP per head is below 75% of the EU average.

The challenge for cohesion policy in these cases is to provide effective support for economic restructuring and for the development of innovative capacity in order to arrest declining competitiveness, falling relative levels of income and employment and depopulation. A failure to do so now will mean the problems are even greater when action is eventually taken.

A substantial widening of regional disparities with enlargement

Some 92% of the people in the new Member States live in regions with GDP per head below 75% of the EU25 average and over two-thirds in regions where it is under half the average.

If Bulgaria and Romania, where GDP per head is under 30% of the EU25 average, were to join the Union, the population living in regions with GDP per head below 75% of the EU average would more than double from the present number (from around 73 million to

over 153 million). The gap between their average GDP per head and the EU average would also double (from around 30% below average to over 60% below).

At the same time, economic restructuring has led to a fall in the number employed in the new Member States, with the result that the proportion of working-age population in employment is well below the EU15 average.

The effect of enlargement is to add just under 5% to EU GDP (measured in Euros) but almost 20% to the Union's population. As a result, average GDP per head in the EU of 25 Member States will be around 12½% less than the average in the EU of 15. For 18 regions with GDP per head at present below 75% of the EU15 average with population totalling around 19 million, including Malta, one of the new Member States, this will mean that their income per head is no longer below the 75% threshold.

Since the regions concerned have exactly the same structural weaknesses after enlargement as before, there is a compelling case for maintaining support.

Social cohesion and the risk of poverty

A significant number of people in both the present and new Member States have income levels which put them at risk of poverty, in the sense of relative deprivation (defined as income below 60% of the median in the country where they live). In 2000, around 55 million people, some 15% of the total population, faced the risk of poverty, more than half of these having income levels this low for three years in a row. The proportion was relatively high in the countries of southern Europe and Ireland and was also higher than the EU15 average in many of the accession countries. ('Accession countries' is used throughout this report to denote the 10 new Member States plus Bulgaria and Romania.)

Households most at risk of poverty tend to be those with people aged 65 and over, especially if they live

alone, and lone parents (predominantly women), especially in the UK.

The risk of poverty is closely linked to unemployment and inactivity. Almost 40% of the unemployed had income below the poverty level in 2000, while the integration of people with disabilities, the long-term unemployed and ethnic minorities into employment remains a key challenge if the risk of poverty and social exclusion is to be reduced.

The ageing of the population and increasing dependency rates

Population of working age will begin falling over the present decade in all four southern Member States, Germany and most of the accession countries. In the next decade, the fall will spread to all countries, apart from Ireland, Luxembourg and Cyprus. On the latest projections, the number of people aged 15 to 64 is projected to be 4% smaller in the EU15 in 2025 than in 2000 and in the accession countries, 10% smaller.

This decline will be accompanied by substantial growth in the number of people of 65 and over. By 2025, there will be 40% more people than now beyond retirement age in both the present EU15 and the accession countries, implying a ratio of under three people of working-age for every one aged 65 and over as opposed to a ratio of over four to one at present. Other things being equal, the ageing of population will lead to a gradual contraction of the EU's work force and is likely to have implications for growth potential.

The significance of this, however, will depend on real income and employment growth in future years, which will determine the ease or difficulty of supporting those in retirement. In practice, only 64% of people of working-age in the EU15 and 56% in the accession countries are in employment and generating income at present. The effective ratio, therefore, is already only around 2½ people in work to every one in retirement in the enlarged EU. In 2025, if employment rates remain the same, this ratio will have fallen to under two to one.

These prospects give added importance to the need to sustain economic growth across the EU and to increase employment rates and reduce early retirement. Immigration could in some cases be an important source of additional labour supply, giving greater prominence to ensuring the effectiveness of integration policies.

Narrowing disparities in regional competitive factors

As indicated above, two complimentary sets of conditions need to be satisfied for regions in the Union to sustain economic development and employment in a competitive environment. The first is that they must have suitable levels of both physical infrastructure (efficient transport, telecommunications and energy networks, good environmental facilities and so on) and human capital (a labour force with appropriate levels of skills and training). The second is that, in the new knowledge-based economy, regions must have the capacity to innovate and to use both existing know-how and new technologies effectively as well as to follow a development path which is sustainable in environmental terms. To achieve both requires an effective institutional and administrative framework to support development.

Improving infrastructure endowment

Over the past decade, transport links both within the Cohesion countries and between these and the rest of the EU have improved markedly. In particular, with Structural Fund support, the density of the motorway network in these countries increased from 20% below the EU15 average in 1991 to 10% above in 2001. This increase, however, was largely concentrated in Spain and Portugal. In Objective 1 regions as a whole, though the density was higher than 10 years earlier, it was still only around 80% of the EU15 average. In the accession countries, motorway density is much lower still (under 20% of the EU15 average). Construction is occurring at a rapid rate, despite the environmental trade-offs that have to be made, but mostly around

capital cities or on transit routes to the present Member States.

Some modernisation of the rail network across the Union has occurred over the past decade, but the rate of electrification of lines and conversion to double track has occurred at much the same pace in the lagging parts of the EU as elsewhere, so the gap remains large. In the accession countries, the state of the railways reflects decades of neglect and considerable investment is needed both for modernisation and for replacement of worn-out track. The need for investment, however, is no less acute for roads. The increase in road building, however, is reinforcing the rapid shift of both passengers and freight from rail to roads.

In telecommunications, the number of fixed telephone lines in relation to population remains much lower in both the cohesion and accession countries. This is being offset by a rapid rise in mobile phone use, though in Greece and the accession countries, usage is still less than the EU15 average, in most of the latter, substantially so. At the same time, access to broadband lines, which is important for internet use and the development of various ICT applications and services, shows wide disparities across the Union, broadly in line with relative levels of prosperity. Availability is still very limited in many parts of the EU15 as well as in nearly all the accession countries.

Other infrastructure — schools, colleges, health facilities and social support services of various kinds — is equally important, since it is likely to have a growing influence on decisions of where to invest and locate new businesses. This is especially the case in respect of knowledge-based activities, which are not tied to any particular location by a need to be close to sources of raw materials or a large market.

As regards the environment, the need for investment remains substantial in the Cohesion countries and, even more, in the accession countries, as reflected, for example, in much smaller proportions of the population connected to waste-water treatment plants as compared

with other parts of the Union. The need is no less important, however, in waste management and control of emissions, especially given the rapid growth in road use occurring in the accession countries.

Strengthening human capital

While the European Employment Strategy launched in 1997 has contributed to increasing the resilience of employment in a period of economic slowdown, important structural weaknesses remain in both present and new Member States.

In order to prevent unemployment and support the integration of the unemployed into work, there is a need to offer personalised services to job seekers in the form of guidance, training and new job opportunities. Developing preventative and active labour market policies is particularly important in the new Member States to promote economic restructuring.

A high level of education and skills is of increasing importance both for individual advancement and economic competitiveness. The relative number of people with education beyond basic schooling remains much lower in Objective 1 regions than in the rest of the EU15, especially in Spain, Italy and Portugal, the one exception being the German new Länder. Here the relative number is more similar to that in the accession countries, where it is much higher than the EU15 average (around 80% or more as against an EU15 average of 64%).

The skills obtained from further education and initial vocational training in the accession countries, however, are not necessarily in line with labour market needs and curricula and teaching structures are not well adapted to the modern economy. Moreover, many fewer young people than the EU15 average go on to complete university-level education, which is a key requirement for making a significant contribution to the development of the knowledge-based economy. This is also the case in the present Objective 1 regions in the Union, where, despite the increases over the past decade or more, the gap with the rest of the EU remains large.

Equally, many fewer people in both the cohesion and accession countries seem to participate in continuing training than in the rest of the Union (under 20% of those employed in enterprises in Greece, Portugal and all the accession countries apart from the Czech Republic and Slovenia in 1999), despite the critical need to adapt to economic change.

Strengthening social cohesion

Economic, employment and social policies are mutually reinforcing. Economic development must go hand in hand with efforts to reduce poverty and to fight exclusion. Promoting social integration and combating discrimination is crucial to prevent social exclusion and to achieve higher rates of employment and economic growth, notably at regional and local level.

Equally, providing comprehensive support to those most disadvantaged, such as ethnic minorities and early school leavers, can be important in securing economic and social gains throughout the EU.

Continuing disparities in innovative capacity

In an increasingly knowledge-based economy, innovation holds the key to regional competitiveness. The capacity to innovate, access knowledge and exploit it, however, varies between regions in both the existing and the new Member States. While the aim of policy is not to ensure that all regions have the means for contributing equally to advances in new technologies, they should nevertheless be equally placed to take advantage of those advances and to put them to productive use.

Various indicators, however — the relative scale of R&D expenditure, employment in research activities and the number of patent applications, in particular — suggest that there is a wide gap in innovative capacity between the stronger regions in central parts of the Union and others. (According to the latest figures, 8 of the 213 NUTS 2 regions in the present EU account for around a quarter of total R&D expenditure in the Union and 31 are responsible for half.) There is a similarly

wide disparity both between the accession countries and the EU15 average and, within the former, between capital city regions and others.

There is a growing consensus about the importance for regional competitiveness of good governance — in the sense of efficient institutions, productive relationships between the various actors involved in the development process and positive attitudes towards business and enterprise. Nevertheless, regions still differ markedly in these respects and in their ability to develop their own competitive advantage given the expertise they possess.

Impact of Member State policies on cohesion

Public expenditure in Member States is a great many times larger than the amount spent by the EU on cohesion policy. Whereas the former averages around 47% of GDP, the budget allocated to cohesion policy amounts to a bit less than 0.4% of EU GDP. Nevertheless, despite its relatively small size, EU cohesion policy performs a valuable role in tackling the underlying causes of disparities across the Union in income and employment. While Member State policies involving public spending are mainly directed at providing basic services and income support, EU cohesion policy is focused on reducing the structural disparities which directly affect the economic competitiveness of regions and the employability of people.

Public expenditure mainly focused on ensuring access to basic services ...

The bulk of public expenditure in Member States, therefore, goes on providing a range of services aimed at ensuring that everyone has access to education, health care and social protection. Together these three functions account for almost two-thirds of total government spending in the EU. By contrast, public spending on investment in human and physical capital amounts to only just over 2% of GDP on average and

is under 4% of GDP in all countries apart from Ireland and Luxembourg. The amount spent by national governments on business support services, higher education, innovation and R&D is similarly low (the latter averaging only around 0,3% of GDP across the EU).

In relation to the sums allocated to structural expenditure by Member States, therefore, the scale of the budget for cohesion policy no longer seems so small. Moreover, unlike the former, EU structural spending is concentrated in the regions which are most in need of assistance (the EU structural allocations to Greece and Portugal, for example, amount to around 2½% of their GDP in each case).

And contributes significantly to narrowing regional disparities in income...

For the most part, government expenditure per head of population in relation to GNP on basic services, like education and health care, is relatively similar across regions in Member States, reflecting a concern to ensure a common level of provision to people irrespective of where they live. However, the main variation occurs in spending on social protection because of differences in unemployment and the number of people in retirement, although spending on administration also differs because of government ministries being concentrated in the national capital.

The combined effect of these tendencies is that the contribution of public expenditure to income is in general much higher in the less prosperous regions than in the more prosperous ones, but mainly because of the lower level of income rather than higher public spending.

While government revenue is proportional to income

Government revenue, on the other hand, seems to be broadly proportional to income, in the main because in all Member States most taxes are levied centrally

either on income or expenditure. It, therefore, does not tend to offset the positive contribution of public expenditure to reducing income disparities between regions. Moreover, in countries where a significant proportion of revenue is raised locally, redistribution mechanisms are in place to reduce disparities in the income available to regions to fund expenditure.

The widespread trend towards devolving responsibility for public services to regional and local level has not, therefore, been accompanied by a similar trend in respect of raising the money to fund these services. The main exception is Italy, where responsibility for raising revenue is being increasingly devolved to the regions without a counterpart strengthening of regional transfers.

Foreign direct investment: a major factor in regional development

Foreign direct investment (FDI) can potentially play a key role in reducing regional disparities in economic performance not only as a source of income and jobs but as a means of transferring technology and know-how to lagging regions. It is particularly important for the accession countries, in need of substantial restructuring of their economies and of a step increase in productivity and competitiveness. Irrespective of the financial inducements on offer, however, foreign investors are not necessarily attracted to places where the need is greatest, for much the same reasons as domestic investors (infrastructure deficiencies, the lack of a skilled work force, and so on).

FDI, therefore, tends to go disproportionately to the stronger rather than the weaker parts of the Union. Over the period 1999–2001, investment inflows represented around 21% of GDP in Ireland — the country with the second highest GDP per head in the EU — 15% in Denmark (the country with the third highest level) and 13% in the Netherlands (the fourth highest). By contrast, inflows into Portugal amounted to only just over 4% of GDP, while the countries with the

smallest inflows were Spain (1½% of GDP), Italy (1%) and Greece (just under 1%).

Within countries, FDI is generally concentrated in and around large cities, especially national capitals, with very little going to lagging regions. The new German Länder, excluding the eastern part of Berlin, therefore, accounted for only just over 2% of total inflows into Germany between 1998 and 2000 and Objective 1 regions in Spain for under 10% of inflows into the country in 2000. Similarly, in Italy, under 4% of the total employed in foreign-owned companies were in the south of the country.

The same general pattern is evident in the accession countries. In 2001, over two-thirds of inward FDI into Hungary went to the Budapest region, over 60% of inflows into the Czech Republic to the Prague region and a similar proportion of inflows into Slovakia to Bratislava.

Impact of Community policies: competitiveness, employment and cohesion

Unlike structural policy, other EU policies are not aimed principally at narrowing regional disparities or reducing inequalities between people. Nevertheless, they have implications for cohesion and in many cases take specific account of disparities.

Building the knowledge-based economy

Community enterprise, industrial and innovation policy is aimed at strengthening the competitiveness of EU producers by promoting competition, ensuring access to markets and establishing an environment which is conducive to R&D across the Union.

As is recognised, a lack of innovative capacity at regional level stems not only from deficiencies in the research base and low levels of R&D expenditure but also from weaknesses in the links between research centres

and businesses, and slow take-up of information and communication technologies. The Innovation Relay Centres which have been set up and the Innovating Regions in Europe network are therefore designed to encourage regions to develop innovation policies and to provide technological support to businesses.

Disparities in access to Community funding for research programmes are still evident, particularly at regional level, though the Sixth Framework Programme is in part aimed at improving links between scientific centres in the more central parts of the EU and those in peripheral areas.

Strengthening education and training

The skills of its work force are the EU's prime comparative advantage in global competition. A high level of education and the provision of a high standard of training, which is accessible to people throughout their working lives, are key to strengthening innovative capacity throughout the EU and to the attainment of the Lisbon objective of making the Union the most dynamic knowledge-based economy in the world. The 'Education and Training 2010' programme has been implemented to help achieve this end, with the complementary aim of making education and training in Europe "a world reference for quality by 2010".

More and better jobs in an inclusive society

At the Lisbon European Council, the EU defined a comprehensive strategy aimed at long term economic growth, full employment, social cohesion and sustainable development in a knowledge based society. The European Employment Strategy (EES) was revised in 2003 better to underpin in an enlarged Union the objectives set at Lisbon and was directed at supporting Member State efforts to reform their labour markets, achieve full employment, increase quality and productivity at work and reduce social disparities.

Success in implementing the EES depends on a clear commitment from Member States to help workers and

enterprises increase their adaptability, attract more people into employment; invest more, and more effectively, in human capital and improve governance. Action to increase social inclusion contributes both to reducing inequalities in access to employment and to raising the growth potential of the economy. Following Lisbon, a common strategy for social inclusion was adopted by the EU in 2001. The second generation of national action plans produced by Member States in 2003 recognises the multi-dimensional nature of social exclusion and need to combat it through a wide range of measures by making economic, employment and social policies mutually supportive.

The Union's commitment to equality between men and women needs to be translated into a comprehensive mainstreaming approach, ensuring that all policies take account of their gender impact in planning and implementation. If the Lisbon employment target set for 2010 is to be achieved, the factors underlying the gender gap in employment, unemployment and pay need to be tackled vigorously. In this respect, actions which attract women into employment, encourage them to stay longer in the labour market and make it easier to reconcile a working career with family responsibilities through the provision of care facilities should be further pursued.

Environmental protection for sustainable growth and jobs

Sustaining economic development and creating long-term, stable jobs depends on protecting the environment against the potentially damaging effects of growth and on preventing excessive depletion of exhaustible resources. The Sixth Environmental Action Programme, *Our Future — Our Choice*, sets out the environmental actions necessary to sustain the pursuit of the EU's economic and social objectives. These involve limiting climate change, preserving the natural environment and biodiversity, reducing emissions damaging to health and diminishing the use of natural resources by cutting waste. They also involve taking account of environmental considerations when implementing structural policy decisions involving investment.

Although there are costs to environmental protection, not least in the lagging regions where infrastructure needs tend to be greatest, there are also substantial potential gains from improvements in health and job creation in the eco-industries, as well as from more sustainable development.

The internal market and services of general economic interest

Liberalising the markets for transport, telecommunications and energy has led to increased efficiency and lower prices. It has also, however, involved a threat to particular social groups or regions of being excluded from access to essential services. Public service obligations have, therefore, been established to ensure that everyone can obtain essential services — or ‘services of general economic interest’ — of reasonable quality and at affordable prices, as required by the EU Treaty (Article 16). Community funds have been made available to help ensure that these obligations are respected across the EU.

At the same time, the trans-European transport networks have increased the accessibility of the more remote regions and facilitated the expansion of trade, and those planned to link the new Member States with the existing ones are likely to have similar effects. The trans-European energy network guidelines, adopted in 2003, put increased emphasis on investment in gas pipelines and electricity distribution systems in landlocked, peripheral and ultra-peripheral regions in future years. And the trans-European telecommunication network programme (or eTEN) is intended not only to improve communications between more remote regions and other parts of the EU but also to tackle deficiencies in ICT applications and services.

Reforming common policies: agriculture and fisheries

Although expenditure under the Common Agricultural Policy (CAP) has declined gradually over time, it still accounts for almost 47% of the Community Budget.

Since the reform process began in 1992, direct aids to producers have risen to 70% of total spending, but they remain below the EU average in Spain, the only cohesion country where this is the case. On average payments are larger relative to income for large and medium-sized holdings than for small ones.

Support for rural development in the 2000–2006 period is larger in Objective 1 regions (56% of the total spent) than in other parts of the EU, though only around 10% of this goes on measures to strengthen the rural economy outside of agriculture. In the next programming period, 2007 to 2013, CAP expenditure will be lower in real terms, with a decoupling of direct payments from production, a reduction of payments to large holdings, lower prices and more emphasis on both rural development and the environment.

With enlargement, employment in agriculture in the EU will increase by around 60% with a substantial rise in the number of small holdings. The share of total spending under the CAP going to Objective 1 regions in the new and existing Member States is estimated to increase by around 10 percentage points to some two-thirds.

The Common Fisheries Policy (CFP) is aimed primarily at conserving fish stocks and restructuring the industry to ensure its sustainability. The recent emergency measures introduced will have significant effects on a number of regional economies, especially in Spain and Portugal. While in the longer-term, a slimmed-down industry should return to profitability once the emergency measures come to an end, in the short-term, it is largely the responsibility of Member States to alleviate the adverse social and economic consequences.

Of the accession countries, only Poland and the three Baltic States have fishing industries of any size and these are already in decline. Together their total catch amounts to under 7% of that in existing Member States.

State aid and cohesion policy

Insofar as the present regime allows for discrimination in favour of problem regions, control of state aid can both

contribute to and support cohesion policy. In line with commitments made at the Stockholm Council, overall expenditure on state aid fell significantly in money terms between 1997 and 2001 and declined relative to GDP in 12 of the 15 Member States. At the same time, spending is increasingly being shifted towards horizontal objectives. Nevertheless, it remains higher in the more prosperous Member States than in the Cohesion countries.

In 2001, only around 9% of total state aid in the EU took the form of assistance to Objective 1 regions and the amount involved was under a third of that in the peak year of 1993, mainly because of large reductions of aid to the German new Länder as well as to southern Italy. Regional aid to Objective 2 areas accounts for around 6% of total state aid.

Given its effect on the regional distribution of economic activity and income, the control of state aid remains of major importance in the context of enlargement. For the period after 2006, efforts will therefore continue to be made to modernise, simplify and clarify state aid rules, taking account of changes in cohesion policy, with the aim of having less but better targeted assistance.

Justice and home affairs: improving the conditions for development

A high crime rate, the existence of organised crime and corruption tend to inhibit economic development and deter potential investors. A strengthening of the capacity to combat crime, increased cross-border cooperation, improved controls of external borders and better integration of third-country nationals into society are, therefore, all ways of supporting regional development. This is particularly the case in the accession countries.

Perceptions of Community policies in the regions

Surveys carried out among regional officials across the EU indicate that Community policies are largely

identified with Community funding and that projects financed by the Structural Funds tend to be both the most visible and those regarded as having the greatest impact. This is especially the case in Objective 1 regions and most particularly in the Cohesion countries. The positive impact of the Community INTERREG Initiative was also acknowledged because of its focus, visibility and stimulus to cooperation.

While the effect of the CAP on cohesion was generally regarded as being positive in regions where agriculture was most important, it was claimed to be unfair in Mediterranean regions and to favour the most profitable farms and the most developed areas in other cases. The absence of a link between the CAP and environmental policy was criticised, while the integration of environmental considerations into regional development policy was widely welcomed, as was the incorporation into the latter of investment in R&D infrastructure, considered especially important in Objective 1 regions.

At the same time, there was widespread criticism of the high cost of managing Structural Fund programmes in the present period and of the increasing complexity of procedures. By contrast, the greater involvement of businesses and the social partners was viewed as an important advance which should be carried further.

The impact and added value of structural policies

The scale and direction of intervention in Objective 1 regions

The Structural Funds and the Cohesion Fund, which amount to only around 0.4% of EU GDP, are concentrated on assisting the least prosperous parts of the Union. In the 2000–2006 period, the amount transferred to Objective 1 regions is equivalent to 0.9% of GDP in Spain and over 2½% of GDP in Greece and Portugal. More significantly, these transfers are

estimated to add some 3% to investment in Spain and 8–9% in Greece and Portugal, as well as 7% in the Italian Mezzogiorno and 4% in the German new Länder.

In most cases, national public expenditure supplementing Structural Fund interventions was larger in real terms in the 1994–1999 programming period than the previous one, increasing the amount available for investment by 40–50%. This was added to further by private funding, which was especially significant in Austria, Germany, the Netherlands and Belgium, though the amounts 'levered' in this way were relatively small in the Cohesion countries, France and the UK. The leverage effect on private investment in the present period seems to be similar, though much smaller in Germany.

Structural expenditure is also supplemented by European Investment Bank (EIB) loans. Lending to assisted areas in the EU15 totalled EUR 20 billion a year between 2000 and 2002, over half of which went to Objective 1 regions, and that to the accession countries EUR 3 billion a year. Over a third of loans went to investment in transport in the present Objective 1 regions, while in the accession countries, 90% went to transport, the environment and energy.

The Structural Funds have been deployed, in particular, to reduce disparities in infrastructure and in human capital endowment between Objective 1 regions and other parts of the EU. Transport systems, both trans-European links and secondary networks within regions, have, therefore, been improved markedly over the past decade, while counselling and training have been given to the unemployed and those in work vulnerable to job loss in order to increase their employability and their skills. At the same time, support has been given to R&D and innovation, both to construct new research capacity and, equally importantly, to help formulate regional strategies for directing R&D towards meeting local opportunities for development, as well as to furthering the spread of ICT and the basic skills required to use the new technologies.

In addition, a significant proportion of the Structural Funds (14% in the 2000–2006 period) has gone to

financing investment to improve the environment, to waste management and waste water treatment especially, while environmental considerations are explicitly taken into account when deciding structural interventions.

The effect of intervention on real convergence and economic integration

Empirical analysis shows not only that growth of GDP, employment and productivity in Objective 1 regions has exceeded that in the rest of the EU since the mid-1990s in particular, but that convergence has been most pronounced in the least prosperous regions among these. (It should be noted that this analysis is based on a consistent set of data specially compiled for the report.) It also indicates that structural interventions have boosted growth in the Cohesion countries both by adding to demand and strengthening the supply side of the economy. In Spain, therefore, GDP in 1999 is estimated to have been some 1½% higher than it would have been without intervention, in Greece, over 2% higher, in Ireland, almost 3% higher and in Portugal, over 4½% higher. In addition, GDP in the new German Länder is estimated to have been increased by around 4% as a result of intervention.

Structural intervention has also encouraged a growth of trade between Cohesion countries and other parts of the Union — which has more than doubled over the past decade — and closer integration. The evidence suggests that, on average, around a quarter of structural expenditure returns to the rest of the Union in the form of increased imports, especially of machinery and equipment. This 'leakage' is particularly large in the case of Greece (42% of expenditure) and Portugal (35%).

Since a large proportion of any increase in spending in the new Member States goes on imports and around 60% of these come from the existing EU Member States, structural expenditure in these countries is likely to involve similarly large leakage effects to the benefit of growth in the rest of the Union. As in the Cohesion countries, this spending tends to go disproportionately on imports of machinery and equipment, to

the benefit of Germany, in particular, which accounts for around 45% of all such imports purchased from the EU15.

Intervention in Objective 2 regions: restructuring and job creation

Over the period 1994–1999, 82 regions in 12 Member States received Objective 2 assistance totalling around EUR 2,4 billion a year (increased to EUR 3,3 billion a year in the present period) because of the presence of areas of industrial decline. This was supplemented by similar amounts of funding from both national public and private sources, increasing overall structural expenditure in these areas to around EUR 7 billion a year. Spending was concentrated, in particular, on the reconversion of old industrial sites and business support services (together accounting for around half the total), while some 20% went on human resource development and 10% on support for R&D and ICT.

Evaluation studies suggest that overall, structural intervention in these areas led to the creation of some 700 thousand jobs over the period and just under 500 thousand in net terms, while around 300 thousand SMEs received assistance to improve their production methods and to seek out new markets. At the same time, some 115 million square metres of industrial waste land were cleaned up and reconverted, enabling new economic activities to be developed, including leisure and cultural ones. Partly as a result of these measures, unemployment declined by slightly more in these areas than in the rest of the EU, though GDP per head rose by a little less.

More detailed analysis indicates that support for R&D, innovation and technology transfer was particularly effective in creating new jobs or maintaining existing ones, though in general the innovative capacity of most Objective 2 areas remains less developed than in more successful regions. By contrast, endowment of infrastructure and human capital seems comparable to levels elsewhere.

Although the interventions have had positive effects, these might have been greater if both the areas

eligible for support and the scale of operations funded had been bigger and if the time horizon for projects (three years) had been longer. These changes would enable programmes of more strategic importance for regional development to be supported.

Support for agriculture, rural development and fisheries

Interventions under Objective 5a during the 1994–1999 period were aimed at improving agricultural efficiency and helping to safeguard the countryside and seem to have been relatively effective in supporting restructuring of small farms in Objective 1 regions.

Interventions under Objective 5b amounted to around EUR 1.2 billion a year and were implemented in areas housing some 9% of the EU population. They seem to have led to some diversification of agricultural production and a growth of activities, such as agri-tourism and environmental services, while helping to renovate villages and develop public services.

In the present programming period, support for rural development has been integrated into a single overall strategy, though divided between two programmes, one subject to the Structural Fund regulations, the other to those of the EAGGF-Guarantee. The latter are designed for agricultural market policies and not well adapted to multi-annual action programmes.

The fishing sector is concentrated in a limited number of regions in peripheral parts of the EU, which have been hit by the measures taken to preserve fish stocks and where, accordingly, interventions under the Common Fisheries Programme can contribute significantly to the development of other economic activities

Promoting employment, education and training through the ESF

During the 1994–1999 period, the European Social Fund (ESF) provided support for the development of

human resources amounting to a third of overall Structural Fund interventions, around half going to Objective 1 regions.

Interventions under Objective 3 were aimed at integrating young people, the long-term unemployed, and those at risk of exclusion into employment and at promoting equal opportunities. Interventions under Objective 4 were focussed on helping workers adapt to industrial change. Evidence suggests that the most successful measures were those offering a combination of support, such as guidance, training and job search, tailored to individual needs.

In addition, the ESF provides finance for employment, education and training systems at both national and regional level. In Objective 1 regions, the ESF helped to increase levels of public investment in education and training. Although the European Employment Strategy (EES) was launched when the programming period was already underway, the ESF provided significant support, from 1997 on, for policies included in the National Action Plans for employment (NAPs), especially in the southern Member States

In the 2000–2006 period, the link between the ESF and the EES has been strengthened considerably. With a budget of around EUR 60 billion overall, the ESF has become the main Community financial instrument underpinning the EES, and the EES, in turn, provides a stronger policy framework for ESF interventions and employment creation.

Promoting cooperation and networking

Community Initiatives are designed to promote innovation, partnership and the development of collaborative ventures between countries and regions, addressing needs often unmet by the mainstream programmes implemented under the Structural Fund Objectives.

In the 1994–1999 period, INTERREG II supported three broad types of programme, cross-border cooperation (Strand A), energy networks (Strand B) and

cooperation over regional and spatial planning (Strand C). Most funding went to Strand A programmes for improving the environment, supporting cultural activities, tourism and services for SMEs and assisting the development of transport links, especially cross-border routes. Significant improvements were made, in particular, to border crossings in Objective 1 regions in Greece, Germany and Finland. The main benefits, however, have come from increased contact and better understanding between public authorities and private and semi-public organisations on either side of the border.

During the period 2000–2006, INTERREG III — endowed with around EUR 5 billion — reinforced the cross-border component (Strand A), promoted strategic cooperation at trans-national level on spatial planning themes (Strand B), and favoured cooperation and exchange of experiences between regions (Strand C).

In the future, INTERREG will need to take account of the new context in which border areas represent a larger part of the EU in terms of both population and land area.

The URBAN Initiative covers the 44% of the EU population living in cities of over 50,000 people. In the 1994–1999 period, support amounted to just EUR 148 million a year and was divided between 118 cities. In the present period, this was reduced to EUR 104 million a year divided between projects in 70 cities. The main focus is on small urban neighbourhoods and on encouraging local involvement in schemes which directly affect people's lives. This has helped to raise the visibility of EU structural policy as a whole. It has also helped to attract private investment. On the other hand, the concentration of support on small areas leaves out of scope projects for tackling wider regional issues, such as the relationship between urban and neighbouring rural areas.

The EMPLOYMENT and ADAPT Initiatives supported around 9,300 projects in the 1994–1999 period, involving some 1,6 million people in programmes for

labour market integration and job creation at local level. Projects funded included measures for facilitating access to work and training, support for new sources of employment, help for SMEs to anticipate change and child care support for women to make it easier for them to pursue a working career.

In the 2000–2006 period, EQUAL is focussed on new innovative approaches to combating inequalities and discrimination on the labour market, giving strong emphasis to trans-national cooperation, partnership and the exchange of experience and good practice.

LEADER II provided support in rural areas to around 900 local action groups over the period 1994–1999 from a budget of EUR 300 million a year which was increased to EUR 700 million through co-financing. The main activity funded was tourism, though assistance was also given to SMEs and the development of local products.

With LEADER+ (2000–2006), which has the same annual budget as LEADER II, more emphasis has been put on the pilot nature of projects and cooperation has been made easier.

Pilot innovative actions

Nearly one in three regional authorities across the EU15 has formulated a Regional Innovation Strategy (RIS) or a Regional Information Society Initiative (RISI). The most visible effects of the two Initiatives have been public-private sector partnerships and support for SMEs to access new technologies.

A new system for innovative actions, with Structural Fund support of around EUR 400 million in total, was introduced in 2001 to encourage regions to develop programmes for increasing regional competitiveness through technology and innovation (the Lisbon strategy), applying new forms of ICT (the eEurope action plan) and promoting sustainable development (Gothenburg). So far three out of four regions in the

Union have applied for funding for programmes relating to one of these three themes.

Improving the effectiveness of Structural Fund management

In the last review of the Structural Fund regulations in 1999, there was an attempt both to simplify the system and decentralise day-to-day management to Member States. Though Member States are increasingly responsible for how the Funds are spent, the Commission remains ultimately accountable to the budgetary authority for expenditure. The need before the new funding period is to review the regulations with a view to increasing the effectiveness of the system and further reducing its complexity.

The core principles

Programming, partnership, concentration and additionality have remained the central principles of the Structural Funds since the 1988 reform. Programming, in the sense of planning expenditure over a number of years to achieve strategic objectives, has resulted in greater certainty and more stability and coherence in the policy followed and the projects funded. While the programming period has lengthened as planning capabilities have increased and while objectives have become more quantified, concerns have grown over the complexity and time involved in approving programming documents and over the need to ensure that programmes are flexible enough to adapt to change.

Partnership in the design and implementation of programmes has become stronger and more inclusive, involving a range of private sector entities, including the social partners, as well as regional and local authorities. This has led to better targeted and more innovative projects, improved monitoring and evaluation of performance and the wider dissemination of information of their results, at the price, in some cases, of additional complexity of programme management.

Concentration, in the sense of focusing funds on the areas most in need, has increased over time, though evaluations suggest that resources are still sometimes spread too widely and thinly. In the present programming period, 41% of the EU15 population live in either Objective 1 or Objective 2 regions, though the complicated process of defining the latter led to some fragmentation of regions and excessive dispersion of resources.

Additionality has been largely respected in Objective 1 regions, in the sense that the Structural Funds have supplemented rather than replaced existing public expenditure. However, verifying that this has also been the case as regards Objective 2 and 3 programmes, especially the latter, has proved more difficult.

The search for greater effectiveness

Although expertise in managing the Funds has increased over time, improving the effectiveness of programmes remains a key challenge. The control procedures required are often regarded by Member States as unwarranted given the costs involved and as duplicating national systems. A particular criticism is that present requirements were decided so late that they have led to delays in programme implementation, creating pressure for funds to be spent quickly at the expense of quality. Costs of financial management seem especially high for Objective 2 programmes.

While the management of public funds has improved, it was still the case, in the last programming period, that only a third of Objective 1 projects evaluated were completed on time, while a third were over a year late. In addition, two-thirds of projects were over budget. The discipline imposed by the 'n+2' rule during the current period has contributed to improving significantly the use of structural monies. In 2003, the financial execution of the Structural Funds was close to 100%.

Monitoring is an essential part of the system, but evaluations suggest that it has not been as effective as expected, partly because of the difficulty of collecting

meaningful information. Moreover, the focus on financial issues rather than strategic ones tends to lead to funds being spent where they are most easily absorbed instead of where they might be most effective. Although improvements have been made in the present period by identifying indicators and targets, the former are often not well defined and the latter too broad.

Evaluation has also improved over time, but still varies considerably between Member States in the way it is implemented. Evaluations are now required to be undertaken *ex ante* by Member States, at mid-term in cooperation with the Commission — in time for the results to affect decisions on the remainder of the programme — and *ex post* by the Commission, though only two years after the programme ends. More involvement of regions and Member States in the process might make it more useful and relevant.

To encourage better management, a financial incentive in the form of a performance reserve, with 4% of Structural Fund resources, has been introduced in the present period for allocation in 2004 on the basis of the achievement of programme targets specified initially.

Management systems have in many cases become more decentralised over time which, according to evaluations, has tended to increase their effectiveness by making them more responsive to regional needs.

The challenge of enlargement

The Structural Funds are of key importance to the new Member States in helping them strengthen their competitiveness. Over the period 2000–2006, the accession countries are receiving some EUR 3 billion a year from ISPA (for transport and environmental projects), SAPARD (for agriculture and rural development) and PHARE (for strengthening economic and social cohesion and administrative and institutional capacity). After the 10 new Member States enter the EU, they will continue, together with Bulgaria and Romania, to be eligible for PHARE assistance for three years (totalling EUR 1.6 billion a year).

Under ISPA, 324 projects had been approved by the end of 2003, divided fairly evenly between transport and the environment and, in the former, between road and rail. Under SAPARD, resources amounting to EUR 500 million a year go to support development plans for agriculture and rural areas formulated by the countries themselves.

The new Member States will be eligible for support from the Structural Funds over the period 2004 to 2006. Support, amounting to some EUR 21.8 billion in total over the three years, will be concentrated on a limited number of priority areas to maximise impact and minimise problems of programme implementation. The priority areas selected by the countries differ markedly in terms of the relative importance attached to spending on infrastructure, human resources and productive investment, in part reflecting differences in the prevailing state of the capital stock in these respective areas.

The need to develop a strategic approach and to focus on a limited number of priorities, highlighted during the negotiations, is to be maintained in the implementation phase. In addition, special attention will need to be given to ensuring the maximum coherence between the Structural Funds and national policies, to environmental considerations and to equal opportunities. At the same time, the issue of administrative capacity remains a concern, despite the progress made at both national government and regional level, though experience of actually implementing programmes will help strengthen capacity.

From this and other perspectives, the 2004–2006 period can be regarded as a transitional one, allowing the new Member States concerned to prepare the ground for the next, and much longer, programming period.

The challenge ahead for structural policy in the new Member States is:

- to identify the structural deficiencies in each region which have the most damaging effect on competitiveness and growth potential and to give priority to tackling these first;
- to formulate a long-term development strategy for each region in line with its comparative strengths and weaknesses, which recognises that all needs cannot be tackled simultaneously and which orders investment projects in the light of the interaction between them and the growth path it is intended to follow over the long-run;
- to give due weight to environmental considerations in investment decisions in order to ensure that the growth path chosen is sustainable;
- to avoid excessive concentration of investment in the present growth centres where the impact on economic activity might be greatest in the short-term but which may be at the expense of balanced development over the long-run;
- to help strengthen the administrative capacity for designing, implementing and managing development programmes at regional level.

1 See, for example, T. Padoa-Schioppa, *Efficiency, stability and equity — A strategy for the evolution of the economic system of the European Community*, Oxford University Press 1987, which emphasises that "there are serious risks of aggravated regional imbalance in the course of market liberalisation ... (and) adequate accompanying measures are required to speed adjustment in structurally weak regions and countries ... reforms and development of Community structural funds are needed for this purpose" (pp. 5-6).

2 On this and previous points, see *Agenda for a growing Europe*, report of an independent high-level study group, chaired by André Sapir, July 2003.

