COMPLEMENTING EMU: RETHINKING COHESION POLICY

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Under EMU, the less competitive regions of the EU—usually assumed to be peripheral—have been widely expected to lose ground, yet it is the core of the EU that, so far, has appeared to have suffered from the advent of the euro. This paper looks at the processes behind regional divergence in the EU, and presents evidence on recent and prospective trends as EMU is consolidated. Bearing in mind that the imminent enlargement of the EU will radically change the political economy of the EU’s efforts to assure ‘cohesion’, policy issues are then discussed. Looking forward to the next renegotiation of the Structural Funds, it is argued that difficult decisions have to be taken about the extent and character of EU policy. The option of an open method of coordination for cohesion policy is put forward as a means of resolving some of the hard choices.

I. INTRODUCTION

Although the fall in the external value of the euro, slow growth, and the travails of the Stability and Growth Pact (SGP) have dominated the headlines on Economic and Monetary Union (EMU), it is also important to recognize that the arrival of the single currency significantly changes the framework of economic governance. New problems of adjustment will arise and the adequacy and effectiveness of policy instruments are open to challenge. Most obviously, ‘countries’ that previously had the full range of macroeconomic policy instruments available to them to promote adjustment (at least on paper) become ‘regions’ of the single currency area. However, in contrast to the stylized optimal currency area models from Mundell (1961) onwards, it should be noted that in the policy architecture of EMU, euro-area countries retain (constrained) autonomy in setting fiscal policy and greater autonomy in supply-side policies. Regional policy is a competence both of the supranational and member-state levels.

New forms of regional problems are bound to emerge in the monetary union and a frequently

1 I am grateful to Giuseppe Bertola, Chris Allsopp, an anonymous referee, and participants in a conference held at the European University Institute for helpful comments on earlier versions of this paper.
expressed concern about European economic integration, generally, and monetary union, in particular, has been that it would favour ‘core’ countries at the expense of the ‘periphery’—see, for example, Padoa-Schioppa (1987) and the ‘Delors Report’ (EC, 1989) which mapped out the route that has, largely, been followed to achieve EMU. The reasoning behind these fears has varied and it has never been altogether clear how the two classes of area should be defined, but the political economy inferences have been unambiguous: there has to be some compensatory mechanism to ensure that the losers from integration have an incentive to persevere with it. The EU response has come in the form of the Structural Funds and the Cohesion Fund which, together, now account for about a third of the expenditure of the EU level of government.

From a macroeconomic management perspective, too, there were worries that the conduct of policy would be dominated by the interests of the large core countries, especially France and Germany, while the periphery would have to put up with a wholly inappropriate policy stance. Yet the irony is that, in the first 4 years of the euro, it is the periphery that has prospered while much of the core has suffered. As Figure 1 shows, the slowest-growing economies over the 4-year period 1999–2002 were Germany and Italy, while it is the so-called ‘cohesion’ countries which have been in the vanguard, with only Luxembourg from the core showing prominently. Moreover, according to the most recent European Commission (EC) forecasts published in November 2002 (EC, 2002), the five countries at the top of the chart will continue to have the highest growth rates in 2003 and 2004.

The question, however, is whether these short-term trends (though 6 years is arguably an extended definition of ‘short’) debunk the expectations about the vulnerability of the periphery, or are simply the result of unusual circumstances that will be reversed as the natural order is restored. The first aim of this article is to look behind the theories and some of the emerging evidence to try to answer this question. Bearing in mind that a further enlargement of the EU is imminent and that nearly all the new members will immediately be eligible for substantial support, there will be difficult issues to confront about the future of cohesion policy. The second aim of the article is, therefore, to explore these policy issues. The next section briefly reviews the extent

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Figure 1
Cumulative Growth of EU Member States, 1999–2002 (%)

Source: Eurostat.

It would be interesting to disaggregate to the regional level to see whether that is where the problem manifests itself, but harmonized regional GDP data are simply too out of date to be able to shed light on whether the advent of the euro has made a difference.
I. Begg and causes of regional disparities in the EU. Section III then looks specifically at how EMU, a profound regime change, affects ‘cohesion’. The fourth section highlights some of the problems that policy has to confront, not the least of which is EU enlargement. The article concludes with a review of policy options.

II. EU REGIONAL DISPARITIES AND EMU

‘Cohesion’ is a fundamental aim of the EU. However, it is not an easy notion to define and, although there is often a tacit understanding of what it means, it is open to a variety of interpretations. It arguably embraces inequalities, whether in income, living standards, employment, or environmental conditions, and also has to be seen in terms of opportunities as well as outcomes. The related notion of ‘convergence’ is also germane, though with the emphasis on ‘real’ variables rather than the nominal criteria that were embodied in the obligations member states had to fulfil to be eligible for stage 3 of EMU. Convergence or divergence, however, are long-term processes that reflect both history and the effects of recent trends that shape the ability of a local economy or social group to compete. Cohesion in this latter sense is about ensuring that the least well-off are able to share in the benefits of economic integration, possibly disproportionately.

(i) Causes of Regional Disparities

In practice, in the EU, cohesion tends to be most directly associated with differences in regional performance. Several sorts of mechanisms bear on the causes, extent, and persistence of regional disparities. Four very different (though possibly overlapping) types of regional problem can be identified.

Lack of development has left many regions deficient in the dynamic sectors of activity that have supported economic advances. Such regions, typically, have large, often low-productivity, agricultural sectors and did not experience large-scale industrialization. In much of southern Europe, until quite recently, agriculture remained a dominant industry and there was relatively little industrialization. High ‘natural’ rates of labour-force growth (that is, where the entry of youths into the labour market is substantially higher than the retirement of older workers) have traditionally characterized much of southern Europe, as well as Ireland, and have led to a steady emigration of working-age individuals. Advances in agricultural productivity have meant that fewer workers can be supported by farming, with the result that in such regions there has been a drift of population towards urban centres. This pattern of a shake-out in agriculture is likely to be repeated in many of the countries of central and eastern Europe which are candidates for accession to the EU.

Peripherality, remoteness, or inaccessibility are purely geographical disadvantages that amount to a permanent competitive disadvantage that is unlikely to be easily countered. Most of the currently designated ‘less-favoured’ regions are on the periphery of the EU, suggesting that this, in itself, is a significant reason for support. The notion of peripherality as a geographical one of distance from an economic ‘core’ implies that transport costs are the main obstacle, but it may be more meaningful to analyse peripherality in terms of marginalization in a wider sense. It is also important to note that there are many relatively prosperous regions (Grampian or North Yorkshire in the UK, Bavaria in Germany, or Finland) in ostensibly remote locations, whereas some of the less-favoured regions, such as Hainaut in Belgium or the Saarland, could scarcely be more centrally located.

Loss of competitiveness can arise for a variety of reasons, and can be especially hard to reverse if cumulative processes reinforce the initial loss. In northern Europe, where the decline of agricultural employment occurred at an earlier stage, regional problems are associated mainly with the contraction of old staple industries, especially coal-mining, steel-making, textiles, and shipbuilding. More recently, some regions have been adversely affected by the relative decline of newer manufacturing industries, such as motor vehicles—the West Midlands of England being a prime example—and it is apparent that the ‘sunrise’ industries, such as computer software or biotechnology, are drawn to different sorts of locations (Malecki, 1997). For most of the regions affected by industrial decline, adjustment has proved to be slow and painful, instead of happening quickly as might be predicted by the more sanguine economic theories. In addition, there has been something of a drift away from large conurbations as...
both residents and businesses have found it more attractive to relocate to smaller cities and more rural areas.

The consequences of economic integration can be pronounced where the dismantling of barriers, or a reconfiguration of the policy or regulatory frameworks may in themselves precipitate regional problems. The impact of integration can arise in a variety of ways, and is explored, notably, in the ‘new economic geography’ (NEG) approaches (Krugman and Venables, 1995, 1996; Puga, 1999). If integration tips the balance of industrial organization in favour of economies of scale and scope, the effects may systematically affect a whole region, although the NEG analyses tend to have conflicting views on what the outcomes will be, depending on the assumptions made about labour mobility and wage flexibility. At a macroeconomic level, other mechanisms come into play. In particular, a changed macroeconomic policy mix may have an uneven regional incidence. A general fall in interest rates (expected from the single currency) will favour indebted regions at the expense of creditor areas. Curbs in public expenditure to meet the SGP may result in lower discretionary spending in fiscally weaker regions.

All four categories of regional problem are in evidence in the EU at present. Eastern enlargement of the Union will, moreover, bring new demands on policy. EU policies to promote cohesion (through the Structural Funds and the Cohesion Fund) focus principally on enhancing the long-run competitiveness of weaker regions. Current eligibility rules distinguish between two classes of recipients: the lagging regions (those with a GDP per head relative to the EU of 75 per cent or below—Objective 1 of the Structural Funds) and other regions facing socio-economic restructuring (Objective 2). Nearly all the regions in the former group have been slow to develop and tend to have above average proportions of primary industry. The Objective 2 regions, by contrast, have generally seen an erosion of competitiveness.

(ii) Regional Indicators

A variety of indicators can be used to monitor the well-being of regions, although the most commonly used are GDP per head (a somewhat suspect proxy for income) relative to the EU average, and the unemployment rate, both of which have acknowledged shortcomings. Despite these methodological caveats, the gaps revealed by both types of indicator are sufficiently large to be persuasive. Thus, according to the European Commission’s latest Cohesion Report (EC, 2001), the ten most prosperous regions have a GDP per head three times as high as the ten least prosperous.

These disparities in income are mirrored in other indicators of standard of living, such as possession of consumer goods or access to care services. Moreover, the dynamics of regional growth and convergence have been erratic. As successive Commission reports have shown—for the latest, see EC (2001, 2003) and for more analytical studies, see Rodriguez-Pose (1998) and Tondl (2001)—there had been convergence up to the mid-1970s, but there followed a decade of renewed divergence. During the late 1980s and the 1990s, the least favoured member states did especially well, with Portugal and Greece progressing from around half the EU average (expressed in purchasing power standards (PPS), a measure that makes allowance for differences in price levels) to two-thirds, and Ireland having grown so rapidly that it now exceeds the EU average. Tondl notes that faster aggregate growth in the EU seemed to underpin the gains during the second half of the 1980s, but the convergence that has taken place in the 1990s clearly has other roots. Accession of much poorer countries from eastern Europe would inevitably widen the disparities again, with no clear vision of whether they would be able rapidly to converge.

Unemployment disparities are also great, with particularly high rates of unemployment in the south and west of Spain, in southern Italy, and in the eastern Länder of Germany (Figure 2). In Greece and Portugal, by contrast, unemployment is much less severe, although it is difficult to compare like with like. Comparing the US states with the EU regions at an equivalent level of territorial breakdown, there is a considerably greater spread of unemployment in the Community than in the USA. Explanations for this include the much higher labour mobility in the USA, which tends to equalize unemployment rates, the generally lower level of unemployment in the USA, and the fact that there is greater social protection in much of the Community, which re-
duces pressure to migrate in search of work. Tondl (2001) also points to the extent of previously hidden unemployment becoming overt as an important factor.

It is instructive to compare performance and potential indicators for groups of regions. Table 1 distinguishes between groups of regions by income quartiles and shows some marked, and telling, differences. On this crude averaging, it appears that high-income regions have both higher employment rates and lower unemployment rates, and that these rates fall and rise, respectively, the lower one moves down the income distribution. Similarly, rich regions are characterized by high shares of part-time work and high female activity rates, both of which fall progressively along the income distribution.

Turning to measures of potential, productivity is (unsurprisingly) lower in lower income regions, but productivity growth over the period 1995–9 was pretty uniform. Both low productivity and the low employment rate in the regions in the bottom quartile suggest a much greater scope for expansion in future through ‘catch-up’, yet they also highlight the lags that need to be overcome. Moreover, the relative lack of skills in the working population as measured by the qualifications of workers does not augur well, although the drop in the proportion with only low skill is encouraging. The inference to draw from these admittedly crude figures is that substantial further enhancement of human capital will be needed if the potential for catch-up is to be realized.

The poorer EU member states all have higher shares of employment and activity in traditional sectors—notably agriculture—and it is noteworthy that this is even more emphatically the case for most of the countries expected to accede to the EU. The lagging regions also (see Rodriguez-Pose, 2001) have consistently worse performance on R&D and innovation indicators, both of which relate to long-run productivity potential.

(iii) The Implications of Enlargement

The accession of the Central and Eastern European countries (CEECs) will bring into the EU ten new members (assuming that Bulgaria and Romania join within a couple of years of the eight already agreed) that, collectively, have a GDP per head of just under 40 per cent of the EU average when measured in PPS, but much lower in current prices because of their low price levels, especially for non-traded goods and services. In PPS terms, the spread is from just under 25 per cent in Romania to some two-
Table 1
Indicators of Regional Performance and Potential, by Income Quartile of Regions
(based on a classification of NUTS 2 regions according to GDP per head)

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Top 25%</th>
<th>Upper middle 25%</th>
<th>Lower middle 25%</th>
<th>Bottom 25%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income per head, 1999 (000’ PPS)</td>
<td>28.5</td>
<td>20.5</td>
<td>17.0</td>
<td>11.2</td>
</tr>
<tr>
<td>(growth, 1995–9, %)</td>
<td>1.9</td>
<td>1.8</td>
<td>2.2</td>
<td>2.4</td>
</tr>
<tr>
<td>Employment rate, 2000 (%)</td>
<td>67.0</td>
<td>63.3</td>
<td>61.2</td>
<td>54.7</td>
</tr>
<tr>
<td>Unemployment, 2000 (%)</td>
<td>5.5</td>
<td>7.4</td>
<td>9.0</td>
<td>12.7</td>
</tr>
<tr>
<td>Female activity rate, 2000 (%)</td>
<td>63.6</td>
<td>61.1</td>
<td>58.8</td>
<td>50.8</td>
</tr>
<tr>
<td>Share of part-time, 2000 (%)</td>
<td>14.6</td>
<td>11.9</td>
<td>9.7</td>
<td>7.1</td>
</tr>
<tr>
<td>Productivity growth 1995–9 (%)</td>
<td>3.8</td>
<td>3.4</td>
<td>3.5</td>
<td>3.4</td>
</tr>
<tr>
<td>Share of low-skilled, 1995 (%)</td>
<td>28.0</td>
<td>39.9</td>
<td>49.0</td>
<td>63.0</td>
</tr>
<tr>
<td>Share of low-skilled, 2000 (%)</td>
<td>25.8</td>
<td>35.1</td>
<td>36.4</td>
<td>49.4</td>
</tr>
<tr>
<td>Share of high-skilled, 1995 (%)</td>
<td>18.3</td>
<td>14.4</td>
<td>14.5</td>
<td>11.2</td>
</tr>
<tr>
<td>Share of high-skilled, 2000 (%)</td>
<td>21.4</td>
<td>17.2</td>
<td>17.3</td>
<td>13.4</td>
</tr>
</tbody>
</table>

Source: Table 42 in EC (2002)—derived from Eurostat data.

thirds of the EU average in Slovenia. Only a sprinkling of regions in the accession countries (notably the three capital-city regions of Prague, Bratislava, and Budapest) exceed the 75 per cent of EU GDP threshold for Objective 1 eligibility, and many of the more remote areas of even the more advanced countries have income levels around a quarter of the EU average. This poses major problems, from diverse vantage points, for the future of EU policy on cohesion (Hallett, 2000).

Thus, nearly all the regions of the candidate countries will qualify for the current Objective 1 status. However, if all the candidates accede at once, the average EU GDP per capita would fall overnight, taking many regions currently designated as Objective 1 over the 75 per cent eligibility threshold. In an EU of 25 members (that is, those agreed at the 2002 Copenhagen European Council), GDP per capita would fall by some 10 per cent. As a result, the number of EU-15 regions below the eligibility threshold for ‘Objective 1’ of the Structural Funds would fall sharply. This so-called statistical effect raises measured relative prosperity, even though there is no change in absolute terms. Greek GDP per head relative to EU-25 is 90.6 per cent, just above the threshold for Cohesion Fund eligibility and leaving only three of the Spanish regions below 75 per cent. And only one small region in Germany—Dessau—would remain eligible for Objective 1, while three of the four British Objective 1 regions would lose their eligibility.

III. EMU AND ITS IMPACT ON COHESION

Perhaps surprisingly, there is little consensus in the academic literature on whether monetary union will favour or disadvantage less competitive economies in the EU. Nor is there agreement on the likely impact of the furthering of economic integration that will be engendered by EMU and the accumulated evidence as the euro enters its fifth year provides few obvious answers. Part of the explanation for this uncertainty is that there are so many different mechanisms that bear on the outcomes, and it also has to be recognized that economies with very disparate characteristics cannot easily be treated as homogeneous.

Among the most persistent criticisms of monetary union is that the key adjustment mechanisms that
operate in other monetary unions are largely absent in the euro area (Feldstein, 1997). Principal among these are the stabilizing effect of public finance flows and labour-market reactions, although there is also considerable potential for other mechanisms not only to contribute to adjustment, but also to play a more prominent role under EMU (Begg and Hodson, 2000). The stabilizing effect of top-down public finance flows is widely regarded as one of the most potent means of avoiding regional divergence. Empirical estimates vary widely, but evidence from the USA suggests that between a third and two-thirds of an asymmetric shock affecting a region will be offset by increased public spending or lower tax yields triggered by a downturn (Bayoumi and Masson, 1996). This regional form of ‘automatic stabilization’ of demand is, moreover, reinforced by private savings. Because the EU does not have a large central fiscal authority (barely 1 per cent of GDP) and has little in the way of private insurance flows—especially across borders—it cannot perform this role.

But the argument that the lack of a substantial central budget is a fundamental flaw would only have real force if the incidence of asymmetric shocks were predominantly national. On occasion, this will be true, as in the downturn that hit the Finnish economy in 1990, but for the most part, any shocks are likely to be confined to individual regions and thus amenable to stabilization from the next tier up (that is, the member state). Moreover, in an increasingly integrated EU economy, national boundaries must be expected to be of diminishing salience in delimiting shocks. Indeed, Overman and Puga (2002) find evidence already that there is cross-border clustering of unemployment rates. Whether stabilization flows within the member state are likely to be sufficient will depend on the nature of the shock.

Monetary union has disparate and potentially contradictory effects on cohesion. These can be listed under three main headings, and a typology of effects is presented in Table 2, distinguishing between the shorter and longer runs, and trying to identify the factors that will bear on whether the outcome is positive or negative. It should be stressed, however, that the circumstances of individual regions or countries will potentially alter the predicted effect, and that there is likely to be significant endogeneity in the outcomes. Indeed, endogenous responses may well override the various ex-ante factors listed in Table 2.

(i) Direct Macroeconomic Effects

On joining a single currency, the monetary regime to which countries were accustomed changes, possibly quite markedly. As is well known, the mandate for the European Central Bank (ECB) is to pursue price stability, so that for those countries that were used to high inflation (and, to a degree, to exploiting it to keep the real value of public debt in check and to ease relative price adjustment), the change will be pronounced. It would also be expected to be painful and to require much greater adaptation for such countries than for those (Germany is the obvious comparator) for which the Eurosystem closely parallels what came before in terms of institutional structures and rules.

Despite the shift to the price stability regime, inflation differentials remain, especially in the peripheral economies (though also, at least until 2002, in the Netherlands) where, as noted above, the first 4 years of EMU have seen relatively robust economic performance compared with the core (i.e. Germany and France). Low real interest rates in these boom areas have, arguably, fanned the flames, aggravating risks of asset bubbles. Yet it can also be argued that, virtually overnight, the high-inflation countries have had a windfall gain in policy credibility that will result in permanently lower nominal interest rates, reduction or elimination of risk premia, and, possibly, big cuts in real interest rates. For Ireland, Portugal, Spain, and, latterly, for Greece and the Netherlands, the inflation rates in Table 3 show that real rates (assuming that all countries face the common ECB-set interest rate which has fluctuated only between 2.5 per cent and 4.75 per cent) have indeed been very low throughout the euro period. In some cases this has had an effect similar to that implicit in the ‘Walters critique’ of inappropriately low interest rates that have then induced potential overheating.

In Ireland’s case especially (also in Portugal), a further effect has been rapid asset-price inflation manifesting itself, above all, in the property market, while elsewhere strains have emerged on the current account of the balance of payments. EMU has, in short, been accompanied by signs of macroeco-
Table 2
The Impact of EMU on Cohesion

<table>
<thead>
<tr>
<th>Mechanism</th>
<th>Effect</th>
<th>Incidence and impact on cohesion</th>
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<tbody>
<tr>
<td><strong>Macroeconomic shifts, of which:</strong></td>
<td>Change to the new policy regime recasts established policy signals and rules</td>
<td>Affects all members of EMU, but spatial impact uncertain; depends on willingness, and capacity, to adapt</td>
</tr>
<tr>
<td>Acclimatization in the short-term to new policy settings</td>
<td>Low nominal interest rate; impact on asset prices; but disparities in real rates</td>
<td>Previously inflation-prone regions face over-heating. Thus far, positive for less prosperous areas, but increases prospect of macroeconomic imbalances</td>
</tr>
<tr>
<td>Adoption of stability-orientated macro policy approach</td>
<td>Alters government and financial market behaviour</td>
<td>Most pronounced for those who have to change most, with need for policy learning; risks from Balassa–Samuelson effect for cohesion countries.</td>
</tr>
<tr>
<td><strong>Labour market and transformations of it, of which:</strong></td>
<td>More of the burden of adjustment falls on labour market</td>
<td>Creates problems for least flexible regions. Could aggravate unemployment in weaker regions</td>
</tr>
<tr>
<td>Systems for wage-setting</td>
<td>Influence wage flexibility and scope for short-term adjustment</td>
<td>Potentially damaging for areas with rigid systems and engenders problems of social cohesion (insiders and outsiders)</td>
</tr>
<tr>
<td>Geographical, sectoral, and occupational mobility</td>
<td>Affect medium-term scope for labour-market adaptability to deal with competitiveness problems</td>
<td>Induced pressures from migration; could lead to brain drain (gain). Possibility of aggravated imbalances within countries</td>
</tr>
<tr>
<td>Regulatory setting and institutions under-pinning labour market</td>
<td>Shapes long-term potential for adjustment through supply side</td>
<td>Adverse for less developed economies that lack training provision, especially where de-facto regulation is pronounced.</td>
</tr>
<tr>
<td><strong>Induced effects on economic structure</strong></td>
<td>Market opening accelerates pace of restructuring</td>
<td>Potential threat to least competitive regions. Likely to widen disparities</td>
</tr>
<tr>
<td>Regional industrial specialization</td>
<td>Mix of centripetal and centrifugal NEG consequences</td>
<td>Initially favours core regions; but creates opportunities for low-cost areas. Ambivalent overall</td>
</tr>
<tr>
<td>Concentration of financial services</td>
<td>Lowers intermediation margins; enhances pool of liquidity and supply of risk capital</td>
<td>Regions with weak financial sectors lose activity. Ambivalent overall</td>
</tr>
</tbody>
</table>

*Note:* This builds on the analysis in Ardy et al. (2002); see also: Bertola et al. (2001); Boeri et al. (2002); Calmfors 2001; Morgan and Mourougane (2001).
I. Begg

1. Economic imbalance, although only in Portugal has this been translated into a fiscal position incompatible with the SGP. Indeed, there is more than a little irony in the growing problems that Germany and France have in conforming to the Pact at a time when the majority of the supposedly more vulnerable countries have been doing well. The underlying question, however, is whether the temporary benefits will subsequently be reversed. In practice, the answer will depend on the degree to which the economies themselves adapt, as discussed below.

(ii) Labour-market Adjustment

Under EMU, it is inevitable that more of the burden of absorbing shocks will fall on labour markets, especially where there is what would otherwise manifest itself as a balance-of-payments problem. As is well-established (see, for example, Goodhart, 1989), under a single currency, regions can only adjust via the real economy, with the result that persistent problems of competitiveness ultimately become higher unemployment rates. The two questions that then arise are, first, whether labour markets can achieve adjustment without provoking an undue rise in unemployment, and, second, whether other mechanisms can substitute for the loss of monetary autonomy so as to lessen the burden on the labour market. Labour markets themselves vary substantially, above all between countries, but even to some extent between regions within a country (Soskice and Iversen, 1998; Calmfors, 2001; EC, 2002). As Table 4 shows, there are big disparities in labour costs between countries, with Portuguese nominal labour costs less than a third of those in Denmark or Sweden, while the average of the 11 candidate countries is barely 15 per cent of the EU figure. There are also marked differences in monthly hours worked, with Danes working just over three-quarters of the hours of the EU average, while the Irish work 12 per cent longer, and between direct and indirect costs, largely accounted for by the level of social charges.

Labour-market adjustment can be of various types. Migration and changes in activity rates affect the

### Table 3

<table>
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<tr>
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<td>1.6</td>
<td>2.7</td>
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<td>2.0</td>
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<td>2.1</td>
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<td>2.6</td>
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<td>Luxembourg</td>
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<td>3.8</td>
<td>2.4</td>
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<td>Netherlands</td>
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<td>1.9</td>
<td>2.3</td>
<td>5.1</td>
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<td>1.2</td>
<td>2.0</td>
<td>2.3</td>
<td>1.9</td>
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<td>12.2</td>
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<td>3.5</td>
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<td>2.3</td>
<td>1.6</td>
<td>3.0</td>
<td>2.7</td>
<td>1.9</td>
</tr>
<tr>
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<td>4.2</td>
<td>1.1</td>
<td>1.3</td>
<td>2.7</td>
<td>2.1</td>
</tr>
<tr>
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<td>3.4</td>
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<td>0.8</td>
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</tr>
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<td>1.7</td>
<td>2.4</td>
<td>2.5</td>
<td>2.3</td>
</tr>
</tbody>
</table>

**Note:** Consumer prices (harmonized index) from 1991 where available; deflator of private consumption otherwise.

**Source:** European Commission, Autumn 2002 and Spring 2001 Forecasts.
### Table 5

The *Ada* Index: An Overall Adaptability Index

<table>
<thead>
<tr>
<th></th>
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<td>6.85</td>
<td>69.0</td>
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<td>3.27</td>
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<td>6.92</td>
<td>5.54</td>
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<td>5.62</td>
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<td>3.52</td>
<td>69.0</td>
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<td>7.29</td>
<td>72.2</td>
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<tr>
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<td>71.6</td>
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<td>6.17</td>
<td>5.06</td>
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<td>3.97</td>
</tr>
</tbody>
</table>

*Note:* A higher value implies greater adaptability.

*Source:* Derived from Boeri *et al.* (2002)
supply of labour and, as there are substantial barriers to migration in the EU (Bertola and Boeri, 2001), much more of any change in labour supply will occur through entry or exit of working-age people. Wage flexibility is a second possible route to adjustment, while a third is regulation affecting the speed with which hiring and firing takes place: Garibaldi and Mauro (2002) suggest that countries which have liberalized their labour markets, notably by easing hiring and firing, achieve higher employment rates. On all three counts, the concern about EMU is that the mechanisms are weak, slow, or both. There is, however, also evidence that a fourth route, in which the emphasis is on increasing flexibility by improving employability, has worked well in Denmark (Andersen and Rasmussen, 1999).

In reviewing the character of labour markets, a useful distinction is suggested in a study done for the European Commission by Algoé and Alphametrics (2002, p. 3). They argue that labour-market flexibility (defined as the short-term response of wages and labour costs) is only one (though often critical) component of a broader notion of adaptability, ‘defined as the broad process by which labour markets adjust to exogenous developments over a period of time’. An index computed by Boeri et al. (2002), although admittedly based on rather dated information, shows not only that the least prosperous EU member states have the least adaptable labour markets, but also that their shortcomings are across three distinct dimensions identified by the authors. Table 5, drawn from their work, shows how the different countries rank, suggesting that the Nordic countries are most ‘adaptable’, a contrast with the flexibility that is presumed to characterize the UK, which, on the Ada index, only has an average ranking.

(iii) Medium- to Long-term Competitive Shifts

As Krugman (1998) makes clear, NEG offers an analytic approach with a greater degree of formal modelling than much conventional regional analysis. It does not, however, yield unambiguous predictions about the *ex-ante* effects of integration on the core and the periphery. Factors identified by Krugman favouring centripetal effects resulting from removal of barriers include economies of scale, linkages encouraged by agglomeration, and thicker labour markets. Centrifugal effects include the impact of congestion, lower property and labour costs, and immobility of factors of production. Consequently, the outcome for regional disparities will depend on the relative strengths of different mechanisms and the impact on them of different policy choices.

Further consolidation of the single market is occurring both because of measures in specific sectors (notably, at present, financial services and major network industries such as energy and telecoms) and the direct effects of monetary union. The effect on cohesion will be positive to the extent that it encourages the spread of capital and technology, especially if the induced impact on trade of monetary union is as powerful as Rose (2000, 2001) claims. In this regard, the nature of restructuring will be critical. Takeovers that remove indigenous control from economic activity in the region and change the stages of production adversely can be damaging in some circumstances. The demand side can also be influential, given the anchor role in an economy that is often played by public procurement.

The interplay between specialization, regional disparities, and economic integration is widely considered to be critical (Hallett, 2000). Table 6 shows at a very aggregated level that the least prosperous member states have a relatively high share of agriculture and correspondingly low activity in business services—also broadly true of even the more advanced of the CEEC candidates. Specialization is central to the NEG approach to the analysis of the EU (see, for example, Amiti, 1999), not least because of the comparison with the USA, where specialization is greater. Midelfart-Knarvik and Overman (2002), in a study of the effects of structural support for less-advantaged regions, find that the regions that have adapted most successfully have increased their specialization within manufacturing. This is put forward as evidence that the sort of specialization predicted by NEG should be allowed to happen, rather than being countered by intervention.

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3 Faini et al. (1997) even suggest that the lack of migration in spite of growing unemployment differentials between regions has become a puzzle.

4 Persson (2001), using a different methodology, argues that the Rose results are vastly overstated, whereas Kenen (2002) finds them to be positive, but not as large as Rose does.
An alternative perspective on specialization flows from analyses in the economic geography and evolutionary economics traditions. The former stresses the role of institutions and social capital, while the latter suggests that it is only by being in the ‘right’ sort of industries that a region (or country) gains. Several of the contributions to Fagerberg et al. (1999) stress this point. Indicators show unambiguously that there is a strong concentration of technological performance and innovation in a small number of leading regions (EC, 2001; Simmie and Wood, 2002). Rodríguez-Pose (2001) examines the impact of R&D spending in different EU regions and notes that, although R&D is spatially very concentrated, the recent trend has been for the lagging regions to gain at the expense of more prosperous areas. But despite the recent growth, the absolute level of R&D in lagging regions remains low and much of it is the direct result of policy support. Nor is it necessarily the case that there is a direct correlation between the better R&D performance and the improved growth rate observed, as the latter may be explained more convincingly by other factors.

(iv) Endogenous Responses

Hitherto, much of the analysis of how members of a newly integrated currency area will adapt endogenously has been in terms of the trade-integrating effects of monetary union (Frankel and Rose, 1998; Rose, 2000). This, in turn, is seen as conducive to faster growth, although predictions about the regional distribution of such gains are rarer. The contention here is that it is necessary to look beyond trade creation—without belittling its significance—to consider the behavioural and policy-setting consequences of monetary integration and the ensuing regime change. Such endogenous responses to currency union can be expected in labour markets and, more generally, in the behavioural relationships that underpin policy choices. In particular, for countries, the burden of restoring competitiveness shifts from the exchange rate to the labour market (Allsopp, 2002). This, however, is precisely the sort of mechanism that has always been to the forefront for regional economies within nation states.

Some consequences are predictable and can be expected to have quite marked impacts. Thus, we know that inflation rates will fall simply because that is what the ECB is obliged to deliver. In member states which have been accustomed to high inflation and regular indexing (whether formal or implicit) of pay rates, the switch to a regime of price stability will represent a substantial behavioural change. The evidence to date is that the process of acclimatization has happened relatively straightforwardly, with no evidence of disruption to bargaining or wage-setting arrangements. As Table 3 shows, the change for the four, previously inflation-prone, southern European member states has been marked, certainly compared with the late 1980s. But can it last, especially if workers in low-pay economies start to compare wage rates with other parts of the euro area? Judging by the continuing moderation in wage demands, it seems likely that EMU will, indeed, assure a new regime of lower wage inflation, but that will depend on whether the ECB is able

<table>
<thead>
<tr>
<th></th>
<th>Agriculture and fishing</th>
<th>Industry</th>
<th>Business services</th>
</tr>
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<tbody>
<tr>
<td>Greece</td>
<td>11.0</td>
<td>-5.0</td>
<td>-1.4</td>
</tr>
<tr>
<td>Portugal</td>
<td>5.3</td>
<td>4.1</td>
<td>-4.3</td>
</tr>
<tr>
<td>Spain</td>
<td>2.7</td>
<td>-1.0</td>
<td>-1.3</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>1.0</td>
<td>10.7</td>
<td>-3.5</td>
</tr>
<tr>
<td>Poland</td>
<td>14.0</td>
<td>3.6</td>
<td>-4.8</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>5.2</td>
<td>7.1</td>
<td>-5.1</td>
</tr>
<tr>
<td>Romania</td>
<td>34.0</td>
<td>3.1</td>
<td>-7.5</td>
</tr>
</tbody>
</table>

Note: A positive figure indicates that the country has a share higher than the EU average, and vice versa. Source: Figure 162 in EC (2002).
One key change expected to result from EMU is that a fresh fillip will be given to financial integration. This will arise from a combination of single-market measures (under the umbrellas of the EU’s Financial Services Action Plan and the parallel Risk Capital Action Plan) and the advent of the single currency. Research conducted by Giannetti et al. (2002) suggests that countries with what they describe as a ‘weak financial structure’ (such as Belgium, Denmark, Greece, and Italy) are predicted to benefit most from lower capital costs, while those which have already achieved a relatively high level of financial development (such as the UK, Sweden, and the Netherlands) are predicted to benefit little. It is likely that such benefits will be even more pronounced for regions that have still more backward financial sectors. However, Giannetti et al. warn that there may be a price to pay in that the financial sector itself in weaker regions may lose ground precisely because it has been backward.

IV. THE POLITICAL ECONOMY OF COHESION

The conflicting views on the causes, consequences, and significance of regional disparities are not just theoretical debates, because they bear on the difficult decisions about the future of EU regional policy. Moreover, from a macroeconomic perspective it matters whether the EU economy is spatially balanced. Lack of such balance could greatly complicate the setting of macroeconomic policy, as emphasized in a seminal article on regional policy by Kaldor (1970). Faced with the existing regional disparities in the EU-15, the imminent enlargement, and the additional impact of EMU, how should EU cohesion policy evolve? A related question is whether market integration is, or is not, at odds with the aim of assuring cohesion (for a range of views, see Hall et al., 2001), and, especially, whether monetary union aggravates or diminishes any adverse effects. That some form of EU regional policy will continue is not really in question, if only because assuring cohesion is a Treaty obligation and the Structural Funds are the designated instrument in the Treaty, but the philosophy, scale, spread, and instruments to be used are open to debate.

Even so, there are critics of regional policy who believe that the solution for regional problems is, largely, to rely on market mechanisms, especially private capital flows, to counter regional disadvantage (Braunerhjelm et al., 2000), and that regional policy is ineffective and wasteful. Boldrin and Canova (2001) are particularly disparaging about the apparent shortcomings of EU regional policy, although their methodology is criticized in most of the comments appended to their article. It is also important to recognize that transformation of a regional economy takes a long time and requires consistent effort, rather than being visible quickly. That said, as Puga (2002, p. 373) notes in a more nuanced critique, ‘despite large regional policy expenditures, regional inequalities in Europe have not narrowed’.

Midelfart-Knarvik and Overman, (2002, p. 351) argue that policy ‘is encouraging relocation counter to comparative advantage’, but also that ‘regional comparative advantage . . . is severely restricted by the fact that factor price returns tend to be equalized within nation-states due to the centralized nature of wage-setting’. The trouble with this conclusion is that it offers no concessions to the ambition of structural policy to transform the competitive (as opposed to comparative) advantage of assisted regions. Nor, with their focus exclusively on manufacturing, does it allow for disparities in the service industries, despite the fact that the latter are often central to the prosperity of such regions.

Certainly, there is only limited evidence about whether or not EU cohesion policy—or, indeed, regional policy in general—works. Although evaluation has been given a progressively greater weight in policy implementation (Bachtler and Turok, 1997; see also the successive regulations governing the Structural Funds), studies of the impact on out-turns (for example, that on Ireland by Honohan, 1997) are the exception rather than the rule.

(i) Assuring Cohesion

One of the most fundamental challenges is to resolve what should be done by the EU level and what

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5 Launched in 1999 to restore the momentum for completion of the single market in financial services.
should be left to member states. This in turn raises the question of whether the EU level should focus exclusively on the forms of public investment it supports at present, or aim for a different role. In particular, should the EU level contribute to stabilization policy, as advocated in the MacDougall report (EC, 1977) published over a quarter of a century ago? Pragmatically, the answer is no, because the required increase in the EU budget is implausible. But the implication is that member states have to create room for manoeuvre to allow automatic stabilizers to work.

Three broad categories of cohesion policy objectives can be enumerated.

- **The first is competitiveness-enhancing measures** aimed at correcting shortcomings on the supply side of the economy that result in a deficient economic performance.

- A second category of cohesion measures is those that *boost demand* in an area and thus act in a *preventative* manner to forestall the emergence of disparities.

- Third, there are measures that deal, above all, with the consequences of a lack of cohesion, with a focus on *solidarity and palliative measures*.

It can be argued that Community policies should be confined strictly to the first category, leaving member states to deal with other dimensions: in principle, this is already the implicit division of labour. Nevertheless, persistent regional disparities typically reflect a lack of competitiveness that will only be altered by concerted policy action, suggesting that improved coherence between national policies and the Structural Funds should be a priority. In thinking about how cohesion policy should evolve, and assuming that some form of EU policy will continue, four key questions can be put forward.

- **Which regions or member states should benefit from EU support?** Accepting that the candidate countries will, mostly, be eligible, should EU regional policy continue to be offered to richer member states at all?

- **How much?** EU spending on ‘structural operations’ is already thinly spread. Raising it would imply ‘taxing’ richer member states more heavily: is this politically realistic and even if it is, to what degree?

- **What mechanisms?** The modalities of EU regional policy have been stable since 1988, but the time may be ripe for a fresh look at such matters as: the regional (as opposed to national) focus for at least some countries; or the co-financing arrangements. A review of the content of policy would also be timely, especially the use of less traditional instruments such as technology support or education (de la Fuente and Vives, 1995).

- **How does explicit regional policy fit into the broader policy framework?** The issues here include how EMU and cohesion policy interact, and how national policies should be integrated with EU policies. An important aspect is how the tensions between state aids and cohesion policy can be reconciled.

At present, support from EU ‘structural operations’ in Objective 1 regions amounts to 220 euros per head of the population in eligible regions (up from 187 in the 1994–9 programming period), while in Objective 2 regions it is 41 (down from 46). All the member states also spend substantial amounts on ‘state aids’ intended to support economic development (Table 7), despite the best efforts of the Commission—wearing its pro-competitive hat—to curb their use. Only a minor proportion of this state aid is for the explicit regional policies of the member states, but the table nevertheless shows that, for Germany and Italy especially, domestic policy greatly outweighs EU transfers. In addition, all member states promote social cohesion through social protection systems which redistribute resources from dynamic to weaker regions.

There is, plainly, a strong case on equity as well as political grounds for EU support for the least prosperous areas of the soon-to-be-enlarged EU, and a case could even be made on efficiency grounds. Budgetary restrictions are expected to be stiff in the next EU Financial Perspective, with little disposi-
tion among the net ‘donor’ countries to increase the EU budget ceiling from its current 1.27 per cent of EU GNP, or to increase the aggregate resources for structural operations. However, now that accession negotiations have concluded, the new members will soon be in a position to exert a strong influence on future deals.

For the period from 2007 to (probably) 2013, a reinvented Objective 1, the bulk of which will go to the new member states, is a racing certainty. Despite reservations about value for money and policy effectiveness, there is a political bargain behind cohesion policy that is unlikely to be challenged. It is also a pretty safe bet that most of the areas in EU-15 set to lose Objective 1 status will be offered a gradual weaning-off, rather than brutal cuts in Structural Fund support. But, for the EU-15, it is likely that the scale of regional assistance from the EU level will have to be cut, although by how much is both disputed and open to negotiation. Calabria, Andalucia, or Thuringia will be no better off in absolute terms because new, poorer members accede to the EU, even though their GDP per head relative to the new (lower, post-enlargement) EU average rises. There are echoes here of the well-known debates about relative and absolute poverty lines.

For the new member states due to enter the EU in 2004, a deal on structural transfers was, with some difficulty, agreed for the remainder of the current round of the Structural Funds up to 2006. Beyond this transitional period, it is widely expected that transfers will be capped at 4 per cent of GDP in current euros. Given that the aggregate GDP of the ten CEEC candidate countries in current euros is just over 4 per cent of EU-15, the cost of structural operations in the CEECs would be a very manageable 0.18 per cent of EU GDP. A perverse consequence of the 4 per cent cap is that the biggest per-capita cost to the EU budget would be for the most prosperous accession countries (Slovenia at 393 euros per head) while the transfer per head to Bulgaria would be just 63 euros. The 4 per cent limit has been set to reflect what any receiving nation can reasonably absorb and to this degree makes sense, especially if it is recognized that much of the expenditure would fall on the construction sector. Equally, if the money is used to purchase goods and services from abroad at world prices, rather than indigenous output at domestic prices, the least well-off will be penalized by the mechanical operation of the 4 per cent rule. This, plainly, is a thorny issue.

Also germane to enlargement is the question of how any development support should be provided. Given the needs of the new member states, a shift of emphasis towards national economic development, rather than regional, would probably make sense. It is, however, unlikely that the disciplining devices of co-financing and Commission oversight of programmes will be relaxed. It will also be important to learn the lessons from past shortcomings in policy in EU-15.

(ii) EU Cohesion Policy in Richer member states

The real challenges are about EU regional policy in richer member states, for which budgetary resources will be scarce. Many regions will continue to face problems and new ones are bound to arise. Put bluntly, however, why should the problems in the eastern Länder of Germany or the conurbations of the UK be dealt with by the EU level rather than directly by the member states? There simply is not an easy answer. On the one hand, regions that have EU-funded programmes in place argue forcefully that they still need assistance and that continuity of support is vital. A frequently articulated fear is that if the support from Brussels is withdrawn, it will not be replaced by national schemes and long-term initiatives will be disrupted. On the other hand, channelling so much of the regional assistance through ‘Brussels’ rather than national administrations could be adjudged to impose a needless additional tier of bureaucracy. Supporters of EU policy, in its defence, point to the longer-term character of Structural Fund support, the benefits of a different model of economic development, and the opportunity for greater coherence. Detractors, even if they acknowledge these benefits, maintain that once these ‘process’ benefits have been realized, the arguments for the EU level diminish.

In several national capitals, questions about whether the EU should continue to have a strong role in regional policy are becoming louder. In part, this is because there is a fuzziness at the heart of cohesion policy that makes it difficult to judge whether it is well-conceived (Begg, 1998). EU policy has, in addition, been subject to regular criticism, some fair,
some motivated more by wider political machinations, about whether or in what ways the EU adds value. There is, too, concern in many quarters that the resources allocated to cohesion policies are often poorly used, too thinly spread to be effective, and inadequately monitored, with the implication that comprehensive reform is needed. The argument that it makes little sense for money to be sent to Brussels, for conditions to be attached, then for it to be returned to the member state is both colourful and compelling.

The stakes were raised by the UK government (2003) when it published a consultation paper in which it canvassed a substantial ‘repatriation’ of regional policy for the better-off member states. While acknowledging that the policy thinking had benefited from the approaches adopted under the Structural Funds, the paper argues that the lessons have now been learned, so that continuing to accept the restrictions imposed by ‘Brussels’ no longer afforded benefits to offset the costs in terms of additional bureaucracy. To many local actors this point of view may seem disingenuous, as they fear that the member-state level might not substitute adequately for the EU support that is lost, either because it would set different priorities or because short-run budgetary imperatives might see the continuity of regional funding disrupted.

State aids raise a further dilemma for cohesion policy. On the one hand, it is entirely reasonable for any member state anxious to limit regional disparities to use regional subsidies as part of its policy response.\(^6\) On the other hand, the widespread use of state aids in relatively prosperous countries and regions could counter the effects of EU support for the least prosperous economies by reinforcing the competitive position of the stronger countries, quite apart from any concerns about distortions of competition. One factor in this regard is that the less prosperous countries can least afford state aids.

\[^6\] There are lively, if inconclusive, debates among practitioners and academic commentators about the virtues of the many policy approaches and, in particular, whether subsidies to firms are effective compared with ‘bottom-up’ policies (for an overview, see Armstrong and Taylor, 2000).
V. CONCLUDING REMARKS

As EMU is consolidated, attention will inevitably focus not just on the overall performance of the EU economy, but also on whether the fruits of economic growth are equitably distributed and on whether the EU economy is spatially balanced. The fact that it is the periphery of the EU that, thus far, has been the main beneficiary of monetary union is, at first sight, encouraging from the perspective of economic and social cohesion. Whether it will last is an open question: favourable macroeconomic impacts and the advantages of improved market access have to be set against continuing competitive weaknesses, problems in the labour market, the productivity gap, and the lack of potential of the less competitive regions.

The political challenge is how to recast cohesion policy, bearing in mind that some of the biggest net contributors to the EU budget stand to lose one of the principal means by which they are seen to receive some return from what they pay into the budget. None of the options is easy.

- One would be to accept that all member states can no longer necessarily receive support from the Structural Funds. This would, in principle, be equitable, but would exacerbate resentment about the scale of net contributions by the richer member states.

- A second, apparently favoured by Regional Policy Commissioner Barnier, would be to recast the current Objective 2, so as to offer a menu of support options to each member state. This ‘something for everyone’ approach might be politically more palatable (and in this context, the value of even some level of support is not to be under-estimated), but risks spreading the funds too thinly. It can, however, be argued that the thrust of policy should be much more towards achieving the aims set out at the Lisbon European Council in 2000 to boost EU competitiveness, especially in knowledge-intensive activities.

- A third option, increasing the cohesion expenditure budget, would be deeply unpopular among net contributors, especially those that are struggling to maintain the disciplines of the SGP.

- Finally, there could be re-nationalization of regional policy, as advocated by the UK government (2003).

Looking beyond the current round of the Structural Funds, and bearing in mind the new environment introduced not just by monetary union per se, but also by the transformations it has wrought in the wider policy framework, the time may be ripe for articulating a new approach to cohesion policy. Instead of trying to squeeze a quart or more out of the Structural Funds’ pint pot, it might be better to look for a radical alternative. Cohesion is clearly affected by a broad range of policies, including macroeconomic management, employment policy, and social protection systems (EC, 1997; Buti et al., 1999; see also the contributions to Bertola et al., 2001), as well as explicit regional policy. In the areas of employment and social policy, the development of the ‘open method of coordination’ (OMC), has allowed for a form of integration through common policy objectives and guidelines, while leaving implementation to member states. Rather than imposing rules and disciplining mechanisms, the OMC operates by encouraging policy learning and by peer review and benchmarking. It can be argued that for the richer EU countries, a similar approach might be envisaged for cohesion policy, while Community support is concentrated on the less well-off member states. The proposal from the UK government to repatriate regional policy in richer member states (UK Government, 2003) hints at such a solution, but it is worth exploring in greater detail.

How might an OMC approach work? Following the example of employment policy, the starting-point would be to set out objectives for both regional development and equity. Governments would then be asked to put forward comprehensive strategies for achieving these objectives, to commit themselves to meeting targets, and to show how national and EU-level policy instruments contribute to the policy aims. Monitoring by the Commission would then provide a check on whether the policy aims were being met. In this way, regions that lose support from the EU level would expect their national governments to provide viable alternatives. The key to success will be for member states to recognize that cohesion aims as espoused by the EU are worth pursuing, but that they can be achieved by nationally tailored policies. Plainly, therefore, gov-
Plainly, therefore, governments would have to accept long-term responsibility for maintaining the spirit of current EU policies.

An acknowledged drawback of OMC, however, is that it relies on the willingness of member states to participate and lacks the means of enforcement to compel them to conform. Scharpf (2002) has proposed the use of framework directives enacted at European level to underpin these ‘soft law’ agreements, and it may be that such an approach would, indeed, make it easier to countenance using the method for cohesion policy. Ultimately, though, OMC can only be effective in achieving shared aims if member states have the political will to make it happen.

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