NEED FOR REGIONAL POLICY AND SOME THEORETICAL BASIS

Zsuzsanna Trón

Debates about structural spending and its distribution always flare up whenever a new budgetary period is discussed in the European Union. While poorer countries reason for the increase of Structural Funds, the countries paying net contribution emphasise that the underdeveloped regions hardly seem to have worked off any of their disadvantage, despite relatively high spending and structural support. The current paper summarises the basic theoretical approaches of the two parties and tries to detect these approaches in the formation of Brussels' policies. The first part of the study is devoted to the need of regional policies and its theoretical basis, including the theories of convergence and divergence. Next, the conflicting interests and driving forces shaping regional policies are examined. Finally, the author asks whether spending by the Structural Funds can be justified at all in the light of the highlighted processes and achieved results.

The Third Report on Economic and Social Cohesion (EC 2004), published at the end of February 2004, confirmed the same as the previous ones had, i.e. the income disparities among member states were increasingly narrow, but they remained constant among the regions of the European Union. Although the 'cohesion countries'[1] had been gradually working off their disadvantage (resulting in a decrease in disparity among the member states), regional disparities stagnated, even showing some increase in the member states in 2000. The regions with the lowest and highest per capita GDP (Ipeiros in Greece and Inner London in Britain) had 47% and 241% of the EU average, respectively (see also the table in EC 2003: 12). The income disparities in the most and least developed regions did not change at all between 1990 and 2000. It is worth giving a second thought as regional spending has permanently amounted to one third of the total spending since 1994, which will correspond to a total of €213 billion between 2000 and 2006 (EC 1999a).

According to the Commission, the results justify the need for continuing the balanced regional policies in all of the regions of the EU (EC 1999a:8). Others

[1] 'Cohesion countries' are Ireland, Greece, Spain and Portugal

(Boldrin-Canova), however, ask whether these transfers can be justified and are right at all or if they are just political issues. It may make one meditate whether these transfers should be further increased[2], continued in a similar or different fashion (Hervé 1999; Midelfart-Knarvik – Overman 2002) or if this kind of regional policy should be discontinued.

The paper reveals interests playing a role in the formation of regional policies and examines the Structural Funds, the main method of the common redistribution policy of the European Union. It provides a summary of the relevant literature and emerging problems thus laying the grounds of a study examining the Structural Funds in which the Funds are analysed as high amount fiscal transfers from the point of view of macroeconomic efficiency.

NEED FOR A REGIONAL POLICY

The European Union, which is a deepened form of integration, is simply expected to contribute to our economic growth and development through establishing a single market and introducing the Euro. According to economics, bringing down the different barriers will result in the intensification of positive economic effects through efficiency, and resources will find their way to the most cost-effective investments. This is how economic welfare will improve everywhere. It should be noted, however, that profits resulting from efficiency are not evenly distributed among the participants in freely competing markets. As early as the mid-1970s, it was clear in the Union, too, that the newly entering countries with different conditions were 'rewarded' with different profits (quite often losses) by the integration. The resulting profit inequities may induce economically favourable structural changes (i.e. in location and component factors) supposing different macroeconomic conditions, i.e. prospering markets and a free flow of factors. But if the conditions are not given (or too short time is available to correct for structural adjustment) structural changes will yield different results in the economies in question. In the EU, a supranational integration, a remedy for the emerging social problems is expected to come from sources from the common budget.

---

[2] Barnes (1995) The Enlarged European Union. Longman London, quoted by Kengyel (1999) p.139.

Owing to the above, two policies have been given increasingly strong emphasis in the Union. One of them is competitive policy, the importance of controlling state support by which independent national interventions can inhibit structural adjustment and, as a result, state support will function as a commercial barrier again. On the other hand, the advantages of structural changes are distributed unevenly among the member states. Uneven distribution, however, may directly work against cohesion, i.e. the goal of the Union. That is why regional policy is so important.

Let us see what the goal of the regional policy of the Union is. In 1957, the Treaty of Rome was aimed at strengthening the economic units of the Community and ensuring their harmonic development. After regional problems had emerged, the inclusion of provisions 130a-e in the Single European Act in 1988 (provisions 158-162 according to the current nomenclature) dealt with structural policy as part of corporate policy. The provisions say that the Community develops and continues its activities aimed at strengthening social cohesion in order to promote harmonic development in the whole of the community (quoted by Fazekas 2000:142). Therefore, the aim of regional policy is to help achieve the primary goal set by the Community. This statement will be of special importance later in the paper.

Cohesion, i.e. the development of community spirit is an idea difficult to interpret. Basically it means a 'distance' between individual regional or social groups, which is still acceptable from the moral and social, and, in the first place, political points of view. One of the most important tasks of economics in this field can be the study of these differences and the elabouration of appropriate tools to handle them, in addition to the follow-up of existing tools.

It is interesting to review what Hungarian researchers of this field think the aims and tasks of regional policy are. Gyula Horváth (1998:17) puts his ideas as follows: "The aim of regional policy lies in the reduction of negative features induced by economic processes on the one hand, and regional policy is also aimed at lifting the barriers interfering with the spread of innovative economic activities on the other hand." In Rechnitzer's opinion (1998:21) the aim is "…to ensure the effective utilisation of resources, equalise the differences in regional structures, thus ensuring nearly identical conditions for life or at least the chance for them." As Ákos Kengyel (1999:67) wrote in his book, "Regional policy means the intervention in economic activities, made in the interest of reducing social and economic differences between the regions." These 'aims' reflect different theoretical approaches.

Boldrin and Canova (2001:213-217) wrote a brief summary of the theories serving as the basis of Brussels policies concerning economic growth and trade. Following their logic and including minor modifications two main streams are distinguished: the theories of convergence and divergence.

Theories of Convergence

Models developed from Heckscher-Ohlin's traditional neoclassical theory[3] have come to the conclusion that factor returns come closer to each other by abolishing duties and establishing common markets. Of course, this model is true in traditional cases, i.e. it requires perfectly functioning markets and an unlimited flow of factors. Presuming exogenous technological progress, a well formalised, single-sector neoclassical theory of growth predicts straightforward convergence; it is considered as the strong hypothesis of the theories of convergence. In addition to the traditional theory (including the capital, work, productivity of all factors) these models also contain human resources, natural factors, public goods and effects of political stability. According to the weak hypothesis of the theory of convergence, socio-political conditions may inhibit technological adaptation, but at least hinder it. So it appears that convergence can be promoted by supporting competition and free trade, i.e. via widespread technology, in the first place. Keeping the goals in mind, the Preamble of the Treaty of Rome included similar ideas but the goals of cohesion and the Hungarian experts in question talk about more than just that.

Theories of Divergence

The new theories contradict the theories of convergence, mainly because they are based on the bitter experience of developing countries. In this approach, the basis for growth is provided by beneficial externalities and, at the aggregate level, the resulting increasing returns. This induces competition among the regions, i.e. instead of resulting in convergence, it results in divergence. This is called the strong version of the theory of divergence. The source for growth is ensured

[3] Based on Krugman-Obstfeld (2003).

by high fixed costs, all-pervasive increasing returns and externals, comparative advantages or the competitive situation only serving as secondary factors. Krugman and Venables (1996) call attention to forces of agglomeration and expectations in the first place. The force of agglomeration urges companies to become geographically concentrated as a result of localised external economies of scale. Expectations sometimes lead to the following situation: If Country A offers better prospects in terms of salary and profit than Country B, capital and work will start flowing from B to A, which further deepens the differences between the two countries.

These theories predict different outcomes. While some forces are against governmental development (as this would result in the fast mobility of the most productive factors)[4], others emphasise the initiative roles of the government due to the high fixed costs and beneficial externalities, as these projects can only be profitable if the number of projects amounts to a critical mass. This can justify EU support and allowances allocated to companies and projects in poorer regions. But it only applies if the aim is sustainable growth and not economic efficiency in the whole of the Union.

However, the weak hypothesis of the theories of non-convergence only claims that inputs (human capital, R&D activities, accumulation of minimum stocks of physical capital and infrastructure) resulting in externalities should reach certain threshold levels. If there is no political intervention, or if the intervention is inadequate, the regions become clustered and the clusters will be determined on the basis of the initial state of factor supply. This is the so-called ‘club-convergence’ (Boldrin-Canova 2001:215).

It is also worth examining what results individual theories predict concerning the choice of premises and relocation of different industrial sectors. Table 1 shows the possible results of profound integration, depending upon the mobility of factors and forces of agglomeration.

[4] E.g. the best skilled would leave the underdeveloped region, which would worsen the chances of growth in that region.

Table 1. *Possible results of European integration*

Agglomeration gains / **Mobility**	**Small**	**Large, but only on the industry level**	**Large, across industries**
Low	Geographical dispersion	Localization	
Labour: Low, Capital and firms: High	Specialisation and factor price equalization	Industry "black holes"	Polarization
High			One black hole

Source: Midelfart-Knarvik, K.H. & Overman, H.G. (2002: 327)

The mobility of factors keeps growing as we proceed downwards in the lines, while proceeding from left to right in the columns we can see increasing advantages of agglomeration, and the nature of agglomeration also changes. The first column may belong to the theories of convergence, which do not count upon the results of agglomeration. At low factor mobility, companies will settle near the factors of production, suppliers or, possibly, the market; unlimited mobility of the capital, work and companies leads to specialisation and the equalisation of factor prices.

If agglomeration forces are considered (theories of divergence also do so), in a way in which connections between industrial sectors are regarded close, the concentration of certain industrial factors can be expected ('industry black holes').[5] If the connections between the sectors are strong, a large industrial centre or cluster results in one of the central regions ('one black hole'). But what happens when the connections of companies in the different industrial sectors are strong but the workforce is immobile? Even in this case it is possible that a widespread geographical agglomeration of industrial activities is seen. This cluster seems similar to the one when the workforce was still mobile, but welfare results reflect great differences. In the case of a mobile workforce, people move to the central region, and so everyone profits from the integration. But in our example industrial and capital owners move, but the workforce does not follow

5 A welfare problem, i.e. the settling of industrial clusters in certain regions or countries, bringing higher profits to these regions than others, may emerge here. The settling of high-tech industries can serve as an example.

them. This is suggestive of the polarisation of welfare elements; disparities between central and peripheral regions grow.

REASONS FOR COMMUNITY INTERVENTION

In real life, the functioning of the economy and the market is characterised by overflows and information disorders; that is, the failures of the markets themselves. Factors outside economic considerations, i.e. social factors are also important. Traditionally, governments try to intervene for two reasons: in the name of efficiency and equity (Stiglitz 2000).

Considering efficiency, community interventions try to correct for the functioning of the market. According to the traditional economic approach these measures should destroy the barriers and points of friction in free trade in order to let effective resource allocation take place. Aggregate welfare will grow owing to the fact that these formerly misused factors are utilised in a better position in production.

Equity is based on the idea that it is morally unacceptable when certain layers or groups of the population fall behind or if income disparity is too striking; decreasing the differences between the different social groups will improve social welfare (the feeling of the total utility). Such governmental interventions can be well illustrated by the general level of public wealth (e.g. drinking water supply) in every area, central transfers for the poorer regions or the introduction of uniform safety and welfare standards in the social area, affecting the employees, and also the introduction of social security systems (old-age pension, unemployment benefit).

As far as efficiency is considered, the aforementioned industrial clusters may have undesired results in case agglomeration forces do not strengthen but, on the contrary, counteract comparative advantages. National empirical results provided by Midelfart-Knarvik and Overman (2002) justify the gradual development of industrial clusters in the European Union. If there is any explanation at all for EU interventions, it may be as follows: (1) the industrial clusters have developed in the 'wrong' place, therefore they delay the efficiency of resource allocation, or (2) market forces distribute the more valuable industrial clusters unequally among the countries (Midelfart-Knarvik – Overman, 2002:328).

These two ideas concerning the reasons of intervention do not exactly define the rate of redistribution. It should always be based on precise calculations, although it is mostly decided by political compromise.[6]

Mention must be made here of the criticism of governmental intervention, too. Should efficiency be the issue, governmental activities are always criticised by economists. Stiglitz (2000) called attention to both the failures of market mechanisms and an increased moral risk owing to transfers.

Do results justify the efficiency of intervention by the Union?

Hervé (1999) denied the statement by the European Committee claiming that the regional financial transfers coming from the Structural Funds and Cohesion Fund might successfully contribute to Greece, Ireland, Portugal and Spain approaching the average per capita GDP in the Union, if a collective budget policy is applied. The claim by the Committee was merely based on ex ante macroeconomic simulation models. These models basically presume that EU transfers result in a rise of growth-stimulating budgetary spending, which is at least as much as the transfer itself. In the case of Ireland, Portugal and Spain, the analysis, covering 20 years, could not disprove the hypothesis that EU regional transfers had no positive effect on the growth-stimulating budgetary spending. In the majority of the cases, transfers resulted in a rise of budgetary spending not having a stimulating effect on growth (Hervé 1999).

Although examining polarisation on the regional level and looking at 'equity'-based distribution of clusters Midelfart-Knarvik and Overman (2002) found community interventions justified, but they do not think the current policy is right.

Artner (2002) emphasised that there were necessary and adequate conditions to effectively exploit the potentials in the regional policy of the EU. The conditions include the liberalisation of the donor country, increase in productivity (especially work productivity), technological development and macroeconomic stability. But the efficiency of structural policy is also affected

[6] In a 1977 report by MacDougal, the necessity for interregional transfers amounting to 22.5% of the aggregate GDP of the member states was proposed. According to the calculations by Barnes, at the request of the Committee in 1995, transfers amounting to 1% of the GDP would significantly decrease regional differences (Kengyel 1999).

by factors such as the initial state of the economy, degree of exploiting funds, the system of goals and resources and the learning process accompanying it.

On examining the efficiency of interventions[7] Boldrin and Canova (2001) first wanted to clarify what the goal of the EU was. They gave their conclusions as follows: If the aim of the EU is to maximise aggregate economic growth in the EU15, the current policy is not adequate and has to be changed according to the model initiated by the Committee's own report. These changes should support the strengthening of agglomeration and divergence. On the other hand, even if the aim of the EU is to support poor regions and help convergence and promote convergence, the policy represented be the Committee cannot be justified despite the highly authentic statistical means.

This is not an easy situation. But how can one easily give his opinion of a regional policy in which transfers and support programmes, unable to hold their original grounds, have become stable. Why is it that policy making in the EU implies that, in the case of decreasing support, donor countries have to present new reasons to get transfers from Brussels at all, instead of simply reducing the existing ones? This question may be answered if one examines the power to enforce interest within the community.

CONFLICTING INTERESTS

There are two approaches to explain why Structural Funds exist and what their functioning and development are influenced by. According to some authors (e.g. Allen 2000) their existence is merely explained by a high level international deal which was arranged between the governments of the member states and the European Committee. This approach does not put emphasis on the interests of the regional parties.

According to the other view, the foundation of the Structural Funds presents a challenge to the autonomy of the governments of the member states. They may feel threatened 'from above', owing to the supranational power of the Committee on the one hand, and 'from below', from regional level, on the other one. Supporters of regionalism and the concept of the 'Europe of the Regions' presume the Structural Funds and their institutions are driving

---

[7] Many economists suggest a management approach to the Structural Funds during efficiency investigations and monitoring (Sauerborn & Tischer 2001, Bauer 2001)

forces of regionalism (Keating 1997). Regional organisations have had an increasingly greater role in the community policies.[8] The followers of this idea have introduced the term 'multi-level governance' and examined the division of tasks at regional, national, community, decision-making and executive levels (Sturm 1998). An interesting study has been devoted to the role and headway of the regions of member states, with different domestic constitutional structure, in the regional policies of the Union. Börzel (2001) highlighted that although the federalised Germany and the regionalised Spain started their journey at different points on the path of enforcing their regional interests, they were able to successfully and flexibly introduce institutional changes solely via a regional strategy, in strong co-operation at governmental level.

It is worth looking at some of the continually changing lines of interest and areas of conflict within the European Union disregarding completeness for the moment being (based on Forman 2001). A member state can be either the net beneficiary or loser of a concerted agricultural policy (France and Denmark, and Great Britain and Sweden, respectively). Certain countries, e.g. the Netherlands, signed, while some others, e.g. Great Britain, refused to sign the Schengen Agreement. Some other groups are based upon whether a country also belongs to the EMU (the Netherlands, Ireland) or has decided not to join this organisation (Denmark, Great Britain); rely on nuclear energy (France, Belgium, Great Britain) or do not make use of it (Germany, Sweden), let alone the ones which do not even want to hear about it (Austria, Italy). Lines of interest have formed on the grounds whether a country is scared by the prospect of workforce overflowing the Union after the eastern extension of the EU (Germany, Austria) or not (the Netherlands, Denmark, Sweden). What could be most interesting for us is whether a country acts as a net contributor to the common budget (Germany, the Netherlands, Austria, Sweden) or if the country is a beneficiary (Italy), or if a country is a donor (Spain, Greece) or financer of the Structural Funds.

Several reviews have been published about the regional policy of the EU, even in Hungarian (Horváth 1998, Kengyel 1999, Forman 2000).

---

[8] A statement, having prevailed especially since the reforms of 1988.2. Haselsteiner, IDM-Info 3/1996

CONCLUSION, OR WHAT MAY THE FUTURE BRING?

The aforementioned views do not help much in foreseeing the future. ‘Scenarios’ by Illés (2002) may help us with researching the future. He also thinks that the system of decision making and ‘side-payments’ lie in the core of the problem. Concentration should be enforced and priorities should be decreased. But the institutional conditions of the candidate states should also be considered, for as they are regionally still poor they will be able to meet the requirements by the union slowly and with difficulty.

Parallel to these conditions there is another vision of the future in which intervention by the Union will continue according to the old rules. In that case, only a few of the regions in the candidate states will be excluded (Prague, Bratislava, Central Hungary) but a significant part of the cohesion countries, the area of the former GDR, will also be excluded. The workload of administration will increase and 90-100 underdeveloped regions will have to be considered instead of 55.

According to the ‘differential’ approach by Illés, different systems would apply to the old and new members. But this would drift the task of regional development into a politically sensitive area. He suggests a variety, in which support will be restricted to the poorest regions only and the circular flow of money will stop. The danger in this case, however, is that many countries would lose interest in maintaining the system.

A ‘horizontal’ approach might lead to renationalisation. Brussels will lose its role, or it will be restricted to enforcing the basic rules alone. Support by the Union will become more differentiated, but, at the same time, it will be integrated into the national systems of support and central regionalisation will come to an end. In the author’s opinion, if uniform policy is discontinued the differences are more likely to increase (Illés 2002).

It is up to Europe to choose from the possibilities. And she must choose! Therefore it should be decided whether the goal is sustainable development or economic effectiveness in the whole of the Union. The Third Report on Economic and Social Cohesion (EC 2004) can help to analyse this, but that would be another study to write.

References

Artner A. (2002). Az EU struktúrapolitikájában rejlő lehetőségek tagországi tapasztalatok alapján, különös tekintettel Írországra és Görögországra. MTA VKI. *Kihívások*. Vol. 153. April. pp. 1-14.

Allen, D. (2000). Cohesion and the Structural Funds. In: Wallace H.-Wallace W. (ed.) (2000). *Policy Making in the European Union*. Oxford University Press. pp. 243-265.

Bauer, M. (2001). *A Creeping Transformation?*. Dordrecht – Boston-London: Kluwer Academic Publishers.

Boldrin, M. & Canova, F. (2001). Inequality and convergence in Europe's regions: Reconsidering European regional policies. *Economic Policy*. Vol. 32. April. pp. 207-245.

Börzel, T. (2001). Europeanization and Domestic Institutional Change: Toward Cooperative Regionalism, In: Green, C., Caporaso, J. & Risse, T. (eds.). *Transforming Europe: Europeanization and Domestic Change*. Ithaca – London: Cornell University Press. pp. 137-158.

EC (1999a). Presidency Conclusions. Berlin. European Council 24 and 25 March 1999.

EC (2003). Second Progress Report on Economic and Social Cohesion. Commission of the European Communities. Brussels.

EC (2004). Third Report on Economic and Social Cohesion. Commission of the European Communities, Brussels. http://europa.eu.int/comm/regional_policy/sources/docoffic/official/reports/cohesion3/cohesion3_en.htm. Downloaded on 2004-02-25.

Fazekas, J. (ed.) (2000). *Az európai integráció alapszerződései*. Budapest: KJK-Kerszöv.

Forman, B. (2000). *Regionális politika az Európai Unióban*. Budapest: VÁTI.

Forman, B. (2001). *Az Európai Unió strukturális és előcsatlakozási alapjai*. Budapest: Európai Bizottság Magyarországi Delegációja.

Hervé, Y. (1999). EU regional transfers and macroeconomic fiscal reaction in the cohesion countries: An empirical analysis. Prsentation at the World Bank. Washington. (University of Saarland). pp. 1-29.

Horváth, Gy. (1998). *Európai regionális politika*. Budapest-Pécs.: Dialóg Campus.

Illés, I. (2002). *Közép és Délkelet-Európa az ezredfordulón*. Budapest-Pécs.: Dialóg Campus.

Keating, M. (1997). *The Political Economy of Regionalism*. In: Keating, M.& Loughlin, J. (eds.) (1997). *The Political Economy of Regionalism*. London: FrankCass. pp. 17-40.

Kengyel, Á. (1999). *Az Európai Unió regionális politikája*. Budapest: Aula Kiadó.

Krugman, P. & Obstfeld, M. (2003). *Nemzetközi gazdaságtan*. Budapest: Panem.

Krugman, P. & Venables, A. (1996). Integration, Specialisation, and Adjusment. *European Economic Review*. Vol. 40. pp. 959-967.

Midelfart-Knarvik, K. H. & Overman, H. G. (2002). Delocation and European Integration: is Structural Spending Justified? *Economic Policy*. Vol. 35. October. pp. 323-359.

Rechnitzer, J. (1998). *A területi stratégiák*. Budapest-Pécs: Dialóg Campus.

Sauerborn, K. & Tischer, M. (2001). Evaluierung und Monitoring der europäischen Strukturförderung als Qualitätmanagement zur Förderung einer nachhaltigen Entwicklung. Informationen zur Raumentwicklung. 6/7. pp. 409-421.

Stiglitz, J. E. (2000). *A kormányzati szektor gazdaságtana*. Budapest: KJK-Kerszöv.

Sturm, R. (1998). Multi-level Politics of Regional Development in Germany. *European Planning Studies*. Vol. 6, No. 5. pp. 525-536.

Wallace H. & Wallace W. (eds.) (2000). Policy Making in the European Union. Oxford University Press.