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# WHAT TO REFORM IN THE EUROPEAN BUDGET?
## Some reflections on the stakes of the current budget review process

**Dragoş Negrescu***

***Abstract.*** *The EU budget is the financial tool supporting European integration. The way it has developed over decades, both as concerns revenues and expenditure, superposed to a complex decision-making process, where member states retain veto rights in crucial respects, means that it currently displays a significant inertia, while its size and structure are not the most appropriate for endowing the Union with the means allowing it to best react to the present-day challenges. Tensions are also rising between the national interests of individual members and the common interest, which previous attempts to reconcile by way of special treatments granted to some countries are clearly unsustainable, while inducing additional rigidities to the budgetary construction. This obviates the need for a comprehensive reform, which the 2008/2009 budget review that the Commission was mandated to undertake may set in motion. The following paper attempts at taking stock of the most significant problems in need of a solution and to explore the most appropriate ways available for tackling them.*

***Key words:*** *EU budget, EMU, European tax, VAT*

The EU budget is an unprecedented construction. Its significance surpasses by far that of the budgets of any international organisation (be they as developed and substantial as those of the UN or the Bretton Woods institutions), but at the same time it displays far more limitations than either national or federal budgets: with a size of just about 1% of the Community's combined GDP, it is dwarfed by the percentages of at least 15% (going up to over 50%) that exist in any ("non-failed") state of the of the world. This feature reflects, at the end of the day, the special nature of the entity – the European Union – that this budget is meant to serve: a strong emphasis on regulatory (as opposed to allocative or redistributive) functions and a lack of competencies in precisely those areas which burden the most public budgets in general: social security, health, defence, public order etc.

There is, however, an important additional explanation for the small size and, hence, the limited functions of the Community budget, which may be expressed as the "fundamental dilemma of the EU finances"[1], namely the fact that, although collectively interested in fulfilling some common goals in the most effective and efficient way, the member states have an individual desire to secure the most favourable net balance out of their interaction with the budget. This is a good illustration of the pitfalls of the "logic of collective action", as identified by Mancur Olson.

The institutional framework of the budgetary process is very complex, in spite of its successive reforms carried out by way of amending the Treaties or decisions made at the level of the European Council. The

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[1] Iain Begg, Friedrich Heinemann: *New Budget, Old Dilemmas,* CER Briefing Note, February 2006, p.1

Commission enjoys its typical prerogatives of sole right of initiative and of implementation (execution) of the budget, but it does so in a particular way: its proposals for the annual budget have to abide by the spending constraints contained in predetermined "multi-annual financial perspectives" (hereafter, MFPs) and strengthened by the legal obligation of a perfect balance between revenues and expenditure, while for some 80% of the funds it is ultimately responsible of, the actual management is either sub-delegated to other Community institutions or exercised jointly with the member states. The Council and the Parliament are the two arms of the so-called "budgetary authority", but their prerogatives are distinct from those they exercise in any of the classical forms of Community decision-making (consultation, cooperation, or codecision). The power of decision concerning the resources of the budget is strictly reserved to the Council (and, moreover, requires unanimity), while that on the expenditure structure (not size, since this automatically derives from that of resources) is split between the two bodies, each having the last say as concerns one part of the outlays: "compulsory expenses" are the realm of the Council, while "non-compulsory expenses" are ultimately decided by Parliament, with some limitations of its room for manoeuvre. Either arm of the budgetary authority has the possibility to veto the entire budget, be it implicitly (the Council, by withholding its agreement on the size and structure of the compulsory expenditure), or explicitly (the Parliament, by voting down the entire draft budget). Exercising this option amounts to a very serious setback to the proper functioning of the Community, yet it occurred four times in the past, twice because of Parliament (1979 and 1984) and twice because of the Council (1982 and 1986). Laborious negotiations were then required to avert a complete blockage of the Community activities, which obviated the need for a more lasting solution.

This was found, as from 1988, in the so-called MFPs which set, for a longer period (7 years, currently), the maximum amount of resources available and, on this basis, the amount and structure by large categories of expenditure. The MFPs are subject to tripartite (Commission, Parliament and Council) Inter-Institutional Agreements (hereafter, IIAs), the current legal status of which is ambiguous, as they do not constitute secondary legislation in the proper sense of the word. This feature would be corrected by the Lisbon Treaty, which provides that "the multiannual financial framework" will be established by a European Law of the Council, the approval of which will require the unanimous consent of the Member States in the Council and the acquiescence of a majority of MEPs.

**Overall context of the reform process**

The IIA of April 2006, which paved the way for the approval of the 2007-2013 MFPs, mandated the Commission to "undertake a full, wide ranging review covering all aspects of EU spending, including the CAP[2], and of resources, including the UK rebate, and to report in 2008/9".

While the prevailing expectations concerning the concrete final outcome of this undertaking tend to strike a skeptical note, there are also views which, drawing a parallel with the mid-term 2003 CAP review (which unexpectedly led to some radical decisions, dubbed the "Fischler Reform"), do not rule out the possibility that at least some important

[2] Agricultural expenditure was practically excluded from the negotiation of the current MFPs, having been „frozen" in real terms by a Franco-German agreement which received the endorsement of the European Council of Copenhagen in December 2002.

steps forward towards reforming the EU budget may occur as a result. While it is unrealistic to expect any significant alteration of the current MFPs, which are the result of protracted negotiations, leading to complex and elaborate trade-offs impossible to undo without tearing apart the whole fabric on which the overall balance of concessions was based, there is a good chance that improvements agreed as a result of this reflection process will start being implemented as early as the next multiannual programming cycle.

What renders plausible a significant, rather than gradual and piecemeal (as used to be the case until now), reform of the Community budget is the accumulation of problems which, left to develop further, risk blocking this essential instrument of the European construction. To begin with, the increased EU membership, whereas the "newcomers" will no longer be prevented to take part in the crucial decisions concerning the financing of agriculture, will make reaching an agreement on the MFPs even more difficult than was the case until now. Secondly, the continuous increase of the proportion of budget revenues clearly attributable to direct contributions from Member States can only enhance national approaches focused on securing the most favourable net balances, to the detriment of privileging the pursuit of the Union's general interest. Furthermore, and linked to the above consideration, the pressures for extracting new *ad hoc* corrective/compensatory arrangements (of which there are already several, the "UK rebate" being just the most visible of them), combined with the insistence of the current beneficiaries to preserve theirs, risks complicating the construction of the budget beyond the border of reasonableness. Finally, an overall structure of expenditure further determined by path dependency more than by the goals that the EU has set for itself will become an ever growing obstacle to their fulfillment.

It is beyond doubt that, ultimately, political economy considerations and particular interests of member states will significantly shape the outcome of this exercise. Nevertheless, to the extent that making substantial progress is crucially important, the content of the reflection launched by the Commission in its Communication of September 2007[3], has to be informed by solid considerations of principle. A starting point is offered by the fiscal federalism theory, which suggests two important orientations:

a) financing through the Community budget of European public goods, the identification of which rests on simultaneously applying the criteria of: *critical mass*, which cannot be attained by isolated interventions of individual member states; and *impossibility to assign individually* (at the level of member states) *the benefits* of common policies financed out of the Community budget;
b) generating value added through Community financing, thanks to *economies of scale* which can be reached by pooling together the resources of Member States.

As often recalled by academics and politicians alike, the European Union is not (as yet?) a federation, hence the theory of fiscal federalism cannot be fully relevant for the EU budget debate. It should be mentioned, however, that the precepts of fiscal federalism are somehow reflected, under the name of subsidiarity, in the theory and practice of European integration, the said principle stating

[3] European Commission: *Reforming the Budget, Changing Europe. A public consultation paper in view of the 2008/2009 budget review*, SEC(2007)1188 final, Brussels, 12.9.2007

the need for involving the supranational (Community) level only in those cases where its intervention elicits better results than those of the intervention by individual member states. Other principles derived from the Community construction are also useful for guiding the reform of the EU budget. Such is the case of:

- proportionality, which – in this particular context – may be regarded as the corellative of subsidiarity, and which obviates the need that Community intervention limits itself to what is strictly required for reaching the goals set; and
- additionality, which refers to the need that Community resources do not simply replace national funding which would had been forthcoming absent this financing. This principle has been applied so far in the context of EU's regional policy, but it would be usable to other chapters of the Community budget as well, even if not to all of them.

Last, but not least, the EU budget must be a tool adapted to the largest extent possible to the need of reaching the Union's goals, i.e. something which obviously presupposes their correct identification. This may induce a certain tension between the goals explicitly stated in the Treaties and those deriving from other documents. From a "legalistic" perspective, for instance, the absolute preeminence of the goal of the "Lisbon Strategy" – which many recent studies dedicated to the EU budget reform are taking for granted, but which derives from an instrument typical for the "open method of coordination", not for the "Community method" – may be questioned, especially when it is emphasized to the detriment of the Common Agricultural Policy, whose legal bases are clearly laid down in the Treaty (TEC).

Since the budget review is meant to be, in keeping with the requirements of the IIA, full and wide-ranging, one can legitimately infer that institutional aspects, as well as the decision-making procedure itself, could also be touched upon. Otherwise, this would implicitly limit the extent to which the reform of the revenue and spending parts of the budget can be envisioned.

### Budget decision-making and procedures

The unanimity rule, and hence the possibility of any member state to block, in the process of adopting the MFPs, the attribution of adequate budget revenues and/or the allocation by large chapters of Community expenditure, is a formidable institutional constraint, which can only grow as the number of EU members increases and the gaps between their net balances widens. Aware of the prospects of a mounting difficulty from this point of view, the Convention on the Future of Europe, which debated the first draft of the now failed Constitutional Treaty, proposed a switch to qualified majority voting starting already with the current MFPs (2007-2013). This idea was to be subsequently dropped by the Member States in the context of the ensuing Inter-Governmental Conference.

Apart from national selfishness, easy to understand though not also to condone, which dictates the preservation of veto rights, one has to admit that there are also systemic considerations which go against the replacement of the unanimity requirement with qualified majority voting, at least in its current form (or the one it would take in keeping with the Lisbon Treaty provisions). This is because abandoning unanimity in these circumstances would render theoretically possible that a majority of member states decides to alleviate their own burden by transfering a larger part of

it on the shoulders of the minority, or that net beneficiary member states impose even higher contributions on those with already negative net balances.[4]

A compromise solution might nonetheless exist and it could consist of giving up the unanimity requirement in favour of a particular type of qualified majority, applicable solely to major budgetary issues (resources and multiannual breakdown of expenditure ceilings by large categories) and inspired *mutatis mutandis* from the vote allocation in the framework of the international financial institutions (IMF and the World Bank), that is, by weighting the voting power of any member state with the proportion of its "national" (as opposed to the traditional EU "own resources") contribution to the Community budget. This obviously entails complicated methodological problems which may not be solvable in an ideal manner, but the clear advantage of such a voting mechanism is that it has a built-in "moderating device" since, as some member states would be pushed by the majority towards larger contributions, their capacity to oppose this grows correspondingly, up to the point of being able to block the most excessive initiatives deriving from the "reverse selfishness", i.e. that of the large net beneficiaries.

An alternative way of smoothing the decisions requiring unanimity would be to dilute the relevance of the "net balances", which could be achieved by assigning the largest proportion, among the revenues of the budget, to genuine "own resources", this being tantamount to instituting true "European taxes".

[4] Simon Hix: *The Budget of the European Union*, in "The Political System of the EU", Palgrave MacMillan, 2005, p.306-7. For a similar argument, see also Friedrich Heinemann: *The EU Budget Must Get Rid of the Distribution Burden*, Intereconomics, September/October 2001, p.79

Relinquishing the unanimity requirement in the Council would result in an enhanced influence of the other two sides of the "institutional triangle", namely the Commission and Parliament. Given the special significance of the budgetary process (deriving from its historical relevance for the concept of sovereignty, as well as from its special visibility for citizens), increasing the legitimacy of these institutions in the eyes of EU citizens would become very important in order to defuse national temptations to preserve the current veto rights. Once the issue of qualified majority decision-making gets solved, resulting in increased roles for the Commission and Parliament, the current (7 years) time-span of the multiannual budgetary cycles would lose any logic and would need to be modified so as to coincide with the "political" cycles, determined by the moments of election/designation of composition of the two bodies and the duration of their mandates. It should nevertheless be mentioned that such a solution is met with reservations in some quarters, on grounds that, on the one hand, it would render negotiations with high stakes (hence, prone fo failure) more frequent than is currently the case and, on the other hand, it would further "politicise"[5] the budget decision process, though it has to be pointed out that the latent tension between feasibility and legitimacy considerations does not necessarily be solved in favour of the former.

Another required procedural improvement, even if less important than the ones already explored, pertains to the relaxation of the strict requirement of annual budget balancing. From the standpoint of *opportunness*, several macroeconomic considerations would plead in favour of such

[5] Henrik Enderlein et al.: *The EU Budget. How Much Scope for Institutional Reform?*, ECB Occasional Paper No.27, April 2005, p.18

a measure. They are linked to the particular circumstances induced by the functioning of the EMU, which means that, as the "Eurozone" enlarges, they will become even more persuasive. There is, thus, the argument – derived from the theory of the "optimum currency area" – according to which losing the possibility to have recourse to monetary and exchange rate policy tools in order to counteract economic shocks with asymmetrical effects requires more centralisation of fiscal policy and its counter-cyclical use. Concretely, one may envision that, should an economic recession localized at the level of just some member states occur, the centralised budget steps in and supplies resources meant to bridge the gap between the national and the EU/"Eurozone" growth rates.[6]

In the context of the EMU, the need for such a lever is magnified by the fact that other adjustment mechanisms that could operate in such adverse economic circumstances are relatively ineffective (than is the case, for instance, in the USA): labour mobility is low because of cultural and linguistic barriers and the labour market is relatively inflexible, thus leaving little room for wage adjustments. Moreover, the constraints imposed by the Stability and Growth Pact on the use of national budget levers further limit the reactive capacity of individual national economies. What is more, in a single market context, in which the high degree of opennness of national economies may lead to a situation whereby a large part of the national budgetary stimuli may "leak" in the absorption of additional imports, hence in stimulating partner economies as well, the assumption of such a function at the supranational level may be regarded as equivalent to supplying a "European public good".[7]

Assigning a stabilization function to the European budget would represent a natural complement to its current allocative and redistributive functions which, in particular circumstances, may themselves exercise destabilizing effects. Indeed, for at least some member states, Community funds allocations are important (significantly over 1% of GDP) and, moreover, concentrated in some sectors, which magnifies their pro-cyclical impact. Thus, for instance, over 10 billion EUR-worth of structural funds were injected in Spain in 2000-2006, mostly in the construction sector, substantially contributing to its overheating, which is now being regarded as one of the main sources of vulnerability for the Spanish economy. Finally, the amounts available in the Community budget, because of the rigidity of their use (in particular, the impossibility of transferring them towards subsequent budget exercises), are being absorbed at a speed which is not dependent on (nor even adjustable according to) the phase of the national economic cycle.

The only *opportunness* consideration which seems to point against assigning a macroeconomic stabilization function to the Community budget pertains to the fact that the effectiveness of the fiscal tool, which economic theory presupposes, is severely affected in practice by the lack of timely information concerning the emergence and nature of the asymmetric shock (which would indicate to what extent the budgetary lever could play the role of a corrective device), as well as by the often significant time lag between the moment when the budgetary tool starts being used and the one when its corrective virtues begin to be felt.

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[6] Jorge Nunez Ferrer: *EU budget and policy reforms to promote economic growth*, ITPS Working Paper no.15, 2007, p.32

[7] Sebastian Dullien, Daniela Schwarzer: *Integrating the the Macro-economic Dimension into the EU Budget,* EU-Consent Working Paper No.4, August 2007, p.7

*Feasibility* considerations are the weakest point when it comes to assigning a stabilization function to the Community budget. Giving up the unanimity rule is, anyway, a *sine qua non* condition in order to allow the Community budget to assume the role of an automatic stabilizer, but not also a sufficient one. Such an instrument is, realistically speaking, conceivable only in the framework of a true federation, where the perception of solidarity among its members is stronger than is currently the case within the EU. Secondly, exerting a stabilizing function requires reaching a critical mass of resources that can be mobilized in the case of an asymmetric shock, which, depending on the severity and localization of the shock, may reach substantial dimensions, equivalent to 1-5% of the Community GDP. As long as the size of the whole EU budget continues to hover around just 1%, its ability to fulfill a stabilization function will remain negligible.

**Expenditure reform**

The current structure of the EU budget expenses is, to a large extent, the result of transactions between the member states reached at various critical junctures of the European integration process. Thus, the privileged position of agriculture among the various destination of budget outlays is routinely attributed to the "founding trade-off" between the German interest in open markets for industrial goods and the French desire for comprehensive support of its large agricultural sector. Later on, the massive increase of structural funds between 1984 and 1992 reflected not just the accession to the EC of three considerably less prosperous new members (with *per capita* GDP of less than half that of the existing ones) but, even more so, it played the role of softening the opposition of some member states (typically, the less wealthy of them) towards implementing the crucially important projects of the Single Market and the EMU. In the rigid decision-making framework described above, which renders radical changes extremely difficult, these transactions have induced a strong path dependence for the EU budget outlays. Under such circumstances, the structure of the Community expenditure could only by accident have been optimal.

But even the co-ordinates of what an "optimal" structure entails are a matter of debate. This is not only because, as mentioned above, since the EU is not a federation the commandments of fiscal federalism are only partly relevant, but it is also the inevitable consequence of the fact that the practical operationalisation of such theoretical criteria as internalising externalities, exploiting economies of scale or preference homogeneity is far from being straightforward. Besides, while it is relatively uncontroversial to agree that the Community budget should serve the attainment of EU's goals, there can be diverging views both with respect to their concrete identification and as concerns the extent to which fulfilling these objectives requires budgetary support (as opposed to regulatory intervention, for instance), as well as the extent to which, if required, this support should be provided from the supranational budget.

From Article 3[8] of the Treaty on the European Union, four important objectives can be "distilled":

- establishing a space of freedom, security and justice without internal borders;

[8] Which is a recasting and renumbering, by the Lisbon Treaty, of the current Article 2 TEU.

- sustainable development, based on balanced economic growth, price stability and a highly competitive social market economy;
- supporting economic, social and territorial cohesion, as well as solidarity among member states;
- contributing to the peace, security and sustainable development of the planet, to free and fair international trade, poverty eradication and human rights protection.

The former two objectives have a budget correspondent in the expenditure chapters devoted to internal policies, the third is covered by the "cohesion" chapter of the budget, while the latter is supported financially by the external actions ("EU as a global actor") part of the budget. In other words, none of the stated objectives has been ommitted by the current budgetary construction. Of course, the size of their financial coverage matters a lot, but this is an issue far more difficult to gauge in a rigorous manner, the more so that the means of pushing forward these goals have a very significant regulatory component, which is largely prevalent in all cases, except economic cohesion (which, being subject to the pressure of the agglomeration effects engendered by the free movement of products and production factors within the borderless internal market, requires redistributive compensatory interventions of relatively large dimensions). Hence, the fact that structural funds will come to represent at the end of the current multiannual programming period the largest expenditure chapter of the Community budget can be regarded as a *prima facie* indication that this requirement is being satisfied. There are, of course, details which need to be assessed more thoroughly in order to validate this assumption.

Before moving on to the individual assessment of the main expenditure chapters of the Community budget, which is an inescapable requirement for identifying the desirable reforms, it is useful to highlight a trade-off which several recent studies, following the path opened by the "Sapir Report" of 2003, have singled out as the indispensible element of any substantial reform of the Community budget expenditure, that is, the abandonment of the centralised budgetary support for agriculture in favour of substantially increasing the outlays destined to implement the "Lisbon Strategy", that is, primarily, of the amounts earmarked for R&D, education and trans-european infrastructure networks (TENs). While very convincing at first glance, such a radical recommendation conceals (or, at least, minimalises) numerous considerations which do not lend it support. The most important of these would seem to be that there is a critical mass which expenditure devoted to incresing the competitiveness of the European economy needs to reach in order to be efficient and there are good reasons to doubt that this can be attained against the background of total Community expenditure capped at just 1% of the combined GDP of the EU, out of which an incompressible percentage of at least 10% has unavoidable destinations: administrative expenses and those for external actions. Hence, an expenditure reform predicated on the notion of keeping the total size of the budget largely unchanged elicits serious doubts as to the rationality of refocusing it on the "Lisbon Agenda" at the cost of crowding out other categories of expenses.

Secondly, the solidity of the legal basis of the two categories of expenses which the "Sapir Report" and its followers are putting in direct competition would seem to favour agriculture. The application of a common policy in this field is explicitly provided for by the primary legislation (the Treaty establishing

the European Community – TCE), and its co-ordinates are defined by a vast body of secondary legislation, whereas the goals of the "Lisbon Strategy" are only generically referred to in the primary legislation (currently, Article 2 TUE) and its co-ordinates are not set by way of the "Community method"", but by the far less legally binding "open method of co-ordination". These distinctions are not deprived of practical relevance. At least as long as the CAP will retain an important market intervention pillar, and the Community's stance in the context of the WTO Doha Round negotiations seems to confirm this perspective, a "renationalisation" of the expenditure devoted to the functioning of the common policy in this respect is inconceivable, since it could lead to the absurd situation whereby national budgets would have to finance intervention acquisitions of and export restitutions for agricultural surpluses generated by other member countries. On the other hand, it is debatable whether the fulfillment of the Lisbon Strategy goals hinges more on the generous financing of R&D, education and TENs than on implementing essentially regulatory reforms (of the labour market, first and foremost) which fall mainly under the responsibility of the individual Member States.

***Agriculture***

If a Community budget almost exclusively subordinated to agriculture (as used to be the case in the 1970s and 1980s, when over two thirds and sometimes – e.g., in 1970 – slightly above 90% of expenses were allocated to it) was obviously irrational, the current situation, whereby the weight of agricultural expenses declines towards 30%, cannot *a priori* be described as a "historical relic".[9] One of the main arguments supporting this assertion, namely that agriculture is a declining sector, has become far less convincing in the light of the developments unfolding since 2007, the structural (rather than conjunctural) nature of which seems to be supported by the nature of their determinants: the changing eating patterns of half of the world's population; the crowding effect exerted on the agricultural output destined to food by the booming demand for biofuels; and the chronicisation of extreme weather phenomena, engendering repeated supply deficits, at least alternatively, in various parts of the globe.

The idea of putting on national foundations the financing of EU's agriculture is, as mentioned above, incompatible with the functioning of a common policy comprising a "guarantee" component. Theoretically, such a switch could be foreseen for the rural development pillar of the CAP, but there are moderating considerations in this respect as well. The nature of these expenses is ambiguous: they have, *a priori*, allocative virtues, but their *de facto* redistributive nature cannot be overlooked against a background whereby the quasi-totality of EU's new members are both less prosperous than the other member states and more "rural" from the standpoint of agricultural employment and of the contribution of agriculture to GDP formation. Consequently, the "renationalisation" of the financing of this pillar would have the practical significance of backstepping from the principle of Community solidarity. It is true that, as it will be shown below, the proponents of this solutions are, at the same time, supporting the refocusing of the "cohesion" expenditure (the structural funds) away from its current regional dimension and towards a national one, which would result in a certain compensation for the new members. Nevertheless, such a re-balancing cannot occur in isolation, but only in

[9] Marco Buti, Mario Nava: *Towards a European Budgetary System*, EUI Working Paper RSC 08/2003, p.1

the context of an integrated agreement, whereby the restructuring of the Community expenditure for rural development goes *pari passu* with that of the structural funds.

Having said this, even assuming that in such a case there may be an important room for manoeuvre as concerns the outlays currently earmarked for rural development, their rather modest weight in the total Community budget (about 10% in the current multiannual financial framework) also means that it would not be possible to extract from here the important resources to be reallocated for destinations considered more "deserving".

***Regional development***

A surprisingly strong wave of opinion has emerged, at least at the academic level, in favour of the recommendation formulated in the already mentioned "Sapir Report", to the effect of switching the eligibility criterion for structural funds from a regional, to a national one, with the corollary that the "poor" regions from "rich" member countries would lose their entitlement to Community budget support.[10]

The consequences of such a move makes it very vulnerable from the perspective of *feasibility* considerations. Indeed, this would result in a situation whereby the more prosperous member states would be left to solve by themselves their regional disparity problems, while continuing to contribute to the alleviation of the similar problems confronting the poorer member countries. In other words, a policy predicated on the notion of Community solidarity would be replaced, for all practical purposes, by one based on principles similar to those of the development policy in favour of developing countries. Yet, the classical official development assistance (ODA) granted by industrialized countries to the Third World states is unilateral and voluntary, while the *sui generis* one that would result from implementing such a reform would be contractual and mandatory, hence very unlikely to take roots.

It should also be mentioned that none of the recommendations made to this affect offers a concrete solution as to the level of prosperity which would draw the line between the member states which can and those which will not be able to benefit from structural funds any longer. Yet, since these funds are, already now, the main chapter of the Community budget, it seems obvious that the natural impulse of any member country would be to determine the choice of an eligibility threshold not affecting it, especially as long as there are no convincing theoretical arguments for setting a particular threshold. This triggers the quasi-certainty that such a decision will prove impossible to take in a framework of unanimity voting. Moreover, adjustments would be required, which none of the studies mentioned refer to, so as to ensure that a minor overtaking of the eligibility threshold by a member states does not substantially alter in a negative way the net balance of its interaction with the Community budget.

*Equity* considerations are not better served by such a modification. By definition, this violates the principle of international equity, but moreover it is bound to deteriorate the inter-personal equity as well, since prosperity differences at personal level are better approximated by the gaps in average *per capita* revenues computed at regional level than by those computed at national level. This consideration is the more important that the European construction does not have

[10] Torbjörn Danell, Anders Östhol: *The EU Long-term Budget. Reform and New Priorities*, Swedish Institute for Growth Policy Studies, January 2008, p.43; Jorge Nunez Ferrer: *op.cit.,* p.16; Filipa Figueira: *How to Reform the EU Budget? Going Beyond Fiscal Federalism*, Utrecht University, 2007, p.13

solely an inter-governmental component, but also a citizen component, formally enshrined by the letter of the Treaties as well as by the existence of a European Parliament directly elected by the EU citizens.

Neither is the perspective based on *opportunness* considerations very convincing. It has thus been claimed that the more prosperous member states dispose of the means, which the others lack, for supporting their laggard regions. Yet, this argument only shows the possibility of changing the allocation key for accessing structural funds, not also the necessity of doing so. An argument common to several studies highlights the positive virtues of a better focus of Community funds, which the reduction of the pool of potential beneficiaries is somehow supposed to bring about. Figures matter, however, and the supporters of the concentration of funds do not offer any estimate of this effect, although some of them refer to potential efficiency gains deriving from allocating money at country level and letting the countries themselves decide where to invest them.[11] There are, however, rather contradictory assessments of the effectiveness of assistance targeted at regional level. On the one hand, there are studies which found that the structural funds have contributed to reducing inter-country gaps, but failed to correct intra-country disparities between rich and poor regions.[12] Other authors emphasize that the efficiency of structural funds was greater in the poor regions than in the richer ones.[13]

[11] Marco Buti, Mario Nava: *Towards a European Budgetary System*, EUI Working Paper RSC 08/2003, p.13

[12] Jacques Le Cacheux: *Future of the EU Budget and Financing of Common Policies,* in "What Kind of European Budget for 2013?", CEES & IFRI, Paris, 2005, p.55

[13] Filipa Figueira, *op.cit.*, p.13

Somewhat unexpectedly, the perspective which seems to offer the most persuasive arguments in favour of changing the allocation method of structural funds is the *strictly political* one. It is, thus, debatable whether the kind of direct links established between the Commission and other Community institutions, on one side, and the regions from the member states, on the other side, has only positive repercussions. Without speculating on the extent to which such direct links can co-exist without tensions with national sovereignty considerations, it has to be mentioned that, very often, they create "complicities" *sui generis* which are not always coincident with the priorities of the national authorities. Besides, the current possibility of granting financial assistance also to regions located in prosperous countries ehances the transactional climate in which structural funds are apportioned, resulting in complex arrangements and *ad hoc* designations meant to appease all member states, to the detriment of satisfying the requirements of opportunness, effectiveness and efficiency of Community budget interventions. Such "special measures" have been on a rise, their number growing from 13 in the 2000-2006 programming period (with a financial envelope of 5,6 billion EUR) to 18 in the current multiannual financial framework (with a budget support increased to 10 billion EUR).[14] For their largest part, these arrangements target sub-regions from the wealthiest countries (Corsica and Hainaut in France, Bavaria in Germany, Burgenland in Austria, Northern Ireland in the UK), which would not have been eligible for receiving structural funds according to standard criteria.

[14] Peter Becker: *Reforming the European Financial Framework,* EU-Consent Working Paper no.5, January 2008, p.4

***Other internal policies***

The number of internal policies receiving some sort of financial support from the Community budget is impressive (27 in 2004), and this excessive dispersion is a problem in itself. Before attempting to generate additional funds by amputating the main two expenditure chapters, a reexamination of the need to finance such a large number of areas (e.g., fishing, culture and audiovisual, information and communication, European political parties, nuclear security, consumer protection, labour market, statistics etc), of which many only get symbolic amounts, apt at most to increase the visibility of the Union in the eyes of its citizens, would be very useful. Selecting those areas for which Community financing is appropriate entails, first, an assessment of their relevance for achieving the Union's goals and, secondly, an analysis of the need that their funding be carried out at Community level based on the principles of fiscal federalism, as well as of those validated by the European construction process (subsidiarity, proportionality, additionality).

A first category of internal policies entitled to Community financing are those destined to enhancing the competitiveness of the European economy, that is, primarily those for R&D, education and TENs (in particular for transport). These areas are closely associated with the attainment of the Lisbon Strategy, while also displaying features which firmly justify a supranational approach: important cross-border externalities and relatively homogeneous national preferences. The homogeneity of preferences is lowest in the case of education, but it does increase with the level of education, becoming fairly high in the case of university-level studies, the most relevant for economic growth and, hence, the only for which Community financing would be justified.

The Community budget is not, however, the only form of supranational intervention which is useful in these areas, nor necessarily the most important. A regulatory approach aiming at limiting the overlaps of R&D and infrastructure projects or at harmonising the university *curriculae* is not only very desirable, but also an important source of savings and rationalising the use of funds, irrespective of their origin.

While financing these areas through the Community budget is justified in the light of the above-mentioned criteria, this funding would need, in order to fully exploit its virtues, to fulfill some conditions, the most important being its quantitative adequacy. The funding of R&D activities and, even more so, of important infrastructure projects requires reaching a certain critical mass, which the Community budget, with its current size, would not be able to ensure even if entirely allocated to such projects. For instance, the current level of national R&D expenditure by member states is comparable to the whole Community budget.[15] Besides, fully exploiting the advantages of a centralised financing requires that the selection of the funded projects be impartial and insulated from political influences, something which cannot always be taken for granted, as demonstrated by the the fact that priorities in the Research Framework Programmes are the result of political negotiations in the Council[16], as well a by the intense lobbying of Member States with respect to the itineraries of the trans-European transport corridors.

Since the Community budget does not seem able to satisfy to a very large extent the requirements (both quantitative and

[15] Torbjörn Danell, Anders Östhol, *op.cit,* p.71

[16] Daniel Gros, Stefano Micossi : *A Better Budget for the European Union. More value for money, more money for value*, CEPS Policy Brief No.66, February 2005, p.6

qualitative) of financing these areas, one can legitimately question whether a relatively limited diminution of the quantitative inadequacy of the resources devoted to them justifies the abandonment of a sector that is both important and not deprived of good prospects like agriculture and/or the radical reshuffle of the rules of the game in another area (regional development) which is generally regarded rather as a success of the European integration process to date.

Other internal policies of importance for reaching the Union's goals are environment protection, justice and home affairs, as well as social policy. The funds currently earmarked for them are very limited (on the face of it, in aggregate, just 1.4% of the 2008 budget), though it should be mentioned that resources serving these purposes are included in other expenditure items as well (environment – in the chapter covering agriculture; and social policy in that devoted to cohesion). There are, however, no convincing arguments in favour of a substantial increase of these outlays, because of two important reasons:

- the regulatory component is, in their case, largely prevailing over the financial one (and, in the case of environment, the financial resources have a well-defined origin, not necessarily linked to the public budgets, encapsulated by the "polluter pays" principle); and
- the high degree of heterogeneity of national preferences significantly narrows the scope of supranational interventions that would be both desirable and useful.

Bearing in mind these considerations, proposals like the one of the "Sapir Group"", to the effect of setting up a European "restructuring fund", meant to alleviate unemployment problems triggered by corporate relocations induced by the functioning of the single market are difficult to grasp, the more so that even their authors acknowledge that most of the resources destined to this end have to come "by far ...through the national social security systems".[17] The fact that, albeit in a very dilluted way, this idea has made its way by the inclusion of a modest "solidarity fund", endowed with 500 million EUR, in the current multiannual financial perspectives, is rather disappointing. We can, hence, legitimately ask what use (let alone value added) other than visibility can Community financing have in this case, and whether this benefit (rather dubious and anyway non-quantifiable) justifies giving up other benefits, which Community financing is able to generate to a larger extent.

### Reform of the Community budget revenues; the "European tax"

The large and growing prevalence (likely to reach 90% by the end of the current programming period) of resources originating, in fact, in national contributions has become a major weakness of the Community budget. It further erodes the financial autonomy of the Union as it favours an excessive focus of national authorities on "extracting" the most favourable net balance, even at the cost of sacrificing actions important for achieving EU's objectives, and moreover it reinforces the intransigence of Member States as regards keeping in place rigid budgetary rules, concerning the requirement of annual budget balancing, as well as the impossibility to make use of the surpluses which might emerge during the execution of the budget.

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[17] André Sapir: *Going for Growth: An EU Budget for the 21st Century*, The Lisbon Council, Policy Briefing, Brussels, 28 June 2005,p.14

The *ad hoc* adjustments of the contributions of some members, which tend to become more frequent and to have larger financial stakes, further dents financial solidarity within the Union.

Finally, the current mix of traditional own resources and either explicit ("GNI resource") or implicit ("VAT resource") national contributions is rather opaque for EU citizens, who are, ultimately, the contributors to the Community budget, and hence does not allow them to understand what is their stake in this instrument to the same extent that they can do relative to the national budgets.

Absent a radical reform of the way of constituting the resources of the Community budget, any changes operated will be mere palliatives, unable to improve more than marginally the current situation. Worth mentioning, in this respect, are two older initiatives of the Commission, which have not even come to be discussed by the member states:

- a proposal for the establishment of a generalised corrective mechanism for "excessive" net contributions (tentatively defined as over 0.35% of the national GDP), which would have had at least the merit of instituting a uniform treatment for all countries confronted with similar problems and would have been less confusing than the plethora of *à la carte* regimes being applied currently;
- the idea to base the "VAT resource" on the amounts effectively collected by the member states on behalf of this tax, without completely harmonising the tax base (since the difference between the "actual" and the current "national" tax bases is fairly small)[18]; it should be mentioned, however, that this solution is likely to elicit avoidance tactics from the member states, which might have recourse to a "rebalancing" of their national tax systems, by putting a stronger accent on those types of taxes not affected by levies due to the Community budget.

A substantial reform of EU budget's revenue side can only occur by moving to a genuine "European tax", conceived and destined wholly to this budget. Such an undertaking is confronted with many obstacles, hence the perspective of carrying it out cannot be very close.

Political reticences are the most serious impediment, the more so that they can be reinforced by opportunness considerations. Indeed, the current financing system of the Union has the big advantage of being able to fulfill some important taxation principles:

- it is quantitatively adeqaute and predictible, because it ultimately rests on a resource (the "GNI resource") which is, by design, perfectly elastic to the level of expenditure decided;
- the collection of most of its resources is virtually cost-free, as it only entails transfers from the national Treasuries;
- it is fairly equitable, since national contributions are almost proportional with the wealth of the member states, and this feature could be improved even without a radical reform, by adjusting the current complex system of "rebates" (which, for instance, allows the UK to "pay" the equivalent of just 0.7% of its GDP, whereas the contribution of practically all other member states revolves around 1% of GDP).

It should nonetheless be mentioned that the adequacy of resources that the current system provides is not cast in stone, but dependent on the size of the Community budget. One should expect that any attempt to

[18] Carlo Altomonte, Mario Nava: *Economics and Policies of an Enlarged Europe*, Edward Elgar, 2005, p.224

significantly increase it would be fiercely opposed by the member states, precisely because the financing mechanism is closely linked to *de facto* national contributions.

From a political standpoint, moving to a genuine European tax, which represents more than the "traditional" own resources, cannot fail to be perceived as a loss of national sovereignty in an area (taxation) essentially and closely linked to the historical origins of this concept. It is true that, as it was pertinently noted, a transfer of sovereignty in an area with similarly high stakes (currency) has already occurred within the EU.[19] There are, however, important circumstantial differences leading to a higher sensitivity of the fiscal area: the closer link to citizens (in their capacity of taxpayers) and the credibility of the supranational institutions to which the national prerogatives revert. If the European Central Bank is an authority enjoying the respect and appreciation of its national peers, to a good extent also because the latter are directly involved in its decision-making, the relationship between national parliaments and the European Parliament is less harmonious. The fact that they are, ultimately, competing with each other, magnifies the mutual antipathy, and the institutional shortcomings of the European Parliament (lower quality of the pool of politicians from which its members are recruited, absence of a credible structuring along ideological lines, since strictly national interests often prevail over allegiances to the "political families") make it a less known and less legitimate entity in the eyes of the national parliaments, hence not fully deserving to be entrusted with decision-making prerogatives concerning the taxation of the citizens of the member states.

Another serious potential problem of the European tax is that, reasonably speaking, its collection will remain under the responsibility of national tax authorities. Yet, the effectiveness, diligence and even honesty of the latter varies a lot from one member state to another, hence the risk of widely different degrees of exploitation of existing national tax bases, to the disadvantage of those countries endowed with a competent fiscal administration.

Other objections to the establishment of a European tax are more specious and easier to correct, but their mere existence reinforces the oppositions to such an initiative. This is the case, first, of the likelihood that such a tax, to the extent that it replaces the fully proportional "GNI resource", worsens (relative to the current situation) the inter-national equity of mobilizing the revenues of the Community budget, though it should be mentioned that, at the same time, inter-personal equity might be well served.[20] Also, one can fear a negative reaction on the part of the citizens towards what they might perceive as "a new tax", although there are ways to ensure such a rebalancing between the European and the national taxes that would hold constant the fiscal burden exerted on taxpayers.

On the other hand, the establishment of a European tax, besides facilitating the better orientation of the Community budget towards financing actions in the common interest and, potentially, even the significant increase of this financing, may diminish the distorsions affecting the proper functioning of the single market (e.g., through the higher degree of fiscal harmonisation which it would inherently

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[19] Nicolas-Jean Brehon: *European Tax,* in "What Kind of European Budget for 2013?", CEES & IFRI, Paris, 2005, p.126

[20] Eulalia Rubio: *The Case for a European Tax: Benefits, Practical Aspects and Options for Endowing the EU with a Veritable Own Resource*, Notre Europe, January 2008, p.2

entail) and could also allow the use of the fiscal levers as supporting tools for reaching other goals deemed desirable (e.g., discouraging consumption detrimental to health or to the environment, stimulating "virtous" behaviours etc). It is true that, in the latter case, an unavoidable trade-off with the size of the collected resources exists. Another argument in favour of a European tax derives from the fact that the higher involvement of Community citizens that it would engender should enhance the sentiment of accountability of the "budgetary authority", thus contributing to more discipline and restraint in spending public funds.[21]

Finally, the introduction of a European tax would have another implication, which cannot be unambiguously defined as either positive or negative, as its connotations are inherently subjective. This is because taxes are, for taxpayers, both an element identifying one as a member of a community and a factor of constraint. Yet, European citizens are far from having identical perceptions as to which of the two considerations prevails.

The requirements that a European tax should satisfy have been extensively analysed, both in the academic milieux[22], as well as by the Community institutions (the European Commission, in a document released in October 1998[23], and the European Parliament, in the more recent "Lamassure Report" of March 2007)[24]. Most of these requirements stem from the classical taxation principles, that is:

- *adequacy and stability* of the resources yielded by the tax, considerations which are the more important for the Community budget the longer it will be subjected to the constraint arising from the compulsory annual budget balancing;
- *fiscal neutrality*, which in the particular case of the Community budget may be regarded as a stronger requirement, given that it would mean protecting from an additional tax burden not only the member states, but also their citizens;
- *fiscal equity*, which also has in the case of the Community budget a dual component (inter-national and inter-personal, respectively), with the crucial caveat that ensuring it at both levels simultaneously is very difficult, if not outright impossible, in practice;
- *collection cost*, which must remain reasonable relative to that of the current resources, while noting that, if some particular type of taxes is chosen, this cost might even be diminished.

Other requirements derive from the special nature of this instrument:

- *visibility,* both for the EU citizens, so as to enhance their feeling of belonging to a community based on important values, as well as for their representatives (the MEPs), which might therefore get closer involved in the assessment and control of the budget's execution;
- *simplicity*, able to make it easier to be understood (and, on this basis, accepted) by taxpayers;
- *compatibility* with the principles of the single market; and, possibly,
- *positive contribution* to the fulfillment of other EU goals.

[21] Peter Becker, *op.cit.,* pp.11-12

[22] For a comprehensive inventory of these requirements, see Philippe Cattoir, *Tax-based own resources: An assessment*, Taxation Papers, DG ECFIN, Working Paper no.11/April 2004, p.7-13

[23] apud Nicolas-Jean Brehon, *op.cit.,* p.124

[24] *L'avenir des ressources propres de l'Union européenne,* Résolution du Parlement européen, 29 mars 2007, par.29-30

Finally, the identification of the most adequate kind of European tax can be informed also by the principles of fiscal federalism, which favour the centralised setting and collection for those taxes levied on the most mobile tax bases, so as to minimise the risk of harmful tax competition. This precept, however, needs to be qualified in light of the degree of homogeneity of national preferences which, for instance, is remarkably low as concerns personal taxation.

Some authors have even identified some "errors of design" which should be avoided, such as the creation of a new, untested, kind of tax, or the choice of "symbolic" taxes, with low yields.[25]

It is obvious that there can be no single tax able to satisfy, simultaneously and to a reasonable degree, such a wide range of requirements. Hence, it might be conceived that, instead of a single European tax, a "Community mini-fiscal system" be put in place, consisting of several types of taxes, which could mutually compensate their respective weak points.

Having said this, not all conditions enumerated above are equally important. The adequacy criterion, for instance, is absolutely crucial, though it should not be interpreted rigidly, in the sense that it has to be fulfilled by one single tax. Putting in place several European taxes is not to be excluded, but there are fairly tight limits as to how many taxes dedicated to the Community budget might exist. Particularly important is also the requirement of compatibility with the rules of the single market, especially with a view to avert the introduction of additional distortions in its functioning, while the identification of taxes that could contribute to the removal of some of the existing distortions would represent a definite plus. The equity considerations are also important, not only because they serve values important for the EU, but also because neglecting them too much could lead to the rejection by the member states and/or by the European Parliament of those taxes that do not fulfill them to a reasonable degree.

As concerns the other, less important, requirements, a distinction can be made between those which, if completely disregarded, might generate oppositions difficult to overcome (collection cost, visibility, simplicity) and the criterion which, if met to a high degree, might tip the balance in favour of those taxes displaying this feature: contribution towards reaching other objectives of the Union.

There is a large number (almost a dozen) of taxes identified, by studies and debates carried out in the last years, as potential sources of revenue dedicated to the Community budget. Some of these are weak candidates, however, as they are unable to fulfill the crucial requirement of the adequacy of resources yielded:

- central banks seignorage;
- communication tax (with various possible bases, which can co-exist: telecommunications, radio-TV broadcasting, road vehicles);
- tax on financial transactions;
- tax on air transportation, with a base adjusted according to fuel consumption and/or polluting emissions;
- tax on "relocated" economic activities.

Apart from this important common shortcoming, some of the taxes listed above also display other serious weaknesses from the standpoint of other requirements, which further reduces the desirability of them becoming revenue sources for the Union's budget. The tax on "relocated" activities would go directly against the principle of free

[25] Nicolas-Jean Brehon, *op.cit.,* p.128

movement of capital, which should exclude it from the outset from any serious consideration. The tax on financial transactions, although it could theoretically bring substantial revenues, is very vulnerable to the flight of capital towards extra-European fiscal jurisdictions and/or to the elaboration of complex financial instruments aiming at reducing the tax base, hence its yield can be expected to decline rapidly. Moreover, stock exchange transactions tend to be volatile (hence the stability of revenue would suffer), international equity would be precarious because the preference for equity versus debt financing differs a lot among EU member states, and its visibility for the largest part of citizens is quasi-inexistant. Seignorage, at its turn, is an invisible and incomprehensible source for the population, and its surrendering to the budget might dent the independence of central banks, as it would constrain their capacity to intervene on the market for purposes related to price and/or financial stability.

Under these circumstances, there are five kinds of taxes that would deserve a more thorough assessment, namely:

- dedicating a portion of the national VAT rate applied by the Member States to the Community budget, most logically after an additional harmonisation of the tax bases;
- replacing national corporate income taxes with a European corporate income tax ("EUCIT"), levied on a common (and, for transnational corporations, consolidated) tax base, which would have the additional appeal of correcting some important distortions to the functioning of the single market;
- creating a European tax on personal income (or, alternatively, transferring to the community budget a portion of the national tax rates, which would however require a harmonisation of the tax bases difficult to imagine against the background of the enormous heterogeneity of direct personal taxation in the EU member states)[26];
- levying a tax on energy consumption, which could also serve the purpose of stimulating energy saving;
- a "vice tax" (on tobacco and alcohol consumption), most likely in the form of an excise supplementing those currently applied, which might also discourage harmful consumption habits.

As concerns the latter two types of taxes, there is an obvious tension between the extra-fiscal goals that they could push forward and the requirement of a sufficient flow of funds for the budget. Moreover, the "vice tax" would be extremely inequitable from an international perspective, as national consumption patterns for tobacco and alcohol vary enormously among member states.

A synopsis of the degree to which the above-mentioned taxes would fulfill the various requirements is provided below. Because some criteria are more important than others, the scores corresponding to them have been weighted by an (admittedly, non-rigorous) coefficient of 1.5. The criterion "stabillity" was not deemed important, because its influence can be mitigated by relaxing the rigid condition of annual budget balancing. Also, the neutrality criterion was disregarded because all types of taxes can be so devised as to satisfy it.

[26] The size of this gap is indeed impressive: the contribution of personal income taxes to national budget revenues in the Member States varies from just 3-4% (in countries like Poland or Slovakia) and over 25% (in Denmark). Apud Daniel Gros and Srefano Micossi, *op.cit.,* p.11

| | VAT | EUCIT | Personal income | Energy tax | "Vice" tax |
|---|---|---|---|---|---|
| ***Adequacy*** | ++ | ++ | ++ | + | + |
| *Stability* | ++ | - | ++ | ++ | ++ |
| ***International equity*** | + | 0 | + | 0 | - |
| *Inter-personal equity* | -* | + | + | -* | -* |
| *Collecion cost* | + | + | - | + | + |
| *Visibility and simplicity* | + | 0 | ++ | ++ | + |
| ***Acquis compatibility*** | +** | ++ | 0 | +* | +* |
| *Reaching other goals* | 0 | 0 | 0 | + | + |
| **Non-weighted score** | **8** | **5** | **7** | **7** | **5** |
| **Weighted score** | **9** | **7** | **8** | **8** | **5.5** |

* based on the assumption that indirect taxes are, by definition, regressive
** because it would require an additional harmonisation of the tax base, hence it would reduce existing distortions

Based on the criteria considered and the degree to which they are being fulfilled by the various kinds of taxes explored, the tax that would seem the most appropriate for serving the EU budget is VAT.

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# MANAGING DIVERSITY FOR A GROWING EUROPE: A ROMANIAN VIEW ON THE EU BUDGETARY REVIEW PROCESS

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***Key words:*** *cohesion policy, common agriculture policy, EU budget*

***Executive summary****

The European Union is facing major exogenous and endogenous challenges. ***Exogenous challenges*** reside in the changing global context, which impacts on the development of the Union. Globalisation affects the status of the Union in the world, due to newly emerging global powers. There is an increased risk of massive illegal immigration, with implications concerning issues such as clash of civilisations and terrorist threats. Excessive dependence on third parties leads to insecurity and losses of bargaining power. The effects of global warming are increasingly worrying.

***Endogenous challenges*** originate in the Union's unique character as a geo-political entity. The Eastern Enlargement has increased the complexity of the Union. Ageing population and falling birth rates endanger the welfare systems. The functionality of the single market implies the existence of the four liberties and the free circulation of knowledge, conditions which still raise questions about their complete implementation. Re-location within the Union stirs dissatisfaction and rivalry among EU citizens and challenges the solidarity among the European nations.

When re-designing the budget to better tackle these challenges, there are several **principles** which need to be considered:

- The starting point should be the different realities in the Member States, and in particular, the variety of social and economic circumstances in Europe.
- Solidarity is fundamental
- The budget reform at the EU level should lead to national budget reforms in order to ensure synergy between European and national policy-making tools.
- The legal framework of the review/ reform should be the Lisbon Treaty

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** At the 2006 December Summit the European Council asked the Commission to carry out a review of the budget of the European Union by 2008/2009, paying particular attention to the Common Agricultural Policy and the own resources system In September 2007, the European Commission launched a Consultation Paper, which started the debate on the EU budget review. This paper is part of the document presenting a Romanian, non-governmental view, which aims to contribute to this debate. The whole study is available at http://ec.europa.eu/budget/reform/index_en.htm.

- The review/reform of the EU budget should consider public opinion support for EU policies.
- No budget item should be dealt with separately, as policies are interdependent;

The **expenditure side of the EU budget** is examined by looking at the added-value of the EU action and what may constitute European public goods. What constitutes European public goods is a function of priorities that exist at the EU level, which hinge on the state of economies and societies.

**The Common Agricultural Policy** needs to be reformed in line with global challenges and inner pressures.

- There is increasing pressure on the demand for agricultural products due to the growing Asian economies, in particular. Also, there is considerable pressure on food supply due to effects of global warming on agricultural plots and sources of water.
- The rise in the prices of food on world markets diminishes considerably the need for agricultural subsidies in the EU. From an age of food surpluses (which originated the CAP) the world seems to be moving to an age of shortages.
- The CAP is questionable because the use of resources is questionable in terms of optimality and social equity. The answer to both problems, however, is not necessarily the further decoupling, because decoupling does not seem to work very well within the current structure of distribution of the direct aids.

A reform of the CAP should consider the following issues:

- Farmers are a particular category of society, and many of them have been threatened by globalisation side-effects. The rise in the prices of food does change the picture dramatically for European agriculture, but not a few farmers would continue to be in need of support for a while at least.
- The European production capacity of food must be valued and used so that the dependence on external sources of food supply should not become excessive
- Good quality land and water are European public goods of growing importance and should be managed accordingly, via the CAP too.
- There are other sectors and policies related to the CAP, which will be affected by the reform.
- Possible options for strengthening and diversifying rural economies.

A reform of the CAP should focus on a redistribution of expenditures within the CAP, possibly co-financed with the Member States, and improve the targeting of measures:

- More money should be allocated to the second pillar of CAP, focused on rural development
- The sums allocated for the income-support objective for farms less than 5 ha should not diminish, as long as rural modernisation and economic diversification for possible displaced farmers to find other jobs; likewise the sums allocated to large farms should be phased-out in accordance with the rise in food prices on world markets
- Crisis management schemes should be devised in order to confront delicate situations
- Targeting can be improved by moving from multifunctional purposes to a clear distinction of objectives.

**The Cohesion Policy** is challenged by the high expectations stakeholders have from it to tackle various needs in Europe, by the threat of 're-nationalisation', and by what we think is misdirected policy analysis to claim that the policy is responsible for re-location. The budget reform should not affect the Cohesion Policy envelope. Nonetheless it should lead to the consideration of the following elements, for a better use of Structural and Cohesion Funds (SCF):

- It is our opinion that the budget allocation for Cohesion Policy should be maintained or even increased.
- The Cohesion Policy has added-value, but there is a need to focus on results more than in the past.
- Improvements in the allocation efficiency of the SCF require both a better alignment of the national development plans with the EU policy priorities, and a better integration of the EU-wide strategic policy agenda into national development programs.
- Given the past experience of Ireland and Spain, the Cohesion Policy context could serve as a framework for anchoring national policy-making, especially in the new Member States.
- The SCF represent, in our opinion, an important instrument for accelerating real convergence within Europe, but the need to improve the allocation and efficiency of public spending, in general, remains an outstanding and sizeable challenge for many Member States.
- At national level, there is a need to improve consistency and clarify the strategic direction across policy products and processes.
- Integrating policy planning and budgeting across the government is central to sustaining growth and achieving the strategic objectives of convergence.
- More emphasis should be paid to developing medium term expenditure frameworks (MTEF) and budgets on programms, to which the SCF should be an integral part and treated similarly to other financial resources.
- Improving absorption and effectiveness of SCF should also target the reform of the annual budget cycle in some members.
- There is a need to pay significantly more attention to upgrading the administrative capacity of SCF beneficiaries, especially at sub-national level, and of managing authorities.
- The economic rate of return of SCF projects should be given more prominence, which in turn requires more focus on developing project design skills.
- In order to improve the linkages between programs performance and resources allocated from the SCF, there is a need to strengthen monitoring and evaluation (M&E) systems.

To sum up, Cohesion Policy is one of the most important EU policies at the moment because it has the capacity and the potential to contribute to a cohesive development of the Union, with tools designed to manage the EU's socio-economic complexity. There is however considerable scope for improving its implementation.

Three aspects linked to the future of **R&D and competitiveness** policy of the EU are to be singled out:

- First, the EU funding for R&D and competitiveness does provide value for money. Impact assessments in general

prove a high return of R&D investments, but there is substantial scope for greater efficiency.

- Second, there are more forms of R&D, more types of knowledge-based economies, and more types of competitiveness - depending on EU members' level of development. EU R&D expenditure EU R&D expenditure should not relate exclusively to high value added R&D and high-end product innovation.
- Third, the management and implementation of these funds is just as important as the amounts.

It is essential to invest in centers of excellence in order to combat the brain drain within and from the EU. It is also extremely important to have free circulation and access to knowledge in order to increase the propensity of fast development all over the Union.

**As a global actor**, the European Union should consider the following issues:

- A better coordination between the Member States and the Commission and between the world donors could lead to more significant results in tackling issues in the developing world.
- In order to be a global actor, the European Union needs to be able to act coherently and fast at the world level. This implies the necessity of a common external policy which is supported by European resources.
- Ensuring security within and for the European Union is a European public good. Member States should intensify dialogue concerning this issue and the EU budget should contribute to this end.
- The EU needs to better integrate energy policy in its external actions and to allocate more resources to ensuring energy security. The Nabucco project could be supported by the EU budget as well.

**The revenue side of the EU budget**

- As it stands, the own resources system is not just, particularly because correction mechanisms have been designed to respond to and adjust imbalances that belong to the past. It is fundamental to reform expenditure in order to tackle own resources issues.
- Key to a functional system is pragmatism. We need a system that works; therefore it must be sufficient, stable, simple and equitable.
- A larger budget would be needed for the EU policies to be able to sensibly contribute to tackling challenges, however serious frauds in managing EU money impede an increase of the EU funding; there should be more focus on better management.

In consequence at the moment there is no scope for introducing new taxes, and contributions to the EU budget should continue to be GNI based. Provided that the management of the European funds improves, in the long term the EU budget should be increased and new resources should be added to the existing ones.

The **implementation** of the eventual reform of the budget should be carried out gradually, preferably on the length of a Financial Perspective, in order to avoid the emergence of disequilibria. Moreover, for better management and accountability, the Financial Perspective span should be reduced to 5 years, similar to the mandate of the European Parliament and the Commission.

Increased flexibility of the Financial Perspective is an issue that needs to be considered for better answering to unforeseen situations. It should be possible to have a European reserve or to transfer a certain proportion of funds among different headings, if necessary.

*1. The Common Agricultural Policy*

The mission for the Common Agricultural Policy is twofold. On the one hand, its objectives, as stated by the Treaty, should continue to be met by the future reform. On the other hand, CAP, as all EU policies, must be adapted to the challenges posed by globalization and EU inner strains.

The global context is affecting agriculture dramatically. There is increasing pressure on the demand for agricultural products due to the formidable progress of Asian economies. This rise puts upward pressure on the price of basic commodities, including cereals.[1] Likewise, there is considerable pressure on food supply due to the side-effects of global warming on agricultural plots and sources of water.

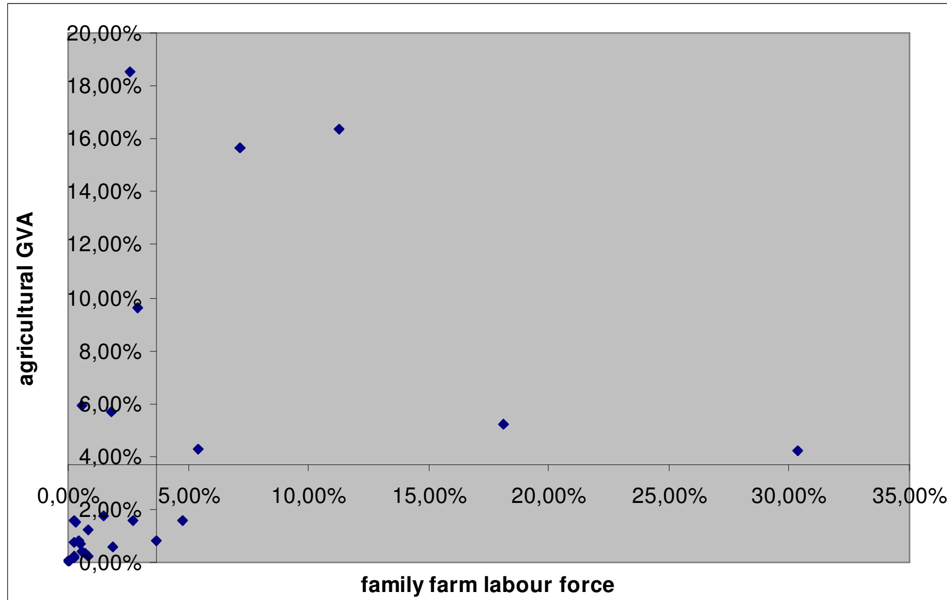
Both supply and demand side dynamics on food world markets would reduce dramatically the need for agricultural subsidies in the Union. But, the impact of global dynamics on the efficiency of farms is largely differentiated and the CAP needs to take it into account, for reasons of social cohesion as well.

The CAP has to be re-examined against the background of the above mentioned dynamics. While the volume of subsidies should diminish decisively over a time frame the EU needs to develop intervention mechanisms to tackle risk and allow for crisis management. At the same tine, the large variety of farm efficiency in the EU should be considered, in the short term at least. Most importantly, good land, as the main agricultural asset, should be better valued (measurements via narrowly constructed cost-benefit analyses are, arguably, misleading). Good quality land and water are European public goods of growing importance and should be managed accordingly, at both national and EU levels. The CAP should be designed in such a way that it be able to answer to the new challenges and resources should be targeted to this end.

An image of the EU complexity is illustrated by the very large structural differences among the EU members in the agricultural sector. Romania and Poland account for 48.5% of the total number of agricultural holdings in the EU27, and for 53.4% of the total number of small agricultural holdings (less than 5 ha). The CAP budget for these two countries, however, represents a much lower share in the total CAP expenditures (it will grow, nevertheless, up to 2013); the indicative ratio between the share in the CAP expenditures and the share in EU number of agricultural holdings is 1:10 for these countries, while the same ratio is 6:1 for Germany and 5:1 for the Great Britain. Italy and Spain also have a large share of EU agricultural holdings and of EU family farm labour force, but they also have an even larger share in EU agricultural gross value added (GVA) – which means that, in these countries, the agricultural labour force is more efficient, and the crops are oriented towards more value-added products.

[1] The current international financial crisis, and an eventual recession in large areas of the world economy, may dampen this tendency for a while. But over the longer term the trends seems to be quite clear.

Fig. 3: Labour force and value added, total agriculture, EU27=100




Source: based on Eurostat
Note: the axes cross at non-weighted EU27 average values.

France, Spain and Italy, which are among the top beneficiaries of the CAP, have also some of the highest shares of agricultural GVA in total agricultural GVA of EU27. This might be interpreted as the result of long-time support through CAP – something that is now questioned for some of the new Member States, which would need this type of assistance. Romania and Poland are the likely candidates for more funds, but also Slovakia and Hungary have small land plots; about 90% of their agricultural holdings are less than 5 ha. Moreover, Greece, Italy and Portugal have a high share of agricultural holdings of less than 5 ha, with ceilings above 70% of total in each case. All these countries would be in fact exposed to severe losses if the decoupled direct aids system is abandoned or if agricultural financing is severely reduced.

Previous reforms attempted to reduce market distortion mechanisms which were entailed by the implementation of the CAP; however their results are questionable. Regarding the assessment of the 2003 reform, Roberts and Gunning-Trant (2007) conclude that moving toward single farm payments is likely to result in less distorted markets for agricultural products, but that there is still a large use of market distorting forms of support (tariffs, quotas, export subsidies) and that the decoupled 'payments could maintain established distortions to production patterns'. The authors identify at least two reasons for this: expectations (farmers believe they are expected to continue production, and they also expect that a review of the CAP might change the emphasis again on production), and the cost of transfer (from a subsidized product to a non-subsidized one). Hennessy and Thorne (2005), based on survey results in Ireland, hold that a considerable number of farmers would opt for

using their decoupled payments in order to subsidize unprofitable production.

**There are two clearly identified problems in the current framework of CAP with the distribution of direct payments:**

- **The first problem is that the distribution is questionable from the point of view of social cohesion – as the Commission stressed it out on a number of occasions (European Commission, 2007).**

In EU-15, in 2005, 50% of beneficiaries received only 3% of total direct aids, while 2% of beneficiaries received 30% of total direct aids. In the ten new Member States that joined the Union in 2005 (NMS-10), 93.1% of beneficiaries received 39% of total direct aids in 2005 (less than 1250 euro per beneficiary farm), and 1.3% of beneficiaries received 45% of total direct aids. The higher share of beneficiaries receiving minimum amounts in NMS-10 reflects the predominance of small farms in the region. But the problem of highly unfair distribution is valid all around the European Union, in the new states and in the old states as well.

- **The second problem is that the distribution of direct payments is suboptimal, given their stated objectives.**
- **The answer to both problems, however, is not the further decoupling, because decoupling does not seem to work very well within the current structure of distribution of direct aids.**

Since the largest farms get most money, and since the largest farms also have the largest production potential, we could in fact expect that decoupling leads to the same result – subsidising production, mainly for the large farms. The solution is, arguably, neither reducing the support level while overall payments to big farms increase, nor increasing the amount of land per farmer to qualify for direct aid (both proposals are presented on the consultation's website[2]) – as either of these proposals would only increase the inequality of payments' distribution. On the other hand, the new situation on world markets should lead to a reassessment of direct payments mechanisms. For the reduction of the need for agricultural subsidies should be mirrored in how much direct payments presumably efficient large farms do get.

The payments for market interventions and direct aids are foreseen to decrease by 5.74% between 2007 and 2013[3]. And the new world situation on food markets would further highlight the rationale for reducing the volume of needed direct payments. However, the persistent disequilibria between the two pillars of the CAP, the beneficiary countries, and the beneficiary citizens[4], on the one hand and, on the other hand, the remaining significant market distortions induced by the CAP, require a reform of the CAP, which would lead to a reconsideration of the different realities in the Member States and of their agricultural assets, which are significant for the years to come.

The Treaty (Art. 33 TFEU) sets five objectives for the CAP: to increase agricultural productivity by developing technical progress, to ensure a good quality of life for the agricultural population, to stabilise markets, to guarantee the security of supply, and to ensure reasonable prices for food products. The CAP reform should not abdicate from these objectives; but it should better ensure that these objectives are clearly identified when resources are allocated.

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[2] http://ec.europa.eu/agriculture/healthcheck/index_en.htm
[3] According to the Interinstitutional Agreement of 2006
[4] See also Boulanger (2007)

There is no one way street for reform; and we should not take for granted that a reform means necessarily a severe cut in expenditures, in a short run There is also a moral implication to it: if, let's assume, the CAP is abandoned altogether, or funds are cut across the board, or funds are redirected only based on performance, then the efficiency gaps between new Member States and other EU members (which benefited from the CAP for 40 years) will become of a chronic nature. There are several issues that need to be considered when deciding over CAP reform.

- **First, farmers are a particular category of the society; many of them have been increasingly threatened by globalisation side-effects. A new "ballgame" on world food markets does not automatically change the lot of small farms.**

In the new Member States agricultural land plots are severely fragmented. The re-conversion of agricultural labour force requires high investments and training programmes. An immediate side-effect of non-conversion will be migration to urban areas, or abroad, unless appropriate alternatives for rural development are designed. Here too, the new Member States have to face a greater challenge due to higher proportions of farmers in the total active labour force and infrastructure shortcomings.

There may be a trade-off between subsidising agriculture and accepting emigration[5] in countries where the GDP/cap is low and one could assume that maintaining CAP could diminish the propensity to migrate. Less money to agriculture may translate, in the poorer EU states, into higher incentives to leave for sources of higher income (and the propensity for migration abroad is higher than the propensity for migration within the same country). Furthermore, as national governments in the transition economies were generally unable to finance agriculture adequately, the CAP transfers may provide the incentive for some migrant workers to return at home, in the rural areas. It is fair to say, however, that the propensity to migrate is mostly due to high wage differentials between East and West and it is not up to the CAP to solve this issue.

- **Second, despite trade liberalisation, the European production capacity of food must be valued and used so that the dependence on external sources of food supply should not become excessive.**

This is necessary, particularly in the case of imports from countries where veterinary and hygiene standards are not always fulfilled, and eventual pandemics could have serious effects on food supply in Europe. The supplies on the European food market should be ensured where possible from internal sources.

- **Third, when addressing the reform of the CAP, one should keep in mind that there are other sectors and policies related to the CAP, which will be implicitly affected by the reform.**

Environment, food safety, rural economy, competitiveness and trade are usually referred to in connection with the CAP[6]. These issues are largely addressed by the CAP itself: cross-compliance requirement helps protecting the environment; rural development is implied by the 2nd pillar of the CAP, while trade distortions have been diminished (at least in principle) by downsizing the intervention

[5] For example, half of the Romanian emigration to EU between 2002-2006 (49%) comes from the rural area – see Sandu (2007).

[6] See DG Internal Policies of the Union, Policy Department on Budgetary Affairs (2007), "The EU Added Value of Agricultural Expenditure – From Market to Multifunctionality – Gathering Criticism and Success Stories of the CAP", Brussels

mechanisms in agricultural markets[7]. Therefore, the CAP reform should account for the context of other EU policies which might be affected. Direct cost-based analysis, as it is now suggested, is necessary, but it does not suffice to understand and analyze the CAP efficiency; opportunity costs should also be taken into consideration.

- **Fourth, the question is how agricultural assets are defined in the 21st century, and which of these are European public goods.**

Assets such as soil and water have increasing importance in the context of climate change. The preservation of the agricultural habitats should be a priority of CAP, so should be the good management of fertile soils. An excessive reduction of farming activities would lead to a considerable reduction in the number of animals in Europe and to a loss in soil quality. Encouraging the production and availability of organic and healthy food products is a must. The increase of public health problems due to diabetes, coronary heart diseases and obesity, particularly among children, as a result of bad alimentation is worrying. It is important for Europe to have a healthy population in the context of speeding up economic growth, ageing population, and pressures of reform on the social welfare systems. Energy security is an issue that touches upon agriculture too, given the possibility of developing biofuel crops, and wind powered stations, where landscape conditions allow.

[7] Gros and Micosi (2005) say that the CAP, by pushing relative prices and incomes in favour of agriculture, discourages investment in industry and services. Moreover, they say that the new member states have a much larger potential in the latter sectors, and should therefore be less interested in supporting the CAP. Their assertion, however, is not substantiated by facts; on the contrary, the prices of production means grew faster than the prices of agricultural production, over the last 10 years.

- **In consequence, a reform of the CAP should focus on a redistribution of expenditures within the CAP, possibly co-financed with the Member States, and improve the targeting of measures.**
- **In the context of globalisation challenges and the necessity to re-orientate and develop the skills of the population occupied in agriculture, more money should be allocated to the second pillar of CAP, focused on rural development.**

The new Member States in particular need to modernize agriculture, to develop rural infrastructure and diversify rural activities. Most of the resources should be redistributed from the reduced (or totally cut) payments for large farms, which represent the bulk of the financial resources allocated from CAP.

- **The sums allocated for the income-support objective for farms less than 5 ha should continue as long as job alternatives are not available, while the sums allocated to large farms should be phased-out in accordance with the dynamics on world food markets.**

Only by doing this an effective decoupling of direct payments from production could be achieved. In this context, we agree with the idea that farms with large turnovers should be excluded from direct payments (except for emergency situations, maybe). In this regard, our proposal is bolder than the current modulation system proposed, which envisages, by 2013, marginal cuts for large farms and no increases for small farms.

- **Targeting can be improved by moving from multifunctional purposes to a clear distinction.**

A part of direct aids should be allocated to income-support for farms less than 5 ha, possibly co-financed with the Member States.

The other part of direct aids should be allocated for improving the cross-compliance of standards, soil and water management, and preservation of agricultural habitats.

**It is important, however, to agree on the direction of the reform. We believe that, as far as the CAP reform is concerned, the liberalization of agricultural markets can be achieved for those who are able to face it; that is mainly large farms. At the same time, the reform should focus on the redistribution of expenditures within the CAP, and on an improved targeting of the measures. As indicated above, there are essential European public goods, which should be managed at the European level through an equilibrated instrument mix. This analysis focused on the role of financial assistance in agriculture, but legislative measures and guidelines should also be considered.**

*2. The Cohesion Policy*

The Cohesion Policy is challenged by the high expectations stakeholders have from it to tackle various needs in Europe, by the threat of 're-nationalisation' , and by what we think is misdirected policy analysis, by claiming that the policy is responsible for re-location. There have been claims in previous negotiation rounds that Cohesion Policy does not deliver at the European level; and that particularly in the case of wealthier Member States, national governments could tackle regional disparities on their own. There have also been claims that Cohesion Policy favours re-location by simply transferring wealth from West to East, rather than reducing the gaps of development and advance cohesion among EU regions. The recent decision by Nokia to close down a factory in Germany and to open a new one in Romania was interpreted by some EU politicians as a Cohesion Policy side-effect. The policy was accused of encouraging re-location rather than reducing the development gaps between European regions and creating new jobs[8]. In our opinion this is a misdirected policy analysis as re-location is a globalization effect, which takes place all over the world. The issue is not to avoid re-location within the EU. It is much more important to avoid re-location taking place from the EU to third countries, to the extent this possible.

This section addresses Cohesion Policy by first assessing its current situation, second, by identifying the problems it should tackle and its added-value and third, by proposing some direct measures to improve its impact.

The challenge to manage EU complexity could not be better reflected than in the case of Cohesion Policy. The shape of the policy itself is a result of conflicting paradigms materialized in negotiation rounds carried out over the years between sympathizers of neoliberal capitalism and those favouring a regulated approach (Hooghe, 1998). The debates between the Friends of Cohesion and the Cambridge Circus, the two informal groups of Member States in Cohesion Policy negotiations, always concerned the size of the policy budget, its redistribution function, and its focus on traditional objectives such as infrastructure, on the one hand, and added-value, sound financial management, competitiveness, and absorption capacity, on the other.

Cohesion Policy is often thought to be a 'pork barrel' policy (De Rynck and McAleavey, 2001). It targets numerous measures within its broadly defined objectives and additional provisions for several Member States with *special status*, in order to allow every Member State to benefit from it. Although these political implications are not contested, globalization side-effects cause problems across Europe. The Union is varied and

[8] See Schui, H. (2008)

disparities materialize in different ways across the regions and Member States, demanding different types of interventions. Consequently, issues are raised questioning the impact and added value of the European Cohesion Policy.

- **The added-value of Cohesion Policy is visible and can be improved.**

Let us approach Cohesion Policy, going back to the idea of spillovers and 'the scale and effects of the EU action' mentioned by Art. 5 in the Treaty. There have been numerous attempts to asses the impact of the Structural and Cohesion Funds (SCF)[9]. Most indicate that convergence was improved, particularly in the case of Objective 1 regions (those with a GDP/cap of less than 75% of EU average). With the exception of the regularly cohesion reports published by the European Commission, which tend to be more optimistic, convergence was hard to prove in the case of regions, other than those under Objective 1. Nonetheless, there are several limitations to this type of evaluations that should be considered.

First, providing that these studies managed to isolate the impact of SCF from other factors and their results are pertinent, is the lack of real convergence in Objective 2 regions, for example, a result of lack of added value or is it a result of few resources allocated at the EU level, which do not allow for a stronger impact? One may recall that Objective 1 regions, where some convergence was reached, have always received more than two thirds of Cohesion Policy allocations, and the EU involvement was greater, providing over 75% of the total assistance and having more clout in the management and targeting of the funds in these areas. On the contrary, the Objective 2 regions were allocated considerably less funds (currently they benefit from 16% of the total allocations), which were implemented in a less coordinated way. Thus the question of impact and added-value should not be isolated from that of resources and implementation approach. In our opinion, claims of re-nationalisation are not justified. In fact, it seems to be the case that added-value can be seen, where EU intervention was greater.

Second, assessing real convergence does not mean assessing overall the impact of Cohesion Policy. The latter does not concern only economic cohesion, but also social and territorial cohesion. Added-value should have a broader definition in order to try to capture these aspects too. For instance, studies[10] that considered other variables besides economic indicators found positive results. These variables included the positive effects of cross-border cooperation, the exchange of knowledge and best practices, and the effects that Cohesion Policy has on the implementation of other national policies with which it interacts. It is noteworthy that social and territorial cohesion is difficult to evaluate empirically. Like economic cohesion, social and territorial cohesion is reached in the long-term. A simple evaluation of a Financial Perspective span cannot lead to conclusive results. Furthermore, the Eastern Enlargement has just taken place. The new Member States are still in a learning process concerning the use and the development of their absorption capacity.

Third, there are differences in performance in the EU, which are embedded in the national policy-making context, rather than in the capacity of SCF to deliver results. There are countries and regions that have progressed rapidly in terms of living standards and productivity, while others continue to lag behind in spite of benefiting from substantial transfers. What has made the difference

[9] See for example Bachtler and Taylor (2003), Begg (2004), Boldrin and Canova (2001), Bradley and Morgenroth (2004)

[10] See for example: Bachtler and Taylor (2003)

between the two sets of SCF beneficiaries? Evidence indicates that there is a broad array of factors explaining the divergence in performance. These can be grouped into three major sets. The first set reflects the limited success in fully integrating national development plans, the umbrella for the SCF deployment, into the country development agenda. The second set has to do with the capacity to plan at strategic level and develop a coherent policy framework, backed by a solid budget formulation and execution process. A third set of factors reflects the poor administrative capacity in the beneficiary institutions, associated sometimes with the initial conditions.

Some would argue in this case that the best approach is a concentration of Cohesion Policy assistance towards those who did not manage to make the most of it previously due to the kind of shortcomings indicated above and to the less developed Member States who are likely to face these difficulties in the future. For the successful cases, re-nationalization would be the right option. A policy targeted only at the poorer Member States of the Union would reinforce a sense of a divide between the rich and the poor; it would stress further the case for simple financial transfers and bring more dissatisfaction for western European citizens. It would contravene to the very purpose of the policy, which is to foster cohesion in Europe and not to divide it. Furthermore, globalization brings challenges that can and should be tackled only together, such as re-location effects, increasing the flexibility of the European labour force, and tackling migration within the EU. Besides building infrastructure, Cohesion Policy facilitates changes of best practices and speeds up the circulation of knowledge, which are essential for fostering growth.

The Treaty (Art. 158, the Reform Treaty) sets a clear objective for Cohesion Policy: to reduce the gaps of development between European regions, in order to promote the Union's 'overall harmonious development'. According to the Treaty, this can be achieved through economic, social and territorial cohesion and solidarity among Member States. Cohesion Policy has proven a great capacity to adapt to new challenges over time in order to answer to its objectives. Currently, a part of its expenditure is allocated to Lisbon Strategy objectives. The second objective of the Cohesion Policy, Regional competitiveness for growth and employment, allocates three quarters of its ceiling to this purpose, and a proportion of 60% of the sums allocated to the Convergence objective in the EU 15 areas are earmarked for Lisbon Strategy priorities. Nonetheless, most of the areas eligible for the Convergence objective are in the new Member States. These areas are still in need of traditional Cohesion Policy actions, such as infrastructure networks in order to connect better with the poles of development in Europe. Actions of this kind are not old fashioned. The purpose of Cohesion Policy is therefore primarily to reduce gaps of development and if this can help implement the Lisbon Agenda so much the better. One agrees that globalization presses for a faster economic growth in Europe and increased competitiveness and Cohesion Policy should help tackling these issues too. However, investing in R&D is not the only way. Regions, which lack basic infrastructure and institutional capacities, will not be able to become competitive unless their underdevelopment related handicaps are tackled first.

- **It is our opinion that the budget allocation for Cohesion Policy should be maintained or even increased.**

Its current structure is, in our view, appropriate, although the former definition of Objective 2, targeted at industrial reconversion might have better served

reaching cohesion all over the Union. However, given the current global context and the need to support the Lisbon objectives, the three policy objectives addressing convergence, regional competitiveness, and territorial cooperation are well designed and resources are proportionately allocated. The objectives capture at the same time the need for traditional structural investments, the need for fulfilling the Lisbon Agenda objectives, and the need for territorial cooperation. Nonetheless, there is much scope for improving the implementation of the policy, and in particular for developing the absorption capacity of the Member States that joined the Union after 2004 and need to speed-up their progress in order to catch up with the most developed areas in the EU.

- **Our view is that there is a need to focus on results more than in the past.**

In turn, this requires a more pro-active stance of the EU institutions, the national governments and the regions vis-à-vis the efficient use of the SCF, including the establishment of solid and performance oriented monitoring and evaluation systems at all levels. To achieve this, a review of the allocation of responsibilities between the EU, national and regional institutions in the management of the SCF might be warranted. Enhancing the institutional capacity of the SCF beneficiaries, both at local and central levels, to design and implement projects should **be** a priority.

The resources allocated to the Structural and Cohesion Funds have constantly increased from around 17.2% in 1988 to an estimated 35.7% in 2013 of the EU budget. There are countries and regions that have made progress in becoming more competitive and there are others where progress has been limited at best. Similarly, there are countries and regions that are catching up with the frontrunners in terms of incomes, while others seem to be trapped, in spite of substantial funding support from both the SCFs and national budgets. Concomitant with the increase in SCF resources, the flexibility of their use has been substantially enhanced, decision making decentralised and more of the funds go towards boosting competitiveness, growth and jobs. Evidence suggests that challenges manifest along two dimensions: a) generic problems, that have to do with meeting the development objectives against which the SCF are being deployed; and b) specific problems, that have to do more with programme implementation.

Against this background of mixed outcomes, two questions appear to demand priority answers: a) are there tensions between boosting competitiveness and the redistribution of resources that affect the performance of the SCF? and b) is enhanced flexibility in allocation, which not only puts the national governments in the driving seat in terms of deciding where resources go, but also gives practically unlimited choices to them to direct the funds, a problem rather than a solution? Are implementation capacity constraints undermining the very purpose of enhanced flexibility and decentralization of decision-making? Some lessons, which illustrate these tensions, are drawn below on the basis of implementation experiences, including some from the new Central and Eastern European members.

- **Improvements in the allocation efficiency and effectiveness of the SCF require both a better alignment of the national development plans with the EU policy priorities, and a better integration of the EU-wide strategic policy agenda into national development programs.**

Experience suggests that countries where the national policy framework has placed global competitiveness at forefront, within an EU context, such as Ireland and Spain, have been most successful in mobilising SCF for development. A stable macroeconomic environment, an outward-oriented productivity and competitiveness driven industrial strategy, within the framework of the *acquis*, important improvements in human capital and physical infrastructure, competition, market liberalization and regulatory reform and, critically, improvements in governance appear to have been prerequisites for a successful deployment of SCF. In those countries the SCF not only have become instruments for attaining national development objectives, but have also shaped the whole resource allocation framework, including the prioritisation and expenditure management framework. Noticeably, this happened against a background of not-so-clearly-defined EU-wide policy agenda at the time, prior to Lisbon Agenda's beginning to take shape.

- **The Cohesion Policy context could therefore serve as a framework for anchoring national policy-making, especially in the new Member States.**

It is generally accepted that most of the priority reforms needed, many regarding the functioning of the public sector, have to occur within the member states themselves, rather than at the EU level. The experience of Ireland and Spain, for example, suggests that the EU SCFs processes have 'exported' and enhanced oversight, benchmarking and knowledge sharing, which have shaped, to different degrees, public sector processes in the beneficiary countries. The introduction of ex-ante program analyses, multi-annual planning and budgeting for SCFs, and the system of ex-post evaluation were subsequently extended in Ireland to the whole public sector, with remarkable results in terms of increasing the efficiency of public spending. We argue therefore that, at least in the context of the new members, the SCFs should have a strong national development dimension, in a comprehensive sense, given the large income and productivity gap relative to the old members. In other words, the SCFs should help the new members exploit the opportunities offered by the EU common market by playing the role of an all-inclusive, integrative framework for national development.

- **The SCF represent, in our opinion, an important instrument for accelerating real convergence within Europe, but the need to improve the allocation and efficiency of public spending, in general, remains an outstanding and sizeable challenge for many members.**

The degree of success in achieving convergence varies considerably across countries and regions in spite of substantial SCF funding support, of which some benefited for long periods. Important public resources, including SCF, still go to unproductive policy actions, or what is even worse, are misused in a fraudulent way. There is significant scope for enhancing the quality of public investment in infrastructure and human capital. Evidence points to the fact that the countries with better state of governance seem to spend more efficiently and effectively.

- **At national level, there is a need to improve consistency and clarify the strategic direction across policy products and processes.**

Policy products include government programs, plans for the implementation of the *acquis*, convergence plans, reform plans, or national development plans (NDP). These

various strategic documents often derive from distinct processes involving different role players and with dissimilar purposes, some political, some focused on deepening EU integration and some focused on SCF access. In reality, not all are true strategic government-wide frameworks that give unequivocal direction to people and the public sector about what the government intends to achieve. While the enhanced flexibility in the allocation of the SCF across sectors to better respond to priorities is welcome, parallelisms in planning prevent reaping the full benefits pursued.

- **Vulnerabilities at the strategic planning stage, which generally takes place at the centre of the government, bringing decision-making into the nexus of politics and administration, manifest primarily in two areas.**

The first of these is the absence or the insufficient development of a broad government-wide policy framework that should define government goals clearly and allow the articulation of more detailed central and local government programs, roles and responsibilities. The second area relates to basic policy-making capacity constraints in sectors and line ministries, and the specification of medium-term expenditure preparation ceilings for government budget entities. This should take place for line ministries and other centres of government agencies and for local government entities. It entails revenue forecasting capacity matched with realistic and prioritised sectoral policy planning, and the decision to use such information to discipline budget preparation. Having such pieces in place would ensure a linkage between policy thinking and government fiscal realities. Without this tie, policy products and budget proposals often become undisciplined 'wish lists' that are difficult to connect to the resources framework.

- **Integrating policy, planning and budgeting across the government is therefore central to sustaining growth and achieving the strategic objectives of convergence.**

Institutional, policy and process weaknesses of the public financial management systems are central obstacles to strengthening aggregate fiscal discipline, improving the effectiveness of public resources allocation and aligning the resources with the strategic priorities of the countries. This affects also the absorption of the SCF. Evidence shows that the relationship between policy, planning and budgeting is one of the most important factors contributing to poor budgeting outcomes at macro, strategic and operational levels in the Member States. Key limitations come from the fragmentation of the public finance management system and vulnerabilities visible at all stages of the public expenditure management cycle.

- **More emphasis should be paid to developing medium term expenditure frameworks (MTEF) and budgets on programs, to which the SCF should be an integral part and treated similarly to other financial resources.**

Faced with conflicting objectives and constrained resources, Member States attempted to establish MTEF as a means of balancing the aggregate affordable resources with the policy priorities of the countries. However, rarely have the MTEF achieved their intended objectives of enhancing the clarity of policy objectives, improving the predictability in budget allocations, the comprehensiveness of coverage and transparency in use of resources. Instead, the MTEF are more of an annual exercise,

projecting revenues and expenditures several years ahead, rather than a multi-year budgeting initiative to guide annual budgets, with limited substantive multi-year programming content. The MTEF are often substantially altered from year to year and lack a thorough connection with other processes, such as the NDP. In some countries, budgets are organised by programme after the line-item allocations are decided upon, indicating the use of programmatic concepts as an ex-post rather than an ex-ante tool to ensure policy orientation in allocations.

- **Improving absorption and effectiveness of SCF should also target the reform of the annual budget cycle in some members.**

Frequent shortcomings include insufficient strategic and policy guidance for the allocation of funds, weak linkages between funding and performance, frequent budget rectifications reallocating important resources within the year, delays in the effective start of the budget cycle, limited cooperation between finance departments and credit holders both in the formulation and execution of the budget. Deficiencies are sometimes augmented by an inadequate macroeconomic and revenue analysis and forecasting framework.

- **There is a need to pay significantly more attention to upgrading the administrative capacity of SCF beneficiaries, especially at sub-national level, and of managing authorities.**

The capacity to design and implement complex projects in order to access SCF is often limited. As a consequence, SCF absorption is low and resources sometimes do not commensurate with outcomes. This is particularly evident in the first years after being granted access to the SCF and in the case of the poorest local governments, which need these resources the most. This situation is occurring in spite of the fact that the new EU members, for example, have received for long periods of time substantial pre-accession funding and expertise support for capacity building. This support has been internalised by the public institutions only to a limited extent, as it was the case with the pre-accession funds (PHARE, ISPA, SAPARD) and occurred mostly outside the national budget process. As a result, the interaction between those involved in the management of the pre-accession funds and the budget planning and policy departments is traditionally limited. Consequently, the net inflows of funds to the Member States, excluding CAP direct payments, (SCF gross inflows minus Member State contributions to the EU budget) are small and often times negative in the early years of membership.

- **The economic rate of return of SCF projects should be given more prominence, which in turn requires more focus on developing project design skills.**

While there have been improvements in clarifying and simplifying the SCF framework, including in what concerns the guidelines for project preparation, the standards remain high and the beneficiaries often do not have the skills to meet them fully in the project design stage. As a result, often beneficiaries cut corners and run into problems. A frequent problem is that absorption and impact are often decoupled, and the internal rate of return of the projects does not ensure their long term sustainability ('building cathedrals in the desert'). There are numerous examples where current spending resulting from project completion was not taken into account. This introduced substantial rigidity in national and local budgets, squeezing capital spending. Identifying ways to better leverage private sector skills should improve the quality of the

projects both in terms of SCF absorption and developmental impact.

- **In order to improve the linkages between programs performance and resources allocated from the SCF, there is a need to strengthen monitoring and evaluation (M&E) systems.**

These systems should assess in a comprehensive and timely manner the extent to which resources help in achieving the intended outcomes and feed-back into the policy framework for eventual corrections and reallocations. Experiences of some old members, such as Ireland, suggest that the effective use of M&E systems not only improves the overall absorption of the SCF, but it also allows for rapid redeployment of resources towards better uses. Appropriate incentives schemes, backed by performance indicators, to reward the better performers and sanction the laggards should be part of the M&E system, taking into account at the same time the institutional capacity of the beneficiaries. While the level of SCF absorption matters, it is even more important to make sure that resources go where the needs are and where their impact is maximised.

Unequivocal positions vis-a-vis these issues are probably not possible, given primarily the large disparities between Member States and regions in term of development and policy and institutional maturity, translating into a broad array of priorities at national and sub-national level. The stated objectives of the SCFs are broad, and the instruments increasingly flexible, allowing member countries to employ resources for a broad array of sectors and activities. This has clear and proven advantages. The downside is whether the funds are not rather too thinly spread in order to make a difference in terms of overarching outcomes.

In this context, a follow up strategic question vis-à-vis the SCF use is whether there is a need to better focus them, making a more clear distinction between competitiveness and redistribution. For example, the funds focusing on competitiveness could target a cross-cutting EU-wide set of policy priorities, in which case presumably the role of the EU institutions in allocating these resources should be enhanced, and the role of the member state appropriately diminished. Equally, the funds targeting redistribution should focus on narrower, country specific set of issues, in which case more delegation should be given to the Member State and eventually to the beneficiary regions themselves. The EU action, in this situation, could focus on fostering exchange of views and best practices.

- **To sum up, Cohesion Policy is one of the most important EU policies at the moment because it has the capacity and the potential to contribute to a cohesive development of the Union, with tools designed to manage the EU's socio-economic complexity.**

The policy is designed in such a way that serves to every Member State, however this reducing the impact of cohesion actions. There are also issues posed by the small absorption capacity, particularly in the new members. A balance must be found between concentrating the funds and ensuring that the problems posed by regions lagging behind all across the Union are tackled. In our view, a clearer distinction between competitiveness and redistribution could be a solution to this dilemma. Improving programming and policy planning, as suggested above are too among the ways to improve absorption and maximize the SCF's impact.

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# EUROPEAN UNION INITIATIVES IN TACKLING MIGRATION AND ORGANIZED CRIME AT ITS NEW EASTERN BORDER

**Adrian Pop***

***Abstract:*** *The EU migration strategy in relation to its new eastern neighbours has started to take shape. Among other things, it includes: applying the Global Approach to Migration to the eastern regions neighbouring the EU; securing the necessary funding for migration management through the European Neighbourhood and Partnership Instrument (ENPI) and the Thematic Programme for the cooperation with third countries in the areas of migration and asylum; promoting mobility partnerships and circular migration; concluding short-term visa facilitation and readmission agreements; and opening the first Common Visa Application Centre in the capital city of the Republic of Moldova. In addition, the EU has improved its regional focus by the help of the Black Sea Synergy European Commission Communication and extended for 2008-2009 the mandate of its Border Assistance Mission to Moldova and Ukraine (EUBAM), which is set to tackling irregular migration, drugs and cigarettes smuggling, and stolen cars and guns trafficking.*

***Key words:*** *EU initiatives; EU eastern border; migration; asylum; organized crime*

## Introduction

The EU Member States have recognized the need for immigrant labour because the EU population is aging. At present, more than 30 percent of the working population in Germany, Finland, Belgium, Italy and Austria is at least 50 years old. Up till 2050, the EU working population is expected to decrease by 30 percent, and the number of European citizens beyond 65 years old out of the total population will constitute 28 percent in Germany, 37 percent in Spain, and 34 percent in Greece. Overall, by 2050 a third of the EU population will be over 65 years of age (Frattini, 2007). Labour shortages, which are already evident in many Member States in some sectors e.g. in healthcare and agriculture, are likely to increase in the near future (Sleptova, 2003). To ensure that there is sufficient population of working age, the EU will have to accept 79.6 million immigrants in the next 50 years, i.e. 1.4 million a year.

At present, the EU immigration policies are marked by ambivalences and ambiguities. Characteristics of these policies include: territorial exclusion of some groups of immigrants; containment of the free movement of citizens from certain EU Member States within the EU; protection of some immigrant groups from discrimination while discriminating against other groups by categorizing immigrants to the EU; special programmes for the protection of immigrant women and children; the utilitarian recruitment of "favoured" categories of migrants, while their presence within the EU is subject to temporal, social, political, and economic restrictions. These ambiguities are rooted in

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contradictory policy logics, especially those of criminal justice, labour market, foreign policy and development, and gender equality policies. There is a need for the "diversity of harmonization" of the EU immigration policy and for an adequate multilateral migration management that will include all stakeholders in migration policy, ranging from old Member States to new Member States and the EU neighbouring countries.

A common immigration policy still remains a remote prospect. However, in recent years, the EU has made much progress with a comprehensive migration strategy. It has secured the necessary finances to take further action. The European Commission, endorsed by the Parliament, has allocated almost 4 billion euros to migration issues in its 2007-2013 financial programme.

Cooperation with third countries is an essential part of the EU migration strategy. In order to work much more closely with third countries, the EU is developing a number of new tools, including assisting countries that are interested in putting together detailed *Migration Profiles* so as to have the relevant information on which to base practical measures; building *Cooperation Platforms* bringing together third countries, EU Member States and international organisations to ensure effective migration management; and creating *Migration Support Teams* consisting of experts from EU Member States to provide assistance to third countries that ask for it (Frattini, 2007).

Both Member States and the EU now put particular emphasis on the need for a "global approach". What's more, taking into account that approximately one third of all third country nationals living in the EU are nationals of Eastern and South-Eastern European neighbouring countries and the Russian Federation, the EU has developed a series of migration management initiatives to tackle migration at its new eastern and south-eastern borders efficiently.

### Applying the global approach to migration to the eastern and south-eastern regions neighbouring the European Union

In December 2005, the European Council adopted the Global Approach to Migration, focused initially on Africa and the Mediterranean region. In its Conclusions of December 2006, the European Council called on the Commission to put forward proposals "on enhanced dialogue and concrete measures" for applying the Global Approach to the Eastern and South-Eastern Regions neighbouring the EU. As a result, in June 2007, the European Commission has issued the Communication no. 247 *Applying the Global Approach to Migration to the Eastern and South-Eastern Regions Neighbouring the European Union*. This Communication focuses mainly on the regions neighbouring the EU to the east and south-east:

- Turkey, the Western Balkans (Albania, Bosnia and Herzegovina, Croatia, the former Yugoslav Republic of Macedonia, Montenegro, and Serbia, including Kosovo);
- The European Neighbourhood Policy (ENP) partner countries in Eastern Europe (Ukraine, Moldova and Belarus);
- The Southern Caucasus (Armenia, Azerbaijan and Georgia); and
- The Russian Federation.

Premised on the "migratory route" concept, this Communication addresses the countries of origin and transit:

- The Middle Eastern ENP partner countries (Syria, Jordan, and Lebanon), Iran, and Iraq;

- Central Asia (Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan, and Uzbekistan);
- Asian countries including China, India, Pakistan, Afghanistan, Bangladesh, Sri Lanka, the Philippines, and Indonesia.

The necessary framework for a bilateral dialogue exists with all of ENP partner countries in Eastern Europe, with the exception of Belarus. Migration policies are already discussed in depth with Moldova and Ukraine in relevant sub-committees. Migration issues have been also raised at the regular EU-Ukraine Justice, Freedom and Security (JLS) ministerial troika and during meetings of the Cooperation Committee and Cooperation Council. The Commission considers it essential that dialogue and agreements on mobility issues be enhanced between the EU and the ENP partner countries (COM (2007) 247 final).

### Mobility partnerships and circular migration

In May 2007, the European Commission (EC) published its Communication on Mobility Partnerships and Circular Migration.

The main idea of the *mobility partnerships* is that the EU would work more closely at tackling illegal migration while citizens from these countries would benefit from enhanced possibilities of mobility between their countries and the EU. Mobility partnerships could offer a mechanism which would enable the EC to directly negotiate with third countries the national quotas set by Member States on the basis of their labour market needs. To put it alternatively, Member States would continue to determine the number and type of jobs available in their labour markets but the EU would negotiate with third countries on the basis of the combined quotas. Within the framework of mobility partnerships, the EU could also provide better information about labour markets and offer skills and language training, as well as financial assistance in areas linked to the management of legal migration. According to the EC, the concept of “mobility” will become a key element for the development of the EU migration management strategies in the approaching decade.

In its turn, *circular migration* provides a flexible approach to addressing labour needs in certain countries of destination and development needs of certain countries of origin. For the EU, the main priorities are return of skilled migrant workers from the EU to their home countries to foster development, labour migration to the EU to meet identified labour needs, and incentives and safeguards encouraging the return of migrants and ensuring that circular migration of migrants to the EU remains circular. As a voluntary and cooperative process catering to labour needs of the countries of origin and destination, circular migration will certainly bring benefits to all parties.

As rightly pointed out by a recent study published jointly by the International Bank for Reconstruction and Development and the World Bank, circular migration programmes may be instrumental in resolving the key migration paradox: the demand for migrant labour coexists with meagre public support for permanent migration — particularly unskilled migration — in many European and middle-income CIS countries experiencing demographic decline. Moreover, circular migration may have the potential to facilitate development in countries of origin by increasing migrants’ human and financial capital, facilitating international skill transfers, building cross-border trade and investment, and preventing the long-term separation of families (Mansoor and Quillin, eds., 2007).

Nevertheless, the proper implementation of circular migration schemes is a function of multiple variables, including governments' capacity building to facilitate circular migration, the possibility of transferring social security and pension rights, ability to preserve cultural ties between migrants and their families, and the existence of a mix of incentives and safeguards to facilitate circular migration. In terms of incentives, the importance of ensuring adequate admission/ readmission and integration/reintegration measures for circular migrants is a key factor. Regarding outward mobility from the EU to third countries, incentives for migrants, such as the portability of social welfare benefits and pensions, career breaks, and flexibility in the workplace, are also important. Concerning inward mobility to the EU, incentives include the issuance of multi-annual permits, multiple work permits (permitting to change employers) and pre-departure information courses. In their turn, safeguards to ensure that migrants return from the EU to their countries of origin include development bonuses or saving funds for returning migrants, special housing projects, or business start-ups. Broader safeguards could include monitoring mechanisms to verify the return of migrants to their countries of origin, or mobility partnerships linking employment offers with commitments of third countries to readmit their nationals.

On July 20, 2007, the EC organized a consultation meeting with the EU Member States about circular migration. The meeting was the first in a series of consultations that aimed to establish agreed parameters on the definition, operating mechanisms, and the framework for the future circular migration initiatives between the EU and third countries. By the end of 2007, the EC hopes to establish pilot projects between the willing EU Member States and the selected third countries. A similar and parallel consultation process is taking place on mobility partnerships; the first states-only consultation was organized on July 24, 2007.

The EC will conduct a series of further consultations with the EU Member States about circular migration in order to develop common elements for a circular migration scheme in the European Council Conclusions by the end of 2007. The EC will try to link the ongoing consultations on circular migration and mobility partnerships, and it has proposed to the EU Member States that mobility partnerships be used as a framework for circular migration initiatives. In EC's view, the new thematic budget line on migration and asylum could be a possible mechanism for funding circular migration projects.

On the one hand, the EC Communication of May 16, 2007 on Mobility Partnerships and Circular Migration should be seen against the background of the existing legal migration policy programme of the EU that began with the Hague Programme. On the other, the EC Communication should be seen in the context of two legislative proposals in the area of economic migration adopted by the EC later on, on October 23, 2007. One of the proposals concerns the admission of highly skilled workers. Another proposal deals with the rights of foreign nationals legally employed in the EU. The rest of the planned directives on the admission of seasonal workers, intra-corporate trainees, and remunerated trainees are scheduled to be introduced during 2008. No common admission regulations for other categories of migrants, for instance, low-skilled workers, have been scheduled.

**European neighbourhood and partnership instrument**

Today, the European Neighbourhood Policy (ENP) is the principal instrument that

connects the countries from Eastern Europe with the EU. This policy is undergoing a broad and thorough process of assessment and change. A complete revision is expected under an "ENP plus" umbrella. It is intended to redesign the character of future relations between the EU and ex-Soviet countries after 2008, following the completion of the Action Plans with Moldova and Ukraine. Given Romania's proximity to the countries covered under the ENP and understanding of the challenges facing the region, the Romanian government is very interested in this dimension of the ENP.

The ENP helps turn the external borders of the EU into the centre for coping with major security problems (visas, immigration, asylum, crime prevention, fight against organized crime, etc.). The Action Plans already include major actions in the European Union's area of Freedom, Security and Justice and envision the possibility for neighbouring countries to become parties in different European and international programmes.

The ENP Action Plans for the ENP partner states in Eastern Europe put forward measures for cooperation in migration, visas and asylum conditions, fighting terrorism, prevention of crime, money laundering, drugs smuggling, and weapons trafficking. Moreover, the Action Plans identify the possibilities for strengthening cooperation to strengthen the system of justice and police, including the cooperation with the European agencies such as EUROPOL and EUROJUST.

In terms of funding for 2007-2013, the ENP benefits from the European Neighbourhood and Partnership Instrument (ENPI), which belongs to the category of "general instruments to support directly the European foreign policies," together with the Pre-Accession Instrument (PAI) and the Development Cooperation and Economic Cooperation Instrument (DCECI). This rather new financial instrument complements the existing instruments (TACIS, MEDA) and functions based on the neighbourhood programme experience previously undertaken in 2004 - 2006. Funding is channelled to fulfil the following key objectives: promote sustainable development in the border regions; ensure cooperation in environmental protection, public security, and prevention conflicts and organised crime; improve border management; and promote cross-border cooperation locally and people-to-people contacts (Pop *et al*, 2006).

The ENPI finances joint projects, proposed by and for the benefit of the EU Member States and the neighbouring countries. Its implementation requires, mainly, the combination of the ENP objectives within the cross border and trans-national cooperation programmes with the economic and social cohesion policy objectives.

Between May 25 and June 30, 2007, Eurobarometer conducted a survey in 27 EU Member States for the EC. The survey confirmed that a significant majority of people in the EU Member States support efforts for increased cooperation with the countries neighbouring the Union. Strong majorities of those polled consider it important, or very important, to cooperate with neighbouring countries on tackling organized crime and terrorism (89 percent) and immigration (71 percent). There is a substantial support for political aspects of the policy: 62 percent of those interviewed believe that working closely with neighbouring states can reduce illegal immigration. A clear majority (61 percent) believe that cooperating with neighbouring states can produce mutual benefits for the EU and its neighbours, but 79 percent of those interviewed are concerned about the cost of such cooperation.

**EUBAM**

The customs and border dialogue between the Republic of Moldova and Ukraine has entered a new phase after a failed attempt in September 2001 to establish joint Ukrainian-Moldovan control posts on Ukrainian territory. In spite of the agreement for tougher and joint control of the Moldovan-Ukrainian border, the situation did not improve significantly, because the uncooperative Transnistrian authorities stalled the progress.

Subsequent customs dialogue was focused on the reestablishment of joint control posts, particularly on the separatist segment at Moldova-Ukraine border (including Kuchurgan-Pervomaiskoe and Kuchurgan-Novosavitskoe). This bilateral dialogue was mediated by the EU and continued by the OSCE.

During March and May 2003, an observation and evaluation team, mandated by the OSCE, carried a fact-finding mission in the separatist region and developed a number of recommendations for an international mission under the OSCE mandate. As a result, the EU Border Assistance Mission to Moldova and Ukraine (EUBAM) was established. The mandate for EUBAM was initially approved for two years (2005-2007), but in March 2007, it was extended for 2008-2009. EUBAM has no executive power, and it cannot enforce legislation. However, it may ask for additional checks at the request or upon suggestion from competent services.

The first year's record of the monitoring mission of Moldova-Ukrainian border is encouraging, as illegal migration, drugs smuggling, trafficking of stolen foreign cars, and chicken meat smuggling decreased. Additionally, the implementation of modern container checking techniques proved effective for finding illegal guns and unmarked cigarettes.

Even more significant is EUBAM's medium term impact. First, it demonstrated the EU involvement and presence in the region, proving the EU ability to organise an important mission rather quickly. It gave a better understanding of the regional situation and a more effective policy orientation for Moldova and Ukraine. Second, it improved significantly the communication and trust between border authorities of the neighbouring countries. Third, the Needs Assessment and Recommendations Report (NARR) will provide guidance for the border reform and modernisation processes in the two neighbouring countries.

The EU has been preparing the second phase of its monitoring mission in the greater framework of the *Concept on ESDP missions at the frontiers,* drafted by the General Secretariat of the Council. This document envisages a new approach for tackling the new border security challenges and risks resulting from the eastward and southward expansion of the EU. As a consequence, shortcomings of the first phase, like steel smuggling, will be dealt with during the second phase with the help of EC. In order to combat organized crime, joint teams of policemen and prosecutors will be created.

**Black Sea Synergy**

With the accession of the two Black Sea states, Bulgaria and Romania, to the EU, the security and stability of this area have become of immediate concern to the EU. As a result, on April 11, 2007, the EC launched the Black Sea Synergy, a new EU cooperation initiative for the Black Sea region under the framework of the ENP. The initiative aims at developing cooperation within the Black Sea region and between the region and the EU. This initiative adds a much needed regional dimension to the ENP and implements the Commission's

December 2006 proposal to that effect. Before the initiative, the ENP included mainly bilateral instruments in the form of the Action Plans. The Black Sea Synergy complements the EU's already substantial efforts to promote stability and reforms in the countries surrounding the Black Sea and completes the network of regional cooperation frameworks in the EU's neighbourhood by adding another region to the Euro-Mediterranean Partnership and the Northern Dimension.

Significant opportunities and challenges exist in the Black Sea area and they require coordinated regional action. At first, the Black Sea Synergy will focus on these challenges, cooperation sectors of common priorities, and other areas, in which the EU presence and support are already conspicuous. A key cooperation area is managing movement and improving security. The EC's document stresses the importance of improving border management and customs regionally, presents the EU Border Assistance Mission for Moldova and Ukraine (EUBAM) as a success story, and underlines its linkage with the Commission's Communication *Applying the Global Approach to Migration to the Eastern and South-Eastern Regions Neighbouring the European Union*, which offers new opportunities for managing migration better and tackling illegal migration.

Furthermore, the Commission encourages the countries in the region to develop further practical cooperation on combating general cross-border crime by capitalizing on the experiences of other initiatives in South-Eastern Europe and the Baltic area, sharing best practices, introducing common standards for saving and exchanging information, establishing early warning systems relating to trans-national crime, developing training schemes, and fully utilizing experience, activities, and infrastructure of the Regional Centre for Combating Trans-border Crime (SECI Centre) in Bucharest and the Black Sea Border Coordination and Information Centre in Burgas (COM(207) 160 final).

### The thematic programme for the cooperation with third countries in the areas of migration and asylum

Building on the experience of its predecessor, AENEAS, the new Thematic Programme will support third countries in their efforts for improving migration management in all its dimensions. The focus will be on countries along the southern and eastern migratory routes towards the EU, although other migratory routes and south-south migrations will also be covered.

The new Thematic Programme for the cooperation with third countries in the field of asylum and migration was established through the European Parliament and Council Regulation that was adopted on December 18, 2006, through a co-decision procedure. The Thematic Programme is endowed with €380 million (excluding the allocation for covering administrative expenditures) for the period 2007-2013, which means a yearly average allocation of approximately €54.5 million per year. If compared to the yearly 40 million budget under the 2004-2006 Aeneas Programme, this figure represents a substantial increase in funding. However, this increase will be felt only gradually.

The 2007-2010 Multi-Annual Indicative Programme adopted on June 22, 2007, details the financial allocations for sub-regions for the first four years of the programme. Three quarters of the available allocation will fund actions linked to a specific migratory route or a sub-region. These allocations will mostly fund projects that will be selected through competitive procedures and by means of Calls for Proposals launched yearly by the European Commission. The first Call for Proposal was launched in the autumn of 2007.

In addition to the initiatives targeting the migratory routes, € 28 millions will be directed to five global initiatives or the initiatives involving more than one of the aforementioned migratory routes or sub-regions. These initiatives will focus on the following themes:

- Migration and development;
- Labour migration;
- Asylum and refugee protection;
- Smuggling and trafficking in human beings;
- Illegal immigration.

Additionally, the allocation of €20 millions will be reserved for funding so-called "special measures." This reserve could be used to finance interventions in third countries, in the event that great risks exist for human rights, lives, and safety of migrants, the border security and public order in the country, or any other country affected by the same migratory flow (including the EU Member States). In particular, this financial assistance is justified whenever the migration situation rapidly deteriorates and a timely financial assistance can improve the situation.

Actions under the new Thematic Programme will complement the migration and asylum initiatives developed under the ENPI, the Development Cooperation Instrument, and the European Development Fund. Geographically, the funding for the Thematic Programme can be spent for actions benefiting any country in the ENP region (including the Russian Federation) and any developing countries in Latin America, the Caribbean, Africa, Asia, and the Pacific Region. However, the Thematic Programme cannot finance actions in the countries that are potential or actual candidates to the EU membership, as these countries may be funded only through the Instruments for Pre-Accession (COM(2006) 26 final).

The programme will include the following activity areas:

- Linking migration and development, especially by encouraging the contribution of diasporas to the development of their countries of origin and increasing the value of migrants' return; mitigating brain drain and promoting the circular migration of skilled migrants; facilitating financial transfers by migrants to their countries of origin; supporting voluntary return and reintegration of migrants and building capacities for migration management; and fostering capacity building efforts to help countries in formulating pro-development migration policies and in managing migration flows jointly.
- Promoting well-managed labour migration, by informing about legal migration and conditions of entry and stay in the Member States of the Community; providing information on labour migration opportunities and needs in the Member States and on qualifications of third country citizens wishing to migrate; supporting pre-departure training for candidates for legal migration; and encouraging development and implementation of legislative frameworks for migrant workers in third countries.
- Fighting illegal immigration and facilitating readmission of illegal immigrants, including between third countries. A special attention to be paid to fighting smuggling of and trafficking in human beings; discouraging illegal immigration and raising awareness of the risks related to it; improving capacities in the areas of border, visa and passport management, including the security of documents and the introduction of biometric data, and detection of forged documents;

implementing effectively readmission agreements concluded with the Community and obligations arising out of international agreements; and assisting third countries in the management of illegal immigration and in the coordination of their policies.

- Protecting migrants, including the most vulnerable, such as women and children, from the risk of exploitation and exclusion through measures including improvement of legislation in the field of migration in third countries; supporting integration, non-discrimination, and measures for protecting migrants from racism and xenophobia; and preventing and fighting trafficking in human beings and slavery.
- Promoting asylum and international protection through regional and other protection programmes by strengthening institutional capacities; supporting the registration of asylum applicants and refugees; promoting international standards and instruments on the protection of refugees; supporting the improvement of reception conditions and local integration; and working toward lasting solutions.

The new Thematic Programme should be seen against the backdrop of the Hague Programme, which called on the European Commission to submit the second-phase instruments of the Common European Asylum System (CEAS) to the Council and the European Parliament with a view to their adoption before the end of 2010.

In June 2007, Franco Frattini, the European Commissioner responsible for Justice, Freedom and Security issued a comprehensive package on asylum, including a Green Paper. The Green Paper is designed to stimulate a broad debate among all the relevant stakeholders: the EU institutions, national, regional and local authorities, candidate countries, third-country partners, intergovernmental and non-governmental organisations, academia and the social partners. The package includes two other documents: a proposal for a Directive extending the possibility to obtain Long-Term Residence status to beneficiaries of international protection; and an evaluation report on the Dublin system, which determines which Member State is responsible for examining an asylum application. The results of the debate on the Green Paper will set out a roadmap for the Commission's work towards the achievement of the Common European Asylum System by 2010.

### The EU Common Visa Application Centre

Following the Hague Programme, on May 31, 2006, the Commission presented a proposal to the European Parliament and the Council, in order to formulate the legal framework for consular offices of the Member States and to enhance consular cooperation.

The aim has been twofold. On the one hand, sharing of premises, staff, and equipment between the participating countries would lead to a better use of resources. On the other hand, it would make visa issuance process more accessible.

In addition to existing forms, new forms of consular offices became possible: co-location, common application centres, and outsourcing. These initiatives are explained below:

- Co-location means that consular staff of two or more Member States are sharing the equipment of the host member state in its consulate;
- Common application centres means that consular staff of two or more Member States are pooled in one

"neutral" building for receiving visa applications;

- Outsourcing means collaboration with the external service providers to create "call-centres" for scheduling appointments or receiving visa applications, including biometric identifiers.

This initiative laid basis for an entirely new development in the common visa policy. It has introduced new forms of cooperation such as Common Visa Application Centres that will receive and process visa application. Consular staff of two or more Member States will be located in a single building, and visa applications will be transferred to the member state responsible for the decision.

Establishment of the Common Visa Application Centres and the introduction of biometrics in Visa Information System (VIS) will reinforce internal security and facilitate legal travel to EU. As registration of biometric identifiers will become a part of the visa application procedure, the Common Consular Instructions (CCI) will have to be amended and include regulations governing collection of biometric identifiers. Each Member State will process and issue decision on visa application for that particular state. In particular, outsourcing raises very important questions of data protection, and these issues will be discussed in-depth at the European Parliament and among the Member States.

When presenting the proposal to the Justice and Home Affairs Council, Vice-President Franco Frattini suggested that pilot projects should be launched for creating such centres.

Moldova was identified as one of the most relevant countries for the programme, because Romania's accession to the EU affected the application process for the Member States' visas for Moldovans. As only a very small number of the Member States are represented in Chisinau, Moldovans now need to travel to their representations in Romania. Anyhow, since Romania introduced visa obligation for Moldovan citizens, Moldovans need first to obtain a Romanian visa to travel to Member States' representations there.

With participation of Austria, Slovenia, and Latvia in August 2006, Hungary opened the first Common Visa Application Centre on the premises of its embassy in Chisinau. Later on, Denmark and Estonia have also joined the project. Other Member States that do not have diplomatic representations in Moldova have expressed an interest in this initiative.

To establish the Common Visa Application Centre, Hungary signed a Memorandum of Understanding with Moldovan authorities and concluded bilateral agreements with the participating Member States on details of their cooperation. The Centre started operating on April 12, 2007, and the official opening took place on April 25, 2007, when Franco Frattini paid a visit to Moldova.

The Centre has capacity to handle about 10,000 applications a year. It collects visa applications for transit, airport transit and short-stay visas on behalf of the participating Member States. The applications are collected in the Centre (scanning of passports and pictures) and then sent at least once a week to the processing consulates. Each application package includes a hard copy of the application, supporting documents, and a reusable smart card with basic data and a photo of the applicant. The smart card contains a photo of the applicant. In the future, the smart card will include also applicant's fingerprints.

The Centre allows Moldovan citizens seeking visas for the participating countries to submit their applications and undergo interviews in Chisinau, instead of being obliged to submit their visa applications abroad (in Romania or Ukraine).

The Republic of Moldova has lamented the difficulties its citizens in obtaining Schengen visas. To obtain a Schengen visa, Moldovans must travel to neighbouring countries, because only two Schengen Member States have consulates in Moldova.

In addition, many Moldovans complained about the "visa for visa" practices, i.e. the fact that they should go to various neighbouring capitals, in order to get visas for Western European countries. High costs involved (travel, room and board, sometime consular "pocket money") may sum up to 14 times more than the actual cost of the visa. In 2002, for instance, there were 76 embassies accredited for Moldova, but only 11 with headquarters in Chisinau. The rest of them were located in Moscow, Kyiv, Bucharest, Budapest, Sofia, Athens, Ankara, and Prague. In order to travel to Slovenia, Moldovan citizens had to travel to Budapest and apply there for a Slovenian visa. A Slovenian visa cost only US $ 40, but the actual cost of getting it was around US $ 550 (Gheorghiu, 2002). Moldovan nationals travelling to Former Yugoslav Republic of Macedonia (FYROM) were confronted with the same "visa for visa" practice. Prior to reaching Skopje, a Moldovan national had to get a Bulgarian visa, travel to Sofia, and there obtain a visa for FYROM.

In light of these difficulties, it is no wonder that many Moldovans preferred to appeal to the services of (more or less ghost) firms specialized in getting Schengen visas. Those services were all but cheap, varying according to the urgency in getting them from US $ 650-800 in 2-3 months to US $ 2,150 in two days. However, they allowed the applicant to avoid the hassles of travelling to consulates. Services for getting visas for Israel were particularly expensive. Moreover, some countries did not approve visas at the border.

Against this backdrop, the Centre marked the first step to the harmonization of the application of the Common Consular Instructions (CCI) and the future Common Visa Offices. However, the main shortcoming of the Centre is the limited number of participating countries; key destination states as Turkey, Greece, Italy, and Portugal are not included.

### The EU-Moldova short-term visa facilitation and readmission agreements

In 1991, a "model" readmission agreement was signed by five states of Schengen zone - Germany, France, Belgium, the Netherlands, and Luxembourg - and Poland. The agreement referred not only to the citizens of contracting parties, but also to citizens of third parties or persons without citizenship who entered the territory of the Schengen countries through Poland. The agreement was soon followed by the decision to grant Polish citizens a visa free travel regime in the Schengen states. The agreement was then used by Germany as a basis for its project of a recommendation to the Council for a specimen of a bilateral agreement of readmission between a member state of the EU and third countries, which was eventually adopted by the Ministries of Interior by the end of 1994. In 1994-1996 Germany became also the first EU country to sign a different kind of readmission agreement, with countries seen as net providers of irregular immigrants, including Algeria, Bulgaria, Bosnia and Herzegovina, FYROM, Pakistan, Romania, and Vietnam. As they were intended to facilitate deportation of irregular immigrants, these agreements applied only to the citizens of contracting parties (Pidluska, 2002).

According to a Communication on the common readmission policy released by the European Commission in October 2002, the

readmission agreements are based on a set of reciprocal undertakings by the European Union and third countries, as well as detailed administrative and operation procedures aimed at facilitating the return of illegal residents to their country of origin or transit. The important aspect is that readmission agreements stipulate the obligation to readmit both nationals of the country with which the EU has signed the agreement and people who are not citizens of the concerned state such as stateless persons or people of another jurisdiction who entered the EU illegally from the country in question, or vice versa.

In political terms, the readmission agreements can be defined as an effective mechanism for managing illegal migration flows. It is a major element in the fight against illegal migration helping stabilize immigration. Moreover, these agreements help halt international smuggling, which, to a great extent, partially represents illegal migration in Europe.

At its current stage, this EU policy is mandatory: the EU does not accept agreements on association, cooperation or other similar agreements, as long as this "compulsory provision" is not confirmed by the third countries. The "compulsory provision" on readmission is stipulated as obligatory in the treaties that the EU concluded with more than 70 countries, most of which are developing countries.

On December 19, 2006, the Council of the European Union mandated the European Commission to negotiate agreements on the facilitation of short-term visa and on readmission between Moldova and the European Community. According to the Treaty Establishing the European Community, Title IV, the decision was taken unanimously. The documents are of special importance for Moldova. The first act is a sort of accelerator for the facilitation of certain categories of Moldovan citizens' travels in the Schengen area and for deepening and strengthening the inter-human relations between Moldovan citizens and those from the EU Member States. The second act stipulates that illegal migrants must return to their homelands and compels countries of origin to contribute financially. These measures create a foundation for a stronger and more effective cooperation in coping with illegal migration and strengthening border control.

So that citizens of the participating states benefit from the ENP, the EU launched negotiations on the facilitation of procedures of issuing visas to certain categories of persons: students, researchers, businessmen, NGO representatives, journalists, and public servants. These procedures were initiated in order to give the European Neighbourhood Policy (ENP) a "more human" side, as Benitta Ferrero Waldner, the Commissioner for External Relations and ENP has put it.

In order to be successful in its pending negotiations with the EU on a facilitated visa regime, on January 1, 2007 Moldova abolished visas for EU citizens and opted for an asymmetric visa regime with the EU. This has had the beneficial effect for Moldova, as it increased its revenues from tourism, trade with, and investment from the EU Member States.

On October 10, 2007 the Agreements on the facilitation of the issuance of visas and on readmission between the Republic of Moldova and the European Community were signed in Brussels and on October 17, 2007, the Moldovan government adopted the Decision on the approval of the draft law on the ratification of the two documents.

The short-term visa facilitation agreement enables a restricted number of Moldovan citizens to obtain visas under a simplified regime. However, the agreement does not

remove visa requirement for most Moldovans (except for holders of diplomatic passports) or simplify the visa issuing terms for applicants.

However, the short-term visa facilitation agreement offers several advantages. The document simplifies processing of visa applications and keeps visa processing fee at the current level of €35. The Council did not change the fee, even though it amended the Common Consular Instructions and the Common Manual introducing €60 fee in June 2006. The agreement limits duration of the visa application processing to 10 calendar days from the date the application and required documentation are received.

At the same time some essential disadvantages of the agreement could be anticipated. Simplification of the visa application process will affect only certain categories of applicants who would be allowed to obtain multiple-entry visas with longer periods of validity and without having to pay handling fees. For this reason, the agreement would divide the Moldovan society into two groups: the few privileged who can get a multiple-entry visa and benefit from a simplified procedure (fewer documents required for visa application) and from a visa application fee waiver, and the vast majority of ordinary citizens who cannot enjoy such advantages. This could generate frustration, a sense of discrimination, and create a perception that the EU is interested only in the Moldovan elite. The EU may be seen in a negative light. As the privileged categories will include journalists, business persons, and drivers, the favouritism might easily lead to corruption. For instance, some persons may try to submit counterfeit confirmation of being journalists or drivers. If these practices become widespread, the relationship of trust between the EU and Moldova could suffer.

It is not by chance that the EU imposes the readmission as a mandatory condition in exchange for a facilitated visa regime. The readmission agreement sets out clear obligations and procedures for the authorities in Moldova and the EU Member States about timelines and procedures for the readmission of illegal immigrants. Currently, Moldova is still the country exporting migrants of Moldovan and foreign origin. Illegal immigration flow from the EU to Moldova is not so palpable as to raise special concerns for the EU migration policy. Nonetheless, there is a risk that the existing illegal migration channels will be used by criminal groups involved in trafficking of drugs, human beings, etc. This potential threat propelled the EU to sign the readmission agreement with Moldova.

One of the major problems of the readmission agreement is its unilateral character. The readmission is a “compulsory provision” of the EU policy imposed on certain countries on the basis of clear-cut criteria. Another problem is incompleteness. For instance, according to the Seville EU Council Conclusions, starting in June 2002, if a third country refuses to cooperate, the EU Council, by an unanimous vote, can “fully use the existing Community mechanisms” as a part of the EU foreign policy in order to honour the Union’s contractual commitments. Yet, the types of mechanisms that the EU can use are not stipulated.

The lack of prior discussions is another problem for the readmission agreement. Usually, if a state wants to sign an agreement with the EU, initially, the so-called “prior talks” are held. But it seems that the EU has never consulted with non-EU states about the readmission. Morocco, Pakistan, and the Russian Federation have refused to the launch of negotiations on this matter for more than two years. Talks with Russia

started only after the EU and the Russian Federation had agreed on the status of Kaliningrad, following Lithuania's accession to the EU.

An eventual problem would concern stateless persons and aliens. Once the Moldova-EU readmission agreement enters into force, Moldova will be responsible for the return of Moldovan citizens, stateless persons, and foreigners. The country will have to assume financial and other commitments pursuant to the readmission agreement. Cases involving stateless persons and persons of other jurisdictions will require greater efforts, because the EU readmission agreements necessitate corresponding agreements with other states and thus trigger a "chain reaction." In order to ease the readmission of persons belonging to other jurisdictions, readmission agreements will have to be signed with the countries under the jurisdiction of which these persons are. These countries tend to be those with high level of emigration, such as China, Russia, Uzbekistan, Kazakhstan, etc.

Despite some structural advantages the agreement can provide, it is not advantageous for countries of origin or third countries, such as Moldova. So long as Moldova signs no readmission agreements with other countries of origin, it runs the risk that illegal migrants will settle down on its territory. Under the readmission agreement, illegal migrants will have to be departed to Moldova, and therefore, they will try to find alternative ways to return to the EU by crossing the countries that have not signed the readmission agreements with the EU. However, the fact that the agreement was signed before the entering into force of the EU-Ukraine readmission agreement (2008) is a positive development.

Although readmission is seen as a unilateral policy focused only on controlling illegal migration, the conclusion of this agreement can have some positive repercussions. Both for Moldova and Ukraine, the readmission is a condition for a facilitated visa regime, and it is a possibility for the economic and commercial cooperation with the EU. Ukraine will be the first Eastern European ENP country to negotiate a free trade agreement immediately after its accession to the World Trade Organization. Accordingly, after signing and implementing the readmission agreement, Chisinau is in the position to conclude further agreements that have the readmission as a mandatory provision, including a free trade agreement.

Another advantage resides in the financial benefit and the possibility of capitalizing on the EU's experience in migration. Often, readmission agreements encompass financial, material, and technical assistance and other incentives. The incentives can be used after the conclusion of the agreement. After nearly one year of negotiations, the EU and Ukraine have agreed on a draft agreement regarding facilitated visa issuance. It was initiated at the Tenth EU-Ukraine Summit in Helsinki on October 27, 2006, by the EC Commissioner Benita Ferrero-Waldner and the Foreign Minister of Ukraine Boris Tarasyuk. The EU accepted some provisional clauses negotiated by Kyiv, including a two-year grace period that would allow Ukraine to prepare for the implementation of the agreement. Consequently, the readmission agreement will enter into force only in October 2008.

In sum, one could conclude that whereas a common immigration policy still remains a remote prospect, in recent years the EU has made much progress with a comprehensive migration strategy, including in relation to its new eastern neighbours.

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# SUBNATIONAL REGIONALISM IN A SUPRANATIONAL CONTEXT: THE CASE OF HUNGARY

**David Ellison***

***Abstract***[1]. *European economic integration drives a political economy of regionalism that—far more than traditional divisions between labor and capital—defines the principal axis of political-economic division in the New Europe. The New Economy drives a radical shift in EU policy from cohesion or redistribution toward innovation promotion, affecting distributional struggles and policy approaches at the EU, national and subnational levels. Shifting strategies pose significant challenges at the national and subnational levels with important implications for future EU, national and subnational economic and regional development policy goals. At the national level, and in particular less developed economies, the New Economy creates incentives for the increasing centralization of decision-making. EU-level reforms, such as the Lisbon Agenda and an increasing emphasis on cohesion as opposed to structural funding, do much to strengthen these trends. Subnational regions, at least in the near term, may be the principal losers. But such trends are likely to strengthen future demands for greater subnational political decentralization.*

***Key words***: *European integration, subnational regionalism, New Europe, economic development, Central and Eastern Europe.*
***JEL classification***: F15 Economic Integration

Increasing economic integration in the European context places national governments and subnational regional entities at odds with each other—in particular in the less developed economies of Europe. Market integration drives greater concentration of economic activity in the more advanced regions of Europe and as well as in the more advanced areas of the New Member states. Increased differentiation on the basis of economic geography drives the rise of national and subnational economic and political regionalism. The consequences of economic geography are multiple, pitting more and less advanced national governments against each other—in particular though not exclusively in the struggle over EU Structural and Cohesion Funds (SCF's, the subject of a companion paper)[2]—and pitting national governments against subnational regional entities (the subject of this paper).

This paper asks what factors create the foundation for the implementation of greater

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[2] This struggle emerges on many levels, but is perhaps most visible at the level of debates over the EU's SCF's (Ellison, 2007). However, this struggle has also triggered EU-wide debates over national and EU-level corporate taxation and competition policies (Ellison, *forthcoming*).

political decentralization and/or regional autonomy. Previous authors have argued that demands for greater subnational regional autonomy are driven by such factors as democratization and potentially ethnic identity, the carrot of EU benefits (structural and cohesion funds), the power and influence of the European Commission (in particular as a tool to weaken states), and broader phenomena such as globalization. Ohmae (1993) argued that economically successful regions are emboldened by failed governance at the national level and the potential rewards of political autonomy at the regional level. More recently, Alesina and Spolaore (1997) have argued that integration into supranational institutional frameworks—in particular those strengthening trade relations—reduces dependence on the state and emboldens demands for greater regional autonomy.

I argue that national governments—in particular in the less developed EU economies—are placed at odds with subnational regional entities due to the challenges of the emerging economic geography. States at lower levels of economic development are subject to cohesion and convergence demands at both the national and regional levels and are thus likely torn between competing demands. National governments are likely to respond by promoting the degree of political and economic centralization—in particular where economic planning and the distribution of resources are concerned. The rise of the exogenous economy characterized by strong vertical integration with the West European marketplace now places CEE governments before the challenge of strengthening ties between foreign and domestic firms, strengthening R&D networks and building domestic potential for innovation promotion.

Subnational regional entities—in particular where subnational regional resources are threatened by centralized interests and projects—are likely to push for greater political decentralization and decision-making autonomy. Such subnational regionalism may take on different forms in different regions depending on the level of economic development and the degree of dependence upon centralized state level authorities. Where national and regional level interests coincide, i.e. where interests in the development of innovation promotion and the building of ties between foreign and domestic firms are compatible with regional interests, demands for greater political decentralization and regional decision-making autonomy will be muted. But these interests are likely to be less compatible in the less developed regions of Hungary. In this case, the carrot of EU SCF resources may potentially drive a wedge between national governments and regional entities—in particular where such resources create prospects for greater regional independence and autonomy.

The development of subnational regionalism however is also impacted by the domestic political context. Two factors stand out. One is the role of regional identity—or the lack thereof—and its potential for creating divisions between central and regional governance. Demands for greater regional autonomy and political decentralization may gain strength with time. But without a strong sense of identity based on ethnicity or language differences, complete secession will not likely be pursued. The second is the role of existing political institutions. In the Hungarian case, the emerging two-party system fuels the degree of political polarization between central elites and regional actors. Moreover, polarization impedes the role of local politicians, since the degree of party discipline common to

parliamentary systems creates barriers for local actors with future political ambitions.

This paper proceeds as follows. The first section discusses the role of economic geography in explaining the structure of national and subnational regional interests. The second analyzes the impact of Hungary's economic integration in the European marketplace. The third provides an overview of the development of regional structure in Hungary. The fourth discusses the structure of interests at the local, county, regional and national levels in Hungary. The final section concludes.

**Paradigm Shift? Cohesion, Redistribution and Innovation Promotion**

In the broader theoretical literature, explanations for why governments choose to decentralize power vary from democratization, the carrot of EU benefits (structural and cohesion funds), the power and influence of the European Commission (in particular as a tool to weaken states), to even broader phenomena such as globalization. There is however a considerable degree of variation in the relative degree of decentralization and also in the importance of the regions among the old EU member states as well. Very few EU Member states have strong regions. Belgium, Germany, Spain and the UK (Wales and Scotland) appear to be the exceptions. For the most part regions are generally weakly developed in the Member States (Le Galès and Lequesne, 1998). Despite attempts by the European Commission to strengthen regional government as a form of institutional leverage over the power of EU Member states, the formation of powerful regions lags expectations. Thus the more relevant research question may be when and why central governments are likely to relinquish more control over the ambitions of regions.

A broad scale rewriting of industrial and regional development goals has been afoot in the European Union for some time. The *Sapir Report* dealt a considerable blow to previous regional policy initiatives. Since that time, DGRegio appears pinned between the competing agendas of regional development and the onslaught of *growth and competitiveness* and *Lisbon Agenda* policy orientations.[3] This intellectual and political economic debate is evidence that *New Economy* models cast new light on the geography and driving forces of economic growth and development. Observations from this literature have repercussions both for theorizing about the shape and substance of EU, national and subnational-level regional policy tools and goals,[4] as well as the institutional framework within which they are formulated. One of the principal contributions of the New Economy Models with respect to regional policy and national (or supranational) development goals is to question the nature of the linkage between regional, subnational development policy and the nature and structure of economic growth and development. In particular, the literature on the *equity vs. efficiency tradeoffs* of economic intervention, industrial policy and regional development strategies highlights both the challenge and problems of formulating compatible regional and national level economic policy goals.

[3] A book-length Danish Technological Institute (2005) study commissioned by DGRegio was dedicated to exploring the compatibility between regional development and *Lisbon* goals. Most recently, Regional Policy Commissioner Danuta Hübner has spent considerable time giving speeches on the significance of Lisbon goals for regional development. See for example the series of speeches listed on DGRegio's website given in early March 2006.

[4] See in particular Bachtler and Wishlade (2005), Martin (2003), and Baldwin and Martin (2004).

*New Economy* models designate the mix of *endogenous growth* and *economic geography* models popularized in particular by Romer (1994), Krugman (1991) and Lucas (1990). *External increasing returns*[5] derive from the geographic clustering of firms. Economic geography models in particular highlight the *territorial* nature of localized factors generating technological progress. Territorial effects arise both from local *spillovers* generated by the geographic concentration of economic activity, as well as from factors limiting the potential geographic range over which knowledge or technological progress is spread (see Leamer and Storper, 2001; Scott, 2000; Martin, 1999; Storper, 1992). Theoretical controversy remains over what specific factors ultimately drive external increasing returns, ranging from the *Marshallian* effects related variation in the size of the available labor pool (Krugman, 1991), to informal informational exchanges (Leamer and Storper, 2001; Scott, 2000; Storper, 1992;) to variation in the level and share of human capital (Lucas, 1990; Romer, 1994). Empirical evidence suggests the most significant impact of globalization and economic integration is regional variation in levels of economic development, in particular at the subnational level (Sala-I-Martin, 2002; Martin, 1999; and Quah, 1996), a phenomenon that is perhaps best explained by New Economy type models of economic development.

For the purposes of this article, *New Economy* models cast new light both on the forces driving economic growth and development and on their territorial impact. Observations from this literature have repercussions both for theorizing about the shape and substance of EU, national and subnational-level regional policy tools and goals,[6] as well as the institutional framework within which they are formulated. A principal contribution of the New Economy Models is to question the linkage between regional development policy and the nature and structure of the factors promoting economic growth and development (Martin, 1999). Theories of economic geography and endogenous growth promote increasing attention to regional clustering and the promotion of regional, geographically-localized spillovers. In doing so, they have two potentially detrimental implications for conventional regional development policies. First, they focus attention on pre-existing geographic concentrations of economic activity—in particular regions that are more economically advanced. And second, by promoting innovation-promotion oriented policies, they draw attention away from redistributive-type policies.

The nature and structure of European, macro-level and regional development goals has undergone considerable revision in the past two decades. European economic policy goals have exhibited a gradual shift away from their previous *sectoral* structure and direct redistribution (e.g. subsidies to firms and the support of declining industries, income support and the like). Emphasis is now placed on more *horizontal* forms of assistance with broad application, in particular on the role of physical and human capital (or infrastructure, R&D, training and education).[7] Reform of EU regional development goals follows in the footsteps of these economic policy reforms.

[5] Krugman's (1991) distinguishes in particular between increasing returns resulting from firm-level economies of scale and *external* increasing returns generated by the geographic concentration of economic activity. The implications of the latter are the focus of this analysis.

[6] See in particular Bachtler and Wishlade (2005), Martin (2003), and Baldwin and Martin (2004).

[7] Early discussion of the shift toward horizontal measures can be found in "Industrial Policy in an Open and Competitive Environment: Guidelines for a Community Approach" (COM(90) 556) and "An Industrial Competitiveness Policy for the EU" (COM(94) 319 final).

Intentionally or not, the *Sapir Report* dealt a considerable blow to previous regional policy initiatives. Since that time, DGRegio appears pinned between the competing agendas of regional development and the onslaught of *growth and competitiveness* and *Lisbon Agenda* policy orientations.

Though the radical shift in development strategies and goals is perhaps only moderately perceptible, what is being questioned is the long tradition of EU and national level policy orientations focusing resources on agriculture, declining industries and lagging regions.[8] As many argue, if Europe is to become more competitive, it must shift more resources to more competitive economic activities. Following Streeck (1999), this is part of a more generalizable phenomenon occurring at the level of the state as well. Streeck emphasizes the current national government practice of promoting *productive assets* (physical and human capital, education, R&D, infrastructure, etc.) at the expense of *redistributional spending* (transfer payments, unemployment insurance and other forms of income maintenance). Competitiveness concerns drive a broad re-orientation of economic management strategies. Moreover, this phenomenon is occurring at both the supranational EU, national and subnational level of policy-making.

The specifically *regional* character of shifting policy orientations is less obvious. Yet New Economy models prompt a comparatively radical rethinking in particular of the compatibility of national and sub-national regional policy goals. These models have focused attention both on the importance of agglomeration economies and their clustering of economic activity, as well as on the importance of regions insofar as such clustering tends to exhibit a particularly regional character. One should not however confuse (as some of the literature appears to do) the focus on the regional clusters of economic activity with the previous focus on regional policy and regional development in the less advanced regions of Europe. The New Economy model is focused on promoting dynamic regional growth—in particular in regions exhibiting a positive propensity to support such growth—while the other is more clearly focused on an attempt to reverse patterns of economic decline. The outcome is likely to be an increasing degree of competition between *growth promoting* and *cohesion inducing* public policy goals or, as phrased at the outset of this article, between *innovation-oriented* and *redistributive* policy goals. Moreover, this competition exhibits a decidedly *territorial* character.

The prospects of Europe's less developed regions are further frustrated by significant regional variation in long-term levels of economic development. Repeated failures to turn some regions around (e.g. the Italian *Mezzogiorno* and East Germany), propel many to ask why EU or national level resources should be allocated to policies that do not always bear fruit.[9] A number of authors thus point to *equity vs. efficiency* trade-offs with respect to national and regional economic policy goals (Brakman et al, 2005; Bachtler et al, 2003; Martin, 1999). In their view, if agglomeration is crucial to the nature and character of economic development, then transferring resources to less developed regions is likely to slow the rate of economic development in advanced regions and accordingly may—by diverting valuable resources—fail to achieve their desired effect in less advanced regions.

[8] This point is clear from the Sapir report (European Commission, 2003: 79, 126).

[9] For recent overviews of the literature on the relative success of regional policy, see Jouen (2005: Annex) and Funck and Pizzati (2003).

Revising policy approaches directed toward less developed regions or reducing government intervention in regions on the decline are likely outcomes of such observations. In fact, promoting growth in the more developed regions is often seen as the key to promoting growth in the less advanced regions (see Brakman et al, 2005; Scott, 2000). As Scott argues, "*geo-economic space*" is made up of a "*central nucleus*" and a "*hinterland*" of variable size (2000: 48). Implicit is the notion that the welfare of more remote regions—though excruciatingly unclear where such regions begin and end[10]—is dependent upon and pulled along by the welfare of the core regions. In this regard, *New Economy* models disadvantage redistributive policy and favor more targeted and potentially more *supply-side* oriented policies focused on the development of human and physical capital (education, R&D and infrastructure), potentially diminishing the *regional cohesion* and *redistributive* content of development policies.

Efficiency motives provide strong incentives for both national governments and regions to exercise greater control over economic development strategies. For national governments, both EU-based and national-level regional development strategies—in particular those focused on cohesion and redistribution—potentially drain resources away from more advanced states and regions. While all states are broadly similar in this regard, the level of economic development across states generates variation in policy interests. For *more advanced states*, such observations drive an interest in promoting Lisbon-type objectives over more traditional forms of regional development. Lisbon-type objectives, however, embody implicit challenges, both to the interests of less developed states and regions and to the future of regional policy more generally.

For *less advanced states*, regional development goals are preferable to Lisbon-type strategies where this portends a greater concentration of funding on less developed states. At the same time however, in the domestic arena the specifically regional focus of regional development strategies may potentially draw resources away from emerging economic clusters and potentially upset the fine balance between regional and national level economic restructuring and overall economic development. If the dispersion of resources designed to promote overall development leads to an overall decline in rates of economic growth, national governments will then presumably favor agglomeration promoting policies over regional redistribution. Less advanced states in particular are thus faced with significant equity vs. efficiency tradeoffs and are torn between the objectives of *cohesion/ redistribution* and *innovation promotion*.

Due to efficiency concerns, states in particular are likely to be torn between *innovation promotion* and *cohesion/ redistribution* and are also likely to favor greater centralization in the institutional structure that oversees the making of economic management policies at the national level. Increasing demands for decentralization (whether their origin is the Commission or the regions themselves), in particular over EU funds, are likely to be paralleled by increasing national government attempts to maintain control—at least as long as politically feasible. Less advanced states in particular have strong incentives to side with growth-club constituencies in the more advanced regions,

[10] One way of thinking about this problem is to ask how it fits the European case which Scott does not directly address. For example, should one think of central nuclei and a hinterland at the national, subnational or European level? The relevant unit of analysis here is terribly important in terms of its policy implications.

since these are presumably more likely to attract important resources for the state—in particular government revenues and improved employment.

The role of the EU and the subnational regional level in attempting to foster greater decentralization at the regional level may well be rendered somewhat ambiguous in this general context.[11] The current trend—even in the framework of EU funding and the institutional management of these funds—seems to run in the opposite direction. For one, the EU has begun shifting more of the redistributional funding away from the *structural* and toward the *cohesion* elements of the SCF. This has the impact of increasing the role and importance of the state over the regions. Moreover, while DGRegio has tended to emphasize the importance of regions, current efforts likewise place considerable emphasis on the coordination of regional and state-level economic strategies,[12] once again pushing the emphasis toward the state level. For another, EU co-financing requirements ultimately favor national level institutions, since approval of such funds tends to depend on national or ministry-level support for individual projects.[13] Finally, despite an initial interest in greater decentralization, during the period 2004-2006 the coordination and management of EU SCF funding was primarily left up to CEE states. Left to their own devices—in particular with the advantage of increased political centralization—states and national governments can more easily decide how best to allocate resources across regions. Thus the EU's indecisiveness and ambiguous approach to the politics of regional development allocates much of the political struggle over economic policy strategies to the national arena.

Efficiency motives are also likely to give rise to intense national level conflicts over resource distribution. The New Economy view of what drives economic growth raises explicit challenges for regions. Economically *more advanced regions*, on the one hand, are likely to lobby national governments in favor of regional development strategies that favor agglomeration and the development of greater innovation potential. Such regions may be at the forefront of national-level autonomy drives, but are less likely to be strong supporters either of national or supranational EU-level redistribution toward less developed regions. On the other hand, insofar as EU membership provides such regions with greater political autonomy and the ability to trade freely with the other regions of Europe, they are likely to be strong supporters of European integration.[14] Economically *less advanced*

[11] For many reasons, DGRegio is likely to find itself in a considerable state of turmoil. For one, such a paradigm shift ultimately entails shifts in the policy constituencies and *entrenched interests* built up over time for the purposes of institutional survival. At the same time, both the phenomenon of paradigm shift and the EU's changing membership basis distinctly threaten older constituencies. In this regard, DGRegio is likely to be torn between competing interests. Moreover, some of this process is likely to be mirrored at the level of the state. The Hungarian case presents an interesting example. Power was first shifted to the National Development Office and only later shifted back to the Ministry of Local Government and Regional Development.

[12] The recommendation of the Danish Technological Institute's (2005) report, for example, strongly recommended that in order to pool the synergies of regional and state-level economic development strategies—and in particular in order to make Lisbon type strategies more compatible with regional development goals—it was important to coordinate and align them.

[13] Co-financing tools—for example the EU's 50% co-financing requirement for structural funds is typically seen as a mechanism for forcing correspondence between regional and national level interests in economic development (e.g. Bachtler et al, 2003: 16).

[14] This is the beauty of Alesina and Spolaore's (1997) argument that as nations become more economically integrated—or as free trade deepens and becomes more widespread—there are increasing incentives for regions to seek greater political autonomy from nation states.

*regions*, on the other hand,—in particular in the less advanced states—are likely to become strong supporters both of more traditional forms of national-level and EU support and in particular of the EU redistributional framework. In addition, they may potentially become strong advocates of political decentralization. Advocating political autonomy, however, is less likely in a context where such regions are dependent upon the approval and resources of national governments—in particular for co-financing of EU-funded projects. But in the context of national government support for more advanced regional economic clusters—less advanced regions—notwithstanding the ambiguities noted above with respect to EU-level loyalties[15]—may eventually see the EU as a haven for the defense of regional interests and as a vehicle through which they can gain greater political control over resources.

There are important caveats to the *New Economy* approach. For one, faster economic growth in Europe's peripheries appears as a potential contradiction to New Economy models and provides some support for neoclassical approaches. Slow growth in Europe's core has been one of the driving forces behind the interest in re-orienting European policy approaches toward the Lisbon agenda. While it is beyond the parameters of this paper to respond adequately to this debate, even some of the more avid and astute proponents of New Economy approaches provide occasionally contradictory data with surprisingly little commentary. Martin, for example, builds an argument around the New Economy approach but then provides data to suggest that the peripheries grew more rapidly over the period 1995-1999 (2003: 22).[16]

Others have likewise noted that although less advanced regions are frequently assumed to benefit less from economic integration and EU membership, the evidence to support this claim is at best mixed. Thus Hooghe and Keating, voice a degree of skepticism about the *core-periphery* model (1994: 369). Such findings generate further uncertainty in the calculation of which regions are likely to win and lose from the process of economic integration and EU membership. Moreover, some countries and regions have met with considerably more success than others, suggesting that other factors also play a role—in particular, the specific institutional features of individual countries and regions. Variation in the economic success of Irish, Spanish, Portuguese and Greek regions, for example, is difficult to explain only on the basis of EU-funding.

### Hungary and the Rise of the Exogenous Economy

The countries of Central and Eastern Europe are faced both with the challenge of promoting a stable, functioning macro-economic framework and with the dilemma of promoting successful regional economic development. Early discussion of the consequences of European integration focused almost exclusively on national level benefits to economic integration and little attention was devoted to the potential impact of economic integration at the local or regional

[15] To the extent that the European Commission continues to lean in the direction of national-level control of EU-funding, this may greatly limit the ability and interest of less advanced regions in promoting their ties to the European Union.

[16] Martin does argue that while there is economic convergence across states, there is economic divergence across Europe's regions. However he essentially neglects the larger question of what explains convergence across the states of Europe.

level in individual countries.[17] However, with the rapid increase in regional disparities, regional development strategies have become increasingly important. Many regions in Central and Eastern Europe have been devastated by the economic transition and the rapid economic restructuring of some regions, leading to high levels of unemployment and cross-regional wage disparities. At the same time, both democratization and the EU accession—in particular through the creation of NUTS II level regional administrative entities and the distribution of EU structural funds—have encouraged the formation and development of regional entities that grow increasingly interested in developing their own capacity to promote regional development and administrate EU funding.

The Central and East European countries are caught at an awkward juncture. On the one hand, they have—in particular the more advanced among them—achieved considerable progress in promoting foreign direct investment (FDI) and economic growth. Most or all of the Central and East European economies are now well integrated into the European marketplace, have dramatically boosted their overall levels of trade with the West and have received substantial FDI. On the other hand, as a number of authors have illustrated (Ellison, *forthcoming*; Pavlínek, 2004), there is a growing gap between those firms that are now well integrated into European networks and those firms that remain on the fringe. This gap is to some extent commensurate with a distinction between foreign affiliates and domestic firms or what some refer to as the *dual economy*. However, some domestic firms in CEE clearly benefit from their growing links to the West or from economic and/or market transition more generally.

EU membership and economic integration in the European marketplace reinforces and exacerbates the existing national-level economic geography. A frequent complaint in Hungary is that FDI and the presence of foreign MNC's has contributed generally to economic growth (a rise in productivity), to rising wages and to rising shares of Western oriented exports. But the share of R&D related activity and thus, many contend, Hungary's innovation potential is on the decline. For one, Hungary previously had far more substantial shares of R&D expenditure (in 1988 these amounted to 2.3% of GDP but by 1996 they had fallen to 0.7% of GDP) (Havas, 2001: 11). For another, incoming MNC's occasionally scaled back existing Hungarian R&D activities or transferred some R&D activities to home bases (Sass, 2004; Pavlínek, 2004).[18]

While the complete picture here is more nuanced, many fear that high reliance on foreign-owned MNC's is likely to reduce the share of Hungarian innovative potential, leading to a degree of path dependence. The worst case scenario is that hopes for greater convergence in the standard of living are likely to be frustrated in the longer term. In this sense, the countries of Central and Eastern Europe are torn between national and

[17] Bachtler et al, for example, note that 'market economy based' regional measures did not develop rapidly. More emphasis was placed instead on macro-level national economic variables (2003: 16). While this may overemphasize the degree to which the regional level was in fact neglected—many of the incentives schemes adopted in the mid to late 90's in countries like Hungary in fact offered quite generous rewards to investment in less developed regions (see Ellison, *forthcoming*)—there does appear to have been a far greater emphasis on national level economic development and a much weaker interest in regional economic development.

[18] Not all of the evidence is so negative and there are a few significant examples of firms importing important shares of their R&D activity. See e.g. Berend (2000) on the example of General Electric in Hungary. For a broader overview of this general problem, see Ellison (*forthcoming*).

regional-level economic strategies and interests. Moreover, the requirements of EU membership ultimately forces these countries to think more regionally or locally than was previously the case—in particular with respect to the use and administration of the EU's structural and cohesion funds.

These countries now face the requirement of consolidating the past decade of privatization, economic restructuring and foreign investment into more firmly embedded systems of economic production and technological development. Essentially these countries would like to improve national networks for innovation promotion—to counter the encroachment of exogenous economic development with the creation of more endogenous economic networks. At the same time, powerful forces are at work in the European Union to limit the degree of economic competition between East and West, potentially reducing the inflow of resources and restricting the nature and shape of the economic development tools these countries have at their disposal. EU membership, for example, meant the disbanding or reduction of many investment promotion strategies previously used by national governments in Central and Eastern Europe (Ellison, *forthcoming*).

Widening regional disparities in income and employment increasingly weigh on national level politics and encourage regional actors to become more and more politically active, in particular with respect to the national and regional level decision-making framework. Moreover, the EU's imposition of decentralization in the formulation and administration of regional policy goals and funding (in particular where regional policy is governed by structural fund projects), reinforces the political strength of regional actors.

Central governments in Central and Eastern Europe have so far been resistant to the decentralization of regional policy. There are of course multiple factors that might explain this. For one, CEE central governments enjoyed highly centralized political power throughout the Communist era and may not be willing to relinquish such power easily. For another, decentralization has for the most part been imposed from above and thus does not always map well onto local and national-level interest formations (Dimitrova, 2002). This fact alone raises important questions about the degree to which the created regions are what one might call "*organic*" structures of interest representation. Dieringer and Lindstrom (2002) argue that the degree of compatibility between EU and national policies is above all a function of the degree of *fit* or *misfit* between existing and adopted EU regional institutional structure. More "*organic*" definitions of regions that preserve the character of locally embedded knowledge-creation and interest networks may be more likely to promote the economic development and long-term competitiveness of regions.[19] To the extent that regions and regional governments—in particular those in decline—are not well-suited to the development of locally embedded knowledge-creation, efforts at decentralization and regionalization are likely to be resisted.[20]

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[19] McDermott (2004) makes the argument that Polish regions represent embedded regional interest networks and thus exhibit a high degree of "fit" in the language of Dieringer and Lindblom. In Hungary, NUTS II regions were superimposed on the existing structure and network of counties with approximately 3 counties for every region (except for Central Hungary, which represents Budapest and the surrounding area). The resulting regions often exhibit little attention to more *organic*, locally based structures of interest and identity.

[20] In Hungary, for example, local governments around the Balaton area have resisted their division and incorporation into 3 separate regions. As the Balaton region has long survived on the foundation of tourism,

The most compelling reason however for resistance to decentralization is simply that highly centralized policy making facilitates the formulation and implementation of cohesive national economic policy goals, while the strengthening of regional bodies may have the impact of fragmenting and dissipating their focus. The vertical rigidity introduced by Hungary's integration into more EU-based market networks propels national level policy initiatives intended to promote the creation of internal innovation promotion networks. This is presumably easiest to do by promoting the strengthening of ties between domestic and foreign firms and investors in the more developed regions and by attempting to strengthen R&D capacity in Hungary.

Thus, the interests of actors in the more developed regions of Hungary are more likely to fit easily with current interests in counter-acting the rise of the exogenous economy. Both foreign affiliates and domestic firms in regions with larger FDI shares are likely to lobby for the extension or continuation of national level economic policy goals. Thus, in the long run these actors are likely to be the allies of central governments since they are likely to favor the continuation of the status quo—in particular to the extent that such policies emphasize investment promotion and other attempts to build linkages between foreign and domestic industry (at least to the extent that these policies do not run counter to the EU competition policy).[21]

In the less developed regions of Hungary, on the other hand, regional development and investment needs are at least potentially very different. While this point is clearly recognized by some analysts (see e.g. Sass, Czakó and Bakács, 2006; Pál, 2005), its implementation and realization remains problematic. Thus both domestic firms and regional government entities in lagging regions are likely to lobby strongly for more pronounced regional policy efforts and ultimately for greater levels of political decentralization. Foreign affiliates—in particular because they are less dependent on local sources for capital and investment support—may potentially go either way. They may remain indifferent to regional policy goals, or they may favor national level policy goals (e.g. Lisbon-type strategies), or more regional policy goals depending on their immediate production and infrastructure needs.

### The Development of Regional Structure: Hungary's Insistent Centrism

In Hungary, centralized, national-level political development has a long history, equaled and eclipsed only by the long historical development of county governments (vármegye). A third level of governance was initiated at the beginning of the democratic transition with the 1990 law on local government and a fourth possible level of governance was introduced with the 1996 and 1999 laws on regions introduced in compliance with European Union (EU) demands for the establishment of Nuts II level administrative units. In important respects, Hungary's growing tug of war between its

some have mobilized for the creation of an independent Balaton region. The division and incorporation of the Balaton region into 3 separate regions comprising the rapid development of manufacturing has meant that regional efforts confront competing demands. In such cases, the presence of significant resources (i.e. EU structural and cohesion funds) may drive strong demands for more local and newly defined regional decision-making autonomy (see Oláh, 2005).

[21] Prior to EU membership, this was in fact the case. EU accession has witnessed the increasing grip of EU–level competition policies and thus the elimination of some national-level investment promotion strategies in Central and Eastern Europe (Ellison, *forthcoming*; Antalóczy and Sass, 2003; Szanyi, 2003)

insistent centralization and regional, county and local demands for economic development and greater political decentralization have only just begun. But given both the rapidly increasing regional differences in the level of economic development, regional disparities and the uneven flow of foreign investment from the European Union, regional politics will become more and more heavily politicized in the years to come.

In the early 1990's, there was stronger government support for political decentralization in Hungary. The 1990 Act on Local Self-Government greatly strengthened the lowest level of governance by allowing local councils to voluntarily form some 3200 local governments with direct elections. At the same time, this Act greatly weakened the previous dominance of Hungarian counties by assigning the right to levy taxes and all basic competencies to the local governments (Vigvári, 2005: 230; Pálné Kovacs, 2005: 206). Thus, local governments were granted far greater political power and autonomy than they had enjoyed under the previous Communist regime. Most argue this was a response to the overly centralized power of the state under Communism and thus an example of democratization (Fowler, 2001).

In contrast however, Hungary began to recentralize political power with the introduction of NUTS II regional administrative units. NUTS II regions were created in Hungary as administrative units for the management of pre-accession and structural and cohesion funds, largely at the behest of the European Union—pointing to the importance of the EU. However, several authors have suggested that the creation of NUTS II administrative regions in Hungary was taken as an opportunity to reassert the powers of the central government and thus the state over the formulation of regional policy and EU funding. Moreover, both of the major political parties in Hungary appear to have been equally interested in maintaining greater centralized control (Fowler, 2001).

Hungary began to introduce NUTS II regional administrative units with the 1996 law on the regions. One of the strongest indicators of the lack of central government will to introduce strong regional governments was the fact that NUTS II regions in Hungary were initially voluntary. Counties wishing to band together to form regional administrative units were encouraged to do so, but there was no legally binding requirement for this to happen. Consequently, the regions established after 1996 were loosely organized administrative structures and were not formed either consistently or uniformly across Hungary.

With the 1999 law on the regions, Hungary introduced legally defined administrative regions and guaranteed funding for them. However, even these regions and the respective "regional development councils" (RDC's) have remained more strongly controlled by the central government and the respective ministerial bodies (Pogátsa, 2005a; Fowler, 2001). Half the RDC votes are distributed among local governments and micro-regions, counties and city-counties and the other half are distributed among government officials representing the various ministries. The more numerous local governments and micro-regions in particular remain heavily under-represented due to their very small seat shares (Pogátsa, 2005a: 21-2). The consequence is that unless regional entities can coordinate voting, they are easily outweighed by central government representatives.

Since, as noted above, the municipal level currently enjoys a far greater degree of democratic accountability and legitimacy, the voting structure in the RDC's results in a

potential mismatch between democratically legitimated authority and authority at the county and regional level. Pálné Kovacs further argues that power within the RDC's is frequently dominated by individuals able to cumulate mandates across county public office (in particular county general assembly chairs automatically become chairs of the County Development Councils), county and regional development councils, and higher offices (e.g. the National Development Council and/or National Parliament) (2005: 14-15).

The socialist MSZP government elected in 2002 introduced a plan in late 2002 that foresaw directly elected regional governments and an increase in their share of own resources[22]—presumably with the intention of increasing the degree of democratic legitimation of regional policy. However, the MSZP government failed to introduce its proposals into law and quickly dropped discussions of them. Part of the problem faced by the socialist (and other Hungarian) government(s) is the requirement of a 2/3rds majority for constitutional amendments (Pálné Kovacs, 2005: 9).[23] Moreover, this requirement is likely to present more and more difficulties in the future, as Hungary gradually becomes more of a 2-party system—potentially rendering it impossible for Hungary to make further constitutional changes. Given Hungary's current two party dominant composition (both the SZDSZ and the MDF are quite small), it is more than difficult for either the MSZP or FIDESZ to call upon a sufficient share of votes to be able to pass such changes on their own.[24] Further, given the degree of ideological distance and conflict between the two major parties, it is difficult for them to pass such constitutional amendments in concert with each other.

The *National Regional Development Concept* (NRDC) published in June 2005 called for regional reform. However, regional elections are put off until approximately 2014, a time-framework that would preserve centralized control even over the general outlines of the EU's 2014-2020 Financial Framework Perspective. Moreover, further discussion on appropriate models for the creation of self-governing regions was put off until 2008-2010. At the same time however, the NRDC provided the foundational framework for the development of regional operative programs (ROP's) for the second National Development Program covering the period 2007-2013. This represents a significant change from the more centralized strategy pursued over the 2004-2006 period. During this period, the first *National Development Plan* (NDP) only provided for one centrally managed ROP for all seven Hungarian regions at once (Lakatos and Túry, 2005). All-in-all, only very limited attention was granted to regions in the first NDP.

While the election of a FIDESZ government in 2006 might possibly have modified some of these plans, big changes in policy were not likely.[25] For one, if previous experience is any guide, the central

[22] See for example the Hungarian Ministry of the Interior's "Public Administration Reform Plans in Hungary (2003-2006)" (2003: 4).

[23] The 1999 reform was made easier for the FIDESZ government to pass by classifying it as focusing on "regional development" and not "public administrative" reform, thus requiring only a simple parliamentary majority (Fowler, 2001: 26).

[24] Since 1989, only one Hungarian government enjoyed a strong enough majority to be able to successfully pass constitutional legislation: the 1994-1998 MSZP-SZDSZ government. This fact represents a significant and under-researched dilemma in the current Hungarian constitutional framework.

[25] During the 2006 electoral campaign, Fidesz criticisms of the MSZP's national development program amounted to little more than objections that the party's platform drew too heavily on the MSZP government's plan. Fidesz proposed few concrete alternatives.

government (whoever is in power) is likely to hold onto central decision-making authority for as long as possible. To date, both of the major parties have tended to favor more centralized control over decisions related to regional development and have failed to make significant institutional reforms to further strengthen regional decision-making autonomy. While frequent promises are made with respect to further decentralization, in general there has been only very limited progress.

The replacement of the head of the National Development Agency (NDA) with the 2nd Gyurcsany Ferenc government in July 2006 ultimately witnessed a further significant centralization of national government control over EU SCF's. Rather than continue to disperse money through different programs and ministries, Bajnai Gordon announced the intention to "centralize spending (and thus decision-making) in the hands of a single office", except where such funds are to be distributed through regional authorities. Where previously several teams from different ministries were involved in the management of EU funds, the funds were then "merged into one single organization".[26] Moreover, despite increased emphasis on regional operative programs, the NDA announced—as outlined in the New Hungary National Development Plan, 2007-2013—it will spend some 75-80% of its 2007-2013 Framework Perspective funding on sectoral programs, while 20-25% will be used for human capital development.

The growing centralization of political control has resulted in strong criticisms from the major opposition party, in particular due to the lack of parliamentary control over NDA decisions. While the broad parameters of the most recent New Hungary National Development Plan have been approved by the national government, on October 25th, 2006, parliamentary control over the broad framework of the program is lacking. Despite discussion of the possibility of elevating the office to the level of a ministerial position—requiring parliamentary approval of NDA decisions—this step was not taken until July 1st, 2007, well after the major decisions concerning the distribution of EU funding had already been made.[27]

Trends from the European Commission tend to reinforce greater centralization at the level of the state. The previous structure of the EU's SCF provided an impetus for stronger regional involvement in decision-making. The reverse was true however for the 2004-2006 Framework Perspective and is likely to remain true for the 2007-2013 Framework Perspective. For one, the 2007-2013 Framework Perspective approved by the European Council in December 2005 represents a significant shift toward the cohesion model. The result is a significant shift toward the state level and away from regional involvement in decision-making (Pogátsa, 2005b: 267).

Features of SCF planning proscribed by the European Commission likewise reinforce the decision-making capacity of the state. For one, EU co-financing requirements ultimately favor national level institutions, since approval of such funds depends on national or ministry-level support for individual projects.[28]

[26] *Budapest Business Journal*: "Bajnai takes over development office ahead of revamp" (July 16th, 2006).

[27] The modified version of Government Decree 130/2006 went into effect on July 1st, 2007. In this modified version, the NDA is responsible to the Ministry of Local Government and Regional Development. Prior to this modification, the NDA was responsible only to the Prime Minister's Office (see Complex Jogtar, 2007).

[28] Co-financing tools—for example the EU's 50% co-financing requirement for structural funds is seen as a mechanism for forcing correspondence between regional and national level interests in economic development (Bachtler et al, 2003: 16).

Moreover, the regions in Hungary are resource-poor and thus not able to finance programs on their own. Finally, a recent DGRegio commissioned study—assigned the task of identifying linkages between the Lisbon Agenda and regional policy goals—came to the conclusion that regional policy should be more firmly integrated into national-level policy goals.[29] Finally, the growing emphasis on the Lisbon Agenda and more horizontal measures further strengthens the hands of the central government.

Thus the role played by the European Union has been ambiguous. Though some view the European Union—in particular the European Commission—as one of the main proponents of decentralization and the rise of regionalism, the Commission's role has been more ambiguous in Central and Eastern Europe. The Commission has seemingly encouraged greater decentralization of regional administration while at the same time requiring—at least for the early years of structural and cohesion fund administration—that the central governments maintain strong control over the formulation of Regional Operative Programs (ROP's), and the administration and use of EU funds for the 2004-2006 period. Thus, while the EU required the introduction of NUTS II regional administrative units for the purposes of distributing EU resources, it failed to require that regions be granted decision-making autonomy.[30]

This does not mean that the effect of the EU has been entirely negative on the formation and strengthening of regional entities. The distribution of both pre-accession and structural funding has encouraged greater organizational efforts at the local, city and county levels for some time (Lakatos and Tury, 2005). But in most respects, the real consequence of creating NUTS II regions and RDC's in Hungary has been a tremendous strengthening of the powers of the central government over local, city and county level interests. The degree of centralized power extends from the control of votes in the RDC's all the way down to the funding of applications for EU structural fund projects, which some argue predetermines the content of final projects.[31]

Few seem to disagree that further reform of the Hungarian regional development model and its institutional underpinnings is clearly needed. Most appear to agree that the regional institutional structure needs to be strengthened. Further, most seem to agree that there are too many local governments and that some more efficient (and moderately more centralized) system of local governance needs to be established. Beyond that, there appears to be little consensus on what form a new version of regional government should take. The establishment of regional governments based on the current NUTS II level of organization would presumably go a long way to legitimizing regional development policies and goals. Moreover, due to the legitimation factor, democratically elected regional governments would presumably make it politically difficult for the central government to dominate decisions over

[29] See in particular the conclusion of the report completed for the EU's Regional Policy Directorate General by the Danish Technological Institute (2005).

[30] See for example Keating (2003), Hughes, Sasse and Gordon (2003). On the Hungarian case, see Pogátsa (2005a). Considerable disagreement is evident in the literature over who was responsible for centralized government control of EU funding during the 2004-2006 period. While Keating (2003) argues that the European Commission promoted centralization, my own interviews suggest that—at least in the Hungarian case—the impetus arose from Hungarian government insistence on retaining centralized control during the first National Development Plan. This view is further supported by Inotai and Szemlér (2005).

[31] I thank discussions with Ilona Pálné Kovács for this observation.

regional policy and the use of EU structural funds. However, given the lack of "organic", embedded interest structures paralleling the NUTS II level in Hungary, there is necessarily considerable competition and concern over the eventual outcome of regional reform.

### The Structure of Local, County, Regional and National Interests

Support for globalization, EU membership and European economic integration is presumably hardest to win in the less developed regions of Hungary (and other CEEC's). Rapidly rising consumer, land and housing prices meet here with rapidly declining levels of employment, falling GDP per capita and dramatically low FDI. Thus nowhere are the differences between winners and losers in the Central and East European transition more evident than in their cross-regional variation. The pronounced geographic and regional distribution of the benefits and disadvantages of integrating markets suggest that while there may be aggregate welfare benefits to globalization and European economic integration, these are not evenly distributed. Empirical evidence suggests the real losers of globalization and European integration are low-skilled workers with little education, especially those in declining regions. Not only do individuals in these regions exhibit the lowest and declining labor force participation rates, per capita GDP adjusted for the cost of living (PPP's) has likewise declined in the less developed regions of Hungary (Pál, 2005; Szemlér, 2004; Ehrlich and Szigetvári, 2003; Déak and Lengyel, 2003).

Variation in regional rates of economic growth and development is of course not news in the wider European Union. Despite evidence of increasing economic convergence across states, increasing regional disparities are a global phenomenon (Sala-I-Martin, 2002) and are likewise well recognized in the European context (Quah, 1996). Their appearance however in Central and Eastern Europe (CEE) represents one of the greatest challenges to the creation of a successful Union. This is above all the case because the less developed regions of CEE have experienced some of the worst features of the economic transition. The fall in both regional real wages and per capita GDP—together with dramatic increases in the CEE price index and declining regional activity rates—place significant burdens on the welfare and future outlook of the less developed regions.

Despite their increasing relevance as socio-economic units of construction, regions may only have a high propensity to become strong political actors within the European framework under certain circumstances. National level expenditure on regional development tends to be more significant than EU level structural and cohesion fund spending. By way of example, approximately 24% of government expenditure in Hungary is delegated to the local governments (Vigvári, 2005: 231). While EU spending in Central and Eastern Europe will not be negligible, it has generally been capped at no more than 4% of the GDP of any individual country.[32] Further, EU structural and cohesion fund spending imposes a co-financing requirement generally paid by central governments and thus—as noted above—likely to favor national over local governments. Although there is some expectation that local governments will participate financially in structural fund projects, local governments in Hungary and other Central and East European countries

[32] Part of the 1999 Berlin Agreement, the 4% of GDP cap has not been modified, despite objections it imposes an artificial ceiling with little relevance to the actual "absorption capacities" of states.

are typically resource-poor and thus highly dependent upon national governments. Finally, as noted above, the gradual shift toward cohesion and away from structural funding further will further emphasize and strengthen the role of national governments over local governments.

At the EU level, regional actors do not as yet play a significant role in the political decision-making process. Despite the relative degree of support such actors may receive from the Commission, they are not able to outweigh the political power of states or individual EP representatives and do not have explicit voting power (in contrast to both state level representatives in the Council of Ministers and country level representatives in the EP). Moreover, on the key distributional questions decided by the EU (the CAP and SCF), voting continues to be made by unanimity. Thus the power of individual states to block agreements remains greater than the power of any other single actor in the political decision-making process. The only caveat here is that the EP appears increasingly willing to exercise its budgetary powers over the multi-annual framework perspectives, in particular the current 2007-2013 Framework Perspective. However, even here, one might expect individual MEP's to vote state interests on such high profile distributional issues.

At the national level, the potential mismatch between national interests in economic growth and regional interests in reversing within border increases in economic inequality is ultimately likely to lead to competing interests at the level of local and national level policy-making processes. Assuming regional variation in economic performance across all states—this may be an erroneous assumption, since smaller states are potentially less likely to be confronted with the demands of regional variation in economic development[33]—one can expect there to be at least two kinds of regional groupings that might form some kind of collective action group. Which collective action formation is likely to be stronger at the national and/or regional level, and which of these two possible groupings is likely to promote specifically regional over national interests is more complicated. For one, both types of regional grouping are potentially equally interested in state support, the one because it will potentially bring higher profits and an increase in the standard of living, the other because it is likely to bring relief from economic decline and citizen discontent.

Evidence that spatial and regional considerations structure interests is provided by suggestions that when questions of territorial significance arise, partisan differences fade at both the national and regional levels in favor of the representation of either national or local government interests. As discussed above, Fowler (2001) demonstrates that the two major parties favor strong centralization of political power in the management of the regions. On the other end, political parties—in particular in the less developed regions—others have observed a willingness to forget party labels and lobby governments independently of the party label. Kulcsar and Domokos (2005), for example, observe that actors engage in cross-party territorially-based coalitions of interest. Such a-partisan behavior is facilitated and reinforced by the application for and potential receipt of EU and other types of funding.

[33] Streeck (1999) argues that smaller states will have an easier time dealing with the problems of regional variation in economic performance and demands for stronger regional governance since small states are more likely to synonymous with regional economic structure. Hungary however, with a population of approximately 10 million, exhibits pronounced variation in regional economic development.

Nonetheless, the regional vs. central dimension is clearly open for political exploitation and polarization along regional-central lines. This in fact happened following the May 2006 re-election of the MSZP government. In September 2006, revelations that the MSZP knowingly shielded a rapidly growing budget deficit from the public eye in order to win the May elections led to widespread public discontent and national protests. Elections to local and county governments in October 2006 resulted in landslide wins for Fidesz led regional governments in all counties except for one. Budapest SZDSZ mayor (Demszky Gabor) also managed to remain in office by a wide margin.

Thus the county level elections are likely to further contribute to the polarization of the regional-central political debate in Hungary. The major part of this regional-central debate is currently focused on the Hungarian government's *New Balance* austerity policy and reforms of the educational and health sectors. However, elements of these reforms likewise generate strong conflicts across the regional-central dimension—in particular where they involve decisions on the survival of regional healthcare facilities and schools. And there are strong indications that the regional-center political debates—in particular in the context of its party polarization—are likely to affect the ability of the central government to promote strong regional development goals and policies.[34]

Perhaps the most interesting question to emerge out of the current political formation is whether the politically polarized regional-central configuration will persist on into the future. The gradual convergence in Hungary toward a two-party system along with the potential staggering of national and local government elections suggests that such polarization could characterize future governments.

Divergent interests dominate the political centralization/decentralization debate. "*Decentralizers*" favor handing over greater decision-making autonomy to regional and lower level administrative bodies. The basic defense of this position is frequently based on arguments supporting decentralization as a means of achieving higher levels democratization.[35] Further, some argue that state-control is likely to reinforce a more "sectoral" approach to regional development—influenced in particular by state ministries and/or the new National Development Agency. Finally, some argue that regional sub-units exhibit little economic uniformity and thus require greater attention to regional specificity and local knowledge resources. Though decidedly difficult to characterize supporters of decentralization, interests in decentralization appear to have a strong regional flavor. Supporters of decentralization are frequently from the regions themselves, while those closer to the center are frequently supporters of more centralized control.

Those favoring stronger centralized control argue that decentralization threatens to fragment or de-concentrate the potential impact of regional economic development spending. In this literature, the consequences

[34] According to news reports, Orban Viktor instructed fellow party members not to negotiate with the central government. This may have disrupted not only government attempts to reform the educational and healthcare sectors, but more importantly for this paper, could hamper regional development initiatives—in particular Regional Operative Programs—funded by the EU's SCF's and requiring co-financing from the central government. See e.g. www.168ora.hu: "Something is Happening" (Feb. 2nd, 2007).

[35] On the case of Central and East European countries, including Hungary, see Bruszt (2005). On Poland, see McDermott (2004). This approach however extends to discussions of economic development in Western Europe. See for example Putnam et al (1993).

of decentralization are two-fold: 1) regional administrative units are ill-equipped—due to insufficient financial resources and weak organizational skills—to handle the co-financing and administrative requirements of EU regional development funding; and 2) the potential impact of regional development spending is likely to be weakened or defeated by the failure to maintain integration and cohesiveness with larger projects organized and approved by central governments.

### Central Governments

Central Governments have a natural desire to preserve their decision-making autonomy and presumably favor decision-making processes that are less distorted by local level concerns. Moreover, some degree of decision-making autonomy may be a good thing—in particular where this protects governments from *capture*. Finally, democracy is likely to provide a more equal distribution of public resources than authoritarian government and central government policies that depend on democratic institutions are more likely to be broadly responsive to the interests of the electorate.[36] In this regard, where there is already some degree of centralized political control over economic policy, one might expect to find a status quo bias in favor of centralized political control. This is above all likely to be true due to the government's gatekeeper role with respect to the chosen level of centralization and decentralization.

Moreover, central governments in Central and Eastern Europe (and in other less advanced states) face somewhat unique circumstances in that they are strongly pressured to find ways to promote greater economic convergence with the more advanced regions of Europe. What the role of the state should be in this regard is far more controversial. At least part of this discussion needs to engage notions of the New Economy and their appropriateness for understanding economic processes. Neo-liberal models assume the state should be much less involved in the management of economic processes. New Economy models, on the other hand, tend to arrive at quite different assumptions about the possible role of the state.

The pressure of pursuing economic convergence and the presumed requirement of government involvement in that process may lead the central government to be more skeptical about the decentralization of economic decision-making. Simply devolving decision-making and resources to lower levels of the decision-making process could lead to the fragmentation of economic strategies or the misallocation of resources and thus to a diminution of the central government's ability to pursue aggregate growth and convergence. Moreover, significant differences in the level of economic expertise or the skills and manpower of regional and local development agencies are likely to lead to a strong status quo bias toward centralized control. Finally, uneven political power (e.g. local dominance of opposition parties) or inadequate reform of local political party structures may likewise lead to hesitation toward the decentralization of political decision-making.

In many ways, this fits the Hungarian case well. For one, the central government has contributed significant resources toward the restructuring and rebuilding of the Hungarian economy (Ellison, *forthcoming*). Many of these

[36] Hellman (1998) argues the countries of Central and Eastern Europe exhibiting greater degrees of democracy were compelled to distribute resources more evenly across the populations in Central and Eastern Europe. Failed democracy made it possible to distribute benefits to government cronies. More generally, Lake and Baum (2001) argue democratic political systems distribute benefits more evenly than authoritarian ones.

policies—in particular privatization and investment promotion strategies—have produced a remarkable degree of success. The Hungarian economy is now heavily privatized and foreign firms in particular contribute to a significant share of economic activity and the export market (see e.g. Hunya, 2004). Moreover, it is clear that government policy has for the most part tended to favor national level strategies and has been much less strongly focused on regional concerns—in particular in the early years of the transition process.

This does not mean however, that government policy has completely neglected the less developed regions of Hungary. Early on, investment promotion strategies in Hungary attempted to favor regions by lowering the minimum requirements for such regions and occasionally granting more significant tax advantages (see Ellison, *forthcoming*). Keune et al (2004) likewise point out that regional actors have been equally successful in attracting state resources. Both types of policies however have seen remarkably little success. While government expenditure has been devoted to less developed regions, as noted above, this has not been accompanied by a similar degree of economic success. The eastern regions remain under-developed, exhibit far higher levels of unemployment and have received very little to none of the large share of foreign direct investment flowing into Hungary. Whether this fact is directly attributable to the mismanagement of funds at the local level or to simple disadvantages of economic geography is less clear.

In the long run, however, the relative success of national level government policies in the western regions and Budapest in particular is likely generate some resistance to the complete decentralization of regional development strategies. In the eyes of some, decentralization will lead to further deterioration in the quality of national and regional economic development policy goals. Moreover, in Hungary, national level economic strategies have begun to take on a new flavor, more oriented in particular toward the promotion of R&D potential and building stronger links between foreign and domestic firms. Finally, there is the insufficiently theorized but ever-present threat that misallocated funds are wasted funds. Misallocated funds draw resources away from regionally centered growth engines that may ultimately have positive feedbacks on less advanced regions as well.

### Local, City, County and/or Regional Governance

Regional entities in Hungary are tremendously fragmented and do not typically work well together. Even the various associations of village, local, city, large city and county government tend not to cooperate with each on attempting to improve the nature and quality of regional governance. The voluntary establishment of over 3000 local governments in Hungary has led to an inefficient public administration structure frequently unable to handle the multiple tasks of government. Thus even the small local government associations argue that local governments cannot continue to administrate all the features of government currently in their purview (healthcare, education, sanitation, infrastructure (local roads) and that some of these tasks need to be organized at more moderately more centralized levels. Further, NUTS II regions have no historical antecedents in Hungary, thus creating considerable mismatch between the regional level and the more “organic” institutional and organizational structures present at the county and local levels.

In many respects, the interest structures in Hungary are still relatively undefined.[37] While the availability of EU funds and the requirement of submitting well-defined and tailored project proposals provide incentives for the creation of stronger regional entities, several features likewise makes them relatively weak bodies. For one, as many authors point out, Hungary has a far larger number of local governments than most other Old Member states, suggesting that the level of governance is too strongly dispersed and unmanageable. For another, governments at the regional and local level lack sufficient funding with which to pursue more independent agendas. Most local, city and even many county governments are thus dependent upon the central government for financial assistance. Finally, local, city and county governments lack sufficient skilled staff with which to engage in the development and formulation of large independent plans for regional development. It is perhaps no surprise that the most successful regional plans have been put together in the more advanced regions of Hungary.

The interests of local and regional governments (or agencies) are likely to diverge depending on how individual regions have fared during the economic transition. As the New Economy literature would generally predict, economic development in Hungary has been quite uneven and regions that have traditionally lagged behind national levels of economic development have continued to do so throughout the process of economic transition. On the one hand, regions that have fared well are likely to be more favorably disposed toward the continued role of the central government in economic policy-making. While the failure of some firms—in particular many domestically owned small and medium-sized enterprises (SME's)—to gain greater linkages into European production networks may not make them favorably disposed toward European integration, the principal political resource for such dual economy firms is above all the central government.

Whether greater local autonomy would necessarily strengthen the political bargaining power of SME's in the more advanced regions is questionable. For one, they are in a minority at the local level and compete against much larger multinational firms (MNC's) for local and state resources. Local elites—to the extent that they wish to keep larger MNC's with sizeable employment effects in the region—are inclined to pay more attention to their interests than those of a much smaller subset of SME's employing far smaller shares of the local population and making smaller contributions to local public revenues.

At the national level, SME's comprise a more sizeable political force and the national government likewise tends to view the degree of "*local embeddedness*" of MNC's as a potential counterforce to the otherwise "*footloose*" nature of many firms in the global economy. Thus, through increasing the share of interactions and exchanges between the larger MNC's and the SME network in individual regions—or by otherwise building supplier-manufacturer networks between foreign and domestic firms—it is hoped to secure longer term economic, social and political stability in these regions. For the most part, national and local government strategies are thus focused on promoting local R&D networks and strongly favor investments in local skill and content. While less advantaged dual economy firms are likely to favor a stronger focus on the local content of investment promotion strategies, they are not necessarily likely to favor strong decentralization.

[37] See e.g. the article "Területfejlesztés" published by Rechnitzer in *Nepszava* (July 31, 2006).

Whether regions that have not fared well are likely to be favorably disposed to maintaining a strong role for the central government in regional policy, or whether they would prefer more regional autonomy is problematic. On the one hand, the less developed regions tend to feel left out of the economic catch-up game. Eastern Hungary, for example, has received very little FDI and even the rate of infrastructure development (e.g. rail and highways) and other government investments have been slower. While there has always been a regional component to the national industrial policy framework (e.g. the investment ceiling required for receiving 10-year tax holidays for large investments was far lower in the less developed regions), foreign investment strategies have tended to follow predictable paths, with the predominant share landing in historically more developed regions of Hungary: Budapest and the Western regions of Hungary.

On the other hand, due in part to the absence of large shares of foreign investors, local governments in the East of Hungary likewise have few independent revenue tracks upon which they can depend. While they do receive a share of national government revenues, this share has been on the decline. This typically means that local governments are highly dependent upon national governments for the funding of local and regional development goals. While this deficit ultimately represents a golden opportunity for the EU to strengthen regional demands for autonomy, essentially the opposite has happened. The EU has by and large favored greater levels of centralization or has failed to insist on adequate decentralization. It is telling that most of the different regional associations in Hungary see the problem of decentralization and greater regional decision-making autonomy as one that Hungary has to solve on its own.

Further, the compatibility of EU-type funding—in particular its suitability for coping with the problems of regional development in the less advanced regions—is a matter of contention (Ellison, *forthcoming*). One of the more successful tools for Hungary has been the use of investment promotion strategies. While the less developed regions have not benefited from this as much as the more advanced regions, it is still one of the more potentially beneficial strategies for these less developed regions. EU state aid policy however extends relatively strong limitations to the use of this type of policy. On the other hand, many of the newer Lisbon-type strategies promoted by the EU are more clearly suited to the needs of the more advanced regions in Hungary.

At least some regional associations—in particular MOOSZ (the Hungarian Association of County Governments) find the ROP emphasis on human capital and adult education somewhat problematic. Their preferences would have been for more emphasis on regular (elementary) schools, especially in the poorer regions and support for both agriculture and the local economy—in particular through SME's. In their view, while financing local government projects is good, too much funding will be spent on local infrastructure and education, but not enough on SME's and employment creation. Further, though most analysts suggest there are few important differences between East and West in Hungary with respect to political decentralization, MOOSZ proposed that Hungary be divided into only 3 regions (instead of the current 7): a Western, Eastern and a Central region. This 3-tiered breakdown maps almost perfectly onto existing regional economic contours and suggests that regional variation in levels of economic development is strongly related to regional variation in interests.

### Discussion

One of the biggest obstacles to political decentralization and greater subnational regional autonomy is the lack of strong regional organization in Hungary. Regional associations themselves are not as actively engaged as they might be in pursuing political decentralization. Without greater unity and active engagement across the different regional associations, there is likely to be only limited movement in the direction of greater political decentralization and regional autonomy. While EU funding represents an important incentive to the greater organization of regional entities, the strong influence of central actors in the political decision-making process and the financial dependence of regional actors contribute greatly to the general increase in centralization.

However, in Hungary there are likewise serious constitutional impediments to the introduction of far-going reforms of regional institutional decision-making structures. For one, constitutional reforms require a 2/3rds majority in the Hungarian parliament. Now that Hungary has evolved into a more or less 2-party system, the ability to introduce constitutional changes is seriously hampered by the unlikely eventuality that any single party would control 2/3rds of the parliamentary seats. Barring this, it would be necessary that either the EU pass a directive requiring parallel changes in Hungary, or that the two major parties manage to iron out some kind of agreement. Though by no means impossible, such agreements are difficult to make. Thus, while the electoral fortunes of individual parties may potentially provide them with incentives to favor stronger decentralization, due to the constitutional hurdle and the presence of an emerging 2-party system, the requirement of cross-party cooperation may ultimately mean that little to no cooperation is likely to ensue.

Given the economic considerations noted above, further decentralization of real decision-making power in Hungary is unlikely in the near future. For both economic and political reasons, the two major political parties and other government actors have strong incentives to favor the existing status quo. At the same time however, to the extent that this continues to reinforce existing regional disparities, there is likely to be continued agitation in favor of greater regional autonomy. In this respect, there is at least the possibility that less advanced regions will feel emboldened by EU membership and will increase their demands for regional autonomy. But at the same time, this must be measured against the need for and dependence on national level resources.

This analysis draws particular attention to the problem of finding models—both economic and political/institutional—that can adequately promote both regional and national level growth at the same time. This requirement is all the more important for less advanced economies—in particular due to the problems outlined by the equity-efficiency trade-off, as well as by the increasing intellectual dominance of Lisbon-type strategies and thus ultimately more centrist focused strategies of economic development. As far as the conclusions of this analysis are concerned, it must remain unclear whether the political and economic dimensions of this debate pull in opposite or in compatible directions. Establishing complete regional decision-making autonomy—in particular with respect to economic development strategies—may lead to more appropriate and regionally-appropriate models of economic development. On the other hand, it may also produce the opposite.

## Conclusion

The advent of EU membership and the governance of EU structural and cohesion funding in Hungary has dashed hopes for a more thorough democratization of local governance and the withdrawal of power from the central government. Where some anticipated the rise of more powerful subnational entities and progressive political decentralization, this has not occurred. Most agree the political center has been greatly strengthened by the confluence of creating EU NUTS II level regions, economic development strategies that tend to favor the interests of the more advanced regions of Hungary, the centralized control of EU and state funding and comparatively weak regional organization.

One of the principal obstacles to more successful regional planning and administration of economic development strategies is Hungary's insistent centralism. The failure to grant more political and administrative authority to the regions—however ill-fitted to respond to the needs of county, city and local governments—is itself the cause of local-level lack of expertise and planning capacity. Presumably the only mechanism available for reversing this process is the creation of regional governments—whether based either on the current NUTS II foundation or on some more aggregated foundation. Politically however this is difficult to achieve. The constitutional obstacle requiring a 2/3rds majority to change the regional electoral and administrative structure is almost unattainable—in particular given the current degree of political polarization between the two major political parties.

*New Economy* models play a powerful role in determining this outcome. Governments in less developed economies in particular face powerful incentives to maintain centralized control over the expenditure of EU and national-level funding in order to promote more cohesive economic development strategies. This may suggest that regional demands for greater decentralization may be more likely in the more advanced countries and regions of Europe. For one, the more advanced countries may be more likely to allow the market to decide how best to allocate resources. And for another, regional political units are more likely to be dependent upon the central government is less advanced states.

Consequently, national level strategies will not likely respond adequately to subnational regional needs and interests. Faced with a competing set of national goals, national actors are less likely to dedicate sufficient attention to regional development agendas—in particular in the less developed regions. In part, the above analysis suggests problems of *subsidiarity* or difficulties in determining the appropriate level of governance beleaguer national and regional level economic development strategies. Such problems are presumably exacerbated by difficulties in determining the appropriate *scale* from which to think about *problems of economic development* (e.g. supranational, national or subnational). The same basic problems are duplicated at the regional level. Regional actors are more likely to emphasize subnational regional concerns, potentially at the expense of national level considerations.

The central research question is to determine when and under what conditions national governments are likely to delegate greater decision-making powers to regions. With respect to the Hungarian case, the central government faces strong pressures to maintain relatively centralized control over the future shape and direction of regional development strategies. Thus in important ways, the potential for political decentralization is strongly influenced by the interests of the center. At the same time,

however, Hungary lacks at least one element that has favored the development of strong interests in political decentralization in other parts of Europe: in particular, the less developed regions are based on distinct cultural or ethnic identities. Finally, the political-institutional structure in Hungary is not conducive to rapid political decentralization. Both the constitutional hurdle and the high degree of political polarization generated by the emerging two-party system represent important obstacles to more rapid political decentralization.

Finally, supranational pressures further encourage national governments to re-centralize political and economic control. With mixed signals coming from the EU, national governments in Hungary and other New Member states are clearly at liberty to organize the management of EU SCF funding as they see fit. Though regional operative programs are gradually gaining in importance, the central state-dominated level clearly plays the central role in Hungary and is likely to do so for some time to come. At the same time, one of the potential consequences of this degree of centralization is the continuing rise in regional economic disparities. This is likely to produce the groundwork for future initiatives toward greater political decentralization and regional autonomy. Thus while the *New Economy* and the incentives it creates toward greater centralization of political control over economic management pose the principal obstacle to greater subnational regionalism, this may provide the future motivation for its revival.

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