Example 23.1
Grants-in-Aid in the European Union

The United States is by no means the only country that uses grants-in-aid to promote fiscal equalization among lower level governments in the fiscal hierarchy. Another important example is the European Union. The redistribution of resources from the richer to the poorer regions through grants-in-aid is one of the main economic functions of the EU. The EU refers to its strategy of fiscal equalization as regional or cohesion policy.

A brief look at the budget of the European Union is in order before turning to the specific equalizing grants-in-aid. The EU collects revenues from three main sources:

1. Duties on agricultural goods, levies on sugar, and customs duties on imports of goods and services by the member nations, all of which are referred to as traditional own resources (about 13% of overall EU revenues)
2. A VAT tax of 0.5% on a tax base harmonized among the member nations (about 16% of the overall EU revenues)
3. A tax based on each member nation's gross national income (GNI). The GNI tax serves as a residual to raise whatever additional revenues are needed and is by far the largest source of funding for the EU (about 70% of the total revenues).

Total EU revenues are capped at 1.24% of the combined member nations' GNI.

The EU's total expenditures are overwhelmingly used for two purposes: the preservation and management of natural resources (approximately 43% of total expenditures), and the promotion of sustainable growth and employment (approximately 44% of total expenditures). The major portion of the natural resources category is the common agricultural policy (CAP), which is a set of crop subsidies to keep European farms competitive on world markets and thereby support farmers' incomes. The CAP is the largest single item in the EU budget, representing approximately 37% of total expenditures. The major portion of the sustainable growth and employment category is the regional or cohesion policy, consisting of a set of grants-in-aid allocated to the poorer regions within the EU. These so-called cohesion grants have been increasing in importance during the past fifteen years and now constitute 36% of the EU budget, just shy of the expenditures on the farm subsidies.

It is hardly surprising that grants-in-aid to promote fiscal equalization have become one of the major policy instruments of the EU. The preamble to the 1957 Treaty of Rome, which marked the beginning of economic cooperation among the nations of Western Europe, mentions the reduction of fiscal disparities throughout Europe as one of the primary goals of the cooperation. This goal was carried through to the Treaty on European Union signed in Maastricht in 1992, which lists the promotion of economic and social cohesion through the reduction of regional disparities as one of the EU's main objectives. In line with this objective, the broad goals of the cohesion grants are to reduce structural disparities, foster balanced economic and social development, and promote equal opportunity for all regions within the EU.

The EU develops seven-year plans for its revenues and expenditures. The current plan runs from 2007 to 2013. It projects total EU expenditures of $976 billion over the seven-year period, with $348 billion allocated to the cohesion grants (in 2007 Euros). The plan establishes three specific objectives for the cohesion grants:

1. **Convergence –** speed up the reduction of fiscal disparities among regions by supporting policies that promote growth and improve employment conditions in the poorer regions.
2. **Regional competitiveness and employment –** anticipate and help regions cope with social and economic changes; promote innovation, entrepreneurial activity, and environmental protection; and develop labor markets in regions not covered by the convergence objective.
3. **European territorial cooperation –** promote cooperation at cross-border, transnational, and international levels and also foster networking between small and medium-sized businesses.

Convergence is by far the most important objective, receiving 81.5% of the total cohesion grant funds. The regional competitiveness and employment objective receives 16% of the funds and the European territorial cooperation objective the remaining 2.5%.

The cohesion grants are financed through three separate funds: the European Regional Development Fund (ERDF), the European Social Fund (ESF), and the Cohesion Fund. The ERDF, established in 1975, is the largest of the three. Its principal focus is to support infrastructure and other employment-creating investments undertaken by private businesses. The ESF, established in 1958, is targeted primarily at individuals. Its principal focus is to support job training for people who are unemployed or disadvantaged in the labor market. The ERDF and ESF are referred to as structural funds. The Cohesion Fund, established in 1994, provides aid for environmental protection and transportation infrastructure projects in regions that have a per-capita GNI less than 90% of the EU average.

The Convergence objective is financed through all three funds. It receives the majority of the ERDF and ESF funds and all of the Cohesion Fund. Ninety-three percent of the two structural funds are allocated to the poorest regions, those with per capita GNI below 75% of the EU average. The regional competitiveness and employment objective receives half of its funding from the ERDF and half from the ESF. The majority of the funds are allocated to economically and socially lagging regions that are not poor enough to qualify for funding under the convergence objective. The European territorial cooperation objective receives all of its funding from the ERDF, with the funds allocated to the smallest regions, those with populations between 150,000 and 800,000.

The cohesion grants are in the spirit of the alternative social welfare model of the distribution function described in Chapter 21, in the sense that they are targeted to the poorer regions. But there is an important difference. The cohesion grants are not the unconditional grants called for in that model, that the member nations can spend as they wish. Instead, they are matching project grants. The total amount of funds available to pursue all three objectives is first distributed to the member nations for each of the seven years of the plan, based on an assessment of their relative economic and social conditions. The member nations then allocate the funds to specific projects in accordance with the guidelines established under the three objectives. They also administer the grants. The grant recipients are required to pay anywhere from 14% to 50% of project costs, depending on the type of project being financed and the objective that it serves. The central EU government monitors the distribution of the grant funds to ensure compliance with the three objectives.

A final point about the equalization program is that the distribution of the grant funds among the member nations in the current plan is quite different from the distribution in the previous plan that ran from 2000 to 2006. The reason is that 60% of the poorest regions are in the twelve nations that became EU members in May 2004 and January 2007. Therefore, many regions within the original member nations that were below the 75% and 90% per capita GNI threshold levels before 2004 and received aid are now above those thresholds and no longer qualify for grants under the convergence and regional competitiveness and employment objectives. The EU has made some allowance for this problem. From 2007 to 2013, it will earmark 5% of the grants under the convergence objective and 21% of the grants under the regional competitiveness and employment objective for transitional assistance to the regions that no longer qualify for the regular aid because of the recent expansions of the EU. Despite this transitional assistance, there will be a marked redirection of the cohesion grants in favor of the twelve newest members under the current plan.

Virtually all redistributive programs generate incentives for inefficiencies and the EU cohesion grants are no exception. At a meeting in Lisbon in 2001, EU officials determined that the European economy had to become more modern. The resulting Lisbon Strategy called for more investment in research and development, the creation of more and better jobs, and policies that would make Europe a better place to work and invest. This explains the goal of sustained growth and employment for the 2007–2013 plan and the types of projects financed by the three cohesion grant funds.

But it is reasonable to question whether supporting investment and job training programs in the poorest regions is the best path to a more modern and vibrant economy. Presumably the poorest regions are lagging because they have relatively unproductive resources – poor soil for agriculture, a relatively small and unproductive capital stock, and a less educated labor force. Might the EU get higher growth and better jobs for its money by targeting the project grants to the richer, more productive regions, while simultaneously encouraging people to migrate from the poorer to the richer regions? It may take many years and a huge expenditure of funds to make the poorest regions competitive in the world economy. And the cohesion grants give people in the poorest regions an incentive to stay put, to the detriment of growth in the short and medium term. The attempt to promote economic and social cohesion among the member nations by reducing fiscal disparities is an admirable objective. One can certainly understand the impulse to help the newest members and also to avoid massive migrations from poorer to richer nations. But whatever gains to social and economic cohesion occur from the cohesion grants, they would appear to come at the cost of a less productive and vibrant European economy. This is a trade-off the EU may have to accept for quite some time.

Sources

European Union Financial Report 2005, European Communities, Luxembourg; Office for Official Publications of the European Communities, 2006.

Also, the website of the European Union: http://europa.eu/scadplus/leg/en/lvb/g24231.htm and http://europa.eu/scadplus/leg/en/lvb/l34020.htm