THE RELATIONSHIP BETWEEN REGIONAL POLICY AND REGIONAL STATE AID POLICY IN THE EUROPEAN UNION AND IMPLICATIONS FOR TURKEY

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ABSTRACT

THE RELATIONSHIP BETWEEN REGIONAL POLICY AND REGIONAL STATE AID POLICY IN THE EUROPEAN UNION AND IMPLICATIONS FOR TURKEY

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The aim of this thesis is to investigate the relationship between regional policy and regional state aid policy in the European Union and to evaluate the implications of this relationship on the transformation of the regional policy approach of both the EU and the member states with specific focus on the implications for Turkish regional policy in the process of EU accession. After providing a critical review of regional policy and regional state aid policy in the EU, this thesis lays out the possible alternatives for regional policy following the enlargement of the Union in 2004. The analysis shows that in the absence of a significant increase in the funding directed to regional policy at the EU level despite an increase in regional disparities and as a result of more strict regulations on regional state aids granted by member states; a trade-off exists, especially for less-prosperous member states, between national growth and reduction of regional disparities. Thus, achieving a proper balance between competitiveness and cohesion in the EU necessitates the coordination of national and EU level funding for regional development. The implications for Turkey is that in order to achieve national convergence with the EU in the short run and to reduce regional disparities in the long run, Turkey needs to revise its regional policy and regional state aid policy as to strategically coordinate national and EU regional policy funding.

Keywords: regional policy, national regional aids, regional development, European Union, Turkey

ÖZ

AVRUPA BİRLİĞİ'NDE BÖLGESEL POLİTİKA İLE BÖLGESEL DEVLET YARDIMLARI POLİTİKASI ARASINDAKİ İLİŞKİ VE TÜRKİYE AÇISINDAN DEĞERLENDİRİLMESİ

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Bu tezin amacı, Avrupa Birliği'ndeki bölgesel politika ile bölgesel devlet yardımları politikası arasındaki ilişkiyi araştırmak ve bu ilişkinin, hem AB hem de üye ülke bölgesel politika yaklaşımlarının değişimine etkilerini, özellikle AB'ye katılım sürecinde Türkiye'deki bölgesel politikaya etkilerini dikkate alarak değerlendirmektir. Bu tez, AB'deki bölgesel politika ve bölgesel devlet yardımları politikasına ilişkin eleştirel bir inceleme yaparak, Birliğin 2004 yılındaki genişlemesinin ardından bölgesel politika için olası seçenekleri ortaya koymaktadır. Bölgeler arası eşitsizliğin artmasına rağmen AB'de bölgesel politikaya ayrılan fonlarda önemli bir artış olmaması ve üye ülkelerin verdiği bölgesel devlet yardımlarına sıkı düzenlemeler getirilmesi nedeniyle, özellikle az gelişmiş üyelerin ulusal büyüme ile bölgesel gelişmişlik farklılıkların azaltılması hedefleri arasında bir tercih yapmaları gerektiği ortaya koyulmuştur. Bu nedenle, AB'de rekabet gücünün arttırılması ve bölgesel farklılıkların giderilmesi arasında doğru bir dengeye ulaşılması, bölgesel kalkınma için verilen ulusal fonların ve AB fonlarının eş güdümünü gerektirmektedir. Bu bulgu Türkiye açısından değerlendirildiğinde ise, kısa dönemde AB ile arasındaki gelişmişlik farkını azaltmak ve uzun dönemde bölgesel eşitsizlikleri gidermek için, Türkiye'deki bölgesel politikanın ve bölgesel devlet yardımları politikasının, bölgesel politikaya verilen ulusal fonların ve AB fonlarının stratejik bir şekilde eş güdümlü hale gelmesini sağlayacak şekilde yeniden düzenlenmesi gerektiği ortaya çıkmaktadır.

Anahtar Kelimeler: bölgesel politika, bölgesel devlet yardımları, bölgesel kalkınma, Avrupa Birliği, Türkiye

Azize ile Faruk Yalçın için…

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TABLE OF CONTENTS

LIST OF TABLES

LIST OF FIGURES

FIGURES

LIST OF ABBREVIATIONS

CEECs	Central and Eastern European Countries
CSF	Community Support Framework
DPT	Undersecretariat of State Planning Organisation (*Devlet Planlama Teşkilatı Müsteşarlığı*)
EAFRD	European Agricultural Fund for Rural Development
EAGGF	European Agricultural Guidance and Guarantee Fund
EC	European Community
ECSC	European Coal and Steel Community
ECU	European Currency Unit
EEA	European Economic Area
EEC	European Economic Community
EIB	European Investment Bank
EMU	Economic and Monetary Union
ERDF	European Regional Development Fund
ESF	European Social Fund
EU	European Union
Eurostat	Statistical Office of the European Communities
FIFG	Financial Instrument for Fisheries Guidance
GAP	South-eastern Anatolia Project (*Güneydoğu Anadolu Projesi*)
GDP	Gross Domestic Product
GGE	Gross Grant Equivalent
GNI	Gross National Income
NUTS	Nomenclature of Territorial Units for Statistics (*Nomenclature des Unités Territoriales Statistiques*)
OP	Operational Programme
PPS	Purchasing Power Standards
R&D	Research and Development
SMEs	Small and Medium Sized Enterprises
SPD	Single Programming Document

Turkstat	Turkish Statistical Institute (*Türkiye İstatistik Kurumu*)
TVA	Tennessee Valley Authority
YTL	New Turkish Lira (*Yeni Türk Lirası)*

CHAPTER 1

INTRODUCTION

Regional policy intends to bring workable solutions to development problems which are specific to certain geographical areas. Growing income disparity among different regions is an undesirable case for governments due to the economic, political, and social threats that are generated in consequence. By providing support to problem regions, regional policy facilitates the narrowing of the wide income gaps existing between the more prosperous and the poorer regions, and as a result, contributes to balanced development.

Since the inception of the European integration, development of backward regions has been regarded as a Europe-wide concern. This concern has been made explicit in the preamble of the Treaty of Rome (1957) by the declaration of an 'anxious' desire to reduce regional disparities through harmonious development. The approach to regional policy in the European Union (EU) has continuously evolved in response to the widening and deepening of the Community, as well as to the global development trend. Consequently, this overall concern declared at the very beginning of integration eventually developed into a distinct and full-fledged policy field in the EU.

There is a range of different policy instruments employed by policy-makers to promote development in problem regions. The primary instrument in the EU has been the Structural Funds which are set up under the EU regional policy and granted to the regions in accordance with different objectives. By taking up around one-third of the EU budget, Structural Funds have been providing considerable amounts of financial support[1] to regions in need and this made them the centre of attention in analysing the progress of regional development in the EU.[2]

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[1] In excess of €130 billion (in 1994 prices) and €200 billion (in 2004 prices) for the periods of 1994-1999 and 2000-2006, respectively. In the forthcoming financial perspective for 2007-2013, around €300 billion (in 2004 prices) is earmarked for Structural Funds.

[2] For an evaluation of regional policy and regional development in the EU with respect to Structural Funds and their impact on regional growth, see (Leonardi, 1995; Martin, P., 1999a; Bache and Jones,

On the other hand, there is another and an older instrument of financial support for backward regions that also has an important impact on regional development in the EU, which is regional state aid (or in other words, national regional aid). Regional state aids are a form of state aid[3] according to EU terminology which is provided by national authorities as financial assistance to firms in the less-developed areas. Prior to the formation of the Community, regional state aid used to be the essential instrument that countries have freely resorted to for encouraging investments in the problem regions. However, following the European integration, these regional development aids that are granted from member state resources started to be regulated at the supranational level through the EU competition policy.

The reason for an EU-level regulation for regional state aid was that as a general rule, all sorts of state aids are restricted in the EU due to their potential competition distorting characteristics. Article 87(1) of the EC Treaty[4] states that:

> any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the common market. (Official Journal of the European Communities, 2002a)

One of the exceptions to this general restriction on state aids is aid directed to less developed areas because of the fact that reduction of regional disparities is deemed to contribute to EU-wide interests. In addition to that, the benefits that the EU receives from this reduction are considered to be greater than the disadvantages created by resulting competition distortion. Despite the derogations for regional state aid provided in Article 87(3)(a) and Article 87(3)(c) of the EC Treaty, member states

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2000; Boldrin and Canova, 2001; Lolos and Theodoulides, 2001; Beugelsdijk, Maaike and Eijffinger, 2003; Rodríguez-Pose and Fratesi, 2004; Sosvilla-Rivero *et al.*, 2006).

[3] State aid is defined by DG Competition as: "an advantage in any form whatsoever conferred on a selective basis to undertakings by national public authorities." (European Commission, 2006k)

[4] Hereafter, EC Treaty refers to the Consolidated Version of the Treaty Establishing the European Community (Official Journal of the European Communities, 2002a)

need to inform the Commission on the use of regional state aid[5] and it is under the Commission's sole discretion to decide whether certain types of state aid have competition distorting characteristics or not. Accordingly, the use of regional state aid is regulated in the EU through specific guidelines[6], which clearly shows that member states are no longer in a position to make use of regional state aid on their own choice even though it is still an important channel of financial transfer to support development in backward regions.

Although, regional policy and regional state aid policy in the EU are the two basic policies that directly influence regional development by controlling the allocation of financial support to less-developed regions, most research in this field deals with each one of these policies individually without specific focus on how they interact in shaping national regional policy at the member state level. This study aims to investigate the relationship between the regional policy and the regional state aid policy in the EU, and the impact of this relationship on the transformation of the regional policy approach of both the EU and the member states with specific focus on the implications for Turkey in the accession process.

In an enlarging Union where the problem of regional development is growing both in scale by the inclusion of relatively poorer member states, and also in scope by the diversification of the types of regional problems, the challenges of regional policy are becoming increasingly complicated. On the one hand, EU needs to constantly transform its regional policy to better address the regional development problem in the Union and on the other hand, member states need to properly adapt to the changing EU regional policy and regional state aid policy to be able to make the most of the available financial support in regional development terms. In addition to that, it is crucial for the candidate countries to swiftly take the necessary steps in aligning their regional policy to the EU in order to accelerate their process of catch-up. As a candidate country with average per capita income lower than all of the current 25 member states and with wide development gaps among its regions, it is

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[5] Article 88 of the EC Treaty specifies the requirement to notify the Commission on the use of state aid.

[6] The most recent of these guidelines has been issued for the 2007-2013 period. (Guidelines on National Regional Aid for 2007-2013 (Official Journal of the European Union, 2006c))

especially important for Turkey to understand the changing policy perspective towards regional policy in the EU together with the available instruments to implement it. Therefore, this research is carried out to answer; 'what kind of a relationship exists between regional policy and regional state aid policy at the EU level, how does the interaction between these two policies affect the approach to national regional policies of member states and what are the challenges for Turkey in conforming to these two policies as a candidate country?'

It is evident that the concept of regional development involves many different aspects related to various variables such as natural resources, human and social capital, infrastructure, and business environment, etc. as well as differing conditions of regional governance, administrative structure, and legal framework. Therefore, a proper regional policy approach should comprise policy measures for every element of regional development. Likewise, a complete assessment of regional policy can only be possible when all these aspects and conditions are taken into consideration. Nevertheless, the main focus of this study is on financial support that is directed to lagging regions under regional policy initiatives from the EU and the member state levels. More specifically, the research will concentrate on financial transfers whose primary objective is to provide support to regional development. Many specific EU level or national policies ranging from transport to training and from employment to environment obviously play important roles in improving the socio-economic conditions of the backward regions. In addition to that, regional policies of the EU and the member states are directly linked to these sectoral policies. However, this study examines the financial assistance policies for regional development independent from these other policies without disregarding the fact that either at the supranational or at the national level, regional aid is not the only factor that brings benefits to less-developed regions by way of regional policy[7]. Therefore, among a multiplicity of national and supranational funding schemes, EU Structural Funds and regional state aids are taken as the two indicators of the financial support as they are

[7] Certain other sorts of benefits can be referred as improvement of the governance structures, capacity building, advancement of interregional interaction, etc.

the two main instruments that provide financial assistance for regional development at the EU and member state levels, respectively.

Corresponding to the national versus supranational duality in the approach to regional policy, two types of mutual interaction needs to be analysed in order to answer the research question: the relationship between regional policy and regional state aid policy at the EU level (horizontal interaction); and the relationship between the EU and member state policies on regional policy and regional state aid policy (vertical interaction).

To be able to analyse the abovementioned relationships, it is necessary to look into the development of the concept of regional policy as it is the overarching concept within which regional aid schemes are designed at the national and supranational level. For this purpose, Chapter 2 reviews the historical evolution of regional policy and examines how it was gradually shaped at the EU level with the formation of the Community. In addition to that, the contribution of EU regional policy to the reduction of regional disparities is analysed with reference to the concept of convergence. While examining the evolution and the role of EU regional policy, special consideration is shown for the successive enlargements of the EU as each time they have influenced the development of this policy significantly. Especially, the impacts of the biggest enlargement that took place in 2004 on the programming for the next financial perspective of 2007-2013 are considered to be highly decisive in terms of the formulation of regional policy in the EU. Therefore, the current challenges on regional policy are analysed in light of the last enlargement of the Union.

Development of the EU regional policy through time explained in Chapter 2 is the first element of the relationship at the supranational level, and as the second element of this relationship, the evolution of the approach to regional state aid in the EU is explained in Chapter 3. Firstly, the rules and regulations at the EU level on the use of regional state aid are laid down, and subsequently, the development of this policy in the member states is reviewed through an in-depth review of the state aid surveys and scoreboards issued by the European Commission. Due to their different policy backgrounds, the 10 new member states are analysed independent from the 15 old member states of the EU.

Following the clarification of the two separate policies at the EU level in the two preceding chapters, Chapter 4 establishes the link between regional policy and regional state aid policy in the EU and elaborates on the implications of this relationship for the member states. In accordance with this relationship, the policy alternatives on regional development in the EU and their impacts on the transformation of regional policy in the member states are evaluated.

As a candidate country, Turkey's approach to regional policy and regional state aid policy is reviewed in Chapter 5. These two national policies of Turkey are assessed in relation to the corresponding EU level policies and the challenges for Turkey in conforming to the EU in terms of financial support to regional development are evaluated. In addition to that, recommendations are made in light of the findings in Chapter 4 with specific reference to the policy alternatives.

Lastly, Chapter 6 summarizes the main points of each chapter and draws conclusions out of the analysis as regards the relationship between regional policy and regional state aid policy at the EU level as well as its implications for member states. Furthermore, the implication of this relationship for Turkey in the accession process and the resulting policy requirements are summarized.

CHAPTER 2

EVOLUTION AND THE ROLE OF REGIONAL POLICY IN THE EUROPEAN UNION

In this chapter, the concept of regional policy in the EU is reviewed first by giving an account of the emergence of the regional policy concept and the approach to regional development prior to the reform of EU regional policy in 1989. This is then followed by the elaboration on how this policy field attained an EU dimension. Subsequently, the type of contribution of EU regional policy to the reduction of regional disparities is analysed. In particular, the impacts of the successive enlargements on regional policy design and implementation are evaluated. The chapter ends with a review of the current challenges on regional policy in a Union of 25 members.

2.1. Emergence of the Concept of Regional Policy

This section examines the concept of regional policy by laying out the main problems that lead to its emergence in the 1920s. Subsequently, the initial response to the problems of regional development is summarized.

2.1.1. Problems that Lead to the Emergence of Regional Policy

Regional policy can be considered as a Western European concept as the policy initiatives of the late 1920s in the United Kingdom indicate the origination of the regional policy practice (Booth, 1982; Taylor, 2002). Therefore, if we examine the principal constraints that had led to the emergence of such an approach in the UK, we observe three specific sets of problems which seem to be very much familiar almost a century later.

The first set of problems that were faced at that time was related to the problems of the rural areas. These regions, where agriculture was the dominant economic activity, lacked the financial capacity to achieve the living standard that was available in urban areas. Not only had most of them been deprived of natural resources (such as coal which was crucial for that period) but also basic infrastructure and social services had remained deficient. Moreover, these circumstances had prevented the inflow of capital which naturally created a vicious cycle of downturn that was highly challenging to break without the assistance of the central government.

On the other hand, the second type of regional problem was observed in some of the industrialized regions. Where stagnant or declining industries were prevalent, the difficulties of transforming the existing industrial and technological infrastructure, as well as the human capital had seriously hindered development. In general, these regions were the ones which had experienced industrialization in its relatively early stages, and which had previously benefited from the social and economic progress brought by the rising production. The impeding factor to development in this case had been the excessive concentration and specialization on a single sector for a long period of time, which had created a one-sided profile for the region and trapped it into an impasse as the specific industrial sector started to wane.

Finally, as the third group of regions with development problems, we see the fast growing ones, which are at the peak of their investment and production levels. Although, income levels continuously rise in these places, the side effects of rapid development, such as congestion and pollution cause a significant reduction in the quality of life. The available infrastructure turns out to be insufficient for the increasing demand, and the region fails to respond to the consequent inflationary pressures.

Although the main problem areas of regional policy are summarized above in three groups, the problem of regional development in each group is highly complex and varies according to many regional factors such as natural resource endowment, geographical attributes, infrastructure, location, history, population, demography, size, politics, culture, etc.

The complexity of the regional problem arises from the fact that there is a mixture of fixed and variable factors involved in the formation of a region's identity. Fixed factors indicate factors or conditions that are usually highly difficult to change or that are able to change only in the long run, whereas variable factors correspond to the ones that can change more easily in the short or medium-term. In addition to that, the definition of 'fixed' and 'variable' change from region to region. For instance, while the in and out flows of labour are considered to be one of the variable factors for regions with high accessibility, it becomes a fixed factor for outermost and inaccessible areas. As a result of this complexity, identification of the regional problem becomes a contentious issue and approaching to this problem with the aim of bringing workable solutions becomes a challenging task not only due to the multiplicity of factors and criteria, but also because of the diversity of actors and stakeholders.

2.1.2. Initial Response to Regional Policy Problems

As the regional problems are complex to systematically identify, the approach to these problems needs to be a policy that comprises a series of complementary measures. Moreover, in order to properly address the regional problem and for the solution to be sustainable, this approach needs to vary in accordance with the specific characteristics of each region. In the 1920s, early attempts in this field aimed at reallocating capital and labour in order to balance the level of output in different areas. The first example of this approach was the idea behind the concern of the British government in relocating labour from high unemployment areas to low unemployment ones in order to prevent the localisation of unemployment through the establishment of the Industrial Transference Board in 1928[8] (Booth, 1982; Taylor, 2002). This method was subsequently applied to firms in order to create a larger impact after the serious consequences of the Great Depression in 1930s. During this period, significant initiatives have also been put forward in the United States of America to tackle the problems of depression. The establishment of the Tennessee Valley Authority (TVA)[9] in 1933 was the first example in the USA of the idea to

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[8] Industrial Transference Board was set up in accordance with the industrial transference policy of the UK. The Board worked to analyse the level of localized unemployment and made recommendations as regards the alternatives of increasing migration through the Ministry of Labour's employment exchange mechanism (Pitfield, 1978).

[9] TVA is a river basin development project initiated by Franklin Roosevelt which mainly aimed at improving navigability along the Tennessee River and producing cheap energy by the construction of hydroelectric dams which attracted industries to the region and consequently contributed to employment (Choguill, 1977).

bring integrated solutions to the infrastructure problems of the region and to effectively manage available resources by reallocating them to areas in need.

These examples demonstrate that the basic idea that lay beneath the early regional policy initiatives was reallocating the mobile factors of production by way of central government intervention. Without such reallocation, it was deemed to be highly difficult to achieve a balanced income distribution among different regions. Although, mainstream neo-classical economics suggests that in the long run, it is possible to achieve regional income convergence through the flow of capital and labour towards the regions with the highest rates of return (to exploit comparative advantage) (Martin, P., 1999a; Bohan and Muylle, 2001); in practice, this cannot be taken as a process that happens automatically due to the market failures that impede the mobility of capital and labour. The impediments to the mobility of capital and labour are basically caused by the costs of transportation and relocation as well as by other barriers such as externalities caused by technological agglomeration, information asymmetry, and differences in the social structure such as culture and language (Martin, P., 2000; Wildasin *et al.*, 2000). As the root of the problem of regional disparity was regarded as these types of failures in the functioning of the market, the initial understanding of regional policy was based on the understanding that central governments were in a position to compensate for the negative consequences of market failures on regional development by way of regional policy (Fothergill, 2005).

However, reallocation in this context is not considered to be a one-time reallocation. As Vanhove and Klaassen (1980: p. 20) point out, one of the most important aspects of regional policy is that it needs to introduce a "continuous reallocation of productive factors". If it was likely to achieve a state of equilibrium among regions through time, there would not be a need for comprehensive regional policy approaches. Yet, on account of the continuous change in rising and declining sectors, regional policy becomes as necessary for developed economies as developing ones.

2.2. Regional Policy in the EU Prior to the 1989 Reform

In this section, the approach to regional development before the reform of EU regional policy in 1989 is explained under two headings. Firstly, regional policy in Europe in the post-war period is reviewed. Then, the approach to regional policy in the early years of European integration is summarized.

2.2.1. The Approach to Regional Development in the Post-War Era

The world in general and Europe in particular had gone through a terrifying period of war and depression in the first half of the 20^{th} century. While barely recovering from the damages of the First World War, a massive economic downturn had broken out in the 1930s and subsequently brought a radical change to the organization of production in the big economies. It was a time of economic turmoil both for the war destroyed countries and also for the newly created states, which required solid and decisive strategies to recuperate. As part of their revival attempts, most governments had chosen to pursue a strongly protectionist strategy that confined production and trade to strict borders and national regulations (Harrop, 2000; Berend, 2006). However, the rise of nationalism and the resultant clashes over the control of resources had set off new disputes among nations. As a result, the fatal stroke in Europe came with the Second World War and made it clear that there was a need to work out an innovative solution to find a way out of the situation arrived in the aftermath of the two world wars (Dinan, 1999; Rosamond, 2000).

This innovative solution came in 1950 with the idea of a common market to cooperate in the utilization of the two most important resources of the time – coal and steel – which had led to the establishment of the European Coal and Steel Community (ECSC). Subsequently, with the extension of the common market to include all products, the European Economic Community (EEC) was created in 1957.

The integration initiative that had started out in 1957 with the signature of the Treaty of Rome was primarily driven by an economic interest corresponding to the situation in the post-war Europe after two catastrophic wars and a historic recession, which made economic revival the top priority. Each nation formulated its own policy on economic development in line with its government structure and sought to achieve the highest level of growth in the shortest possible time span (Friedmann, 2001). The established new Community simply provided a "supportive institutional system" (Heeg and Oßenbrügge, 2002) for the member states to reinforce their own administrative structure and economic policy in this economic transition period. This type of an understanding inevitably caused an overemphasis on state interventionism and national economic planning, and consequently led countries to focus on the creation of their own large industries as national champions behind the protective shield of the state which were envisaged to be engines of rapid growth. Regional economic planning had also taken its place within this national planning approach and each member state have developed its own system of regional development in connection with the legal, administrative, historical and cultural structure that has been present in that particular country. The different forms of regional systems in Europe ranged from centralized to decentralized in terms of administrative structure, from reactive to proactive in terms of policy formulation, and from discretionary to regulatory in terms of the use of government power (Newman and Thornley, 1996). Therefore, regional policy in the EEC member states during the post-war era had been devised in relation to the economic, social, political and territorial organization of each member state and it was practically implemented in isolation from the regional policies of other members.

2.2.2. Community Regional Policy in the Early Years of the European Integration

At the Community level, although regional disparities within and among nations had not been the core concern in the early years, the preamble of the Treaty of Rome made clear references to ensuring harmonious development and to reducing regional inequalities in the EEC. The preamble of the Treaty of Rome (1957) states that the founding members are:

> Anxious to strengthen the unity of their economies and to ensure their harmonious development by reducing the differences existing between the various regions and the backwardness of the less favoured regions.

Nevertheless, despite the recognition of the problem and the statement of an anxious desire to bring solutions to it at the European level, no instruments had been introduced to tackle the issue of regional development. Only, as a response to the insistent assertions of Italy, the Treaty had established the European Investment Bank (EIB) as the financing institution of the Community which was thought to provide loans to the member states to support infrastructure and development projects (De Vet, 1998; Beugelsdijk, M., 2002). On the other hand, the two funds that had been set up by the EEC straightaway, namely the European Social Fund (ESF) and the European Agricultural Guidance and Guarantee Fund (EAGGF), were essentially designed to provide support for employment and rural areas, respectively. Although, there have been a contribution from these funds to the reduction of regional disparities, the specific means directly aimed at supporting regional development had not been put together until the creation of the European Regional Development Fund (ERDF) in 1975.

Concisely, what existed as regional policy during first two decades of the EEC was a collection of different forms of regional economic policy at the member state level together with an overall – but not a targeted – concern at the Community level. The type of regional policy in different member states depended on the legal and administrative structure of the specific country, as well as on the degree of decentralisation (van den Berg *et al.*, 1998). In each system, there had been different definitions of regional problem, and in addition to that, different regulations, instruments, and incentives were designed to address it.

The issue of regional policy to become a Community matter coincides with the first enlargement of the EEC in 1973 to include three new member states: United Kingdom, Denmark, and Ireland. On the one hand, this enlargement had brought into the Community specific regions (especially those of Ireland and some parts of the UK) which were seriously lagging behind in economic development and therefore intensified the regional disparity in the EEC. On the other hand, and more importantly, after a thorny admission, the UK had to figure out a way to take its share out of the Community budget (Sutcliffe, 1995). Most of its regions were experiencing industrial decline and large amounts of investments were necessary in order to regain their competitiveness. Therefore, in 1975 the European Regional Development Fund (ERDF) was established with the purpose to assist the regions in need and with specific emphasis on development in order to eliminate structural and regional imbalances (Bornschier *et al.*, 2004).

Despite the fact that the EEC had started to be actively involved in regional development through the distribution of the ERDF, the financial assistance provided was merely a complementary payment to the national aids (Thielemann, 2002). Funding was allocated directly to the member states according to the annual quotas and countries were to spend the money in line with their own regional policy and plans. That is why; implementation of Community-level regional policy was subject to the national discretion of member states with the EEC having only limited power in deciding the utilization of the Community funds (Bailey and De Propris, 2002). ESF, EAGGF-Guidance Section and ERDF operated as individual fund schemes without coordination (Bachtler and Michie, 1993), which resulted in emphasizing sectoral objectives rather than territorial objectives in the implementation of Community regional policy. The lack of territorial concentration in the utilization of the Community regional assistance also caused a dispersed allocation of funds. The fact that the Community did not exert a territorial dimension to the distribution of the assistance allowed the member states to carry on with their individual identification of sub-national units. In addition to that, the financial resources distributed under the different funds of the Community regional policy have been in limited amounts at only around 10% of the EEC budget (Rodríguez-Pose and Fratesi, 2004) and the Community did not carry out a systematic assessment of the outcomes of regional assistance it provided (Leonardi, 2005). On the whole, the regional development attempt at the Community level during the late 1970s and early 1980s amounted simply to an additional source of funding to national assistance in order to promote economic activity in the selected sectors of each member state.

While regional policy in the EEC started to be shaped during the 1970s, an important issue that needs to be considered parallel to the developments in the EEC is the outbreak of the oil crises of 1973 and 1979, and the subsequent ending of the golden age of European Fordism (Heeg and Oßenbrügge, 2002), which had seriously interrupted the positive trend of economic and political affairs in Europe. Up to the 1970s, in spite of the rise of state controlled and interventionist policies following the Second World War, markets had started to become increasingly international through the expansion in the volume of trade among EEC members due to the common market (Fotopoulos, 1997). However, the economic crisis that took place after 30 years of high level growth since 1945 suddenly reversed this trend and consequently caused the member states to lose interest in economic integration (Heeg and Oßenbrügge, 2002; Rodríguez-Pose, 2002). This, in turn, gave rise to a political and economic dilemma that was then referred to as the 'Eurosclerosis'. The way out of the crisis was seen in leaving the strong regulatory power of the state on one side and focusing on deregulating the market to be able to achieve competitiveness in the international arena.

2.3. Europeanization of Regional Policy with the 1989 Reform

This section describes the Europeanization of regional policy in the Community with the 1989 reform. For this purpose, first of all, the impact of the Single Market decision on the approach to regional policy at the Community level is summarized. Then, in the following part, the reform of the Community regional policy in 1989 is explained in detail.

2.3.1. Impact of the Single Market Decision on Community Regional Policy

The most important step taken towards integration in the history of the Community to overcome the economic, as well as the political dilemma of the 1970s has been the decision on the creation of a single market in 1985. The vision behind this decision was that the removal of all sorts of barriers to the free movement of capital, goods, services, and also citizens would improve efficiency by way of providing a better allocation of resources, which would in turn lower prices, increase the volume of investment, subsequently boost employment, and would altogether raise competitiveness throughout Europe (Rodríguez-Pose, 2002; Bornschier *et al.*, 2004).

In the first half of 1980s, enlargement of the EEC continued by increasing the number of member states to twelve with the admission of Greece in 1981, and with Spain and Portugal becoming members in 1986. However, as the income per capita in these new member states had been relatively lower compared to the rest of the nine, development gaps grew to be an even bigger problem for the Community than before. Despite the commonly accepted aspiration to promote competitiveness in Europe, the heterogeneous economic structure (let alone the political, legal, administrative, and cultural diversities) both among and within the member countries constituted a major obstacle to the realisation of the single market vision. As the less-developed areas would be left more vulnerable to the negative effects of market fluctuation such as reduction in the level of investment and rise in unemployment, due to the increased mobility of the factors of production, creation of a single market would call for necessary policy responses to compensate for these negative effects in backward regions. Therefore, establishment of a single market in Europe required the deepening of the Economic Community to encompass wider policy areas in order to secure free and undistorted competition, as well as to prevent the negative impacts of deeper integration on the disadvantaged regions (Dinan, 1999). Evidently, regional policy is one of these policy areas that have gained an improved Community dimension with the decision on single market.

During the 1980s, while on the one hand, most member states had started to experience economic deregulation and administrative decentralisation with respect to the previous decades, re-regulation at the supranational level began to take place with a growing transfer of competences from central governments to the EEC (Newman and Thornley, 1996). This process has brought in a new supranational level to the organization of administration alongside the conventional tiers of national, regional, and local, which consequently transformed the decision making and implementation procedures of member states.

Particularly, the objective of a single market was interconnected with the concept of cohesion and attached considerable importance to it (Thielemann, 2002). To the extent that the single market has been devised to create a new momentum to integration as a solution to the economic troubles the EEC had faced in the late 70s and early 80s, it was hard to envisage the radical reform measures to find common acceptance without due assurance of Community-wide benefits that were expected to result in economic and social cohesion in addition to enhanced prosperity. Therefore, the Single European Act, that was signed in 1986 and subsequently entered into force in 1987 with a prospect to complete the internal market by 1992 to allow the free movement of the four factors of production, put specific emphasis in its preamble on the improvement of the social and economic situation in Europe through broadening the competence of the EEC (Official Journal of the European Communities, 1987) and added a specific title on economic and social cohesion to the EC Treaty which envisaged the coordination of the activities of the ESF, EAGGF-Guidance Section and ERDF to better contribute to the reduction of regional disparities[10].

The first Delors Commission, which served from 1985 to 1989, had carried out intensive work on the successful formation of the single market. Commission President Jacques Delors, on one of his briefing speeches to the Heads of State and Government in 1986, stated that it was necessary to chose between two alternative methods with regard to achieving cohesion in the Community. The first one was based on compensation, which would be carried out by means of budgetary mechanisms; whereas the second method that he supported relied basically on convergence that was to be realized through economic policies (Brennan, 2006: p. 3). Therefore, with the reform, it was necessary for the Community regional policy to be shifted from being a compensatory mechanism that merely supports national regional policies of member states towards a policy that effectively contributes to convergence in the EEC (Bachtler and Michie, 1993; De Rynck and McAleavey, 2001; Tarschys, 2002).

2.3.2. 1989 Reform of Community Regional Policy

In line with the reform movement initiated by the Single Market objective, the Commission prepared a financial perspective that was commonly known as the 'Delors I Package' (1988-1993) to be put into action in conjunction with the efforts to complete the internal market. The changes introduced to the Community budget with this perspective marked the beginning of a new understanding in terms of regional policy, among other things (Hall and van der Wee, 1992; Leonardi, 2005).

The basic elements of the reform of Community regional policy are summarized in Table 2.1. The Table provides an overview of the transformation of regional policy in the Community by comparing its main features before and after the reform.

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[10] Article 23 of the Single European Act (Official Journal of the European Communities, 1987).

Table 2.1: Europeanization of Regional Policy after the 1989 Reform

REFORM OF COMMUNITY REGIONAL POLICY	
Before 1989	**After 1989**
Annual budget period	Multi-annual financial perspective
Individual fund schemes	Integrated programming (CSFs or SPDs)
Implementation subject to national discretion	Implementation subject to certain principles
Sectoral objectives	Territorial objectives
Dispersed allocation of funds	Objectives based focus
Insufficient assessment of outcomes	Systematic assessment of outcomes
Limited financial resources	Financial resources significantly increased

First of all, the most important of these changes was related to the budget period. Due to the fact that a majority of development investments are large in scale, the annual allocation of money in the former system caused difficulties in financing these medium to long-term projects. Setting up a multi-annual financial perspective by removing annual quotas on funds made medium-term planning and programming possible in order to provide proper funding for the investments in development.

Secondly, the funds aimed at specific issues, such as employment, agriculture, or infrastructure used to operate independently from each other before 1989 and this unconnected nature considerably decreased the overall impact of the total fund expenditure. With the 1989 reform, the three funds within the scope of Community regional policy (ESF, EAGGF-Guidance Section and ERDF) have been grouped under the name of Structural Funds[11]. Grouping the various financing schemes within the framework of Structural Funds not only improved the management of different funds received by each member state, but also facilitated the formation of a synergy to contribute to regional development at the highest possible degree. In accordance with this approach, each member state started to prepare Community Support Frameworks (CSFs) (or Single Programming Documents (SPDs) if there is only a single programme in that member state) to coordinate EU regional assistance. On the other hand, in order to account for the different levels of absorption capacity of

[11] In the first programming period (1989-1993), Structural Funds comprised ERDF, ESF and EAGGF-Guidance Section. In the second programming period (1994-1999), Financial Instrument for Fisheries Guidance (FIFG) has been included to these. Structural Funds in 2000-2006 was similar to the previous period. For the 2007-2013 period, Structural Funds are ERDF, ESF and the Cohesion Fund. To finance rural development policy in 2007-2013, a separate instrument has been created which is called European Agricultural Fund for Rural Development (EAFRD).

financial assistance in different member states, EU also brought an annual upper limit for Structural Funds which was determined at 4% of the member states' GDP.

As a third aspect, the reform had also introduced four principles to the implementation of these Structural Funds. 'Additionality', as one of these principles, denotes that the financial assistance provided by the Community should complement rather than compensate the contributions of member states to regional development. 'Concentration' principle draws attention to the fact that funding should be directed to the areas that are most in need to make sure that the impact of the assistance is amplified. Emphasis was also given to 'partnership' principle in order to ensure the involvement of the sub-national units of administration, as well as to highlight the need to effectively set up cooperation among the Commission and national, regional and local authorities. Finally, 'programming' principle was related to the elaboration of multi-annual development programmes as mentioned above.

The shift from sectoral objectives to territorial ones was the fourth element of the reform. Community regional policy acquired a territorial dimension with the shift to the Structural Funds system in order to better target regional development instead of assisting individual sectors as seen in most of the national aid schemes. For this purpose, a classification system for territorial units (NUTS: Nomenclature of Territorial Units for Statistics[12]) had been utilized throughout the member states since 1988 (European Commission, 2006f) and in this way, standard problem definitions were formulated for different regions in need.

In connection with the abovementioned concentration principle, specific objectives were identified by taking this territorial division as basis in order to accurately target the most important regional development problems in the Community, which makes up the fifth element of reform. The main reason for identifying these objectives is that, prior to the reform; the allocation of available funding to a range of different projects in a dispersed manner had caused their total

[12] NUTS is a classification system that sets out three hierarchical levels of regions. Member states are first divided into NUTS I regions (with population from 3 to 7 million). Then, NUTS I regions are divided into NUTS II regions (with population from 800 000 to 3 million) and NUTS II regions are divided into NUTS III regions (with population from 150 000 to 800 000) (European Commission, 2006f).

impact to be significantly diminished. These objectives are deemed to contribute to the concentration of financial assistance to particular problem areas.

The Structural Funds objectives in the four programming periods (1989-1993, 1994-1999, 2000-2006 and 2007-2013) are listed in Table 2.2. When the formulation of the objectives according to different programming periods is examined from this Table, it is seen that they have gradually become more consolidated. The reason for this was the need to intensify the impact of Community assistance by limiting the number of objectives (Sutcliffe, 1995). While the development of the least-prosperous regions has been the fixed objective of Structural Funds in all periods, other objectives have either been rephrased or completely eliminated. For instance, the objective on the problems of the regions hit by industrial decline has been first reformulated as “revitalising areas facing structural difficulties” in the 2000-2006 period and in the 2007-2013 period it is replaced with “strengthening regions’ competitiveness and attractiveness”. This shows that not only there is a trend to increase the concentration of the funds through these objectives but also there is an increased emphasis on competitiveness in the EU regional policy. In addition to that, the objectives on agriculture and rural development have been completely removed from the Structural Funds as a separate instrument (European Agricultural Fund for Rural Development – EAFRD) has been introduced for the 2007-2013 programming period. On the other hand, a new objective on territorial cooperation has been introduced for the 2007-2013 period which aims to establish cross-border cooperation networks for improving the exchange of experience. As a result, the three dimensions of cohesion, namely economic, social and territorial cohesion are all reflected in the formulation of the Structural Funds objectives for the 2007-2013 financial perspective respectively as convergence, regional competitiveness and employment and territorial cooperation.

According to the Structural Funds regulations for 2007-2013 (Official Journal of the European Union, 2006b), the criteria for eligibility of a region for the Convergence Objective is to have a GDP per capita in purchasing power standards (pps) less than 75% of the EU average. 2007-2013 Structural Funds regulations identify all regions other than those covered by the Convergence Objective as eligible for Structural Funds under the Regional Competitiveness and Employment

Objective. For the European Territorial Co-operation Objective, the regulation defines regions with land or sea frontiers and the trans-national cooperation areas as eligible with the decision of the Commission.

Table 2.2: Structural Funds Objectives in the Four Programming Periods (1989-1993, 1994-1999, 2000-2006 and 2007-2013)

PROGRAMMING PERIOD	OBJECTIVES	DESCRIPTION
1989-1993	Objective 1	Development of least prosperous regions.
	Objective 2	Regions hit by industrial decline.
	Objective 3	Combating long-term unemployment.
	Objective 4	Employment pathways for young people.
	Objective 5a	Adaptation of agricultural structures.
	Objective 5b	Development of rural areas.
1994-1999	Objective 1	Promoting the development and structural adjustment of regions whose development is lagging behind.
	Objective 2	Converting the regions or parts of regions seriously affected by industrial decline.
	Objective 3	Combating long-term unemployment and facilitating the integration into working life of young people and of persons exposed to exclusion from the labour market, promotion of equal employment opportunities for men and women.
	Objective 4	Facilitating the adaptation of workers to industrial changes and to changes in production systems.
	Objective 5a	Speeding up the adjustment of agricultural structures in the framework of the reform of the common agricultural policy and promoting the modernisation and structural adjustment of the fisheries sector.
	Objective 5b	Facilitating the development and structural adjustment of rural areas.
	Objective 6	Development and structural adjustment of regions with an extremely low population density.
2000-2006	Objective 1	Supporting the development in the less prosperous regions
	Objective 2	Revitalising areas facing structural difficulties
	Objective 3	Development of human resource
2007-2013	Convergence	Speeding up the convergence of the least-developed regions and Member States.
	Regional Competitiveness and Employment	Strengthening regions' competitiveness and attractiveness as well as employment.
	European Territorial Cooperation	Strengthening territorial cooperation at the cross-border, trans national and inter-regional levels and at establishing cooperation networks and furthering the exchange of experience.

Source: (European Commission, 2006h)

The sixth ingredient of reform was with regard to the assessment of the actual contribution of Community financial assistance to regional development. Prior to the reform, the Community itself did not have an oversight function on the allocated money and in addition to that, systematic evaluation and monitoring of the national programmes or projects that have been left to the national authorities were difficult to implement (Bachtler and Michie, 1995; Leonardi, 2005). The implications of lack of control were widely observed in the national aids which were mostly serving non-economic (e.g. political) objectives and becoming rent-seeking tools both for governments and for enterprises in supported sectors (Nicolaides and Bilal, 1999). This type of financial assistance used to create a vicious cycle of dependence for the assisted firms or regions which means that when the assistance is granted despite the inefficiency of an investment, constant support would be needed for the persistence of this inefficient investment because of the fact that without the assistance, the investment could not continue to exist under normal market conditions due to inefficiency. (Schina, 1987). Since the benefits would only be attainable as long as the assistance continued to flow; these types of firms become more dependent on assistance instead of becoming competitive. It is evident that such an approach cannot create the maximum development effect in the assisted region. After the reform in 1989, with the Community becoming more involved in the management of financial assistance provided, regular and in depth evaluation of support programmes has been introduced in order to maintain the effectiveness of regional policy and to share experiences and best practices among different regions.

The final but yet highly important change that took place with the 1989 reform was the significant amount of increase in the financial resources available for Community regional assistance. As a first step, Delors I Package had doubled the share for structural assistance in the Community budget from 4.8% in 1975 to 9.1% in 1987 (Bornschier *et al.*, 2004). In the run up to the completion of the single market and together with the increasing emphasis on political integration, the new financial perspective known as the Delors II Package (1993-1999) that was adopted in 1992 once again brought a substantial increase to Community resources to be allocated to Structural Funds and raised the share to almost 30% of the budget.

In addition to the reforms in the second half of 1980s, the Treaty of Maastricht that entered into force in 1993 had brought together the European Communities under the single name of the European Union (EU), which notably reinforced integration through the advancement of economic and monetary union (EMU). As a result of this remarkable evolution towards enhanced integration, the Cohesion Fund was created as a separate financial instrument with the Treaty of Maastricht in response to the unbalanced position of the four poorest countries in the Union (Greece, Ireland, Portugal and Spain)[13] in particularly transport infrastructure and environment, which was seen as too critical of a drawback for these member states to be tackled with the existing measures under the conditions of the fiscal convergence criteria for the EMU (Beugelsdijk, M., 2002).

For the 2007-2013 programming period, the indicative financial allocation of EU cohesion policy is €308 billion (Official Journal of the European Union, 2006b). 82.5% of this total amount is allocated to the Convergence Objective, whereas the allocation for Regional Competitiveness and Employment Objective is 16% and the allocation for European Territorial Cooperation Objective is only 2.5%. There is an allocation for each member state under one or more of these objectives and with the exception of six countries, that are Denmark, Ireland, Luxembourg, Netherlands, Finland and Sweden, all of them are covered under the Convergence Objective. Therefore, in order to promote growth and creation of jobs, the EU aims to contribute to the development of problem regions by allocating 0.37% of its GNI (European Commission, 2006e) which on average corresponds to around 39% of the EU 27 budget.

2.4. Contribution of EU Regional Policy to the Reduction of Regional Disparities

In order to analyse how the EU regional policy contributes to the reduction of regional disparities, this section first explains the concept of convergence as the key measure in assessing the success of regional policy. Subsequently, as convergence in the EU changes with the enlarging Union, the impact of enlargements on the

[13] These countries are usually referred to as cohesion countries.

distribution of EU Structural Funds is summarized. Finally, the section provides details on one of the main arguments related to EU regional policy which is the dilemma of redistribution vs. reformation.

2.4.1. The Concept of Convergence

The main indicator of the success of regional policy has been convergence which is one of the most investigated topics related to the enlargements in European integration. By definition, convergence is the decreasing degree of disparity among a group of initially diverse units, which in the case of the EU the NUTS II level regions. The method of demonstrating convergence is usually carried out in two ways. The first method examines the income growth rate and seeks to figure out an inverse relationship between the initial level of income and the growth rate throughout a certain period (β convergence). If the regions with initially lower levels of income have shown a higher growth rate than those regions with initially higher levels of income, this implies that at the end of the period the incomes of the different regions have relatively converged. This is an expected finding in relation to the decreasing marginal return principle of neo-classical theory, which upholds that economies with lower initial income tend to grow faster with respect to those with higher initial incomes (Barro and Sala-i-Martin, 1997).

Alternatively, in the second type of analysis, the deviation in the income levels of regions is calculated as cross-section time series and the decreasing dispersion trend is taken as an indicator of income convergence (σ convergence). The principle in choosing between these two methods or interpreting them is that the first one answers the question of whether the income of a particular region catches up with the average of all regions; whereas the second one illustrates the evenness of the distribution of per capita income of the whole group (Beugelsdijk, M., 2002).

The main idea is that convergence of economic indicators such as regional income (usually measured by regional GDP per capita in purchasing power standards) to a steady state is an evidence of cohesion. However, there are mixed findings as regards the existence of convergence in the EU. In their analysis of regional income per capita, Boldrin and Canova (2001) find out that there is a lack of fast convergence taking place among the regions of the EU. Cuadrado-Roura (2001) points out that despite a long period of regional convergence prior to 1970s, this process has come to a halt especially in the 1980s and 1990s. On the other hand, Badinger *et al.* (2004) analyse the regional convergence in the EU between 1985 and 1999 by controlling for spatial correlation and find out positive evidence on convergence. As a result of the empirical drawbacks in analysing convergence in the EU, Rodríguez-Pose (1999) concludes that since regional growth demonstrates a complex pattern depending on national and structural characteristics of every region, it is not possible to accurately assess convergence in the EU where significant structural differences exist among the member states. These differences among member states and their regions have considerably increased with the enlargements of the EU, which have influenced the formulation of EU regional policy to a large extent.

2.4.2. The Impacts of Enlargements on EU Regional Policy

European Union has been constantly evolving with successive enlargements and its evolution has different impacts on different policy fields. The impact of this evolution on regional policy is considerable due to its specific focus on sub-national territorial units, which continuously increased in number and increasingly diverged in nature by each enlargement.

Enlargement has always initiated a circular process in the Community where opening up membership to new countries created a policy impact at the supranational level, which then reacted with reformed strategies, and these subsequently made integration more appealing for non-members. The question to be asked here is that how do the acceding countries benefit from European integration? This question can be answered by examining whether enlargement delivers benefits through the redistributive instruments of the Community or it is through the unobstructed access to the integrated market or both. Bornschier *et al.* (2004: p. 85) respond to this question by investigating the economic growth of a total of 33 countries (both member and non-member states) between 1980 and 1998 where the interaction between economic growth of these countries and EU transfers is investigated[14]. The study provides empirical evidence that "the ability of the less developed EU members to grow faster than non-members can be attributed *exclusively* to transfer payments" [emphasis in original]. This conclusion is then interpreted as evidence to reinforce the argument on the 'political logic' of European integration (regional policy), rather than the 'economic logic' (establishment of the common market), and it is asserted that the higher than standard growth of countries that had become EU members (with regard to non-members) is not attributable to integration, single market or membership as such, but to the regional policy transfer payments within the Community. Moreover, the calculation of the per capita net benefit of membership (receipts of member states from the EU minus member state payments to the EU) shows that it is those member states with positive net benefits from the Community whose growth levels are affected the most by the regional policy of the EU.

These findings point out that despite the genuine long-term advantages of taking place in the process of EU integration such as the access to a wider market and securing of peace and democratic governance throughout the Union together with enhanced competitiveness and improved economic efficiency; it is rather the short to medium-term impacts of accelerated growth what the candidate countries are after in membership to the Community. It needs to be highlighted that although the study of Bornschier *et al.* (2004) provides evidence on the contribution of EU regional transfers to the growth of member states, it does not give any finding on whether the regional disparities in the high growth member states have decreased or not.

Since financial assistance is the most important instrument of regional policy in the EU, the impact of enlargements has mainly been visible on this issue. In order to illustrate this, Table 2.3 lays out the distribution of the allocation of structural assistance after successive enlargements. Each member state's share of structural assistance is given as a percentage of total structural assistance and the member states are also grouped according to their accession to the EU in order to demonstrate

[14] In this study, EU transfers are calculated by taking into consideration the "payments of the EAGGF guidance section, [ERDF and ESF], without the payments of the EAGGF guarantee section, without the reimbursement of levying costs of equities and other payments" (Bornschier *et al.*, 2004: p. 78).

the share of structural assistance that the enlargements have captured (shown in bold figures). It is seen from the Table that with the first enlargement, UK and Ireland managed to capture one third of the money available under the ERDF assistance. Nevertheless, Italy had been the biggest recipient of ERDF assistance in that period with 40% of structural assistance directed to this member state. It is important to consider the following enlargements, which marked the accession of Greece, Portugal and Spain, all together as their impact on the allocation of funds was 42.3%. Taking into consideration the additional Cohesion Fund which was essentially created for these Mediterranean countries (that is not included in the Table for the 1994-1999 period), it can be highlighted that it has by far been the most influential enlargement in the EU in terms of structural assistance, whose weight is still perceptible today. On the other hand, exceptionally, we see that the enlargement of 1995 did not have a significant economic effect related to the distribution of the Structural Funds as only 2.8% of structural assistance was directed to the three countries (Austria, Finland and Sweden) in total.

As regards the recent enlargement of the Community to include most of the Central and Eastern European Countries (CEECs), another significant shift of transfers is envisaged which allocates half of the Structural Funds assistance to these new member states (including Bulgaria and Romania). The transfers that the new member states are to receive in the 2007-2013 period constitutes 51.3% of the total allocation of Structural Funds (European Commission, 2006e). Considering that their contribution to the EU GDP is only around a 5% increase (European Commission, 2006n), the assistance to the new member states basically requires a reallocation of half of the assistance for the previous period to the new members.

Table 2.3: The Distribution of EU Structural Assistance after Successive Enlargements (1975-1977, 1994-1999, 2000-2006, and 2007-2013)

MEMBER STATES	ERDF ASSISTANCE (%) 1975-1977	STRUCTURAL ASSISTANCE* (%) 1994-1999		STRUCTURAL ASSISTANCE (%) 2000-2006		STRUCTURAL ASSISTANCE (%) 2007-2013	
Founding Members	**64.5**	**41.2**		**37.6**		**21.3**	
Belgium	1.5	1.3	-	0.9	-	0.7	-
France	14.9	9.8	-	7.2	-	4.1	-
Germany	6.3	14.2	+	14.0	-	7.6	-
Italy	40.0	14.1	-	14.2		8.3	-
Luxembourg	0.1	0.1		0.0		0.0	
Netherlands	1.7	1.7		1.3	-	0.6	-
1973 Enlargement	**35.6**	**13.0**		**9.9**		**3.5**	
Denmark	1.3	0.5	-	0.4	-	0.2	-
Ireland	6.5	4.0	-	1.8	-	0.3	-
UK	27.8	8.5	-	7.7	-	3.1	-
1981 Enlargement		**9.9**		**12.0**		**5.9**	
Greece		9.9		12.0	+	5.9	-
1986 Enlargement		**32.4**		**38.0**		**16.5**	
Portugal		9.8		11.0	+	6.2	-
Spain		22.6		27.0	+	10.2	-
1995 Enlargement		**2.8**		**2.5**		**1.5**	
Austria		1.0		0.7	-	0.4	-
Finland		1.0		0.9		0.5	-
Sweden		0.8		0.9		0.6	-
2004 Enlargement						**43.6**	
Cyprus						0.2	
Czech Rep.						7.7	
Estonia						1.0	
Hungary						7.3	
Latvia						1.3	
Lithuania						2.0	
Malta						0.3	
Poland						19.4	
Slovakia						3.3	
Slovenia						1.2	
2007 Enlargement						**7.6**	
Bulgaria						2.0	
Romania						5.6	
TOTAL	**100**	**100**		**100**		**100**	

* Excluding Cohesion Fund.

Sources: (De Vet, 1998; European Commission, 2006c; 2006p)

It is evident that every enlargement of the Community has had both economic and also political impacts in the formulation and implementation of structural policies. However, it needs to be kept in mind that regional policy of the Community has always been adapted to the needs of the Community and not to the needs or anticipations of the candidate countries as they are not involved in the reform debates (De Vet, 1998). What is more, besides the problem of regional disparities in the EU, national interests of member states also play a role when deciding on the distribution of EU regional funds. The reflection of this reality can be seen at the inception of ERDF assistance in 1975 in the decision to set a fixed distribution ratio among member states with the principle of *juste retour*[15] in order to strike a balance between the payments and receipts (Bornschier *et al.*, 2004). The problem that arises here is whether EU regional policy is a redistributive policy that aims to make proportionate allocations to member states according to their different development problems or a reformative policy that aims to support development in the backward areas.

2.4.3. The Dilemma of Redistribution vs. Reformation

The dilemma of redistribution vs. reformation is one of the long-debated issues in EU regional policy. Understanding the difference between these two types of contribution is an important factor in designing a policy for backward areas. The basic distinction between these two approaches is related to the difference between their primary aims. While the primary aim of the first approach is redistribution of wealth among regions, the primary aim of the second approach is the creation of wealth in the less-developed areas (Matthews, 1994). In other words, redistribution can be regarded as merely an allocative policy which makes transfers to compensate the backward regions for the negative effects of rapid growth and increased competition in the prosperous areas; whereas, reformation is regarded as an innovative policy which brings solutions to the problems in the disadvantaged areas (Friedmann, 1967).

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[15] *Juste retour* means that member states can receive a share of EU financial assistance which is proportional to their contribution.

On the whole, EU Structural Funds serve multifunctional objectives and it is not straightforward to accurately judge the impact of EU regional policy as redistributive or reformative. However, if we look at the Europeanization of regional policy from a redistributive point of view, it suggests that the understanding at the EU level is closely parallel to the regional policy approaches of individual member states which prioritize rapid growth and attempt to compensate for the costs of this growth[16] occurring on less developed areas by side-payments. As national growth is usually generated by a small number of growth poles, despite the positive benefits that are brought about by this growth to the entire nation, the level of regional disparity tends to increase and that is why a trade-off exists between national growth and reduction of regional disparities which becomes particularly important for less prosperous countries (Davies and Hallet, 2002). Therefore, as a result of the prioritization of efficiency to equity (Lackenbauer, 2004) the redistributive policy would not primarily contribute to the reduction of regional disparities but would mainly contribute to the catch-up of national economies to the EU.

According to the reformative approach, creation of wealth in backward regions is deemed to contribute to their development better than a redistributive regional policy (De Rynck and McAleavey, 2001) as it aims to actually solve the regional problems rather than to compensate for them. If the EU regional policy is perceived from the reformative angle, its primary aim should be bringing long-term viable solutions to regional development problems in the common market. As the financial resources to be directed to this purpose are limited, this can be realized by narrowing the target of EU regional policy to areas that are most in need. Nevertheless, this could mean that competitiveness in the EU is subordinated to cohesion.

The regional policy preference as regards redistributive or reformative approaches becomes a significant factor at the EU level as regional disparities tend to increase in an integrated economy due to the change in the relative mobility of the factors of production. In the EU, there is neither a complete immobility of production factors to solely rely on comparative advantage, nor a perfect mobility to count on

[16] These costs can be described as increased income inequality, wide differences in unemployment levels, and unbalanced distribution of social services, etc.

the market completely. The varying degrees of mobility in different regions forms the basis of divergence in integrated economies (Vanhove and Klaassen, 1980). In this context, the selection of the way EU regional policy contributes to the reduction of regional disparities is a political choice that could either favour competitiveness through supporting national policies of growth or it could exclusively focus on cohesion by supporting development in the regions with serious development problems. In other words, the policy choice to be made at the EU level is between decreasing development gaps among the different member states and decreasing disparities within the member states (Martin, P., 1999a).

2.5. Current Challenges of EU Regional Policy

In order to secure the economic, social and territorial cohesion, the EU currently faces two main challenges. One of these challenges is related to the success of EU regional policy in reducing regional disparities within the Union. The second challenge is related to the biggest enlargement of the EU which increased the number of member states to 25 in 2004 and, and to 27 by 2007 with the accession of Bulgaria and Romania.

Taking the first challenge into consideration, EU regional policy has always been under severe criticism on the grounds that the expected regional development impetus had not been reached by the EU in spite of more than a thirty-year involvement in actual commitment to the reduction of regional disparities (Boldrin and Canova, 2001; Puga, 2002). It is also asserted that with its highly ambitious objectives, EU regional policy is aiming to achieve decreasing regional inequalities, competitiveness, and national convergence all at the same time with very limited resources (Martin, P., 1999a).

In order to demonstrate the change in regional disparities in the EU, Table 2.4 provides information on the coefficient of variation of regional GDP in each member state. As coefficient of variation is an indicator of deviation among a set of data, the higher the coefficient of variation figure of regional GDP in a member state, the larger its regional disparities are.

Table 2.4: Analysis of Coefficient of Variation in Regional GDP per capita by Member States (1980-2001)

ENLARGEMENTS	MEMBER STATES	NUMBER OF NUTS II REGIONS ANALYZED	START YEAR[i]	END YEAR[ii]
	Belgium	11	**0.41**	**0.38**
	France	22	0.15	0.18
	Germany	40	**-**	**-**
	Italy	20	**0.26**	**0.25**
	Luxembourg	1	n/a	n/a
	Netherlands	12	**0.26**	**0.19**
1973	**Denmark**	3*	**0.10**	**0.08**
	Ireland	2	0.09	0.21
	UK	37	0.29	0.30
1981	**Greece**	13	**0.29**	**0.16**
1986	**Portugal**	5	0.23	0.23
	Spain	18	**0.21**	**0.20**
1995	**Austria**	9	**0.35**	**0.19**
	Finland	6	0.22	0.25
	Sweden	8	0.06	0.16
2004	**Cyprus**	1	n/a	n/a
	Czech Rep.	8	0.31	0.42
	Estonia	1	n/a	n/a
	Hungary	7	0.24	0.34
	Latvia	1	n/a	n/a
	Lithuania	1	n/a	n/a
	Malta	1	n/a	n/a
	Poland	16	0.15	0.20
	Slovakia	4	0.43	0.48
	Slovenia	1	n/a	n/a
2007	**Bulgaria**	6	**0.21**	**0.19**
	Romania	8	0.15	0.19
	EU 15	**207**	**0.41**	**0.36**

[i] Start Year is 1980 for EU 15 countries except for Netherlands which starts in 1986. Start Year for the new member states (including Bulgaria and Romania) is 1990.
[ii] End Year is 2001 for all member states.

Germany is taken out of the analysis due to the effect of reunification that increased disparities significantly.

Bold figures indicate decrease of variation.

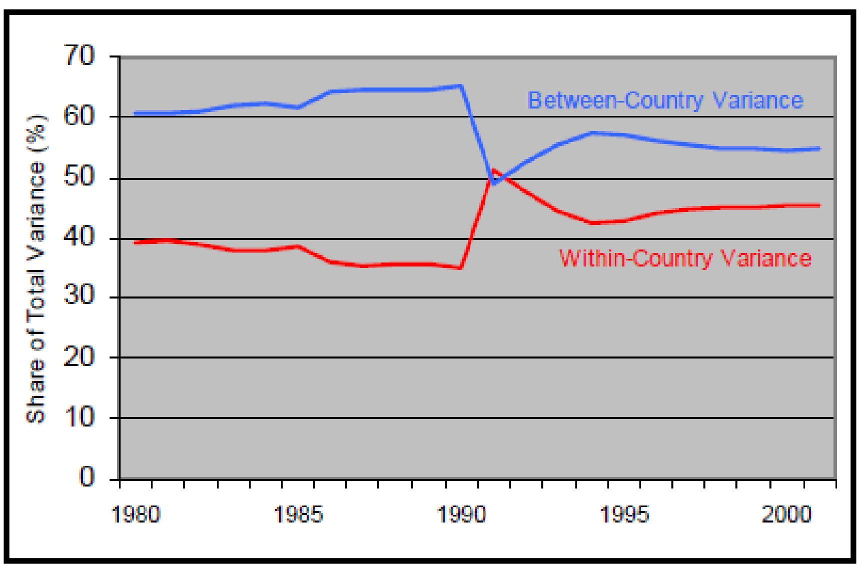
* With extra splitting the country into 3 regions.

Source:(European Commission, 2004e)

If we examine the development of within country regional disparities according to the Table, although the progress in the Community as a whole is towards a gradual decrease of income inequality as seen in the change from 0.41 in 1980 to 0.36 in 2001, it becomes evident that there is a mixed trend by individual member states.

Seven countries (Belgium, Italy, Netherlands Denmark, Greece, Spain and Austria) of the EU 15 display a decrease in their regional disparity. In four of these countries, the decrease is noticeably marginal, while the three best performers are Netherlands, Greece and Austria. In four of the 10 new member states for which data is available (namely, Czech Republic, Hungary, Poland and Slovakia), regional disparities appear to have increased.

Another analysis of regional disparities in a study of factors of regional competitiveness by the EC (2004e) which is carried out in preparation for the Third Progress Report on Economic and Social Cohesion examines the variance of regional GDP per capita in the EU as a combination of two factors. The first one is the variance of regional GDP per capita between countries and the second one is the within-country variance of regional GDP per capita. As a result, Figure 2.1 demonstrates the share of each of these factors in the total variance of regional GDP per capita in the EU.



Source: (European Commission, 2004e: p. 4-9)

Figure 2.1: Variance of Regional GDP per capita (1980-2000)

It is observed that the share of between-country variance has decreased from 1980 to 2000, whereas the share of within country variance of regional GDP per capita has increased. This can be one of the consequences of the greater emphasis on national competitiveness which leads to the promotion of growth centres by intensely concentrating all available resources and investment. After all, it shows that the convergence at the national level, which is indicated by the reduction in the between-country variance, is not reflected at the regional level.

Critics of EU regional policy also call attention to the fact that the profile of Objective 1 regions (i.e. the regions qualifying for GDP per capita <75% of Community average criterion) has changed very slightly over the three programming periods (1989-1993, 1994-1999 and 2000-2006) (Bailey and De Propris, 2002; Rodríguez-Pose and Fratesi, 2004). In other words, the same regions continue to receive assistance since the reform of the Structural Funds in 1989 and that the cases where regions develop fast enough to rise above the eligibility threshold of Structural Funds (GDP per capita <75% of the average GDP per capita of the EU) is very few. This is considered to be evidence against the success of the Structural Funds that receiving Community assistance cannot radically influence regions' performance. Nonetheless, this assertion needs to be approached with due awareness that development problems are inherently long-term and highly complicated in nature to be overcome by simply employing a uniform transfer policy.

If we take the second challenge into consideration, we see that the problem is not specific to regional policy and in almost all policy areas the 2004 enlargement is commonly identified as a big challenge for the EU. It is a central issue in regional policy terms due to the fact that the disparities are significantly widened within the Community and the means to cope with this problem seems to require quite more than what is already available in both financial as well as policy terms. The wealthiest member state in terms of GDP per capita in the 8 CEECs that have become EU member is Slovenia with 79% of the EU 25 average and the poorest member state is Latvia with 43% of the EU 25 average (2004 figures). These countries are also going through a political transition period from centrally planned economy to market economy (Brenton, 2002). Taken together with the existing regional disparities in the EU 15, the level of the regional development problem of the EU has increased considerably. What is more, the current candidate and potential candidate countries[17] are also those having average income per capita lower than the EU (Appendix B; Table B.1) which indicates that regional development will continue to be one of the important issues in the EU for the future.

It is observed that the reform of the Structural Funds has significantly improved the operation of EU regional policy and each programming period aimed to adjust the policy measures according to the regional problems in the EU. Nevertheless, in order to address the increasing level of regional disparities with more effective approaches in response to the two main challenges described above, EU regional policy needs to continue to evolve and adapt to the changing regional structure. Furthermore, it is also necessary for the member states to revise their regional policy approaches accordingly in order to fully benefit from EU regional policy.

[17] EU candidate countries are Croatia, The Former Yugoslav Republic of Macedonia and Turkey. EU potential candidate countries are Albania, Bosnia and Herzegovina, Montenegro and Serbia.

CHAPTER 3

REGIONAL STATE AID POLICY IN THE EU

In order to analyse the relationship between the regional policy shaped at the supranational level and the individual regional policy practices of EU member states with respect to the utilization of regional state aid, it is necessary to describe the Community approach to national regional aid. This section provides a detailed review of the EU rules and regulations related to national regional aid in member states. Furthermore, the adaptation of current member countries to these rules is examined by looking into the development of regional state aid in both the EU 15 and also in the 10 new member states.

3.1. Regulations Related to National Regional Aid in the EU

This section describes the legislation related to national regional aid in the EU first by providing an explanation of what national regional aid is. Subsequently, a review of the EU guidelines on national regional aid is provided. Lastly, other key regulations related to national regional aid in the EU are summarized.

3.1.1. Definition of National Regional Aid

National regional aid is a form of state aid that is commonly resorted to by countries with the aim of reducing regional disparities by supporting investments and the development of industry and services in the less developed areas. The type of aid that is referred to as national regional aid (or in other words, regional state aid) is aid with a primary objective of regional development. Evidently, aid to SMEs, R&D, training, environment, agriculture, etc. all have positive impacts on regional development as they contribute to the improvement of the social and economic environment wherever they are granted. However, their primary objective is not to address regional inequalities[18]. National regional aid exclusively aims at supporting

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[18] The limitation of this approach is the lack of a clear separation of regional state aid from other types of state aid as the aid that is granted to backward regions to support their development is usually paid

backward regions in activating their economies via creating favourable conditions in these regions to set up new investments and businesses, and in certain cases, to revitalize old ones. The rationale of granting national regional aid is to compensate for the unfavourable conditions of backward regions by offering them better investment and business conditions than the rest so that economic activities can find the means to flourish in problem areas. Of course, national regional aid can provide support for a variety of sectors and mainly to SMEs but, the essential distinction between national regional aid and other sorts of financial assistance is the objective of favouring backward regions vis-à-vis the others. State aids other than regional aid may also be granted in backward regions, which in that case contribute to increasing the intensity of the support to problem areas (European Commission, 2004a).

This being so, like all sorts of state aid and due to its selective approach with respect to regional development, national regional aid constitutes a discriminatory policy instrument which may not be compatible with the principles of the common market. State aid control has been one of the four main areas of Community competition policy since the beginning of European integration (the other three being antitrust and cartels, merger control, and liberalisation (European Commission, 2006b)) and its importance became ever more accentuated with the deepening of integration. In the common market, the trade barriers which used to function as the primary protection measures for the development of national industries in isolation from external competition are removed and free movement of production factors is realized. In consequence, as nation-states were stripped of these protectionist measures, there emerged the possibility of state aid to be used by the member states for anticompetitive purposes as a means to replace the forgone protection instruments in keeping their own sectors and industries from international competition (Wishlade, F., 1997). Similarly, state aid could be utilized by member states in order to attract investment with excessive incentive offers at the expense of a more efficient and

to SMEs and R&D. State Aid Surveys and Scoreboards of the EU draw attention to the fact that "primary objectives cannot always give a completely accurate picture of the final beneficiaries" (European Commission, 2002a). Therefore, it is possible that other categories of state aid such as aid to environment or training may have been granted in backward regions, which means that the total amount of aid that backward regions receive can be slightly higher than the total amount of regional state aid.

competitive market (European Commission, 1999; Wishlade, F. G., 2003). Therefore, at the outset, the Community had immediately introduced the necessary provisions in the Treaty of Rome (1957)[19] for the regional aid granted by the member states in order to prevent them to enter into a race to outbid each other in attracting investment (Moussis, 2003).

It is frequently made explicit by the Community[20] that in a properly functioning market economy, instead of supporting individual companies or specific sectors, which usually distorts competition more than it corrects an existing problem, the utilization of state aid should be limited to horizontal measures such as employment, R&D, training and environment that are for the benefit of the entire Union. Therefore, the tendency at the supranational level has always been to lower the total amount of state aid granted in the Community.

Since the definition of state aid is left considerably open in treaty provisions (in Article 87 of the EC Treaty), "grants, tax exemptions, preferential interest rates, the acquisition of land and buildings on favourable terms" as well as "guarantees, the sale of land and buildings, fiscal aids, and … venture capital" (Wishlade, F. G., 2003: p. 9) can all be considered as state aid by the Commission. In fact, it is solely under the discretion of the Commission to determine whether a measure constitutes state aid or not.

There are two basic decisive factors that the Commission makes use of when assessing an aid measure: "(1) whether the aid is in the interest of the Union as a whole and (2) whether a private investor would provide money in the same circumstances." (EU, 2006b) The Commission has also determined the four criteria below to decide whether a business is granted state aid by a member state:

> 1. there has been an intervention by the State or through State resources which can take a variety of forms (e.g. grants, interest and tax reliefs, guarantees, government

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[19] Under ex-Article 92 of the Treaty.

[20] Especially in the Lisbon European Council and Stockholm European Council Presidency Conclusions (EU, 2000; 2001) and through the State Aid Surveys (European Commission, 1997; 1998; 1999; EC, 2000; European Commission, 2001a) and Scoreboards (European Commission, 2001c; 2002b; 2002a; 2003; 2006l).

holdings of all or part of a country, or the provision of goods and services on preferential terms, etc.);
2. the intervention confers an advantage to the recipient on a selective basis, for example to specific companies or sectors of the industry, or to companies located in specific regions;
3. competition has been or may be distorted;
4. the intervention is likely to affect trade between Member States. (European Commission, 2006k)

Article 87 of the EC Treaty classifies state aids in two categories, one of which is state aids that are considered to be compatible with the common market, and the other is state aids that may be compatible with the common market. With the intention of maintaining fair and effective competition in the EU, European Commission monitors the assistance granted by each member state other than those that are considered to be compatible with the common market[21]. The types of aid that "may be considered to be compatible with the common market" are defined under Article 87(3). Aids with a specific purpose of regional economic development are considered to be under this second category and they are defined in Article 87(3)(a) and Article 87(3)(c) of the Treaty as follows:

> 87(3)(a) aid to promote the economic development of areas where the standard of living is abnormally low or where there is serious unemployment;
>
> 87(3)(c) aid to facilitate the development of certain economic activities or of certain economic areas, where such aid does not adversely affect trading conditions to an extent contrary to the common interest. (Official Journal of the European Communities, 2002a)

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[21] According to Article 87(2) EC, the only forms of aid that are considered to be compatible with the common market are:

(a) aid having a social character, granted to individual consumers, provided that such aid is granted without discrimination related to the origin of the products concerned;
(b) aid to make good the damage caused by natural disasters or exceptional occurrences;
(c) aid granted to the economy of certain areas of the Federal Republic of Germany affected by the division of Germany, in so far as such aid is required in order to compensate for the economic disadvantages caused by that division. (Official Journal of the European Communities, 2002a)

The distinction between the two types of regional state aids that may be compatible with the common market is that while the Article 87(3)(a) regions are those where the problem of development is highly severe, Article 87(3)(c) regions are generally the ones with other problems such as industrial conversion, and that is why the aid levels are relatively higher in the Article 87(3)(a) regions (Wishlade, F., 1997; Dunford *et al.*, 2001). The EC Treaty does not put any condition on the granting of regional state aid to Article 87(3)(a) regions other then having abnormally low standards of living and serious unemployment, however, in the granting of regional aid to Article 87(3)(c) regions, there is a specific condition for such aid not to adversely affect trading conditions among member states (Benavides and Argüelles, 1998). Basically, the Article 87(3)(a) regions aim to cover those regions in the EU that might not have abnormally low living standards or serious unemployment but that may face important structural problems that negatively effect economic development in these areas. Article 87(3)(a) and Article 87(3)(c) regions also differ in terms of the eligibility criteria. While NUTS II level is the unit of eligibility for regions under Article 87(3)(a), both NUTS II and NUTS III levels are considered for eligibility under Article 87(3)(c). In addition to that, the selection of the Article 87(3)(a) regions only take into consideration the development level of the region in relation to the EU average, whereas, both EU level and national comparisons are made in the selection of Article 87(3)(c) regions (Wishlade, F., 1997; Wishlade, F. G. and Yuill, 1997).

Given that the EC Treaty sets the scope of state aid extremely wide, the Commission issues specific rules on different forms of aid to be granted by member states. These rules cover specific sectors such as agriculture, fisheries, transport, etc., as well as aids to horizontal objectives such as environment, research and development, rescue and restructuring, and risk capital. National regional aid is one of these specific topics that the Commission issues specific guidelines for.

The first rules on granting national regional aid in the Community date back to 1971 (Wishlade, F. G., 2003; EU, 2006a). Since 1971, a number of legislation have been issued as regards regional state aid[22] and these have been harmonized with the issuing of the first guidelines on national regional aid in 1998 by the Commission in order to simplify a multiplicity of different documents on the subject. The guidelines issued by the Commission on national regional aid aim to set out the specific conditions under which member states may utilize regional aid to support or promote development in their backward regions. Currently, the 1998 guidelines on national regional aid[23] is in effect. Nevertheless, with the beginning of the new financial perspective of the EU covering the years 2007 through 2013 and because of the political and economic transformations in the EU (mainly due to the 2004 enlargement), new national regional aid guidelines have been issued for the period of 2007-2013. In the following section, these new guidelines are reviewed to be able to examine the present approach of the EU on national regional aid.

3.1.2. EU Guidelines on National Regional Aid for 2007-2013

EU Guidelines on National Regional Aid for 2007-2013 (Official Journal of the European Union, 2006c) constitutes the backbone of the national regional aid policy in the EU within the new financial perspective. The new guidelines are the outcome of a continuing debate carried out by DG Competition on the reform of the Commission's state aid policy and more specifically, on the review of the existing regional aid guidelines. As a first step, in 2004, the Commission issued a consultation paper to the experts in member states to review the regional aid guidelines (European Commission, 2004b; Fothergill, 2006) in line with the developments in the EU. This was followed by a non-paper on the review of regional aid guidelines (European Commission, 2004c) which laid down the key proposals for the new guidelines to replace the 1998 guidelines. Altogether, these initiatives are part of a broader State Aid Action Plan (European Commission, 2005b) which envisages an indicative roadmap for 2005-2009 to reform the EC state aid policy to respond to the challenges it faces in the soon-to-be EU 27 with the accession of Bulgaria and Romania.

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[22] For instance; (Official Journal of the European Communities, 1988; 1990; 1995)

[23] (Official Journal of the European Communities, 1998c: p. 9) modified in (Official Journal of the European Communities, 1999a: p. 2) and (Official Journal of the European Communities, 2000: p. 5).

The overall reform idea in the State Aid Action Plan is based on the principle of "less and better targeted state aid". In accordance with this principle, the action plan draws attention to "a focused regional policy". It means that while recognizing cohesion as an important part of the Lisbon Strategy, EU state aid policy aims to contribute to cohesion "by preventing a damaging subsidy race between regions, and by creating the right incentives for growth and jobs, in the least-developed regions and elsewhere" (European Commission, 2005b: p. 11). These principles have formed the basis of the new guidelines on national regional aid for 2007-2013. The intention of further limiting both state aid and its scope of application are directly reflected in the new guidelines.

With reference to Article 87(3)(a) and Article 87(3)(c) of the EC Treaty, the concept of national regional aid is broadly defined in the 2007-2013 guidelines as; "State aid granted to promote the economic development of certain disadvantaged areas within the European Union" (Official Journal of the European Union, 2006c: p. 13). According to this definition, national regional aid involves "aid for investment granted to large companies, or in certain limited circumstances, operating aid, which in both cases are targeted on specific regions in order to redress regional disparities" (Official Journal of the European Union, 2006c: p. 13).

In relation to the Commission's "less and better targeted state aid" objective, the new guidelines emphasize that the effectiveness of national regional aid can be increased only by constraining the utilization of this measure to most disadvantaged areas. Moreover, it is stressed that as a general principle, the positive impact of the aid in the development of a backward region needs to be greater than the negative impact of the aid on competition distortion. These statements lay out clearly that national regional aid is a measure whose prevalent application is to be avoided throughout the EU unless the seriousness of the regional problem is recognized at the Community level. Therefore, member states willing to make use of national regional aid are in a position to justify their regional development problem in relation to the whole Community.

In terms of the scope of the national regional aid, the new guidelines particularly indicate that regional aid to the steel industry and to the synthetic fibres sector are not compatible with the common market. In addition to that, it refers to specific rules and regulations that govern the granting of regional aid to fisheries sector, coal industry, agricultural sector, transport sector, shipbuilding sector and to firms in difficulties as these fields of activity are considered to be highly sensitive to state policies.

One of the most important changes introduced to the national regional aid guidelines for the period of 2007-2013 is the requirement for the regional aid to be an integral part of the member states' overall regional development strategy. It is specifically indicated that "regional aid should be granted under a multi-sectoral aid scheme" (Official Journal of the European Union, 2006c: p. 14) which needs to be defined according to this regional development strategy. Although exceptions are allowed for granting aid in an ad hoc manner, this rule essentially aims to prevent national regional aid to serve political or private objectives by making it a part of a long-term national strategy.

Under these general principles, the new guidelines set out the eligibility criteria for regions where national regional aid may be granted and give details on what types of aid are permissible within the Union. The following two sub-sections elaborate on these two main conditions of granting national regional aid.

3.1.2.1. Eligible Regions for National Regional Aid

The guidelines identify several criteria to be applied in determining the regions which will be eligible for national regional aid in 2007-2013 and these are summarized in Table 3.1. The first of these criteria is the proportion of EU population to benefit from regional aid. In order to keep a tight control on the granting of national regional aid, the Commission sets an upper limit for the population covered by this policy. Although, compared to the 1998 guidelines, this limit remains unchanged at 42% of the entire population of the EU 25, it is envisaged to rise to 45.5% in the EU 27.

Table 3.1: Determination Rules of Eligible Regions for National Regional Aid in the EU According to the National Regional Aid Guidelines for 2007-2013

Rules		Criteria
General	Total Population Coverage in the EU	≤ 42% of EU 25, or ≤ 45.5% of EU 27
	Safety Net	No member state loses more than 50% of its population coverage for 2000-2006
Article 87(3)(a) of the EC Treaty	Regions with abnormally low standard of living or with serious underemployment	Convergence Objective regions (NUTS II regions with GDP per capita in pps <75% of Community average)
	Outermost Regions	Defined in Article 299(2) of the EC Treaty
	Statistical effect regions (transitional: until the end of 2010)	Regions with GDP per capita in pps <75% of EU 15 average, but >75% of EU 25 average
Article 87(3)(c) of the EC Treaty[i]	Economic development regions	Regions with GDP per capita in pps <75% of EU 15 average when 1998 guidelines were adopted, but currently >75% of EU 15 average
	Low population density regions[ii]	NUTS II regions <8 inhabitants per km^2, or NUTS III regions <12.5 inhabitants per km^2
	Distribution of the balance	Subject to the Annex IV of the 2007-2013 guidelines[iii]

[i] These rules are for the first step of determining national population coverage under Article 87(3)(c). The second step of selecting eligible regions is subject to a set of detailed criteria described in the section 3.4.2 of the guidelines (Official Journal of the European Union, 2006c).
[ii] To be applied after taking into account the relative wealth of the regions (i.e. if the region is already eligible for aid under Article 87(3)(a) due to lower income, it cannot be eligible for Article 87(3)(c) at the same time).
[iii] Method for allocation of population shares in assisted Article 87(3)(c) areas across Member States (Official Journal of the European Union, 2006c).

Source: Own elaboration from the National Regional Aid Guidelines for 2007-2013 (Official Journal of the European Union, 2006c)

Evidently, as the average income decreases and regional disparities increases with the enlargement of the Union[24], the coverage of national regional aid policy correspondingly increases. In a Community of 27 member states, almost half of the population will be eligible for national regional aid. From the competitiveness

[24] It should be noted that this is simply due to the fact that aside from the 1995 enlargement, the EU has taken in relatively poorer countries and the 2004 enlargement was the most serious one with respect to both the number of new members and also their relative wealth.

perspective, this can mean that a significant amount of member state resources in the eligible areas will be directed away from their more efficient uses to reducing regional disparities. In order to prevent that and to further restrict the use of national regional aid, the Commission also determines different aid ceilings (in other words, aid intensities) for different regions which are determined by calculating aid as a percentage of the eligible costs of the investment[25] to benefit from regional aid. These are further explained in the following sub-section on the types of national regional aid.

Another regional eligibility criterion which is called ‘safety net’ in the new guidelines ensures that the regional state aid population coverage in member states during the 2000-2006 period, does not decrease more than 50% in the 2007-2013 period. This is a criterion introduced to keep previously assisted regions from suddenly being left without sufficient support. Application of safety net criterion increases the abovementioned population coverage approximately to 43.1% in the EU 25 and to 46.6% in the EU 27 (Official Journal of the European Union, 2006c).

In the application of the provisions of Article 87(3)(a) of the EC Treaty, the guidelines consider the concepts of ‘abnormally low standard of living’ and ‘serious underemployment’ in relation to the entire Community (as opposed to each individual member state[26]) and sets the criteria parallel to the Convergence Objective of the Structural Funds for the 2007-2013 period. Hence, the NUTS II regions where GDP per capita calculated in purchasing power standards is less then 75% of the Community average are considered to be eligible for granting of national regional aid under Article 87(3)(a). Associating the application of member states’ national regional aid policy with the provisions of EU regional policy in terms of putting

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[25] Eligible cost of investment refers to the total cost of an investment that is calculated according to the eligibility conditions of different cost types of an investment for regional state aid which are described in the guidelines on national regional aid for 2007-2013.

[26] This is a fundamental shift of perspective for national regional aid policies because when member states used to grant regional aid to their backward regions prior to the European integration, their sole frame of reference was themselves. Especially for better-off countries in the EU, the new approach has significant impacts as their low levels of regional disparity are played out by the very high figures in the new member states.

forward a definition for the regions in need is a crucial point for the purposes of policy coordination.

On the other hand, regardless of their income levels, outermost regions[27] of the EU are automatically considered to be eligible for national regional aid under Article 87(3)(a) as their geographical remoteness creates specific handicaps for these regions in the common market.

As a fifth criterion for eligibility, in order to compensate for the changing economic structure of the EU as a result of the 2004 enlargement, national regional aid under Article 87(3)(a) is also considered to be admissible in the statistical effect regions until the end of 2010. These are regions of the EU 15 where GDP per capita in pps is below 75% of EU 15 average but above 75% of the EU 25 due to the decreased average. After 2010, it is envisaged in the guidelines that these statistical effect regions will become eligible for national regional aid not under Article 87(3)(a), but under Article 87(3)(c).

For the application of the provisions of Article 87(3)(c) of the EC Treaty, the new guidelines set out a two step process: the first one is qualitative and the second step is quantitative (Wishlade, F., 1997). As a first step, the national population coverage is determined for each member state, and in the second step, the eligible regions in each member state are selected. The first step of determining the national population coverage involves three criteria. Firstly, the economic development regions are automatically considered to be eligible for national regional aid under Article 87(3)(c). Economic development regions are the EU 15 regions where GDP per capita in pps was below 75% of EU 15 average at the time when the 1998 guidelines on national regional aid were adopted but that are currently above the 75% of the average GDP per capita in pps of the EU 15. The justification provided in the 2007-2013 guidelines for eligibility is that these are regions which have previously benefited from a significant amount of assistance and member states need the flexibility to keep supporting these regions until 2013. Secondly, low population density regions which have a population density of either 8 inhabitants per km^2 at

[27] Azores, Madeira, Canary Islands, Guadeloupe, Martinique, Réunion and French Guyana (Article 299(2) EC).

NUTS II level or 12.5 inhabitants per km^2 at NUTS III level are also eligible. As the third criterion, when the eligible population calculated according to both the provisions of Article 87(3)(a) and also according to the abovementioned two criteria of the Article 87(3)(c) is deducted from the total population coverage limit in the EU, the balance is distributed to member states under Article 87(3)(c) according to the method of calculation explained in the Annex IV of the new guidelines[28].

In the second step, eligible regions in each member state are selected according to their level of income, unemployment, population density, geographical location, etc. in line with the provisions laid down in the guidelines.

3.1.2.2. Types of National Regional Aid

Following the determination of eligible regions, the Commission also specifies the types of aid that are allowed in the EU. There are three types of national regional aid that can be granted by the member states according to the 2007-2013 guidelines: regional investment aid, operating aid and aid for newly created small enterprises.

If we first consider regional investment aid, it is defined in the new guidelines as "aid awarded for an initial investment project" (Official Journal of the European Union, 2006c: p. 19) and it covers investments in material and immaterial assets related to:

- the setting-up of a new establishment;
- the extension of an existing establishment;
- diversification of the output of an establishment into new, additional products;
- a fundamental change in the overall production process of an existing establishment. (Official Journal of the European Union, 2006c: p. 19)

Supporting regional investment in backward regions is an important factor in vitalizing economic activity in these areas. However, it needs to be borne in mind that each of the different types of regions described in the previous section has a different type of economic structure which makes it necessary to bring a differentiated approach in formulating the regional state aid policy. Therefore, to be

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[28] This is a three-step method that aims to determine the regions which are to be eligible for national regional aid according to a more refined disparity calculation that takes GDP and unemployment into account with regard to the relative position of member states.

able to address regional development problems in a proportionate manner, the new guidelines define different aid ceilings (aid intensities)[29] to be granted to large companies in different regions.

According to Article 88(3) EC, member states are required to notify the Commission any aid to be granted or any modification to an existing aid scheme. However, according to the group exemption regulations (see section 3.1.3) member states may grant regional aid in accordance with the definition of eligible regions and aid intensities in the national regional aid guidelines without notification, provided that the total amount of aid does not exceed the maximum acceptable amount of aid that an investment with eligible cost of €100 million can receive according to the rules specified in these guidelines. Therefore, notification threshold is the maximum amount of aid that can be awarded to an investment project without notification according to these eligibility and aid intensity conditions. The aid ceilings for regions eligible for national regional aid are summarized in Table 3.2 together with the notification threshold of investment projects.

The highest level of aid intensity is allowed in the regions which have a GDP per capita lower than 75% of the EU 25 average. Moreover, these regions are also differentiated in terms of aid intensity into three categories: first group of regions are those with a GDP per capita lower than 75% but higher than 60% of the EU 25 average (eligible for 30% aid intensity), the second group indicates regions with a GDP per capita lower than 60% but higher than 45% of the EU 25 average (eligible for 40% aid intensity), and in the third group are the regions with GDP per capita lower than 45% of the EU 25 average (eligible for 50% aid intensity). Taking into account the severity of the regional development problem, the highest aid intensity is given to the third group and therefore, regional state aid can be up to 50% of the eligible cost of the investment in these regions. Regions which have above average income but with serious unemployment problems are the type of regions where aid intensity is the lowest with 10% GGE.

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[29] The aid intensities are represented in Gross Grant Equivalent (GGE) which is calculated according to the following formula: $\text{Gross Grant Equivalent} = \dfrac{\text{Discounted value of the aid}}{\text{Discounted value of the eligible cost}}$

Table 3.2: Aid Ceilings and Notification Thresholds for National Regional Investment Aid in the EU

	Regions	Aid Ceilings (Aid Intensities)	Notification threshold[i] (Million €)
Article 87(3)(a)	1) GDP per capita in pps <75% of EU 25 average 2) Outermost regions which do not fall under (1) 3) Statistical effect regions (until 1 January 2011)	30% GGE	22.50
	4) GDP per capita in pps <60% of the EU 25 average	40% GGE	30.00
	5) GDP per capita in pps <45% of the EU 25 average	50% GGE	37.50
	6) Outermost regions which fall under (1)	Up to 20% GGE bonus	-
	7) Outermost regions which do not fall under (1)	Up to 10% GGE bonus	-
Article 87(3)(c)	8) Statistical effect regions after 1 January 2011	20% GGE	15.00
	9) GDP per capita in pps >100% of EU 25 average and unemployment rate <EU 25 average[ii]	10% GGE	7.50
	10) Regions that do not fall under (9)	15% GGE	11.25
	11) Low population density regions 12) Regions (corresponding to NUTS III level or smaller) adjoining a region with Article 87(3)(c) status selected by member states for coverage under Article 87(3)(c) 13) NUTS III regions or parts of those which share a land border with a non EEA or EFTA member country	15% GGE	11.25
In case of aid awarded to SME	14) Aid granted to small enterprises	Up to 20% GGE bonus	-
	15) Aid granted to medium-sized enterprises	Up to 10% GGE bonus	-

[i] Maximum acceptable amount of aid that an investment with eligible cost of €100 million can receive according to the national regional aid guidelines. Notification is necessary if the aid exceeds this threshold.
[ii] Measured at NUTS III level and based on the average of the last three years.

Source: Own elaboration from the National Regional Aid Guidelines for 2007-2013 (Official Journal of the European Union, 2006c)

Focusing on the notification thresholds for different type of regions, we see that corresponding to the aid intensities, the notification threshold is also the highest with 37.50 million Euros for the regions where GDP per capita is lower than 45% of the EU 25 average, and it is the lowest with only 7.5 million Euros in the regions where income is above average but unemployment is a serious problem.

The guidelines also indicate that for aids granted to outermost regions and to SMEs, the aid intensities can further be increased up to 20% GGE as a bonus to account for their specific handicaps.

According to the EU rules, when the eligible cost of an initial investment project exceeds €50 million, it is considered as a large investment project. Following the publication of the first guidelines on national regional aid in 1998, the Commission had also issued the Multisectoral framework on regional aid for large investment projects (Official Journal of the European Communities, 1998d). Due to the wider economic impact of large-scale investment projects and because of the fact that some regions were inclined to assign all regional state aid to a few large investments (which caused significant distortions to competition), it was found necessary by the Commission to lay out specific rules for regional aid to be granted to such investments. The 1998 Multisectoral framework was first replaced with a new framework that was issued in 2002 (Official Journal of the European Communities, 2002b) and for the period of 2007-2013, it is integrated to the national regional aid guidelines. Accordingly, the aid intensities shown above are to be adjusted for large investment projects. While 100% of the regional aid ceiling is applied for the part of the eligible cost of the investment projects up to €50 million, it reduces to 50% for the part between €50 million to €100 million, and further to %34 for the part above €100 million.

The second type of national regional aid that can be granted to problem regions is operating aid. It is a type of aid that is normally prohibited; nevertheless it can be used as a temporary measure to compensate for the specific handicaps of particular regions. The guidelines restrict granting operating aid to the financial services sector or for intra-group activities except when it is granted open to all sectors to compensate for additional transport or employment costs. In addition to that, operating aid shall not be granted to promote exports. Operating aid is only allowed to outermost regions, least populated regions and certain other regions under conditions fully specified in the new guidelines.

Aid for newly created small enterprises is the last type of national regional aid that can be granted by member states to encourage entrepreneurial activity in the assisted regions with an additional support to other types of regional aid. Newly created small enterprises in Article 87(3)(a) regions are eligible for up to €2 million per enterprise, whereas those in Article 87(3)(c) regions are eligible up to €1 million per enterprise. The guidelines also provide specific aid ceilings for the granting of enterprise aid to be applied in the 2007-2013 period.

According to the types of aid admissible by the Commission and the regional eligibility criteria described in the previous section, each member state prepares its regional aid map for the entire territory of the country which shows the eligibility and aid intensity conditions for every region. Following the approval of the Commission, the regional aid maps become binding for the member states to remain in effect during the period of the national regional aid guidelines. (Regional aid maps of 1999, 2000-2006 and 2007-2013 are provided in Appendix A)

3.1.3. Other Key Regulations Related to National Regional Aid

When controlling the granting of national regional aid by member states, the Commission refers to certain key legal provisions other than the Guidelines on National Regional Aid for 2007-2013. Most of these regulations are related to procedures and implementation of state aid in general – such as; Council Regulation laying down the detailed rules for the application of Article 93 of the EC Treaty (now, Article 88 of the EC Treaty) (Official Journal of the European Communities, 1999b) – which are extensive in detail to be reviewed in here. Nevertheless, there are two important regulations that need to be specifically mentioned in order to have a better understanding of the national state aid policy at the supranational level. These are the regulations on group exemptions and the regulations on *de minimis* aid.

The motivation of the Commission in introducing these regulations was to increase transparency and legal certainty in the implementation of the derogations to regional aid under Article 87 of the EC Treaty. Article 1 of the Council Regulation on horizontal state aid (Official Journal of the European Communities, 1998b) (usually referred to as the enabling regulation) states that the Commission may issue regulations on the application of group exemptions in relation to the specific types of aid granted by member states. In this context, group exemptions denote certain categories of aid that are considered to be compatible with the common market according to the Commission and which are not subject to the notification requirements specified in Article 88(3) of the EC Treaty. These categories are described as:

> (a) aid in favour of:
> (i) small and medium-sized enterprises;
> (ii) research and development;
> (iii) environmental protection;
> (iv) employment and training;
> (b) aid that complies with the map approved by the Commission for each Member State for the grant of regional aid. (Official Journal of the European Communities, 1998b)

Group exemption regulations make it clear that within the approved regions and aid intensities, member states are free to grant forms of aid that are compatible with national regional aid guidelines without prior notification. On the other hand, it also sets the ground for the Commission to introduce further detailed regulations on the use of state aid for horizontal objectives such as training (Official Journal of the European Communities, 2001a) and SME (Official Journal of the European Communities, 2001c).

While the group exemption regulations are mainly about the types of aid to be granted by member states, the regulation on *de minimis* aid (Official Journal of the European Communities, 2001b) is related to the amount of the state funded assistance. The regulation indicates that aid up to a certain amount can be considered to be acceptable due to its comparatively smaller impact on competition distortion. In order to define the *de minimis* aid, Article 2(2) of the regulation on *de minimis* aid states that:

> The total *de minimis* aid granted to any one enterprise shall not exceed EUR 100 000 over any period of three years. This ceiling shall apply irrespective of the form of the aid or the objective pursued. (Official Journal of the European Communities, 2001b)

Nevertheless, according to this regulation the *de minimis* rule does not apply to agriculture, fisheries and aquaculture, and transport sectors. Likewise, production processing or marketing of the products listed in Annex I of the EC Treaty, export related activities and aids contingent upon the use of domestic over imported goods are also taken out of the scope of the regulation on *de minimis* aid.

Both the group exemption and the *de minimis* aid regulations serve the purpose of making the granting of aid simpler for member states and at the same time to make it easier for the Commission to control state aid. Basically, member states are required to report the application of group exemption regulations to the Commission at least once a year. In all types of regulation that relates to the grating of regional state aid, the Commission makes it explicit that member states need to keep a full record of all types of aid granted and it is the member state's responsibility to provide the Commission with the necessary information.

There are continuing efforts at the EU level to modernise the Community policy on state aid by increasing transparency and accountability through simplification of procedures and information sharing (both through state aid networks among member states and on the internet) (European Commission, 2005b). The continuous development of the method of openly monitoring state aid in the EU also confirms this. In the Commission's State Aid Surveys and Scoreboards it is repeatedly emphasized that the enforcement of Community state aid rules by the member states depends for the most part on a member state being certain of the fact that the rest of the member states are strictly following these rules.

3.2. The Development of Regional State Aid in the EU

In this section, the development of regional state aid in the EU is analysed in three parts. First of all, the general trend in regional state aid in the EU is outlined. In the following part, development of regional state aid in the member states of the EU 15 is examined. In the last part, the situation in the new member states and candidate countries is reviewed.

3.2.1. The General Trend in Regional State Aid in the EU

As regards the granting of regional state aid, all member states in the EU are obliged to follow the rules set at the supranational level which is basically to reduce and limit granting of such aid to areas that are most in need. However, since the regional development problems are different in every member state, both the scale and the scope of the regional state aid also vary among member states. This situation constituted a problem for the overall competitiveness in the Community since its establishment in 1957 but it was not until the mid-1980s that it gained additional importance.

With the decision on the creation of a single market in 1985, the need for a more systematic and transparent control of state aid in the Community became evident. The reason was that the impacts of this competition distorting policy were deemed to be more intensified in a Community with virtually no barriers to trade. In consequence, the Commission decided to "compile and publish a fact-based analytical survey" (European Commission, 1997: p. 4) in order to monitor the situation in member states related to the granting of state aid. Since the publication of the First Survey on State Aid covering the years 1981-1986, the Commission issued nine surveys[30] until 2001 when its name was changed to State Aid Scoreboard[31] and its content became more comprehensive. These surveys and scoreboards provide comparable data on state aid at the member state level which makes it possible to follow the general trend in the Community.

In order to understand the development of regional state aid in the EU, it is first necessary to illustrate the general trend by analysing the development of state aid in the EU. When state aid in the EU since the early 1990s is examined, it is seen that in 1992, the aggregate amount of state aid granted in the member states of the EU 15 excluding aid to railways[32] was €74.5 billion. However, with the exception of a peak in 1997 at €95.5 billion[33], in 2004 this figure was reduced to €61.4 billion for EU 25,

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[30] European Commission publication reference numbers: COM (1988) 945; COM (1990) 1021; COM (1992) 1116; COM (1995) 365; COM (1997) 170; COM (1998) 417; COM (1999) 148; COM (2000) 205; COM (2001) 403.

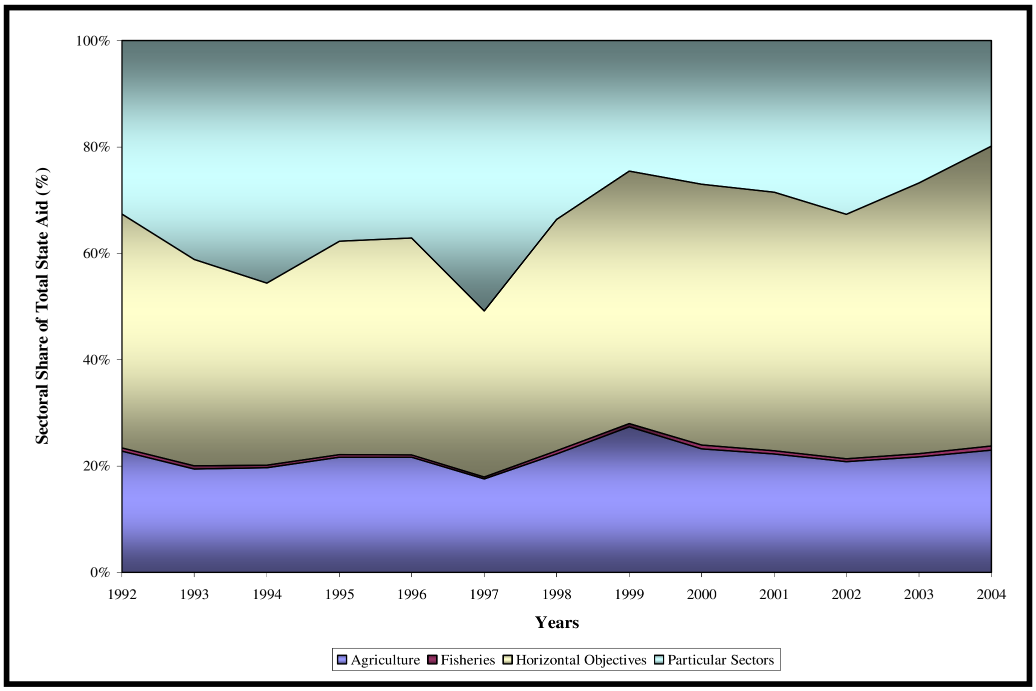
[31] Eleven State Aid Scoreboards are issued biannually since 2001 and the most recent update is expected for Autumn 2006. European Commission publication reference numbers: COM (2001) 412; COM (2001) 782; COM (2002) 242; COM (2002) 638; COM (2003) 225; COM (2003) 636; COM (2004) 256; COM (2004) 750; COM (2005) 147; COM (2005) 624; COM (2006) 130.

[32] Aid to railways is excluded in most of the data available in the state aid surveys and scoreboards of the EU due to the fact that member states do not systematically report to the Commission the public aid granted to this sector and there are different interpretations of the scope of such aid.

[33] Which is mostly due to the very high levels of rescue and restructuring aid granted in France to the banking sector (European Commission, 2004d).

which shows that despite the two enlargements in this period, a significant decrease in the level of state aid has been observed[34].

When the different types of the state aid is taken into consideration, the surveys and scoreboards classify state aid according to the specific objectives they are granted for. The four main categories are: (1) aid to agriculture, (2) aid to fisheries, (3) aid to horizontal objectives (which includes regional state aid), and (4) aid to particular sectors. Figure 3.1 shows the shares of each of these four main categories in total state aid in the EU excluding aid to railways. The shift from sectoral objectives to horizontal objectives is clearly visible in this Figure where the share of horizontal objectives has increased from around 40% in 1992 to almost 60% in 2004 and the share of particular sectors reduced from more than 30% in 1992 to around 20% in 2004.

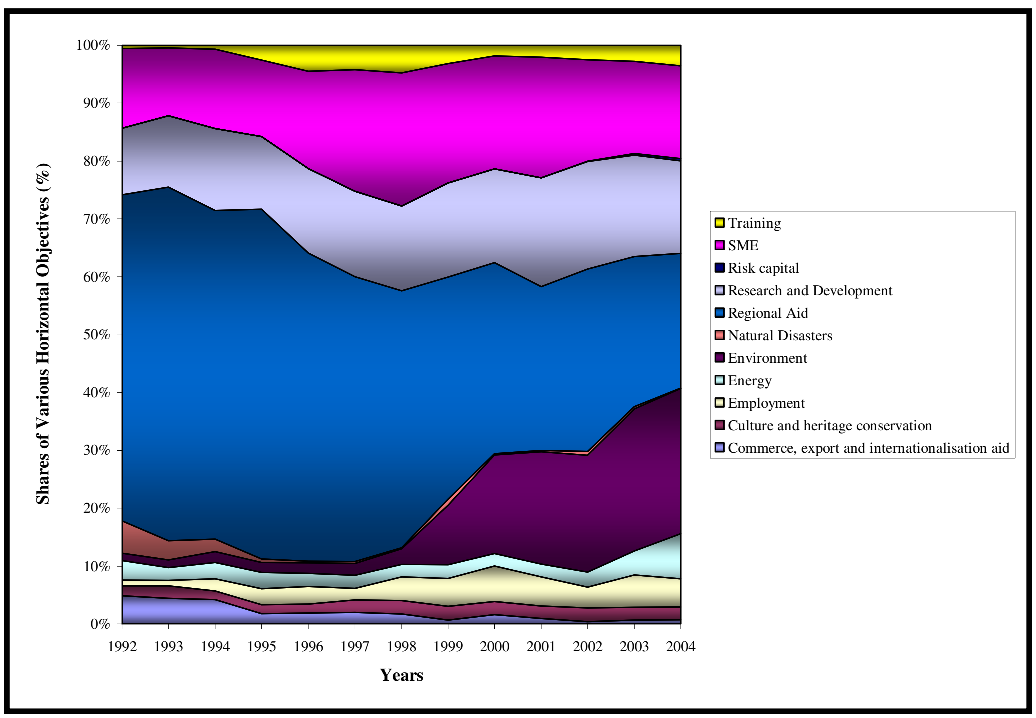


Source: Elaborated from State Aid Statistical Tables (European Commission, 2006m)

Figure 3.1: Share of Horizontal Objectives in Total State Aid in the EU less Aid to Railways (%) (1992-2004)

[34] Figures are in constant 1995 prices which have been re-referenced on the year 2004 according to data from State Aid Statistical Tables (European Commission, 2006m).

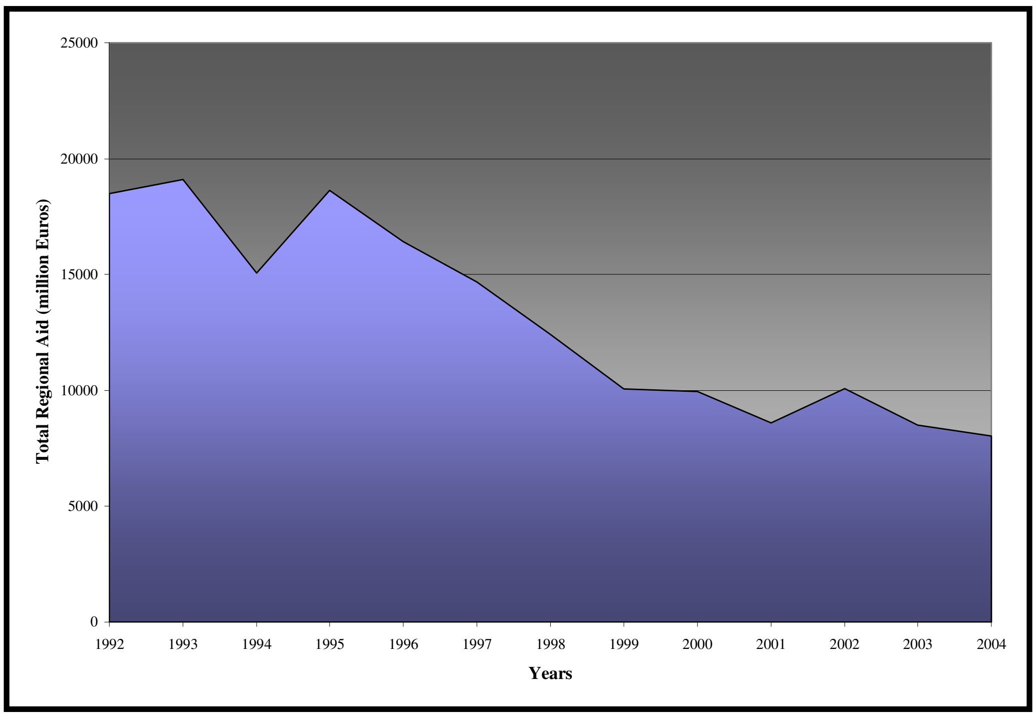
The state aid provided to horizontal objectives comprises different types of aid in line with the specific objectives they are granted for. In general, these are: commerce, export and internationalisation aid, aid for culture and heritage conservation, aid to employment, aid to energy, aid to environment, aid for natural disasters, regional aid, aid to R&D, aid for risk capital, aid to SMEs and aid to training. Figure 3.2 illustrates the composition of state aid to horizontal objectives in the EU between 1992 and 2004. It shows that the scale of regional state aid in the EU in this period with respect to the other ten categories of aid granted to horizontal objectives has decreased from more than 50% in 1992 to only around 20% in 2004. It is notable that the start of the decline in the share of regional state aid corresponds to the year 1998 when the first guidelines were put into effect. The important point to be highlighted here is that although the share of horizontal objectives is increasing in the EU, the share of regional aid in horizontal objectives is decreasing which indicates that state aid in the EU is being directed to other objectives such as environment, training and R&D.



Source: Elaborated from State Aid Statistical Tables (European Commission, 2006m)

Figure 3.2: Share of Regional State Aid in State Aid to Horizontal Objectives (%) (1992-2004)

Annual average of total state aid for 2002-2004 excluding railways was €65 billion in the EU 25. €8.8 billion out of this total annual average was directed to regional aid of which €8.5 billion was granted in the EU 15[35]. Figure 3.3 illustrates the total amount of regional state aid in the EU between the years 1992 and 2004 which clearly shows that regional state aid in the EU have almost halved in the period observed. This trend reveals that although the reduction of regional disparities persists to be an important problem in the EU, the weight of regional state aid as a policy instrument to deal with this problem is decreasing.

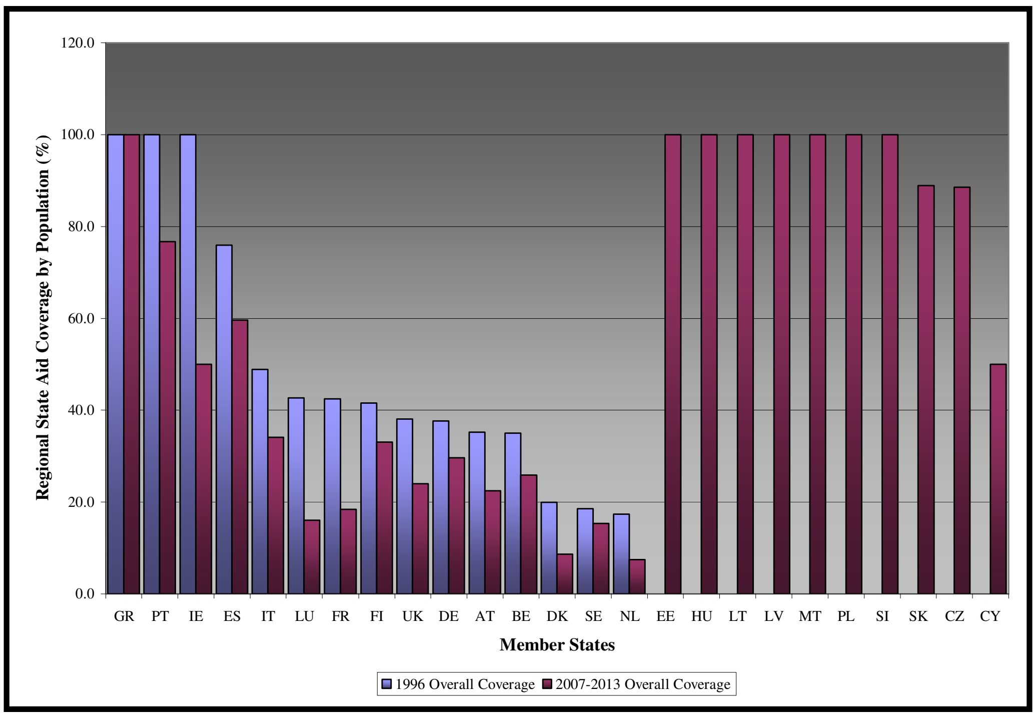


Source: Elaborated from State Aid Statistical Tables (European Commission, 2006m)

Figure 3.3: Total Amount of Regional State Aid in the EU (million Euros) (1992-2004)

[35] Figures in 1995 constant prices which are re-referenced on the year 2004 (European Commission, 2006m).

The decreasing trend in regional state aid is also visible by looking at the population coverage of regional state aid. Figure 3.4 demonstrates the change in population coverage of regional state aid in EU member states between 1996 and 2007-2013. It is seen that compared to 1996, especially Ireland, Luxembourg and France have halved the population covered by regional state aid. Among the countries whose entire population was covered in 1996, namely Greece, Portugal and Ireland, Greece still remains at 100% coverage and it is the only country in the EU 15 with complete coverage for the 2007-2013 period.



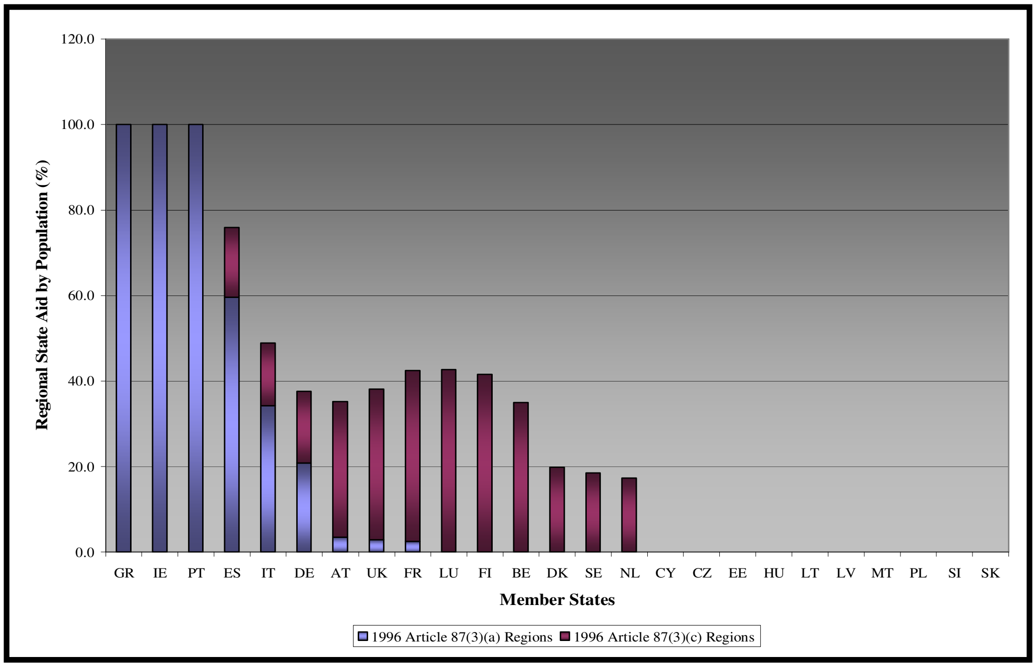
Sources: Elaborated from First Report on Cohesion (European Commission, 1996) and Guidelines on National Regional Aid for 2007-2013 (Official Journal of the European Union, 2006c)

Figure 3.4: Regional State Aid Coverage by Population in EU Member States (%) 1996 and 2007-2013

Furthermore, analysis of regional state aid with respect to Article 87(3)(a) and Article 87(3)(c) regions provides information on the objective of regional state aid in different member states. Between the years 1995 and 1999, a total of €478.5 billion was granted as state aid in the Community (annual average: €95.7 billion) of which €89.7 billion (annual average: €17.9 billion) was granted as regional aid.[36] 80% of this amount was distributed in Article 87(3)(a) regions, while only the remaining 20% was granted in Article 87(3)(c) regions (European Commission, 2001a).

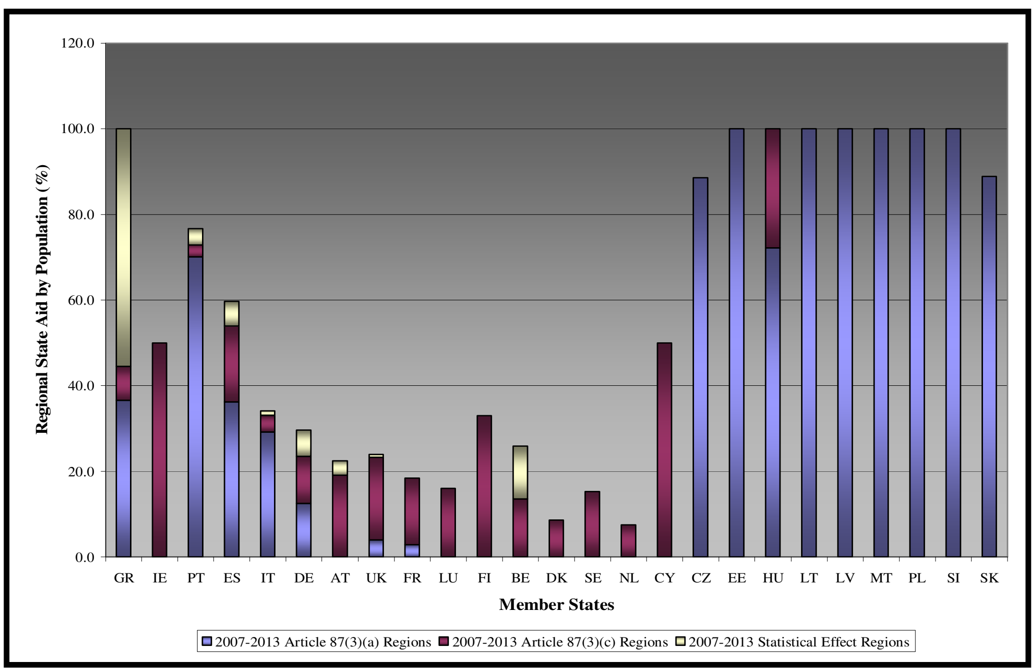
As Article 87(3)(a) regions are those with low income, abnormally low living standards and serious levels of unemployment to which a higher share of regional state aid is granted, the reduction in the coverage of Article 87(3)(a) regions indicates a positive trend in terms of development. The percentage of population covered by Article 87(3)(a) and Article 87(3)(c) regions are shown separately for 1996 in Figure 3.5 and for 2007-2013 period in Figure 3.6. Comparing the two Figures shows that as well as the decrease in overall regional state aid coverage in the EU 15, the coverage of Article 87(3)(a) regions has also decreased. Especially in Ireland and Austria, the Article 87(3)(a) coverage has totally been eliminated. This situation indicates that although there has not been a substantial decrease in the level of regional disparities, the severity of the development problem in the assisted regions has been alleviated. In the case of Greece, it is observed that although the regional state aid coverage is still 100% of population, there is also a significant reduction in Article 87(3)(a) coverage as the greater part of the overall coverage is due to statistical effect. On the other hand, Figure 3.6 also shows that a considerable part of the population in the new member states is covered under Article 87(3)(a) for the 2007-2013 period due to the low levels of average income in these countries compared to the rest of the EU.

[36] Figures calculated in 1998 constant prices from data available in the Ninth Survey on State Aid (European Commission, 2001a)



Source: Elaborated from the First Survey on Cohesion (European Commission, 1996)

Figure 3.5: Regional State Aid by Population in EU Member States According to Different Objectives (1996)



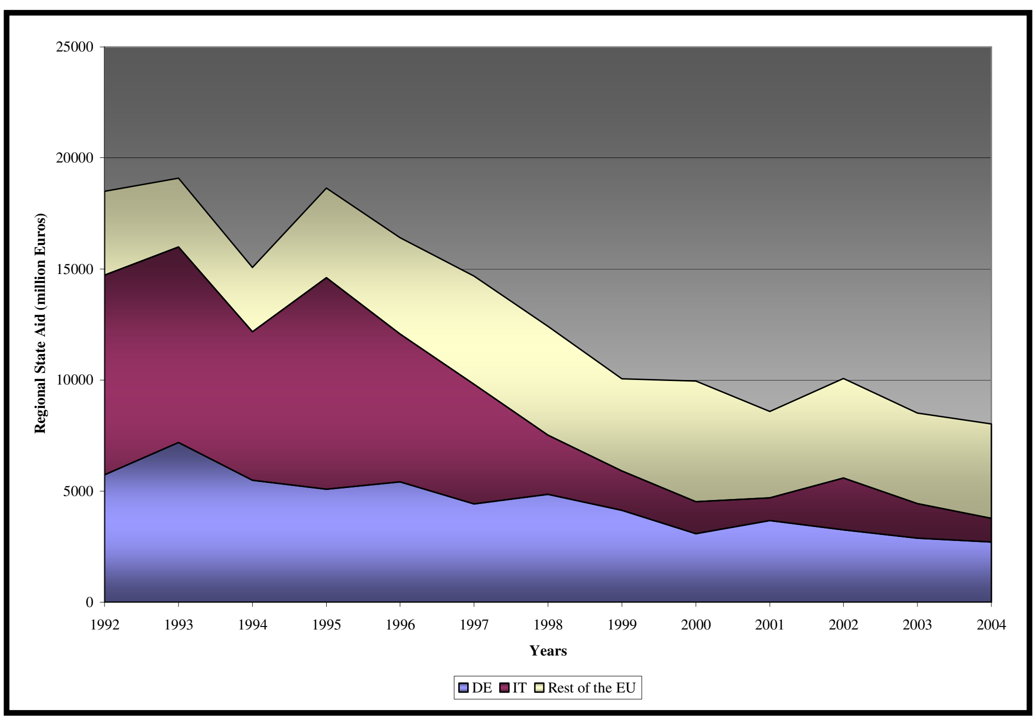
Source: Elaborated from the Guidelines on National Regional Aid for 2007-2013 (Official Journal of the European Union, 2006c)

Figure 3.6: Regional State Aid by Population in EU Member States According to Different Objectives (2007-2013)

Having presented the overall situation with regard to regional state aid in the EU, it is necessary to review the development of regional aid in individual member states in order to analyse their adaptation to Community regional state aid policy more in detail. As the development of the regional state aid policy in the member states of the EU 15 significantly differs from those of the CEECs due to their different political backgrounds, they will be examined separately.

3.2.2. Regional State Aid in the EU 15

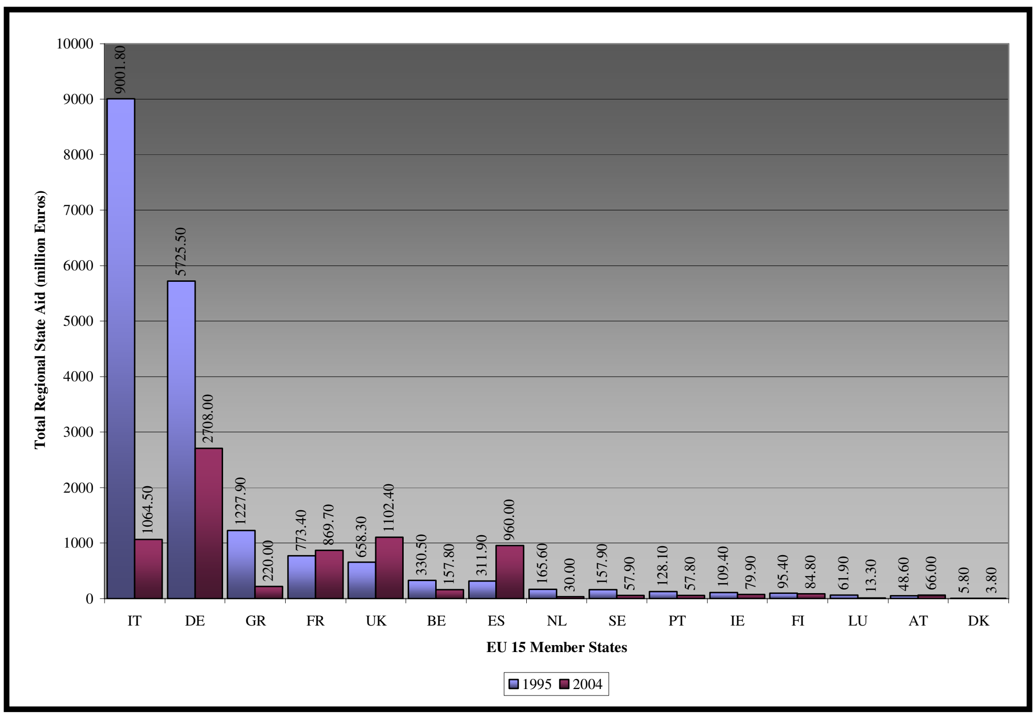
When the granting of regional state aid in the EU 15 is examined, it is seen that the two most striking countries in terms of the levels of regional aid are Germany and Italy. As seen in Figure 3.7, which shows the amount of regional state aid directed to Germany, Italy and the rest of the EU between 1992 and 2004, until the end of 1990s, these countries made up more than two-thirds of the regional aid granted in the Community to less-developed areas.



Source: Elaborated from State Aid Statistical Tables (European Commission, 2006m)

Figure 3.7: Regional State Aid in the EU (Germany, Italy and the Rest of the EU) (million Euros) (1990-2004)

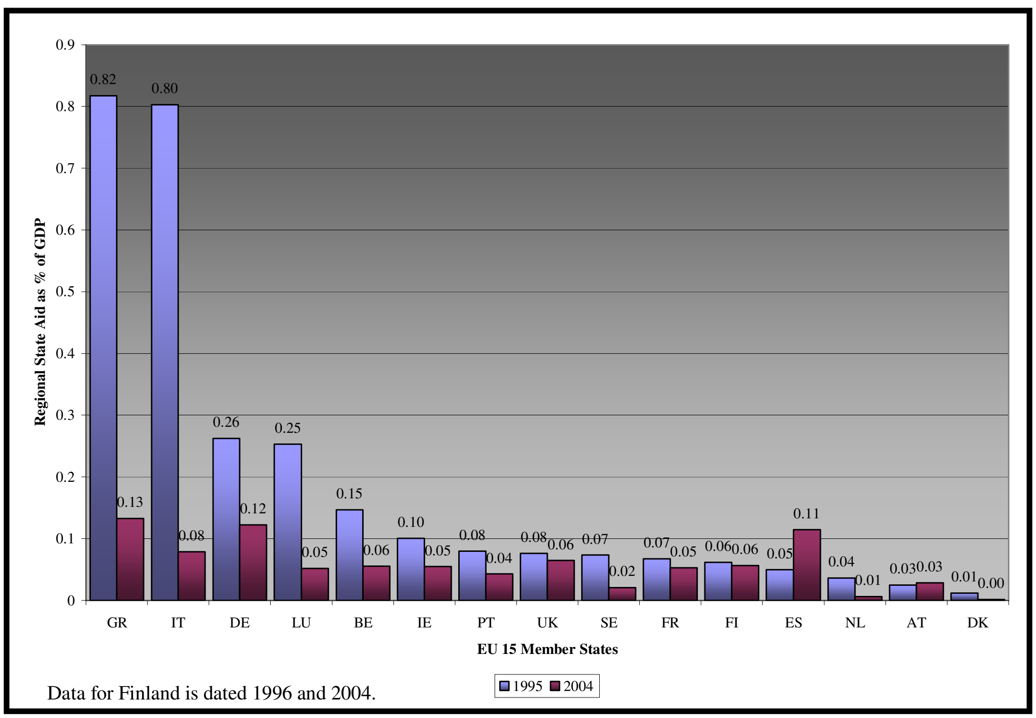
There are basically two reasons for the very high levels of regional state aid that were observed in these two countries during the 1990s. The first one is that economies of both countries had a dual nature – due to reunification in Germany and due to the prolonged disparity between North and South in Italy – which created wide regional disparities; and secondly, because of their relatively large national budgets, these countries were able to allocate substantial amounts of regional state aid to their problem regions (Dunford *et al.*, 2001). On the other hand, as seen in Figure 3.8 which shows the total amount of regional state aid granted in the member states of the EU 15 in 1995 and 2004, both Germany and Italy have considerably reduced the total amount of regional state aid. Nevertheless, according to the 2004 figures, Germany remains to be the only member state where the amount of regional state aid is noticeably higher than the rest of the EU 15.



Source: Elaborated from State Aid Statistical Tables (European Commission, 2006m)

Figure 3.8: Total Regional State Aid in EU 15 Member States, 1995 and 2004 (million Euros)

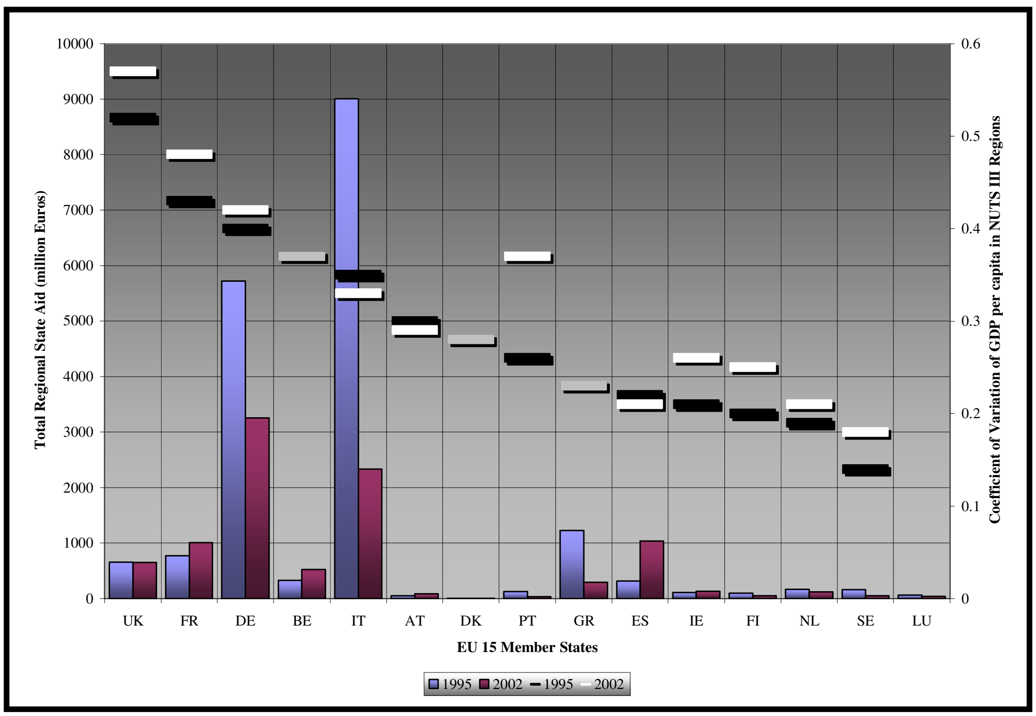
In order to assess the weight of regional state aid in the member states' economy, it is necessary to consider the absolute values of regional state aid in comparison to their GDP. For this purpose, regional state aid in the EU 15 member states is shown in Figure 3.9 as a percentage of the countries' GDP. This Figure provides a slightly different perception of regional state aid in the EU 15 compared to Figure 3.8. In 1995, Greece used to be the member state with the highest share of regional state aid in GDP, which is closely followed by Italy. Interestingly, despite the high levels of regional state aid in Germany, it is observed that the weight of this in the total economy has been much lower compared to Italy. When the situation in the four cohesion countries is considered, aside from Greece, we see that the levels of regional state aid have decreased in Portugal and Ireland, whereas Spain is the only country in the EU 15 which has increased the level of regional state aid.



Source: Elaborated from State Aid Statistical Tables (European Commission, 2006m)

Figure 3.9: Regional State Aid as a % of GDP in EU 15 Member States, 1995 and 2004

The analysis of the development of regional state aid in the old 15 member states of the EU reveals that there is a clear downward trend in almost all member states as regards the granting of regional state aid, which is parallel to the "less and better targeted state aid" strategy of the EU. However, in order to have a more detailed understanding of regional state aid in the EU 15 member states, it is also necessary to take the regional disparities within member states into consideration. Figure 3.10 shows the total amount of regional state aid in the in the EU 15 together with the coefficient of variation of GDP per capita in NUTS III regions of each member state which is used as a measure of regional disparity[37].



Sources: Elaborated from the regional state aid data available in State Aid Statistical Tables (European Commission, 2006m) and coefficient of variation of GDP per capita data available in (Heidenreich, 2006).

Figure 3.10: Change in Regional State Aid and Regional Disparities, 1995 and 2000

[37] Due to the small size of the country, no regional disparity data is provided for Luxembourg.

The Figure shows that the relationship between the level of regional disparities and regional state aid is not very strong. As the member state with the highest level of regional disparities, in the UK, the amount of state aid granted is considerably low with respect to the rest of the EU. On the other hand, despite the relatively lower levels of regional disparity compared to France, Germany and Belgium, very high levels of regional state aid have been granted in Italy. Although, it is not possible to evaluate the impact of regional state aid on regional disparities in the EU 15 member states or the correlation between the amount of regional state aid and regional disparities just by taking this analysis into account, it is observed that in general, regional disparities have widened and regional state aids have been reduced in the EU between 1995 and 2002.

3.2.3. Regional State Aid in the New Member States (EU 10) and Acceding Countries

In 2004, European Union welcomed 10 new members[38] and became a union of 25 member states within which regional disparities are considerably higher with respect to an EU of 15 member states[39]. This is due to the fact that there is a big gap between the average incomes in the new members and the EU 15[40]. The State Aid Scoreboards of the Commission provide comparable data on regional state aid in these new member states only since the year 2000. That is why the analysis of the trend in the new member states covers a relatively shorter time span than those of the EU 15.

The main point to be underlined with regard to overall state aid in the new member states is that in absolute figures these countries have granted very low

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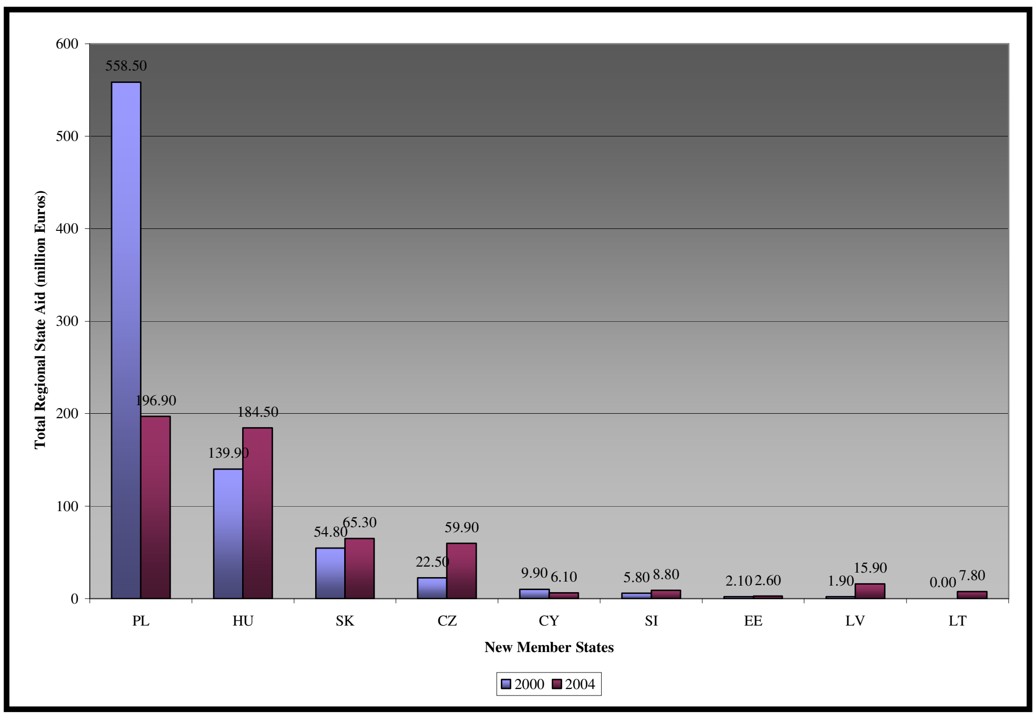
[38] Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, and Slovenia.

[39] The wealthiest region in the EU 25 in 2003 is Inner London (UK) with a GDP per inhabitant in pps of 278% of the Community average. On the other hand, among the member states of the EU 15, the poorest region is Norte (PT) where GDP per inhabitant in pps is 57.4% of the Community average. However, in the enlarged Union, Lubelskie (PL) is the poorest region with a GDP per inhabitant in pps only at 33.2% of the Community average.

[40] According to Eurostat Yearbook 2005 (European Commission, 2005a), GDP per inhabitant in pps was forecasted to be 24300 in the EU 15 in 2004, whereas it decreases to 22 300 for EU 25.

amounts of state aid when compared to the rest of the EU. While EU 15 has granted a total of €57.9 billion as state aid per year in average between 2000 and 2004, this figure was only €6 billion per year for the 10 new member states in the same period. For this reason, the level of aid per capita in the new member states is much less compared to the rest of the EU (European Commission, 2002a).

Figure 3.11 shows the total amount of regional state aid granted in the new member states[41] in 2000 and 2004. It is seen that the highest level of regional state aid among the new members has been granted in Poland. Except Hungary, Slovakia and Czech Republic, the regional state aid granted in the rest of the new member states is noticeably marginal. Although, in 2004, Poland has significantly reduced the level of regional state aid, the trend among the new member states has been slightly upward.

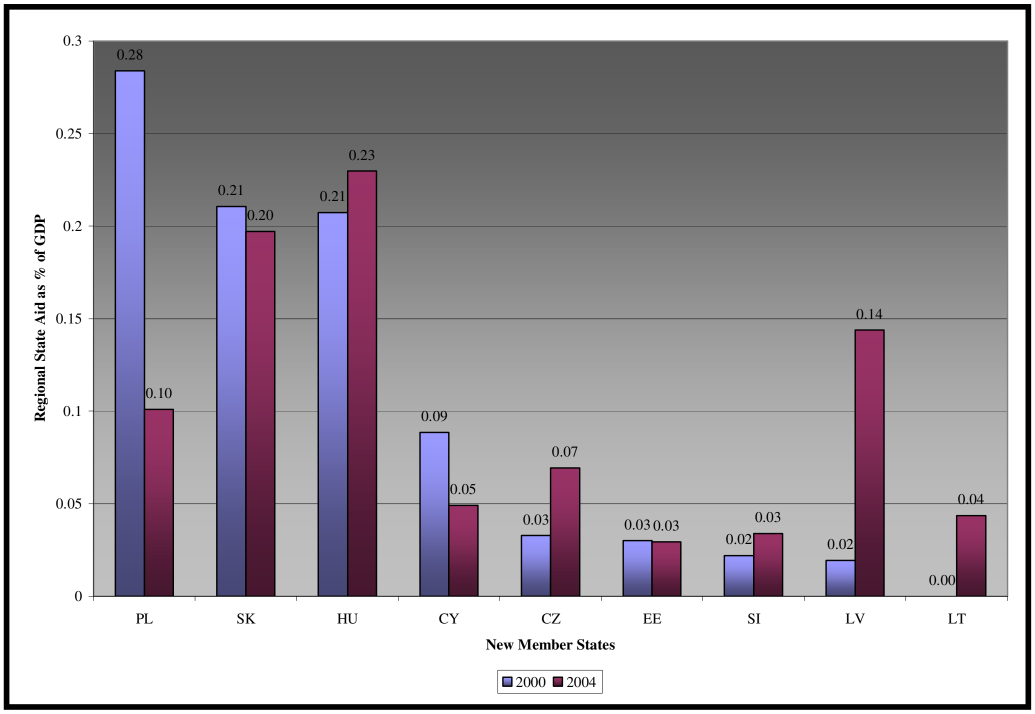


Source: Elaborated from State Aid Statistical Tables (European Commission, 2006m)

Figure 3.11: Total Regional State Aid in New Member States (million Euros), 2000 and 2004

[41] Malta is excluded from the analysis due to data shortage.

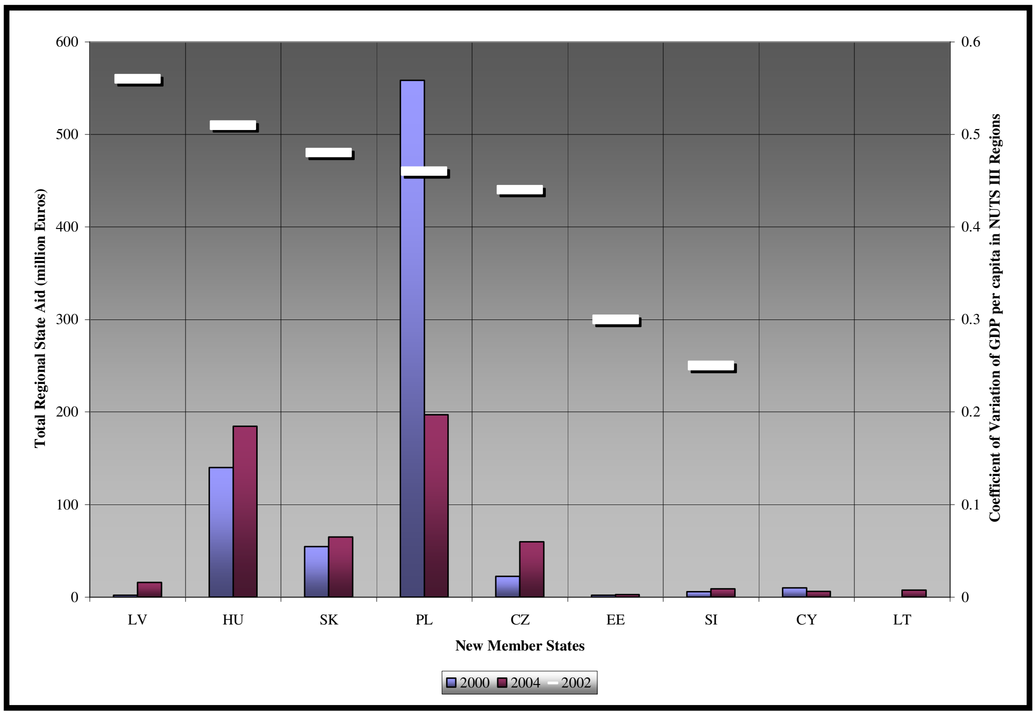
When regional state aid is considered as a percentage of GDP, which is demonstrated in Figure 3.12, it is comes out that in Hungary and Slovakia, the share of regional state aid in GDP are the highest in 2004 both among the old and the new member states. It is also observed that, despite the relatively low amounts compared to the EU 15, the share of regional state aid in GDP has substantially increased from 2000 to 2004 in Czech Republic, Slovenia, Latvia and Lithuania.



Source: Elaborated from State Aid Statistical Tables (European Commission, 2006m)

Figure 3.12: Regional State Aid as a % of GDP in the New Member States, 2000 and 2004

Similar to EU 15, the new member states also vary in size, population, income and in terms of the scale of regional disparities. That is why; it is also necessary to consider regional state aid in the new member states in relation to the level of regional disparities in these countries. For this purpose, Figure 3.13 demonstrates the total amount of regional state aid granted in the new member states together with the coefficient of variation of GDP per capita in NUTS III regions of each country. Due to the relatively shorter period observed between 2000 and 2004, only the level of regional disparity in 2002 is taken into consideration[42], and therefore the development of regional disparities in the new member states is not available.



Source: Elaborated from the regional state aid data available in State Aid Statistical Tables (European Commission, 2006m) and coefficient of variation of GDP per capita data available in (Heidenreich, 2006)

Figure 3.13: Regional State Aid and Regional Disparities in the New Member States, 2000 and 2004

It is observed that the relatively bigger member states of the EU 10 which have higher levels of regional disparity, namely, Poland, Hungary, Czech Republic and Slovakia have granted comparatively higher levels of regional state aid. That is why, there seems to be a more parallel relationship between regional state aid and regional disparity in the new member states than the situation in the EU 15.

[42] Comparable data was not available on regional disparities for Cyprus and Lithuania.

The analysis of the development of regional state aid in EU member states leads to the conclusion that corresponding to an observed downward trend in terms of total state aid granted, the overall weight of regional state aid in the EU is gradually decreasing and that the old member states are in the process of reducing their high levels of regional state aid. On the other hand, there exists a significant disparity between the EU 15 and the new member states in terms of the absolute amount regional state aid granted. In 2004, the highest amount of regional state aid in the EU 15 is almost five times the highest amount of regional state aid in the EU 10. Nevertheless, when the share in GDP per capita is considered, the highest share in the EU 15 is 0.13% of GDP, whereas the highest share in the new member states is 0.23%. This means that although the regional state aid granted in the new member states constitutes a more important part of their economy, its total amount is considerably low in comparison to the extent of regional state aid in the EU 15. That is why, in an enlarged Union, for the regional state aid in the new members to promote development in their backward regions, it needs to be granted strategically to make the highest possible impact in assisted areas.

CHAPTER 4

THE INTERACTION BETWEEN REGIONAL POLICY AND REGIONAL STATE AID POLICY IN THE EU

This chapter aims to illustrate the interrelation between the two EU level policies on regional development; regional policy and regional state aid policy, and how this interaction influences the regional development policy at the member state level. Following the description of the relationship, the problems related to the interaction of these two policies are identified, the policy choices in the EU are reviewed and the different alternatives of approaching to the problem of regional development in an enlarging Union are elaborated.

4.1. The Link between Regional Policy and Regional State Aid Policy

Both the regional policy at the EU level and the regional state aid policies in the member states serve a common objective of supporting regional development. Prior to 1989, when EU regional policy simply used to be a complementary policy to member states' own regional policies, there used to be a direct connection between these two policies (Bachtler *et al.*, 2003). In principle, the support that was directed to backward regions comprised of regional state aid allowed under Article 87(3)(a) and Article 87(3)(c) plus the complementary payments from the EC under the three main instruments of the emergent Community regional policy; namely, ERDF, ESF and EAGGF-Guidance Section. The important point here is that designation of the areas to receive regional aid was under the sole discretion of member states because of the fact that Community was merely providing top-up to nationally assisted areas.

After 1989, Community regional policy was decoupled from member states' national regional policy in order to better serve the Community-wide interests rather than supplementing member states' individual interests and policy objectives. This separation has weakened the direct connection between EU regional policy and member states' regional policy as the areas benefiting from these two policies ceased to fully overlap. Aside from the regions which benefit from both EU regional policy and national regional policy, there appeared regions that benefit only from EU regional policy or only from national regional policy. The problems of such a differentiation can basically be described as follows:

- For the regions which benefit only from EU regional policy[43]; there seemed to be a situation that they were in an adverse condition by not receiving additional funding from their country compared to those receiving both types of funding. This was also problematic from the perspective of EU regional policy because these regions could be considered as unsuccessful cases if they failed to demonstrate a similar development trend to those receiving additional regional state aid.
- From the Community-wide perspective, the regions benefiting only from regional state aid were regions where the regional development problem was not considered to be as severe as those receiving EU funding. Then, aid available at the national level was being unduly directed to these regions instead of being more rationally utilized in supporting the regions with more serious development problems.

Therefore, the separation of Community regional policy from the regional policy of member states resulted in a conflict of interests between member states and the EU in terms of supporting regional development. The emerging "incoherence" (Wishlade, F. G., 2003: p. 151) of EU regional policy and member states' regional policy between 1989 and 1993 can be observed from the Table 4.1 below. Around 27% of the assisted population (13.8% of the 50.8% of population that was assisted) could not benefit from joint regional funding both from the EU regional policy and from the regional state aid policy.

[43] It should be noted here that, there is a requirement for EU regional assistance to be part-financed from the member states budget. However, there is no such explicit requirement for the member state part-financing to come from the regional state aid share of the budget, which means that part-financing can be provided under headings different than regional development. Therefore, the distinction made is between regions that receive both EU and member state funding under regional development as opposed to regions that receive EU regional aid but not member state funding for regional development.

Table 4.1: The 'Coherence' of Assisted Area Coverage (1989-1993)

	% of Community Population
1. Least-favoured regions (Article 87(3)(a))	20.6
2. Development areas (Article 87(3)(c))	24.2
3. Total national assisted areas	**44.8**
4. Objective 1	21.5
5. Objective 2	16.3
6. Objective 5b	5.2
7. Total Structural Fund areas	**43.0**
8. Common coverage	**37.0**
9. National aid only	**7.8**
10. Structural Funds only	**6.0**
11. Combined coverage (8+9+10)	**50.8**

Notes: (i) Objective 2 coverage excludes the areas added under RECHAR (Community Initiative to support the economic conversion of coal-mining areas undergoing industrial decline) which would add a further 0.3 percentage points; **(ii)** coverage and population totals exclude the new *Länder.*

Source: Wishlade, 2003: p. 152

Once the areas that receive assistance from the supranational level and the national level began to separate, two contradictory perspectives have come out in looking at the relationship between EU regional policy and regional state aid policy of the member states. One of these perspectives is that there should be a complete overlap and consistency of the regions that are eligible for EU regional funding and the ones receiving regional state aid from the national budget. On the contrary, the second perspective finds it unnecessary to aim for such an overlap or consistency.

Wishlade (2003) explains that the proponents of the first perspective basically set forth the effectiveness argument about the funding directed to less developed areas. They assert that without a direct link between the two levels of regional policy, effectiveness of both policies would decrease as there would be a large combination of regions and aid intensities in providing assistance which expands policy coverage rather than concentrating it on the most in need. Hence, they uphold that in order to avoid a situation where one type of funding cancels out the effect of the other, EU regional state aid policy should provide the necessary leeway to member states in supporting the EU funded regional development programmes. Such an approach proposes that if a region is eligible for EU funding, then granting of regional state aid should not be subject to EU regional state aid regulations since Structural Funds eligibility lays out a commonly accepted regional development problem which can reasonably be addressed by national regional policy, as well.

According to Wishlade (2003) the opposing argument mainly comes from the DG Competition front. It was pointed out that the primary objectives of EU regional state aid policy and EU regional policy were essentially different; the former being competitiveness (since it is a part of EU competition policy) and the latter being cohesion. For this reason, a complete overlap of assisted areas was not deemed to be necessary. Moreover, it was indicated that through relatively more refined methods of area designation compared to the selection criteria for Structural Funds, DG Competition was already taking into account the regions that have a serious development problem. Yet, to be able to establish a more effective control over competition, it was essential for DG Competition to hold a tight grip on regional state aid. Among the member countries, United Kingdom has also been one of the strong supporters of this perspective by emphasizing that consistency should not be sought between areas receiving EU regional funding and national regional aid since the former should be targeting the poorest member states whereas the latter should remain in the hands of all members as a flexible instrument to individually deal with regional problems at the national level (HM Treasury *et al.*, 2003; Wishlade, F., 2005).

As a response to the changing link between EU regional policy and national regional aid policies and in view of the abovementioned conflicting perspectives, the Commission's stand has been in favour of encouraging the coherence of the two policies in order to better contribute to working out Community-wide regional disparities. This decision was made clear as one of the conclusions of the First Report on Economic and Social Cohesion in the EU which stated as follows:

> within the context of the concentration of resources on the most disadvantaged regions, the Member States and the Commission need to address, in partnership, inconsistencies between the regions which are supported under national regional policies and those which are supported under Union regional policies. Eligibility for Union regional aid should in future become one of the criteria for allowing assistance under Member States' own regional policies (European Commission, 1996: pp. 127-128).

Subsequently, in 1998, the Commission issued the Communication to the Member states on the links between regional and competition policy (Official Journal of the European Communities, 1998a) in order to draw attention to the importance of ‘mutual consistency’ and ‘concentration’ in the implementation of the regional development policy at two different levels: the Community level and the member state level. This document clearly expressed that although the responsibilities for these policies are placed at different levels[44], the intention of the Commission was to reach complete consistency in implementation.

In order to assess whether the consistency objective of the Commission was achieved in the past three financial perspectives (1989-1993, 1994-1999 and 2000-2006), as well as for the next period between 2007-2013, the designated areas under the Structural Funds and under regional state aid schemes are reviewed in Table 4.2[45]. It is visible from this table that the coverage for areas receiving both Community and national regional funding has increased from 37% of the population in 1989-1993 to 44% in 1994-1999. However, it was at its lowest level in 2000-2006 with 35.6%. Similarly, regions that receive Structural Funds but which are not eligible for national regional aid has grown to 6.6% of Community population in 1994-1999 but decreased back to 5.8% in 2000-2006. In contrast, the regions that received national regional aid but which were not eligible for Structural Funds were reduced to 2.7% of the population in 1994-1999, but it increased to 6.7% in the 2000-2006 period. These figures show that in the past three programming periods, a fully coherent map of regional assistance was not achieved throughout the Community.

[44] The responsibility for initiating regional policy and utilizing Community funds for this purpose is the responsibility of national (or regional) policy makers; whereas, the responsibility for ensuring a Community-wide competitive environment by controlling national regional aid policies is the task of the Commission.

[45] The figures for 1989-1993 refer to EU 12, while the figures for 1994-1999 and 2000-2006 to EU 15, and the figures for 2007-2013 to EU 27.

Table 4.2: Mutual Consistency between Designated Areas under the Structural Funds and Under State Aid Schemes (Percentages of the Community Population) (1989-1993, 1994-1999, 2000-2006 and 2007-2013)

	Regions eligible under the Structural Funds				Regions not eligible under the Structural Funds				TOTAL			
	1989 1993	1994 1999	2000 2006	2007 2013	1989 1993	1994 1999	2000 2006	2007 2013	1989 1993	1994 1999	2000 2006	2007 2013
Areas where national regional aid is permitted (Article 87(3))	37.0	44.0	35.6	46.6	7.8	2.7	6.7	0	**44.8**	**46.7**	**42.3**	**46.6**
Areas where national regional aid is not permitted	6.0	6.6	5.8	53.4	49.2	46.7	51.9	0	**55.2**	**53.3**	**57.7**	**53.4**
TOTAL	**43.0**	**50.6**	**41.4**	**100**	**57.0**	**49.4**	**58.6**	**0**	**100**	**100**	**100**	**100**

Sources: 1989-1993 figures from Wishlade, 2003: p. 152;
1994-1999 figures from (Official Journal of the European Communities, 1998a: p. 5);
2000-2006 figures from (European Commission, 2001b).
2007-2013 figures from (Official Journal of the European Union, 2006c)

When we observe the coverage of the Structural Funds for 2007-2013, we see that including the phasing-in[46] and phasing-out[47] regions, the two objectives of the new financial perspective (Convergence Objective and Regional Competitiveness and Employment Objective) cover the entire population of the EU 27 (European Commission, 2006d). Nevertheless, the coverage of national regional aid is limited to 46.6% of Community population for 2007-2013 (including safety-net). This new situation creates a totally different picture in conceptualizing the relationship between Structural Funds and regional state aid. If the entire territory of the Community is eligible for Community regional funds, then the determining factor for the coherence of EU regional policy and national regional policy becomes only the EU regional state aid policy. In other words, member states that are able to match Community regional funds to the regions where they are allowed to grant national

[46] Phasing-in regions are economic development regions described in section 3.1.1.1.

[47] Phasing-out regions are statistical effect regions.

regional aid will be able to achieve policy coherence. Therefore, it is the EU that first determines the areas permitted for granting national regional aid and after that, member states should utilize the related Community regional funds in accordance with these areas if consistency is sought to be achieved. In a sense, this new situation re-establishes the direct link between Community regional policy and national regional policy of the member states with a much more increased Community influence due to a more comprehensive involvement of the EU in regional state aid policy.

4.2. Problems in the Interaction of EU Regional Policy and Regional State Aid Control

The fact that regional development policies in member states are progressively becoming controlled at the EU level both through the Community regional policy and also through the regional state aid legislation of the Community competition policy creates three main problems with regard to the progress of regional development in the EU.

The first problem is related to the concept of competence in the field of regional policy. The authority to formulate and implement regional development policy, which was once solely in the hands of the member states, is being strictly regulated at the supranational level. For the funds to be granted under the different objectives of the Community cohesion policy, EU specifies the total amount to be allocated to the member states. Member states are responsible to make use of the available funding in accordance with Community provisions. However, the utilization of Community funds by the member states is further regulated by the EU through the guidelines on national regional aid. This means that member states are no longer in a position to individually address their specific problems of regional development and that the Community has acquired almost a full competence on this matter. Since regional development problems are specific to the different regions, this highly centralized approach is challenged from the perspective of subsidiarity. It is argued that “EU member states need the flexibility to address their own regional problems in their own way, without undue interference from Brussels” (Fothergill, 2006: p. 22).

The second problem as regards the relationship between Community regional policy and regional state aid policy is related to limited financial resources. When the coverage of cohesion policy is expanded to the entire Community, there emerges a risk for the available funding to be thinly spread among a large number of regions, which would consequently decrease its impact on location decisions of investments (Martin, R., 1998). Moreover, competition turns into a kind of battle on "who" takes control of the money, like a "blind auction" as Wishlade and Yuill (1997) point out, instead of a development oriented conception on "how" to spend it more effectively (Boland, 2000). In such instances, less favoured regions automatically lose their chances since they are not able to compete with the already dominant players in the growth centres[48]. National regional aid can be an important source of funding to compensate for this situation by increasing the total amount of financial assistance going to backward regions. However, the problem that arises here is that while wealthier member states are able to allocate more resources from their national budget for regional policy interventions, aid from poorer member states to their regions remains at a limited level. Therefore, less developed regions in poorer member states are in an adverse situation both in terms of accessing Community funding, as well as in terms of receiving national support.

The third problem is related to the enlargement of the EU. The GDP per capita in all the 10 new member states that acceded to the Community in 2004 is significantly lower than the EU average, which increases the total number of regions that are in need of Community assistance. Although there has been an increase in the total amount of Community funding from around €250 billion for the period of 2000-2006 (in 1999 prices) to €300 billion for 2007-2013 (in 2004 prices), 49% of the allocation for 2007-2013 is directed to members of the EU 15. This means that the new member states are only eligible to the remaining half of the Community assistance. Although according to the national regional aid guidelines, almost the entire territory of the

[48] A good example of this situation is seen in the requirement of co-financing in utilizing EU funds. As member states need to make a certain percentage of national co-financing available to benefit from EU funds (additionality principle), it occurred that wealthier member states were able to make use of a higher percentage of available EU commitments, whereas relatively poorer ones have fallen short in providing the national co-financing and therefore, the realization of commitments in these countries remained low (Brusis, 1999).

new member states are allowed for granting regional state aid, due to the limited Community and national resources as explained above, these countries face with a critical dilemma. If nearly all of the regions of a member state is eligible for both EU funding and also for granting regional state aid, then a choice needs to be made between regional development and national development. This is because if the member state prioritizes competitiveness over cohesion, then available financial assistance needs to be directed to fast growth regions rather than backward regions in order to speed up the process of catch-up with to the rest of the EU. On the other hand, if cohesion is prioritized over competitiveness, less developed regions need to be supported.

The problems identified above indicate that although the harmonization of national and supranational policies on regional development is a desirable case for the EU as explicitly asserted in the Communication from the Commission to the Member States on the links between regional and competition policy: reinforcing concentration and mutual consistency (Official Journal of the European Communities, 1998a), there are important impediments to its realization. Different member states follow different paths in approaching their regional development problems and consequently a set of different policy choices come out with respect to prioritizing equity or efficiency as a response to the problems in coordinating national and supranational regional financial assistance.

4.3. Regional Policy Choices in the EU: Equity or Efficiency

The limited amount of available regional financial assistance makes it inevitable to prioritize either equity or efficiency in allocating the funds to different regions. This is a policy choice which emphasizes cohesion when equity is primarily aimed; while in contrast, competitiveness is supported if the primary aim is efficient allocation of funds.

The EU has identified a strategic goal at the Lisbon European Council in 2000 which was “to become the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion” (EU, 2000). This strategy has been re-launched in 2005 European Council by stressing that:

> "the Union must mobilise all appropriate national and Community resources – including the cohesion policy – in the Strategy's three dimensions (economic, social and environmental) so as better to tap into their synergies in a general context of sustainable development" (EU, 2005: p. 4)[49].

This strategic goal of the EU stands for aiming both competitiveness and cohesion at the same time. Nevertheless, when deciding on the allocation of regional funds, member states are faced with a trade-off between the two aims of the Lisbon Strategy. The main cause of this trade-off is the fact that significant economic growth which increases competitiveness cannot take place everywhere at the same level and at the same time, and it is more significant in a limited number of growth centres in a country (Williamson, 1965). Moreover, as new economic geography supports that spatial agglomeration of economic activities is an important condition for growth, spreading out of investments for equity purposes turns to be a factor which works against higher national growth (Martin, P., 1999b; Bergs, 2001; Petrakos *et al.*, 2003; Crozet and Koenig, 2004; Meyer and Lackenbauer, 2005; Barrios and Strobl, 2006). Accordingly, Martin (1999b) asserts that equal spatial distribution of economic activities result in lower growth. Therefore, high levels of national growth tend to increase regional inequalities as growth occurs mostly in the already well-developed regions and this creates the trade-off between national growth and regional convergence.

On the other hand, Kuznets (1955) and Williamson (1965) find out that the relationship between national growth and regional disparities is non-linear. Their findings point out that regional inequality demonstrates an inverted U-shaped curve as national income increases. This means that when national income starts to increase from very low levels to a certain threshold, regional inequalities also increase. However, after that threshold, continuing increase of national income gradually reduces the regional inequality. Petrakos *et al.* (2003) also support that regional disparities in the EU show a pro-cyclical behaviour which increase with economic expansion and decrease with the slow-down of the growth.

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[49] The Strategy referred here indicates the strategic goal identified at the Lisbon European Council in 2000.

What the relationship between national growth and regional inequalities represent is that the evolution of regional inequalities is different for poorer and wealthier member states in the EU. While increasing levels of growth – which is achieved by supporting the areas with the highest economic potential – may lead to regional convergence in the more advanced economies, for countries that are at the early stages of economic development, the result of increased growth would increase regional disparities rather than leading to convergence (Williamson, 1965).

Taking into account that there is a considerable income difference between the old and new members of the EU, the relationship between national growth and regional inequalities are expected to follow opposing trends for the EU 15 and the newly acceded countries. If the new member states are looking forward to integrate into the common market, then, the policy choice for these countries should be efficiency, as this would help the transition economies to catch-up with the EU. Conversely, supporting the backward regions of the new member states for equity purposes would hamper national growth and subsequently delay successful integration (Petrakos, 2001).

The patterns of the relationship between national growth and regional inequality in the old member states demonstrate that those countries which have supported national growth by aiming efficiency managed to reach a more equitable distribution of income in the long-run. Ireland has been an important example, as the bulk of Structural Funds have been directed to developing human resources and R&D in and around the capital city of Dublin which played a significant role in the country's successful growth (Lackenbauer, 2004). Although, regional inequality has initially increased as a result of this concentration of resources around the capital, as growth progressed, convergence started to take place in the 1990s (Stierle, 2005).

Davies and Hallet (2002) analyse the relationship between national growth and regional inequalities in the EU 15 and find out that similar to Ireland, Portugal and Spain have also pursued efficiency and allocated their resources accordingly. In both countries, until the end of 1990s growth has been concentrated in the capital regions, Lisbon and Madrid (and also Cataluña in the case of Spain) which at first increased regional disparities. Nevertheless, convergence has started to take place after the

1990s in almost all regions of Portugal, while the trend has been rather mixed in Spain with only some of the regions converging towards EU average.

On the other hand, the national growth rate in Greece has not achieved the levels experienced in the other EU 15 countries which resulted in a decrease of regional inequality in Greece (Petrakos and Saratsis, 2000). However, low level of national growth impeded the catch-up of Greece with the other cohesion countries.

Stierle (2005) points out that while focusing on national growth has worked successfully for Ireland, Portugal and Spain; focusing on reducing disparities via national subsidies to attract private investment to the poorer South did not work in Italy. Therefore, he claims that regional policy should aim to support the existing economic clusters in a country to enhance national growth rather than artificially creating unworkable economic clusters in less-developed regions and dispersing the economic activity.

If the level of integration has not reached to a certain extent, support directed to the poor regions becomes a factor that impedes integration process due to the low levels of absorption capacity which creates an opportunity cost for both the national and the supranational financial support (Bergs, 2001). Therefore, the new entrants to the EU are deemed to benefit more from integration if they direct the financial support to their growth centres rather than backward regions (Bergs, 2001; Davies and Hallet, 2002; Lobatch, 2004; Stierle, 2005).

In light of the problems of coordination in the national and supranational regional assistance together with the equity vs. efficiency dilemma faced by the member states in the allocation of regional funds, it becomes necessary in an enlarging Union to work out different policy alternatives to address the widening regional disparities in a more effective way.

4.4. Two Alternatives for the Future of Regional Policy in the EU

Bringing solutions to the problem of regional development is a complicated task and it becomes even more difficult in a Union of 25 member states with divergent economic structures. Many different policy alternatives can be developed in response to the regional development challenges that are caused by the widened disparities in the EU as a result of the latest enlargement. However, with respect to financial assistance that is granted at the national and supranational level to support the development in backward regions, two distinct alternatives can be formulated. The first alternative is to increase the total amount of regional aid available to less developed areas in order to be able to provide sufficient aid to deal with the widened regional disparities. The second alternative is to revise the existing approach to regional policy without significantly altering the amount of regional aid.

The dilemma that regional policy in the EU faces for the future are depicted by van der Beek and Neal (2004) through the concepts of 'active' versus 'reactive' regional policy. In this definition, active regional policy is carried out with a strong emphasis on expenditures, whereas, reactive regional policy focuses more on policy influence in dealing with the problems of the less favoured regions. As the EU has become actively involved in regional policy through the disbursement of Structural Funds since 1989, so far, there has been an active form of regional policy at the supranational level.

The underlying assumption in the active regional policy approach – which is the traditional form of regional policy – is that the financial assistance provided to backward regions will be efficiently and effectively utilized in promoting investments that are lacking in the region, which will in turn contribute to gross output that will reflect in income, employment and social welfare. Therefore, an increase in the number of backward regions would bring an increase to the coverage of such policy. In that case, carrying on supporting the problem regions at a rate that is satisfactory when compared to the initial situation would require an increase for the regional policy budget.

The assumption of the reactive regional policy approach is quite the opposite. It upholds that for the financial assistance to less-developed regions to be efficient and effective, the coverage of the policy needs to be narrowed down by enhanced policy control. When the coverage is limited, the intensity of funding available to backward regions would increase without necessarily increasing the budget for regional policy. The reasoning of this approach is that by way of preventing governments from pouring money into anti-competitive activities in a wide range of different regions with a highly fragmented budget, the increased intensity of funding available for the problem regions would have better impact on regional growth. Therefore, the argument is that the overall outcome of this second type of approach is much more beneficial as it eliminates the overextension of the regional policy coverage and directs assistance to the regions which are genuinely in need.

There is a parallelism between active regional policy and redistributive regional policy due to the fact that the focus is on the financial transfer. Similarly, reactive regional policy is parallel to reformative regional policy as its aim is to increase the intensity of financial assistance to bring sustainable solutions to the development problem and to promote growth. One of the main advantages of the reactive regional policy approach is that it can eliminate the excessive focus on the money itself. As a result, regional policy can attain a more reformative slant by focusing on the roots of the regional development problem rather than trying to take hold of the available funding in one way or other without a proper understanding of that problem. On the other hand, in order to successfully promote regional development, the reactive regional policy approach needs to be supported with appropriate regulations at the supranational level.

Despite its success in redistributing welfare, EU regional policy is criticised due to the fact that its impact on creating growth in assisted regions has been questionable (Bachtler and Yuill, 2001). That is why, reactive form of regional policy by putting policies to the first place and budget to the second (Weise, 2003), is considered to bring an improved focus on the objectives of regional policy, which in turn would result in more efficient and effective allocation of financial resources to promote growth.

4.5. Transformation of the Regional Policy in the EU

If the development of Community regional policy and regional state aid policy is considered in view of the two alternatives set out in the previous section, it is observed that there is a tendency towards a more reactive rather than active type of regional policy. This transformation of Community regional policy is mainly caused by two factors: (1) increased resource requirement, and (2) possible future enlargements of the EU.

If we consider the first factor in detail, it comes out that if active form of expenditure-intensive method is maintained, in order for such a policy to be effective in the soon to be EU 27 with more severe regional disparities compared to the EU 15, a considerable increase would be necessary for the budget of the Community cohesion policy. Nevertheless, allocation of cohesion policy resources for 2007-2013 (European Commission, 2006a) demonstrate that a radical increase in the total amount of EU regional funds that is proportional to the widening of the income gap is not introduced. While the population living in regions with a GDP per capita below 75% of the Community average is more than doubled in the EU 27 (153 million) in comparison to the EU 15 (73 million) (European Commission, 2004f), the budget of the cohesion policy has only increased from around €250 billion in 2000-2006 to €300 billion for 2007-2013. Moreover, almost half of the allocated funding is directed to the EU 15. This is an indication of the fact that despite the increased regional disparities within the Community, the EU is not in favour of expanding the overall budget for regional policy.

The second factor that causes EU regional policy to attain a more reactive position is related to possible future enlargements of the EU. This is because both the candidate and the potential candidate countries are those with regional problems even more serious than the new members. This means that an even greater need for Community regional assistance can be envisaged in the future.

As a reaction to the growing need for an increased cohesion policy budget, the net contributors such as UK, Netherlands and Sweden started to pronounce the re-nationalisation of regional policy (Marshall, 2004) which is in fact parallel to the concept of reactive regional policy. As opposed to the Europeanization of the regional policy, the idea of re-nationalisation refers to a reduced Community intervention in this field and imparts large part of the decision-making and control back to the member states. Although there has been an explicit reaction by the EU on such re-nationalisation of regional policy (European Parliament and Committee of the Regions, 2005), the more affluent member states of the EU accentuate their unfavourable opinion to an increased cohesion policy budget while at the same time trying to retain their national regional aid policies as an instrument to be able to realize their individual objectives.

The more strict regulations on regional state aid at the EU level are a further indicator of the transformation of regional policy in the EU towards a more reactive approach. If the aim of re-establishing the direct link between Community regional policy and national regional policies of member states with an enhanced authority at the supranational level is considered together with the more competitiveness oriented objectives of the Community cohesion policy for the 2007-2013 period, it can be argued that the trend in the EU is towards a less redistributive or payment-oriented but more reformative approach to regional policy.

CHAPTER 5

REGIONAL POLICY AND REGIONAL STATE AID POLICY IN TURKEY

In this chapter, the approach to regional policy and regional state aid policy in Turkey is analysed in comparison to the EU level policies in these fields. Following the review of the development of these two policies in Turkey, the current situation of the regional development problem in the process of EU candidacy is described. Taking the relationship between regional policy and regional state aid policy in the EU and their evolution in the new financial perspective for 2007-2013 into consideration, the challenges for Turkey in conforming to Community policies in terms of regional development are evaluated and recommendations are drawn parallel to the findings of the previous chapter.

5.1. Development of Regional Policy and Regional State Aid Policy in Turkey

The development of regional policy and regional state aid policy in Turkey is analysed under three headings. First of all, the historical progress of regional policy in Turkey is summarized. Subsequently, the key instrument of regional policy in Turkey which is the designation of priority areas for development is explained. Lastly, the development of regional state aid policy in Turkey is reviewed.

5.1.1. Historical Progress of Regional Policy in Turkey

As a considerably large country with a heterogeneous economic structure, Turkey has been struggling with the problem of income disparity among its regions since the foundation of the Republic. Turkey's regional policy history is usually divided into four phases with respect to the approach at the level of the central government. These are:

- 1923 – 1950s: Maturing period – extensive development
- 1950s – 1960s: Democratization period
- 1960s – 1980s: State-centered planning
- 1980s – 2000s: Liberal economy & beginning of the EU integration process

The first phase between 1923 and 1950s is actually regarded as a maturing period for the nation in all matters related to the administration of the country as the newly founded institutions of the new regime had mostly been striving to settle on firm grounds under the tough social and economical circumstances following the War of Independence. Since the entire country can be considered as underdeveloped in those times due to the impacts of perpetual battles, the new Republic merely focused on overall development and restructuring (Kepenek and Yentürk, 2001; Keleş, 2006) without putting a specific emphasis on the issue of regional disparities. On the other hand, it should not be overlooked that decisions such as the choice of central Anatolia for the capital city and the distribution of major new large-scale factories to different locations across the country do indicate an underlying consideration for balanced development (Keleş, 2006). Nevertheless, the policy at the national level basically relied on an extensive development strategy with central government initiative in terms of economic planning. In this period, the Turkish economy was also affected by the consequences of the Great Depression and the Second World War which influenced the strengthening of statism, and this approach played an important role in initiating the first attempts to economic planning in Turkey (Oguz and Bayar, 2003).

1950s mark the shift towards democratisation in Turkey with the transition to a multi-party political system. As opposed to the previous period, the economic planning approach by the government was relatively weakened and priority was given to the private sector to flourish. The observed trend on public investment has been to small cities whereas for private investment larger cities in Marmara and Aegean regions in the northwest and western Anatolia were seen more favourable by entrepreneurs. This trend in the private sector to direct investments to western Turkey has been one of the key factors that caused the emergence of serious regional disparities in this period for two reasons: (1) the uneven income levels due to the increased production in these regions, and (2) the rising migration to big cities in search of jobs.

Regional planning practice in Turkey is considered to have started in this period as a response to the major wave of urbanization that had taken place in the 1950s. In fact, the concept of regional planning was introduced by foreign experts who were invited to work on the urban problems of İstanbul (Milli Güvenlik Kurulu Genel Sekreterliği, 1993), which was (and still is) the most disturbed city from the migration of rural population to urban areas. In 1955, concerning the issues related to the industrial district of İstanbul and the construction of the first suspension bridge, these experts had suggested that in making decisions on such large scale matters, regional plans encompassing the broader impact area would be a useful tool to help preventing the adverse effects on transportation networks, infrastructure and settlement.

In accordance with this approach, the Directorate of Regional Planning Science Board has been set up in 1957 within the Ministry of Public Works (*Bayındırlık Bakanlığı)*, as the first governmental unit responsible for regional planning in Turkey. One year later, with the establishment of the Ministry of Reconstruction and Settlement (*İmar ve İskân Bakanlığı*), the authority in this field has been transferred to this ministry (Milli Güvenlik Kurulu Genel Sekreterliği, 1993). The responsibilities of the Ministry as regards regional planning had mostly been concentrated on balanced urbanization and regional development, along with determining the types and location of infrastructure, industry and service investments accordingly.

In terms of regional policy and planning, the period between 1960s and 1980s is the most important period in Turkey as the State Planning Organisation (DPT – *Devlet Planlama Teşkilatı*) that was established in 1961 institutionalized the practice of five-year development plans and has become the primary institution dealing with regional planning affairs in Turkey.[50] Until 1984, the responsibility of preparing regional plans was shared between Ministry of Reconstruction and Settlement and the DPT, and coordination between these two institutions was carried out through protocols (Keleş, 2006). However, with the restructuring of the Ministry under the name of Public Works and Settlement (*Bayındırlık ve İskan Bakanlığı*) in 1984, its responsibility in the field of regional planning has been eliminated.

[50] Although, two five-year industry plans had been prepared in 1930 and 1936 respectively, this exercise could not continue due to the outbreak of the Second World War. (Oğuz and Bayar, 2003)

Since 1963, the DPT has prepared eight five-year development plans[51] and the most recent one (Ninth Development Plan) to be implemented in the years 2007-2013 is a seven-year development plan which is intended to run in parallel to the new financial perspective of the EU. The principal focus of the development plans until the 1980s has been on import substitution in order to protect the infant industries that were newly thriving around the country from international competition (Duran, 2002). Due to the strong government intervention at the central level, a significant emphasis has been put on balanced development. In this period, the first large-scale development plan was prepared for the Marmara region (Eastern Marmara Planning Project – *Doğu Marmara Planlama Projesi*) which aimed to manage the future growth of İstanbul and the surrounding area. This was followed by the other regional plans for Zonguldak (Zonguldak Project – *Zonguldak Projesi*), Çukurova (Çukurova Regional Project – *Çukurova Bölge Projesi*), Keban (Keban Project – *Keban Projesi*), and Antalya (Antalya Project – *Antalya Projesi*), most of which had been prepared in the second half of 1960s. Unfortunately, political and economic problems of the country together with the administrative problems encountered in implementation, hampered the full realization of these plans as foreseen in the planning documents (DPT, 2000; 2006c).

The period after the 1980s is a period of significant transformation for Turkey in both economic and political matters. The export oriented growth model that has been adopted in this period paved the way to financial liberalisation. In terms of regional policy, the South-eastern Anatolia Project (GAP – *Güneydoğu Anadolu Projesi*) that has been initiated in the 1980s as an irrigation project turned out to be the most important integrated regional development project of Turkey. The first regional development authority of Turkey was established in 1989 for its implementation and administration (Keleş, 2006). In addition to GAP, currently there are three other regional projects in Turkey, which are designed for Eastern and Northern Anatolia (Eastern Anatolia Master Plan – *Doğu Anadolu Projesi Ana Planı*, Eastern Black Sea

[51] First Five-Year Development Plan (1963-1967); Second Five-Year Development Plan (1968-1972); Third Five-Year Development Plan (1973-1977); Fourth Five-Year Development Plan (1979-1983); Fifth Five-Year Development Plan (1985-1989); Sixth Five-Year Development Plan (1990-1994); Seventh Five-Year Development Plan (1996-2000); Eighth Five-Year Development Plan (2001-2005).

Region Development Plan – *Doğu Karadeniz Bölgesi Gelişme Planı* and Yeşilırmak Basin Development Project – *Yeşilırmak Havzası Gelişim Projesi*).

In view of the active involvement of the central government by preparing the plans and projects for the balanced development of the country, especially since the 1960s, we see that the problem of regional disparity in Turkey has always been an important matter of concern for policymakers. In addressing this problem, the key policy instrument that is employed within the plans and projects for development has been the designation of priority areas in order to create a better economic environment in the backward regions.

5.1.2. Priority Areas (Provinces) for Development

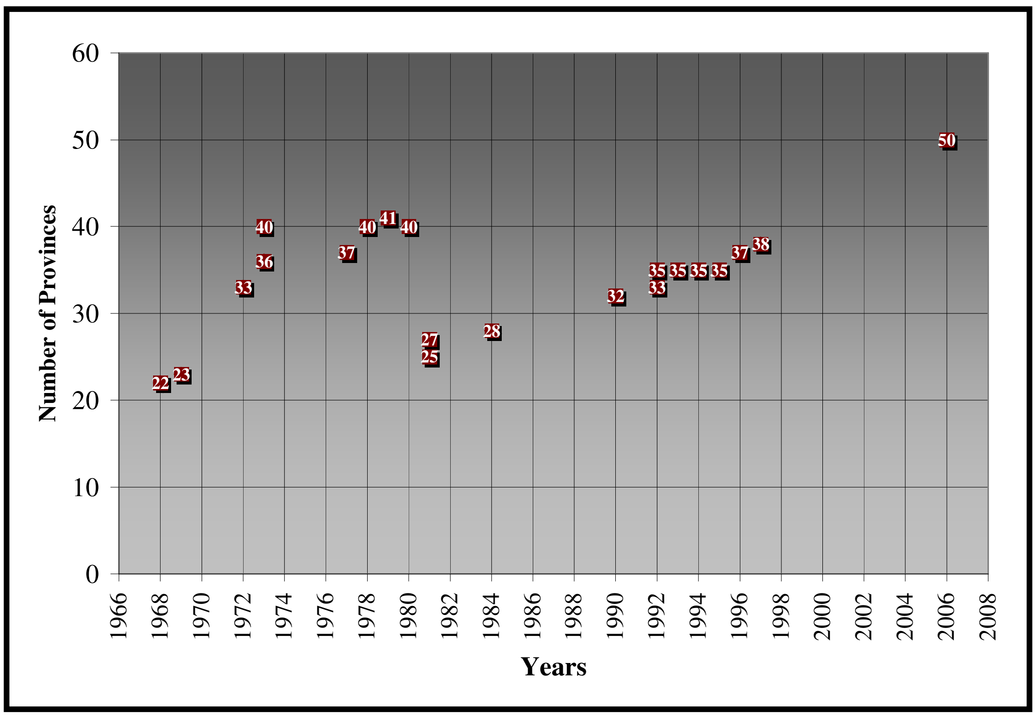
The concept of 'priority areas for development' has entered the Turkish regional planning practice in the period of the Second Five-Year Development Plan (1968-1972). The idea behind the designation of less-developed provinces as priority areas for development was to offer various investment incentives such as tax discounts and preferential interest rates to be available only for investments in these provinces. In this way, not only the investment conditions would be relatively improved for the entrepreneurs in these areas, but also the attractiveness of these provinces would be increased for the external investors.

For the purposes of following an objective determination process in selecting the provinces to be designated as priority areas, in 1971, a specific department has been established within the DPT. The main criteria used for the selection of priority provinces were determined by taking deficient or below average indicators in below headings:

- Industrialisation and mining operations,
- Commerce and financial developments,
- Development in agriculture and its modernisation,
- Social and cultural development,
- Health,
- Education,
- Demography,

- Communication and transportation. (Keleş, 2006: p. 414)

If we look at the number of provinces designated as priority areas for development since 1968 as shown in Figure 5.1, we see that the number has increased from 22 in 1968 to 40 in 1980. Subsequently, it dropped back down to 25 in 1981, but in 2006, 50 provinces (49 provinces plus two districts of Çanakkale) out of 81 provinces in Turkey qualify as priority areas for development (determined with the decision of the Council of Ministers (Resmî Gazete, 2006d)). These figures indicate that the coverage of this policy instrument has been in a tendency to increase since the beginning of implementation.



Source: State Planning Organisation (DPT, 2000; 2006e)

Figure 5.1: Number of Provinces Qualifying for Priority Areas for Development (1968-2003)

According to the population and territory figures of Turkstat (2006) for 2003, the population coverage of priority provinces for development is around 36% of the population of Turkey. In terms of territorial coverage, more than 55% of the country in terms of surface area is eligible for the benefits 'exclusively' available to these priority areas. Looking at the income per capita in each province, it comes out that, these 50 provinces have an average GDP per capita of around 60% of the average in Turkey. On the other hand, there is a significant income disparity within the priority provinces for development, as well. While Ağrı is the poorest province in the group of priority provinces for development (also the poorest province in Turkey) with only 26% of the average national GDP per capita, the wealthiest province in this group, Zonguldak, has an average GDP per capita of 138% of the national average[52].

Other than the public investments which are carried out by the government, the national policy to support development in the priority provinces for development has been carried out through the provision of a number of investment incentives to the private sector in these areas. These investment incentives make up the regional state aid policy of Turkey.

5.1.3. Regional State Aid Policy in Turkey

Supporting development with central government assistance is a policy that goes back to the period earlier than the Republican era. The application of the policy on investment incentives started in 1913 when the legal framework on assistance to industry was enacted (DPT, 1995). Since 1913, there have been various policies to support investments and generally, the expression of 'incentive measures' has been used in referring to this type of policy (Duran, 2002).

The analysis of the transformation of the incentive policy in Turkey by Duran (2002) is in line with the four phases of regional planning described above. After the foundation of the Republic until the 1950s, as the economic system was being newly established, basic industrial investments were carried out by the state. The incentive policy mainly aimed at the creation of wealth in the private sector through the development of profitable investment opportunities for private investors. Between the 1950s and the 1960s, the focus of attracting investment through incentives was both on the domestic investors and also on the foreign capital. Nevertheless, with the 1960s, the incentive system developed to be more inward looking as the objective of

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[52] Figures calculated according to the GDP figures for 2001 available from Turkstat (2006).

the economic planning approach was to pursue a protectionist import substitution strategy in the country. In the last phase after the 1980s, incentives mainly targeted supporting the private sector to become internationally competitive in line with the export oriented strategy.

Since the 1960s, various policy measures such as tax exemptions, application of preferential interest rates and investment allowances have been designed as investment incentives to support development in Turkey. While some of these measures were available for the entire country, others either could only be utilized in the priority provinces for development, or the advantages to the priority provinces for development were privileged. For instance, according to the Communication on the Application of the Decree on State Aids to Investment (*Yatırımlarda Devlet Yardımları Hakkında Kararın Uygulanmasına İlişkin Tebliğ*) (Resmî Gazete, 2006c), the interest support to be applied for investment credit to investments in priority areas for development is 1 million YTL, whereas for investments in other regions to R&D and environment, it is only 300 000 YTL and for investments to SMEs, it is 200 000 YTL. As the primary objective in differentiating the state aid policy as such was to contribute to the reduction of regional disparities, the specific measures that were only available to priority areas for development can be considered as a parallel concept to the regional state aid policy in the EU.

The authority and responsibility to formulate and manage the state aid to investment policy in Turkey has always been distributed to various different units within the central government structure (DPT, 2006d). At present, Council of Ministers, Undersecretariat of Treasury, Undersecretariat of the State Planning Organisation (DPT), Ministry of Finance, and Ministry of Industry and Trade, Ministry of Labour and Social Security, Ministry of Energy and Natural Resources are involved in managing regional state aid to investment in Turkey. The Law No. 5084 on the Encouragement of Investments and Employment and on the Amendment of Certain Laws (Resmî Gazete, 2004) together with the Decree on State Aids to Investments (Resmî Gazete, 2006b) form the legal basis of state aid in Turkey. According to the Decree on State Aids to Investment which was issued in 2002 (Resmî Gazete, 2002), for the purposes of granting state aid, provinces were differentiated into three as; (1) Developed provinces, (2) Normal provinces and (3)

Priority provinces for development. Nevertheless, the most recent legislation enacted in 2006 removes this differentiation and determines only the priority provinces for development.

There are four types of regional state aid measures specified in the Law No. 5084 that are applicable in the priority provinces for development. These are:

- Income tax relief,
- Compensation for the employers' share of the social security premium,
- Allocation of land for investment for free, and,
- Energy support.

These measures are designed for provinces whose GDP per capita in the year 2001 is lower than $1500 (36 provinces) and for the rest of the provinces, whose 2003 socio-economic development indicator[53] is negative (13 provinces). However, in terms of allocation of free land for investment, other provinces grouped under priority provinces for development whose GDP per capita is higher than $1500 and whose economic development indicator is positive can also benefit from this specific incentive (17 provinces) (Resmî Gazete, 2002). Therefore, 66 out of 81 provinces of Turkey are eligible for regional state aid.

If we look at the amount of state aid granted in Turkey, we see that the total amount of aid granted in the ten-year period between 1989-1999 is around €24 billion ($30.8 billion (Leblebici, 2002: p. 23)). It means that an average of €2.4 billion per year has been granted as state aid. This amount is higher than the annual average of total state aid for 1992-1999 in the countries of EU 15 except Germany, Italy, Spain and France[54]. If expressed as a percentage of national income, state aid in Turkey in 1989 was €1.3 billion ($1.67 billion) which corresponded to 1.56% of GDP. In 1999, it increased to €2.8 billion ($3.61 billion) which has been 1.95% of GDP (Leblebici, 2002). Considering that in 1999 the EU 15 average was 0.4%

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[53] Economic development indicator is an index value according to the socio-economic development ranking study carried out by the DPT which takes into consideration development factors such as urbanisation rate, employment rate, number of university graduates, number of manufacturing firms, etc. (DPT, 2003a)

[54] Figure elaborated from (European Commission, 2001a).

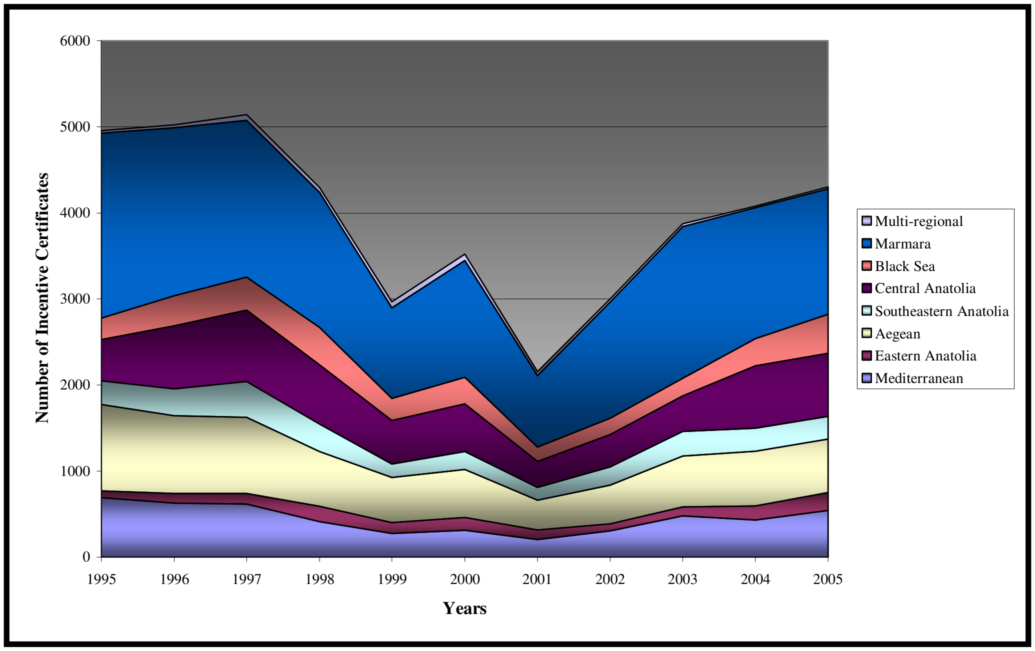
(European Commission, 2001a), this share was also higher than all of the member states.

It is not possible to look at the share of regional state aid in total state aid granted in Turkey because the data on state aid is not differentiated according to different objectives. Moreover, the data on investment incentives provides the total amount of investment without specifying the share of state aid in the total amount. Nevertheless, the regional breakdown of investments with investment certificates can be taken as an indicator to assess the weight of regional state aid in Turkey.

The regional data on investment incentives basically provide information on state aid in three main categories: (1) total number of incentive certificates, (2) total amount of investment, and (3) total number of people employed.

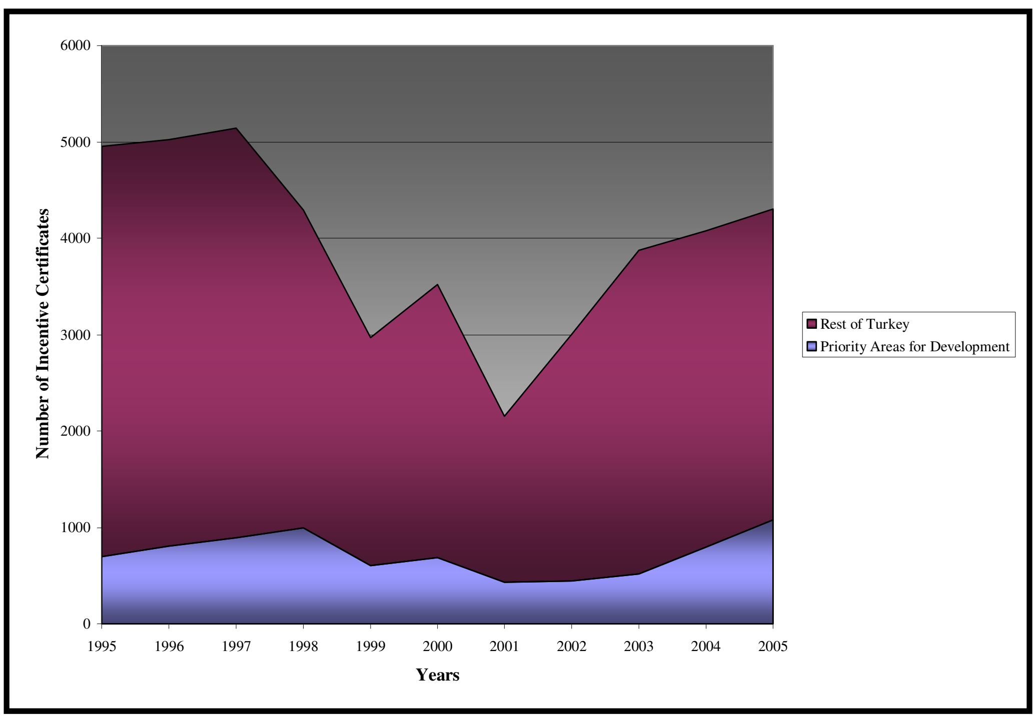
In the first category, looking at the total number of incentive certificates as shown in Figure 5.2, it is seen that Marmara, Aegean and Central Anatolia regions are the three regions where the highest number of incentive certificates have been issued between 1995 and 2005. On the other hand, the lowest number of incentive certificates has been issued in Eastern Anatolia, Black Sea and South-eastern Anatolia which are the regions where GDP per capita is much lower than Marmara, Aegean and Central Anatolia.

If the incentive certificates issued in priority areas for development are considered as an indicator of regional state aid in Turkey, Figure 5.3 shows that in comparison to the total number of incentive certificates issued, the share of priority areas for development is significantly low. Another important point that can be observed from these two figures is that there has been a sharp decline in the total number of incentive certificates issued in 1999 and 2001 corresponding to the two financial crises encountered in these years. Although, the numbers have swiftly increased until 2003, the total number of certificates in 2005 is fewer than that of 1995.



Source: Elaborated from (Hazine Müsteşarlığı, 2006)

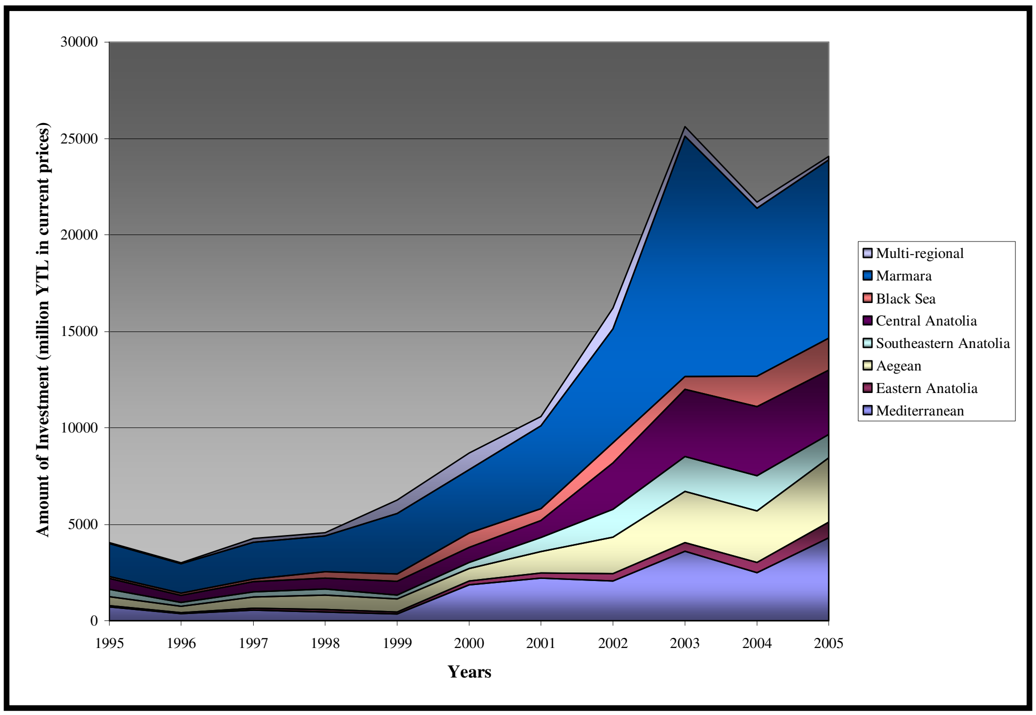
Figure 5.2: Number of Incentive Certificates by Regions (1995-2005)



Source: Elaborated from (Hazine Müsteşarlığı, 2006)

Figure 5.3: Number of Incentive Certificates in Priority Areas for Development (1995-2005)

In the second category, in terms of the total amount of investments carried out with incentive certificates, it can be seen from Figure 5.4 that since 1999, the total amount has been significantly increasing. Investments in Marmara, Aegean, Central Anatolia and Mediterranean regions are those with the highest amount whereas the amount of investment in Eastern Anatolia and Black Sea are the lowest[55].



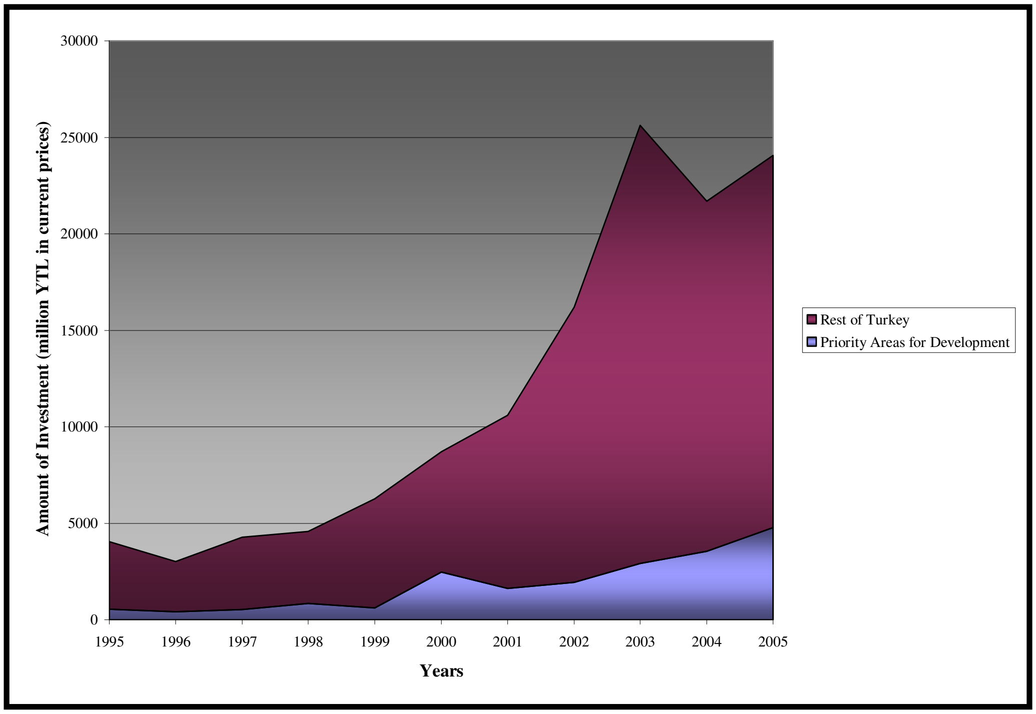
Source: Elaborated from (Hazine Müsteşarlığı, 2006)

Figure 5.4: Investment with Incentive Certificates by Regions (1995-2005, million YTL in current prices)

The total amount of investments with incentive certificates in priority areas for development is demonstrated in Figure 5.5. This figure points out that not only the number of investment certificates issued in priority areas for development is very

[55] The priority provinces for development are mainly those in the Eastern Anatolia, South-eastern Anatolia and Black Sea regions of Turkey. In the Western part of Turkey only the two island districts of Çanakkale are among the priority areas for development. The detailed breakdown of priority provinces for development into geographical regions is: Eastern Anatolia 14, South-eastern Anatolia 8, Black Sea 16, Central Anatolia 9 and Mediterranean 2 provinces.

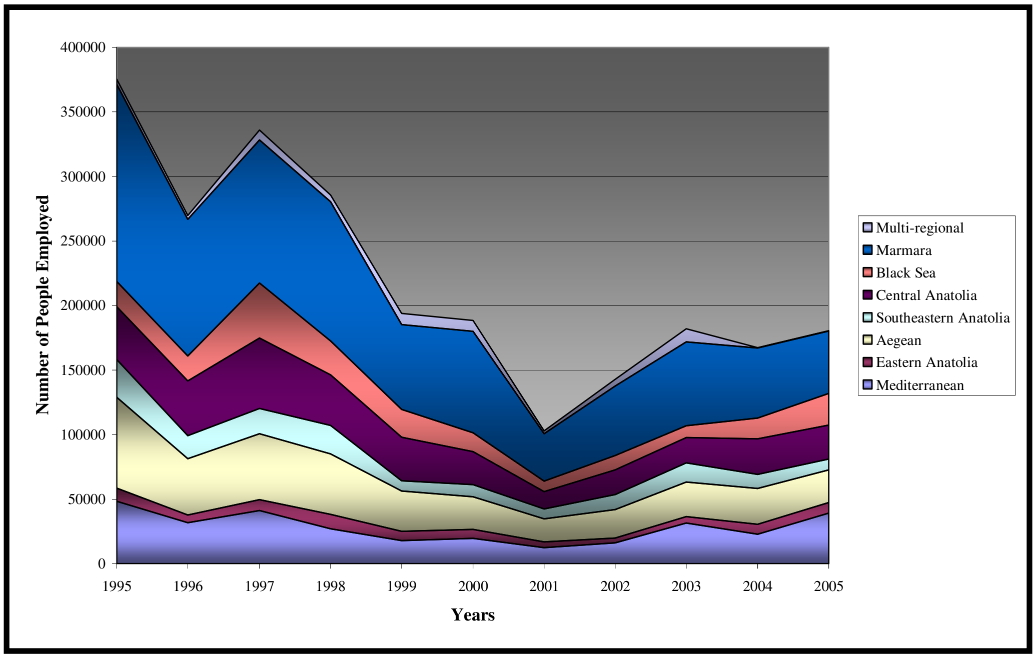
low in number compared to the rest of Turkey, but also the total amount of investment is significantly low.



Source: Elaborated from (Hazine Müsteşarlığı, 2006)

Figure 5.5: Investment with Incentive Certificates in Priority Areas for Development (1995-2005, million YTL in current prices)

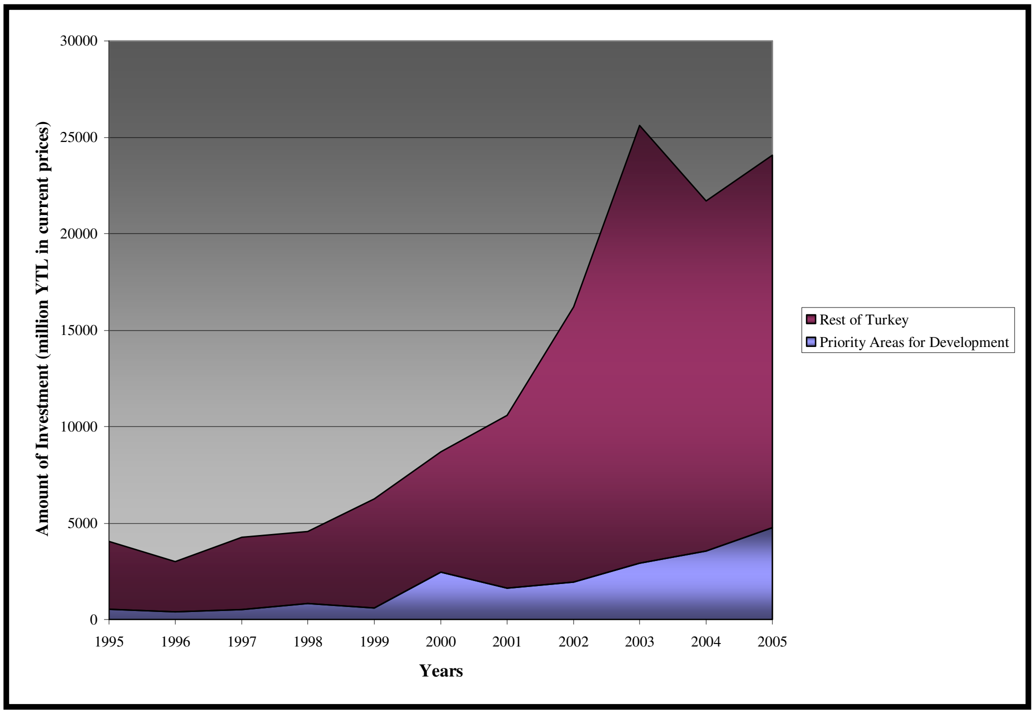
The last category, number of people employed each year through investments with incentive certificates, can be taken as an indicator of the effectiveness of the incentive measure. Figure 5.6 shows that the number of people employed through investments with incentive certificates has significantly decreased from 1995 to 2005. This is especially caused by the decrease in Marmara region, however, the decline can be observed in the Aegean and South-eastern Anatolia regions, as well.



Source: Elaborated from (Hazine Müsteşarlığı, 2006)

Figure 5.6: Employment Created through Investments with Incentive Certificates by Regions (1995-2005)

Moreover, as seen in Figure 5.7, the number of people employed through investments with incentive certificates in priority areas for development has a very small share of the total employment created through investment incentives. This share was only 18% in 1995 and, in 2005 it increased to 22%; however, this is mostly due to the fact that the number of people employed through investments with incentive certificates in the rest of Turkey has decreased and not because of the increase in employment created through investment certificates in the priority areas for development.



Source: Elaborated from (Hazine Müsteşarlığı, 2006)

Figure 5.7: Employment Created in Priority Areas for Development through Investments with Incentive Certificates (1995-2005)

In order to evaluate the effectiveness of incentive measures since the 1980s to 2002, Eşiyok (2005) investigates the regional distribution of investments which have incentive certificates. According to this study, parallel to the findings above, the highest share of investments with incentive certificates have taken place in the Marmara region (with the exception of the year 1985 where the highest share was in the Aegean region). This is followed by Central Anatolia, Aegean and Mediterranean regions; however, there is a big difference between Marmara and the other regions. The less-developed regions of Eastern Anatolia and South-eastern Anatolia did not acquire a significant part of the investments with incentive certificates in the period observed. Especially, Eastern Anatolia could not attract more than 10% of the fixed capital investments with incentive certificates because of the interplay of a number of factors such as remoteness to larger markets, inadequate infrastructure, geographical disadvantages of the region and political unrest.

From an alternative perspective, when we look at the number of private investments with incentive certificates in total number of private establishments together with the GDP per capita of the priority provinces for development (Appendix D; Figure D.3), we see that although for the provinces with GDP per capita up around 75% of the national average there is an increasing trend in both number of private establishments and in the number of private investments with incentive certificates, the priority provinces which have a GDP per capita higher than the 75% of the national average show very few number of private investments with incentive certificates. The priority provinces for development which have a GDP per capita lower than 50% of the national average also do not have many private investments with incentive certificates. Therefore, incentive measures seem to be more effective for the part of the provinces which have a GDP per capita between 50% and 75% of the national average.

The analysis of investment incentives with respect to the priority areas for development, which is the main policy instrument aimed at the reduction of regional disparities in Turkey, shows that despite the availability of preferential conditions to priority areas for development, big portion of investments were directed to regions outside the priority areas. This situation is likely to increase the disparity between richer and poorer regions in Turkey and to assess its actual impact it is necessary to look at regional convergence in Turkey.

5.2. Regional Disparities in Turkey and Convergence

In order to assess the effectiveness of the regional policy and regional state aid policy in Turkey, it is necessary to analyse the development of regional disparities in time.

When the development of regional disparities in Turkey are taken into consideration, after almost 50 years of practice, there has been an increasing rather than a decreasing trend in the level of regional disparity. According to the study of Berber *et al.* (2000) which analyses the change in standard deviation of GDP per capita of the provinces, both the disparity within each region has grown between 1975 and 1997, and also the income difference between the wealthiest region (Marmara) and the poorest (Eastern Anatolia – *Doğu Anadolu*) has widened.

Beside the individual income differences among the provinces of Turkey, there has always been a clear division between the West and the East in terms of development. According to the figures for the year 2001, the wealthiest province of Turkey (Kocaeli) has a GDP per capita of 287% of the national average, whereas the poorest province (Ağrı) only has a GDP per capita of 26% of national average[56] (see Figure D.1 in Appendix D).

For the period between 1987 and 1998, Altınbaş *et al.* (2002) also calculate an increasing income disparity among the provinces of Turkey. The increasing regional disparity is evidence for the lack of σ convergence which indicates that the policies to ensure balanced development in Turkey have not been successful in creating a relatively more even distribution of income.

Gezici and Hewings (2004) investigate σ and β convergence among the provinces of Turkey between the years 1980 and 1997. This study provides two important results; firstly, they find no evidence of convergence either across provinces, and secondly, they find out that priority provinces for development do not grow faster than the relatively developed provinces of Turkey. They also point out that although the Turkish economy has been rapidly growing since the 1980s; regional disparities have also been increasing parallel to this growth.

Aldan and Gaygısız (2006) test for β convergence in Turkey between 1987 and 2001 and as a result, no evidence of convergence is found for this period. This means that the level of regional disparity in Turkey is not reduced. They conclude that the regional policies implemented in Turkey in this period have not been successful in reducing the income gap between richer and poorer provinces and suggest that new approaches are necessary in dealing with the problem of the less-developed regions.

Kırdar and Saraçoğlu (2006) search for convergence of the provinces of Turkey in terms of income per capita for the 1975-2000 period. Their analysis points out to an absolute divergence at a rate of 0.7% which means that provinces that were initially poorer had a lower growth level which made it impossible for these provinces to catch-up with those that had a higher initial income and a higher growth

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[56] Figures elaborated from the GDP statistics for 2001 from Turkstat (2006).

rate. On the other hand, this study finds out conditional convergence[57] among Western and Eastern Marmara regions towards higher per capita income and among regions with higher agricultural share in value added towards lower per capita income.

The analysis carried out by Öztürk (2005) also supports that the level of regional disparity in Turkey has been in an increasing trend since the 1960s. Although there has been a positive growth trend in the country since the 1980s, the persistence of regional disparities indicate that the policies aimed at supporting development in less-developed areas and also the national development plans have not brought in significant contributions to the reduction of regional disparities.

These results are in line with the findings presented in Chapter 4 that at the initial stages of national growth, the level of regional disparity is expected to increase. It can be deduced that the growth trend in Turkey has not yet reached the peak point of the inverted U-shaped curve described by Williamson (1965) and therefore increasing national growth is expected to result in an increase in regional disparities. As observed in the EU, despite the financial assistance, regional disparities have increased in the fast growing countries. Similarly, the policies aimed at the reduction of regional disparities in Turkey have not been very successful due to rapid national growth since the 1980s. It is only after reaching a certain threshold of national growth that its positive effects start to trickle down to backward regions and contributes to the reduction of regional disparities.

5.3. Turkish Regional Policy in the Accession Process to the EU

In order to deliberate on the implications of the relationship between regional policy and regional state aid policy in the EU on the formulation and implementation of regional policy in Turkey, this section first evaluates the developments related to regional policy in the accession process of Turkey to the EU. Subsequently, the challenges for Turkey with respect to regional policy in the accession process are delineated.

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[57] Conditional convergence means that regions with similar initial conditions and structural characteristics such as employment rate, income, demography tend to converge towards their own steady state (Desdoigts, 1999).

5.3.1. Developments Related to Regional Policy in the Accession Process of Turkey to the EU

Turkey attained the status of candidate country to the EU membership at the EU Helsinki Council in 1999. On 3 October 2005, accession negotiations with the EU have been formally opened. Similar to the other candidate countries, in the process of accession, Turkey is in a position to align its policy with the *acquis commuautaire*. Among other topics, regional policy and regional state aid policy (within competition policy) are the two policy areas that policy and legislation needs to be harmonized with the EU.

In order to align Turkish regional policy with the EU, one of the most important steps taken has been the determination of the NUTS regions in Turkey. In addition to that, the Law No. 5449 on the Establishment, Coordination and Duties of the Development Agencies (*Kalkınma Ajanslarının Kuruluşu, Koordinasyonu ve Görevleri Hakkında Kanun*) (Resmî Gazete, 2006a) has recently been enacted. Nevertheless, regional policy formulation in Turkey needs to be restructured by ensuring the better involvement of the regional level.

An important aspect of the accession process of Turkey to the EU is the pre-accession financial assistance Turkey can receive from the EU as a candidate country in line with the Accession Partnership (Official Journal of the European Communities, 2001d). For the implementation of the pre-accession financial assistance, State Planning Organisation (DPT) has prepared the Preliminary National Development Plan (*Ön Ulusal Kalkınma Planı*) (DPT, 2003b) which forms the strategic framework for programming. The Preliminary National Development Plan designated 12 NUTS II level regions[58] in Turkey to which a certain part of the pre-accession financial assistance will be directed for the purposes of supporting regional development to contribute to the reduction of regional disparities.

[58] The 12 NUTS II level regions that are designated in the Preliminary National Development Plan (DPT, 2003b) are: Konya, Kayseri, Kastamonu, Samsun, Trabzon, Erzurum, Ağrı, Malatya, Van, Gaziantep, Şanlıurfa and Mardin.

The total amount of EU pre-accession financial assistance committed for regional development programmes in Turkey stands at €173 million[59]. Taken together with the national co-financing which amounts to €39 million, the financial assistance directed to regional development currently adds up to €212 million. The 12 NUTS II regions to which EU pre-accession financial assistance for regional development is directed cover 42 provinces in total. 39 of these provinces are among the 50 priority provinces for development. The remaining 3 provinces (Kayseri, Konya and Gaziantep) are not one of the priority provinces for development in Turkey's classification but they are considered to have serious development disparities with those provinces in their NUTS II level region. On the other hand, 11 priority provinces for development in Turkey are not covered by the EU pre-accession financial assistance for regional development.

It appears that on average €5 million can be allocated to each province that is eligible to receive pre-accession financial assistance from the EU for regional development. Although, the projects that are to be carried out through this financial assistance are expected to improve the project implementation capacity at both the central and the regional level, their impact on the reduction of regional disparities is questionable considering the severity of the regional development problem in Turkey in comparison to the amount of financial assistance (DPT, 2006a).

5.3.2. Challenges for Turkish Regional Policy in the Accession Process

In terms of regional policy, if we consider Turkey together with the current member and candidate countries[60], we see that despite the reduction in the average income of the EU due to the inclusion of lower-income countries, the whole of Turkey can be eligible for Structural Funds under the Convergence Objective. This is because the wealthiest region of Turkey, Kocaeli, would have only 56% of the EU

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[59] Figure calculated from the information available on EU-supported regional development programmes at the DPT web pages (DPT, 2006b) and on the web pages of the GAP Regional Development Administration (GAP Bölge Kalkınma İdaresi Başkanlığı, 2006).

[60] 29 countries: 25 members plus the acceding countries (Bulgaria and Romania) and the two candidate countries (Turkey and Croatia). Although the Former Yugoslav Republic of Macedonia is the third candidate country at present, it is not taken into consideration.

average GDP per capita and Ağrı would be the poorest region in the entire Union with only 10% of the average GDP per capita[61]. In fact, with the exception of Nord-Est in Romania, all of the Eastern and South-eastern regions of Turkey would be the 10 poorest regions in the EU. This means that the possible accession of Turkey would exacerbate the problem of regional disparity in the EU significantly.

In terms of regional state aid policy, if we take into consideration the new guidelines on national regional aid, we will see that again, the whole of Turkey can be eligible for granting national regional aid under Article 87(3)(a) as the GDP per capita in all the regions would be lower than 75% of the EU average. Moreover, with the exception of Kocaeli NUTS II region[62], the aid intensity would be at its highest level with 50% as all the regions except Kocaeli have a GDP per capita lower than the threshold of 45% of the EU average. The aid intensity in Kocaeli would be 40% as its GDP per capita is lower than 60% of the EU average.

The most important outcome of this analysis is that if Turkey becomes an EU member state, the entire country would be eligible for regional development financial assistance from both the EU level as well as the national level. As explained in the previous chapter, this would mean that the coordination of the assistance from these two levels would depend on the formulation of national regional policy in Turkey.

When the national regional policy of Turkey is observed, it is seen that despite the utilisation of various policy measures to reduce regional disparities, the disparities have widened. A significant reason for that has been the greater importance that was put on national growth by the central government (Gezici and Hewings, 2004; Eşiyok, 2005).

The challenge for Turkey in the accession process to the EU is twofold: how to make the best use of the available supranational and national funding in order to catch-up with the average income level in the EU and in order to reduce regional disparities. Although, all of the regions in Turkey can be eligible for both levels of financial assistance, the total available funding cannot be fully sufficient to address

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[61] Calculated according to the GDP per capita in pps data available from Eurostat for the EU (2003 figures) and from Turkstat for Turkey (2001 figures).

[62] The list of NUTS II regions in Turkey are provided in Appendix D; Table D.1.

the regional development problem. One of the reasons for this is that the EU puts an upper limit to the funding directed to member states by setting a maximum value of 4% of the member state's GDP. In addition to that, taking into consideration the limitations brought to national regional aid with the aid intensities in the new guidelines; it becomes apparent that a trade-off will be necessary in distributing the financial assistance across Turkey.

There are two extreme options in distributing regional financial assistance for Turkey. The first one is fully coordinating national and supranational regional assistance and directing it to the relatively more developed regions in Turkey. This would have a significant contribution to national growth and would be the most appropriate policy to catch-up with the EU. Despite an increase in regional disparities for a certain period, this option would also lead to the reduction of regional income differences eventually (as explained in Section 4.3).

Alternatively, as a second option, both national and supranational regional assistance can be coordinated to be directed to the less-developed areas instead of developed ones. Such an approach would have an important impact on the reduction of regional disparities in Turkey; nevertheless, there can be a risk that its contribution to national growth cannot be as large as the first option. While income disparity can be reduced among the regions of Turkey, the disparity among EU member states and Turkey can be widened due to the lower rate of national growth.

The policy options that emerge between these two extremes needs to take into consideration the economic structure in Turkey to be able to strike the most effective balance between national growth and reduction of regional disparities. The important point that needs to be paid attention to in the case of Turkey in terms of regional policy is the existence of significant intra-regional disparities in terms of income (Dansuk, 1997). Gezici and Hewings (2003) show that intra-regional disparities are highest in the most developed parts of Turkey, namely in the Marmara and Aegean regions, whereas it is relatively lower in the less-developed Eastern part. In that case, the question to be asked here is whether focusing on the growth centres in Turkey would have adverse effects on the intra-regional inequalities similar to its initially negative impact on inter-regional inequalities or not. In order to draw attention to the outcome of the regional policy choice to aim for efficiency and to support growth centres, Kuznets (1955: p. 25) asks the following question: “Can the political framework of the underdeveloped societies withstand the strain which further widening of income inequality is likely to generate?”

Considering the regional policy options of Turkey and the ineffectiveness of regional state aid policy in Turkey to date, it becomes crucial for Turkey to formulate a revised policy for regional development. For the regional policy to be improved in line with the requirements of EU accession, there are basically two challenges in Turkey that are legislative and administrative. These challenges are highlighted in the revised 2006 Accession Partnership for Turkey (Official Journal of the European Union, 2006a) which states the establishment of the necessary legislative and administrative framework to be able to absorb the pre-accession financial assistance and the development of the strategic framework to reduce regional disparities as the two main issues related to regional policy. The Preliminary National Development Plan (*Ön Ulusal Kalkınma Planı*) prepared by the DPT for the years 2004-2006 (DPT, 2003b) also point out that there is a need for a new administrative structure in order to improve the management, implementation and monitoring of state aids in Turkey.

The recent report of the Ad Hoc Committee on Regional Development that was established for the preparation of the Ninth Development Plan (DPT, 2006c) draws attention to increasing regional disparities in Turkey and emphasizes the importance of the coordination of the policy instruments on regional development. This report also refers to the incentive measures in Turkey and points out that there is a wide target for regional state aid policy which fails to bring the necessary regional differentiation due to the lack of appropriate regional development plans. The application of regional state aid policy in Turkey without taking the regional dynamics into consideration is seen as an important problem of regional policy. The report of the Ad Hoc Committee on State Aids (DPT, 2006d) also emphasises the lack of coordination between regional policy and regional state aid policy by pointing out that the state aid system in Turkey has mainly had general (rather than region-specific) characteristics and has been highly comprehensive in scope.

As regards the regional state aid policy, the revised Accession Partnership for Turkey draws attention to ensuring transparency and information exchange, as well as to the establishment of a national state aid monitoring authority to bring strict control to state aids. In order to align the state aid policy with the EU, there are three elements that need to be established in every candidate country. These are:

1. The necessary legislative framework with respect to antitrust and state aid,
2. An adequate administrative capacity (in particular, a well-functioning competition authority),
3. A credible enforcement record of the *acquis* in all areas of competition policy. (European Commission, 2002a: p. 10)

Concisely, these three elements also denote the importance of legislative and administrative transformation. In terms of legislative framework and administrative capacity, although the Competition Authority has been established in 1997, there is no authority in Turkey for state aid monitoring. That is why; the most important step that needs to be taken in Turkey in this field is the enactment of a law on the establishment of a state aid monitoring authority. This is frequently asserted in the progress reports for Turkey and the 2006 progress report (European Commission, 2006o) states that:

> No developments can be reported with regard to the adoption of state aid legislation or the establishment of an operationally independent state aid monitoring authority. Their absence delays the adoption of implementing rules for competition under the Customs Union Decision 1/95, and results in serious distortions of competition. (European Commission, 2006o: p. 38)

Although a draft law on the establishment of the state aid monitoring authority (TBMM, 2001) has been prepared and sent to the Parliament, it is still not enacted. The institutional fragmentation in the management of state aids in Turkey not only creates problems of transparency and accountability but also the responsible institutions start to focus more on administration of state aid rather than specializing in formulating policy for its effective and efficient implementation (Duran, 2002). The problems of the state aid policy in Turkey are also related to complexity and multiplicity of related legislation and lack of selectivity (Leblebici, 2002). Lack of proper record keeping monitoring and evaluation mechanisms also played a role in the ineffective utilisation of regional development assistance in Turkey.

On the other hand, keeping in mind that the regional policy in the EU is transforming towards a less redistributive regional policy, Turkey needs to act strategically in formulating its regional policy in accordance with the policy options explained above. The policy approaches in the EU member states that started to realize convergence by aiming for national growth such as Ireland, Portugal and Spain need to be analysed in detail to provide Turkey with useful inputs in regional policy design. Strategic coordination of the allocation of national and supranational regional aid in Turkey would facilitate the achievement of competitiveness with cohesion as foreseen to be the primary development objective by the EU.

CHAPTER 6

CONCLUSION

The aim of this research was to investigate the relationship between regional policy and regional state aid policy in the EU, and the impact of this relationship on member states in the effort to reduce regional disparities. By analysing this relationship, it is intended to propose policy changes as regards regional development in Turkey in the process of EU integration.

Chapter 2 of this study provided information about the evolution and the role of regional policy in the EU. It is observed that although EU regional policy started out as a supplement to the national regional policies of the member states, with the reform of the Structural Funds in 1989, it attained an enhanced supranational level. When the contribution of EU regional policy to the reduction of regional disparities is viewed from the perspective of the redistribution vs. reformation dilemma, it is concluded that there exists a trade-off between national growth and reduction of regional disparities. While redistributive regional policy works more in support of national growth which contributes to increased competitiveness, reformative regional policy requires the concentration of resources to the problem regions to be able to contribute to their development. It follows that especially the new and less-prosperous member states of the EU are faced with the need to make a political choice between prioritizing catch-up and prioritizing balanced income distribution. Evidence from the EU shows that despite the contribution of EU regional policy to national convergence, regional disparities within the member states have widened. Therefore, it is asserted that in the enlarged EU, the effectiveness of regional policy needs to be increased both at the supranational and at the national level in order to respond to the increase in the level of regional disparities.

In Chapter 3, the regional state aid policy in the EU, which is one of the key policy instruments at the member state level to support regional development, is reviewed. The analysis of the new guidelines on national regional aid shows that the approach at the EU level towards regional state aid has become very strict in line with the overall state aid approach of "less and better targeted state aid". The eligibility conditions and the types of regional state aid allowed in the EU both demonstrate that there is a refined system of granting regional state aid in the EU. The situation in member states as regards granting of regional state aid demonstrated that although the share of horizontal objectives is increasing in the EU at the expense of sectoral objectives, the level of regional state aid has decreased significantly. The analysis of regional state aid in relation to the level of regional disparity in the member states showed that there is no direct link between the level of regional disparity and the amount of regional state aid in the members of EU 15. In addition to that, comparing the amount of regional state aid in the old and new member states, it is observed that there is a significant disparity among the two groups of countries. Due to its very low amounts, for the regional state aid in the new members to have an impact on regional disparities in the enlarged EU, strategic utilization of such aid is crucial.

Following the analysis of regional policy and regional state aid policy in the EU, the link between these two policies is established in Chapter 4. It is observed that although there used to be a full overlap of regional policy and regional state aid policy prior to the reform of Structural Funds in 1989, this connection has gradually decreased in the three programming periods (1989-1993, 1994-1996 and 2000-2006). In order to adequately address the development problems of backward regions, the Commission supports the coordination of national and EU funding for regional policy. Nevertheless, as the entire territory of the EU is made eligible for Structural Funds in the 2007-2013 financial perspective, it is concluded that the coordination of these two policies depends on the formulation of national regional policy. In this context, the regional policy choices of the EU member states revealed that the formerly acceded countries such as Ireland, Spain and Portugal have given priority to national growth rather than the reduction of regional disparities. In line with the non-linear relationship between national growth and regional inequalities that is represented by Kuznets (1955) and Williamson (1965), despite an initial increase in regional disparities in these countries until the end of 1990s, it is indicated that as national growth proceeded, regional convergence started to take place. On the contrary, the efforts of Italy to promote economic activity in the poorer South regions not only proved to be unsuccessful for the reduction of regional inequalities but also hampered national growth due to factors such as reduced labour mobility as a result of excessive welfare payments (Davies and Hallet, 2002).

This finding shows that effectiveness of regional policy in the EU is two-dimensional. While the first dimension is related to the coordination of supranational and national financial assistance, the second dimension is related to the concentration of this coordinated assistance to growth centres or backward areas. In approaching the regional development problem in the enlarged EU from this two-dimensional perspective, two types of policy alternatives are reviewed, which are identified as active and reactive. While active form of regional policy is an expenditure-intensive method, reactive regional policy is an approach with a greater emphasis on policy intervention to limit the coverage of regional assistance and as a result to intensify the impact of regional policy without necessarily increasing the overall budget. With regard to the increasing regional disparities in the EU coupled with the increasing resource requirement to finance regional policy, as well as with regard to the increased regulatory power of regional state aid policy in the EU, it is concluded that there is a tendency in the EU to move towards a more reactive regional policy approach.

By taking the analysis of the relationship between regional policy and regional state aid policy in the EU as basis, in Chapter 5, the regional policy and regional state aid policy in Turkey is examined as a candidate country. It is observed that despite a long period of active involvement in regional policy and regional state aid policy, the regional development gap in Turkey has not decreased. Although, specific policies have been formulated to trigger development in the Eastern and South-eastern Anatolia, investments continued to concentrate on Marmara and Aegean regions.

The findings reveal that in the process of accession, Turkey needs to revise its national regional aid policy and also needs to work out strategies to coordinate national regional aid policy with the regional aid that can be received from the EU. The pre-accession financial assistance for regional development programmes follow a similar path to the traditional regional policy in Turkey where the limited amounts of financial assistance is being thinly distributed by covering 42 of the 81 of the provinces. The impact of pre-accession financial assistance is expected to be mainly on improving the project implementation capacity at the regional level through the creation of the development agencies, rather than on reduction of regional disparities or national growth.

Considering the findings of the Chapter 4, the regional policy at the EU level is in a tendency to transform into a reformative policy rather than a type of policy which concentrates on redistribution. In that case, a political choice needs to be made in Turkey at the national level between the two extreme approaches to regional development: targeting national growth or targeting reduction of regional disparities.

Following the model of Kuznets (1955) and Williamson (1965), the evidence from the EU shows that concentrating funds to growth centres is a more appropriate approach especially for less-prosperous countries with high level of regional disparities since the relatively limited amount of financial assistance would be more efficiently utilized. Taking into consideration that there is already a productive agglomeration in the big cities such as İstanbul, İzmir and Ankara and the Western NUTS II regions of Turkey such as Kocaeli, Bursa, Aydın and Adana, aiming for the increased competitiveness of these regions would have significant contribution to national convergence of Turkey with the EU in the short term and to cohesion within the country in the long term.

On the other hand, an important point that needs to be paid attention in the case of Turkey is the existence of significant intra-regional disparities in terms of income. The policy focusing on national growth could have an adverse impact in the more developed parts of Turkey as well by further increasing intra-regional disparities. The political outcomes of such a policy decision also need to be taken into consideration when making a regional policy choice for Turkey.

Unfortunately, it is not possible to evaluate the outcomes of these policy alternatives within the scope of this study as its main attempt has been to investigate the relationship between regional policy and regional state aid policy in the EU and its implications for Turkey. The implication of this relationship for Turkey is a need to shift to strategic policy combination as regards regional policy in the process of accession. It is concluded that, in order to achieve national economic cohesion with the EU, it will be necessary for Turkey to coordinate EU regional financial assistance with national regional aid by determining a proper balance between national growth and reduction of regional disparities within the two extreme policy options, which would contribute to economic and social development at the highest level. For this purpose, the existing state aid legislation and its implementation needs to be swiftly adapted to the EU and the establishment of a state aid monitoring authority is of crucial importance on that matter. In the preparation of regional development plans, harmonisation of regional policy and regional state aid policy needs to be achieved. Coordinated regional financial assistance needs to be directed to growth centres in Turkey as well as to those regions which have a GDP per capita between 50% and 75% of the national average as they can be relatively more efficient in utilizing the financial support. On the other hand, the redistributive regional policy for the least-developed areas needs to be redesigned to relieve the economic burden created on these regions by increased disparities without counteracting market forces.

The research on the relationship between regional policy and regional state aid policy gives rise to further research questions such as investigating the different member state case studies that give priority to national growth and that manage to reduce regional disparities in the long run. Regional development experience in Ireland, Portugal and Spain can be illustrative cases to investigate these issues in detail. In addition to that, the particular channels of investment which make the highest levels of contribution to national growth and regional development in these countries need to be investigated. Such an analysis would shed light on what sort of a policy should be followed in Turkey to enhance national growth and consequently reduce regional disparities.

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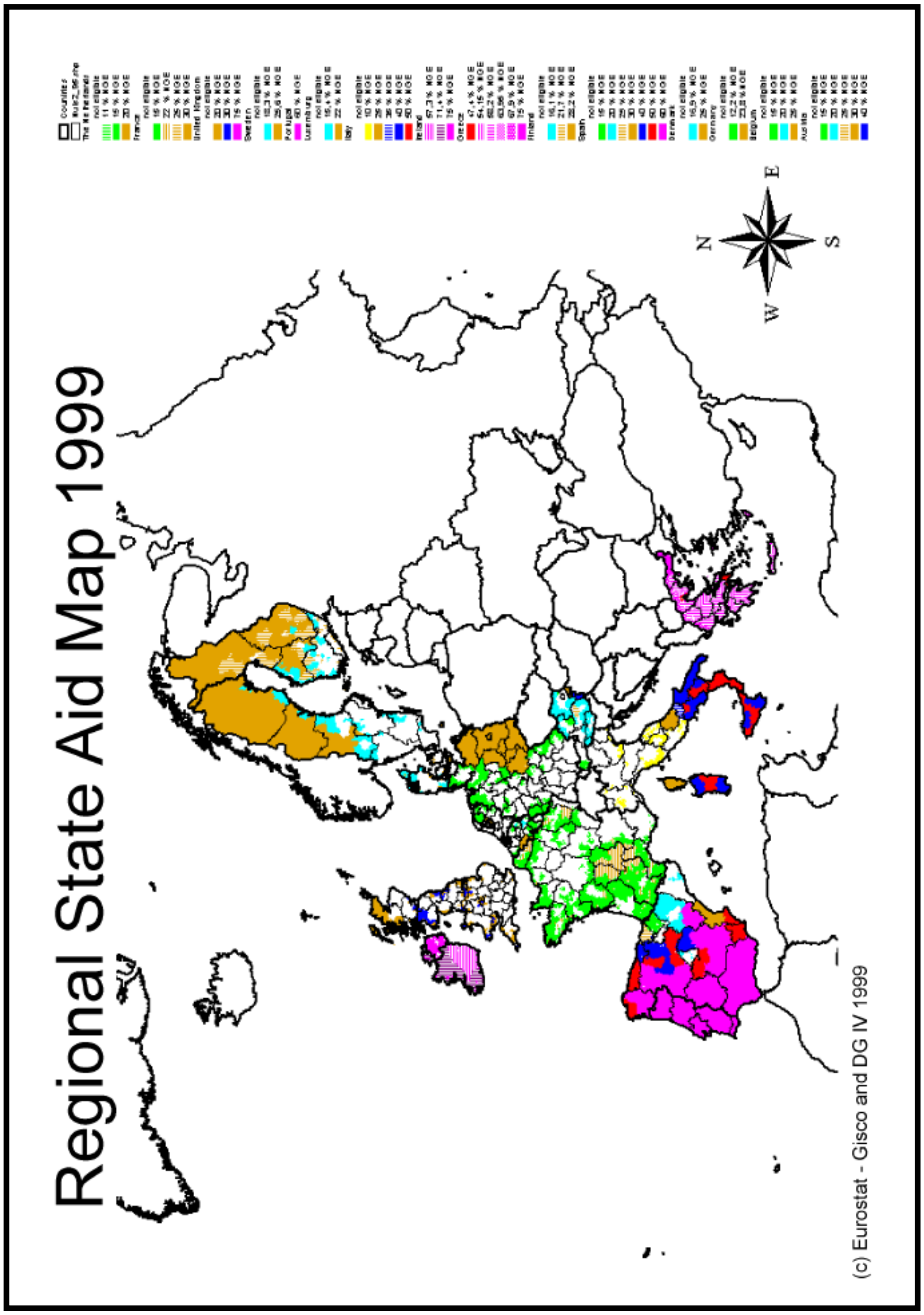
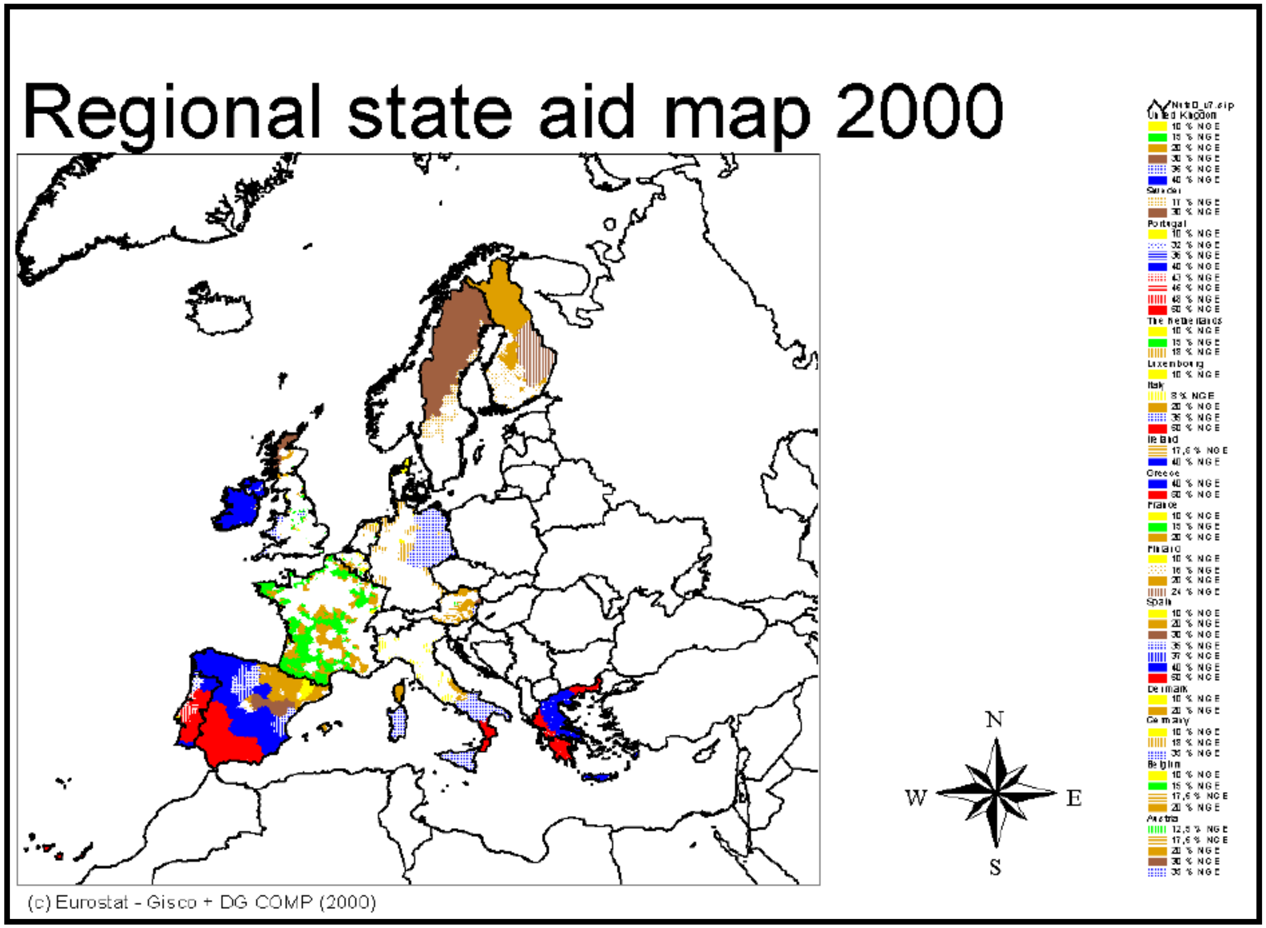
APPENDICES

APPENDIX A: Regional State Aid Maps



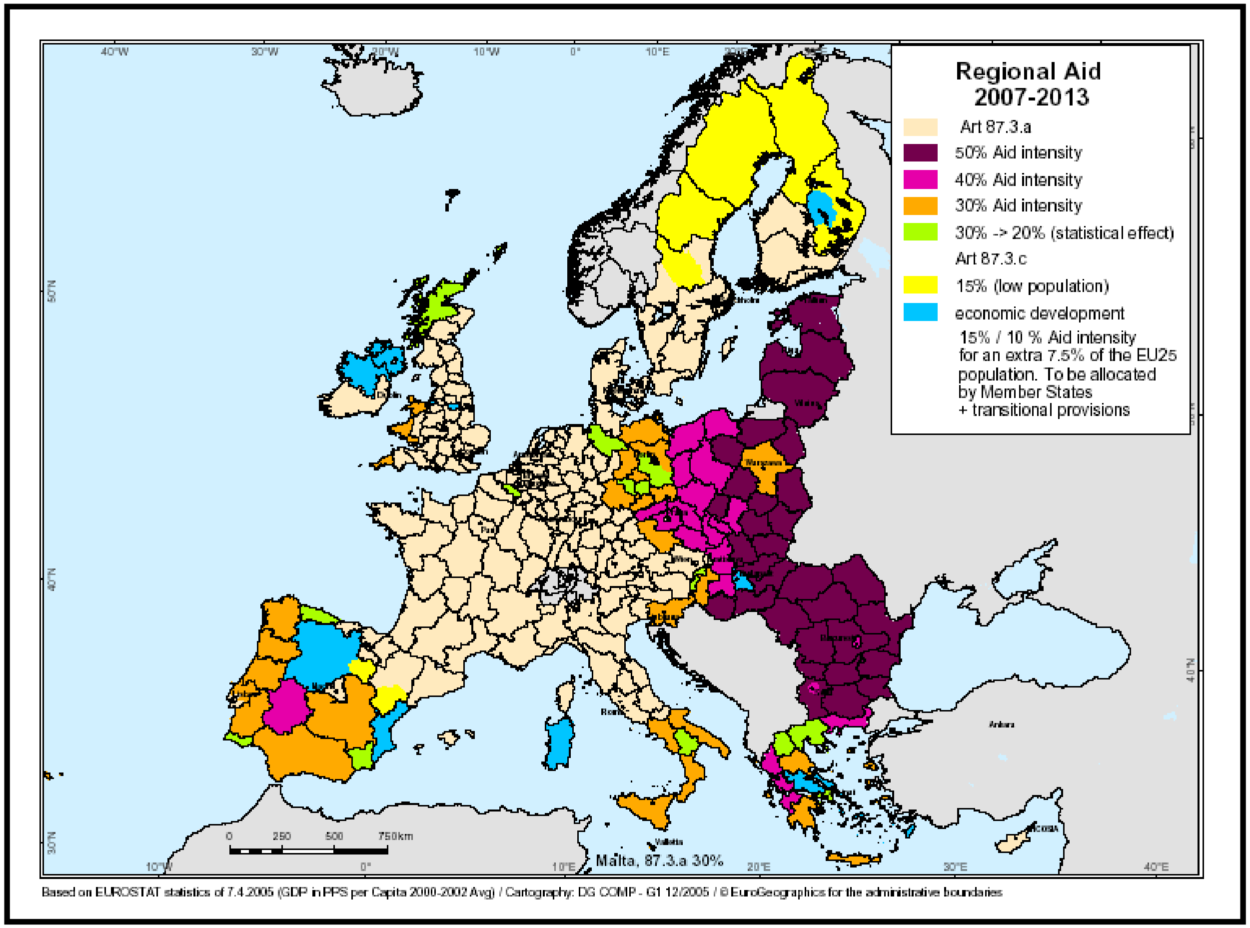
Source: (European Commission, 2006i)

Figure A.1: Regional State Aid Map (1999)



Source: (European Commission, 2006j)

Figure A.2: Regional State Aid Map (2000)



Source: (European Commission, 2006g)

Figure A.3: Regional State Aid Map (2007-2013)

APPENDIX B: GDP Per Capita in PPS by Member and Non-Member Countries

Table B.1: GDP per capita in PPS (EU 25 = 100)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
EU25	*100*	*100*	*100*	*100*	*100*	*100*	*100*	*100*	*100*	*100*	*100*	*100*	*100*
EU15	*110*	*110*	*110*	*110*	*110*	*110*	*110*	*109*	*109*	*109*	*108*	*108* f	*108* f
BE	120	118	117	116	116	117	117	118	118	118	118	118 f	117 f
CZ	68 e	71 e	69 e	67 e	66	65	66	68	68	71	74	76 f	78 f
DK	123	124	124	123	126	126	125	121	121	122	124	126 f	126 f
DE	119	118	116	114	114	112	110	109	108	108	109	109 f	108 f
EE	33 e	35 e	38 e	39 e	39	42	44	47	50	53	60	64 f	68 f
GR	70	70	71	70	71	73	73	77	81	82	82	83 f	84 f
ES	87	87	87	89	92	92	93	95	97	98	99	99 f	98 f
FR	114	113	114	114	114	114	114	112	112	110	109	108 f	107 f
IE	98	101	111	115	121	126	129	132	134	136	138	138 f	140 f
IT	116	116	114	115	114	113	112	110	108	106	103	102 f	101 f
CY	81 e	80 e	78 e	79 e	80	81	83	82	80	83	83	83 f	83 f
LV	29 e	30 e	32 e	33 e	34	35	37	39	41	43	47	50 f	53 f
LT	34 e	35 e	37 e	39 e	37	38	40	42	45	48	52	55 f	57 f
LU	199	197	191	194	218	222	215	221	233	238	248	252 f	256 f
HU	49 e	49 e	50 e	51 e	52	54	57	59	60	61	61	63 f	65 f
MT	:	:	:	78	78	79	75	76	74	70	70	69 f	68 f
NL	118	119	121	122	123	124	127	125	125	124	124	125 f	125 f
AT	126	127	124	123	125	126	122	120	120	122	123	122 f	122 f
PL	40 e	42 e	44 e	45 e	46	47	46	46	47	49	50	51 f	52 f
PT	75	75	76	78	81	81	80	79	73	72	71 f	70 f	69 f
SI	68 e	69 e	71 e	72 e	74	73	74	75	76	79	81	82 f	84 f
SK	44 e	47 e	47 e	47 e	47	48	49	51	52	53	55	57 f	60 f
FI	104	104	109	112	113	114	116	115	113	114	113	115 f	115 f
SE	116	116	115	114	118	119	115	114	116	117	115	116 f	116 f
UK	108	109	111	111	112	112	113	116	116	117	117 f	117 f	117 f
BG	31 e	27 e	25 e	26 e	26	27	28	28	30	31	32	33 f	35 f
HR	36 e	39 e	41 e	42 e	40 e	41 e	41 e	44 e	46 e	47 f	49 f	50 f	51 f
MK	:	:	25	25	26	26	24	24	25	25	26 f	26 f	27 f
RO	:	:	:	:	25	25	26	28	30	32	35	36 f	37 f
TR	30 e	31 e	32 e	32 e	29	30	26	26	27	28	31	32 f	32 f
IS	122	126	127	129	130	127	126	122	121	127	128	130 f	129 f
NO	129	137	139	131	140	159	155	147	146	153	165	164 f	163 f
CH	143	137	139	138	134	133	128	130	130 f	132 f	127 f	127 f	127 f
US	150	151	152	153	155	152	148	145	148	150	149 f	149 f	148 f
JP	120	121	120	115	112	112	109 f	107 f	108 f	109 f	109 f	110 f	110 f
CA	123	121	122	123	126	127 f	126 f	128 f	128 f	127 f	128 f	128 f	128 f

e: estimate f: forecast

Source: Eurostat

APPENDIX C: Geographical Coverage of Structural Funds

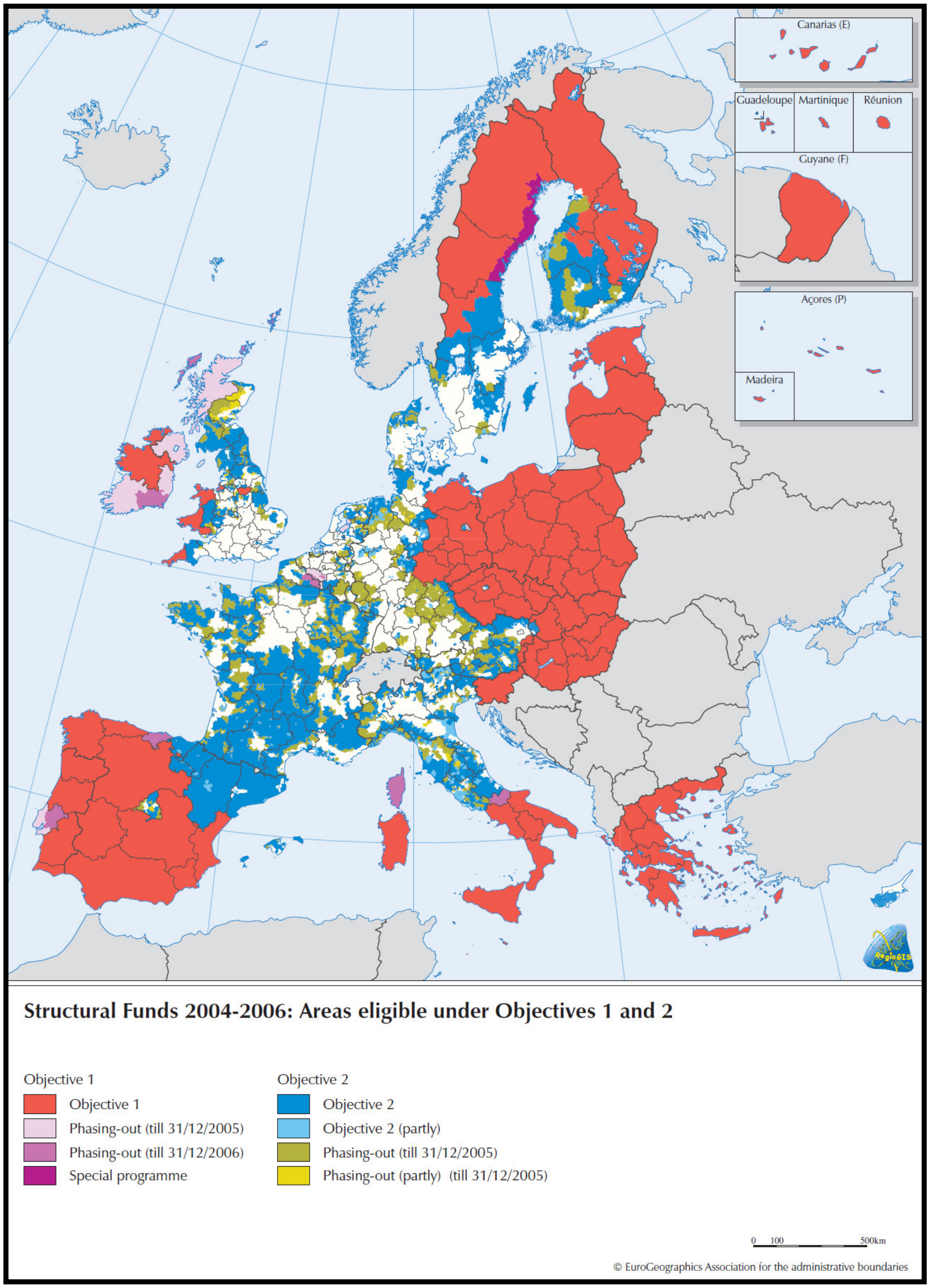


Figure C.1: Geographical Coverage of Structural Funds (2004-2006)

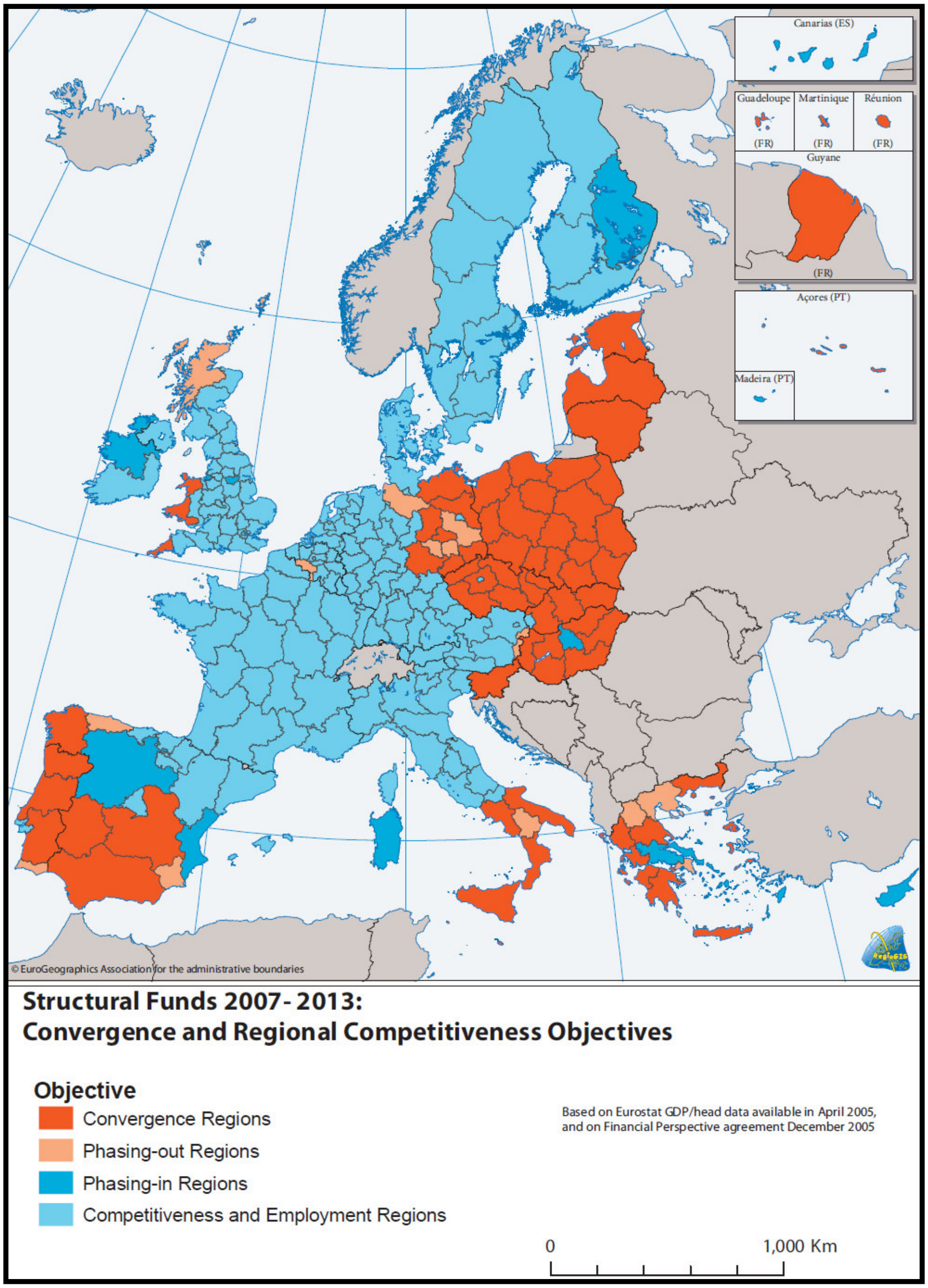
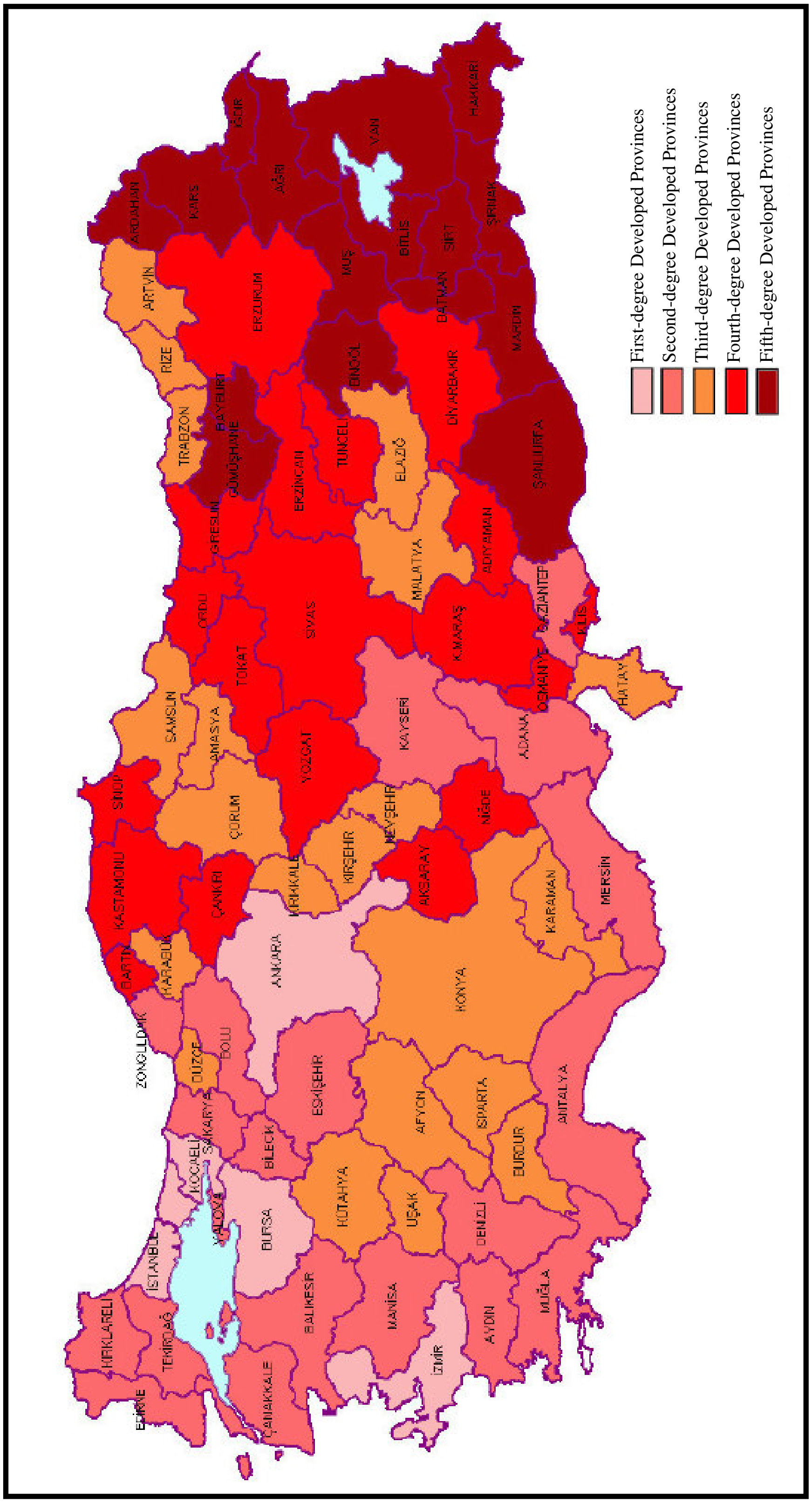


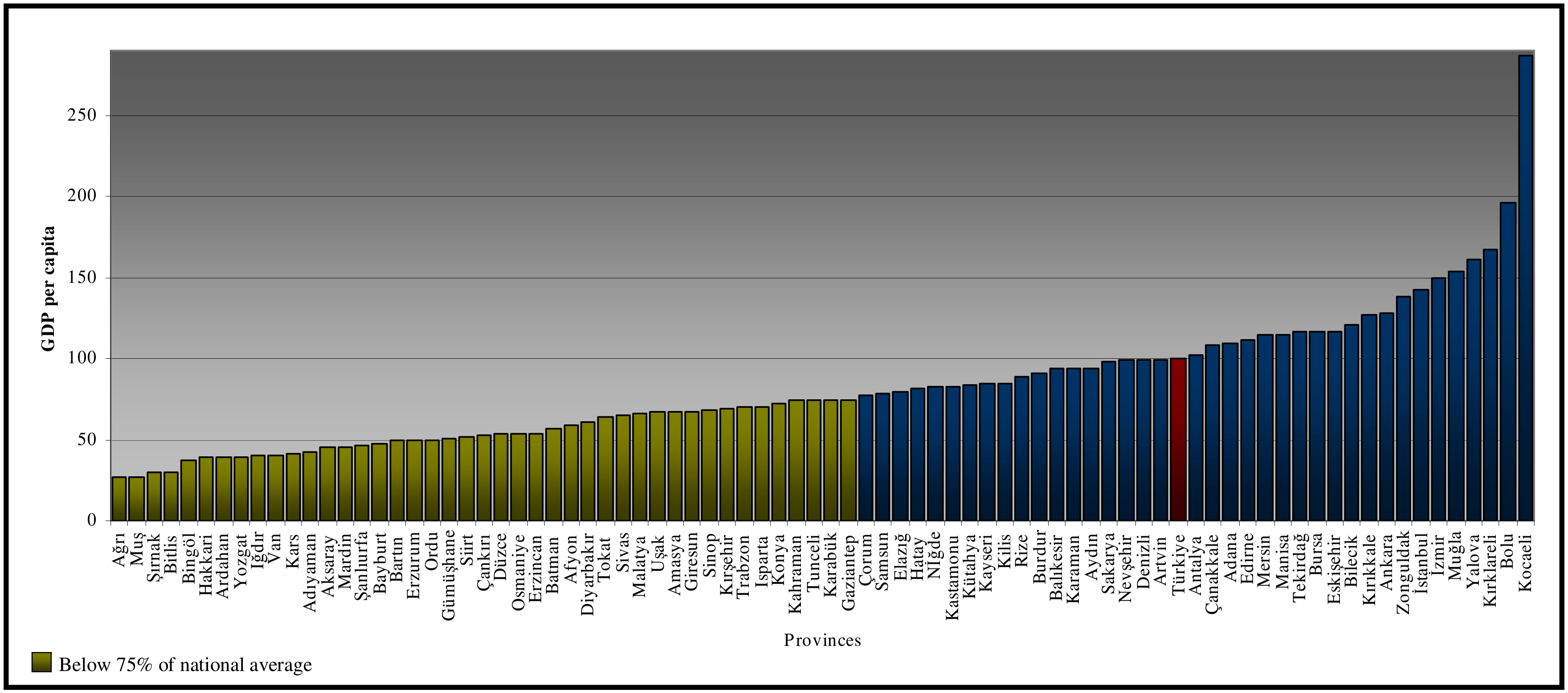
Figure C.2: Geographical Coverage of Structural Funds (2007-2013)

APPENDIX D: Regional Disparities in Turkey



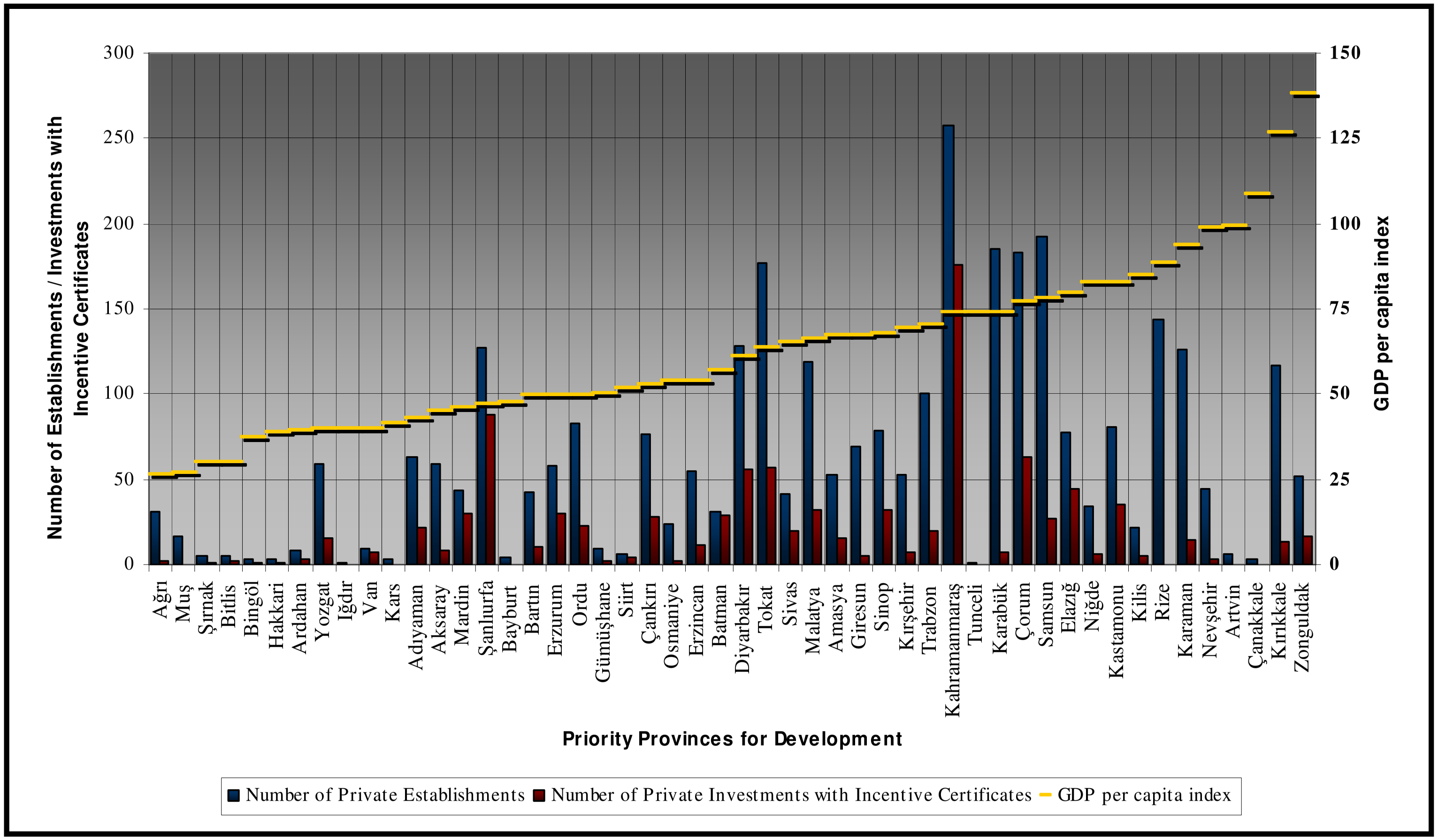
Source: (DPT, 2003a)

Figure D.1: Socio-Economic Development Ranking of Provinces (2003)



Source: Turkstat

Figure D.2: GDP per capita by Provinces (2001)



Source: Elaborated from (DPT, 2000)

Figure D.3: Investments with Incentive Certificates (1998) in relation to GDP per capita index (2001 Turkey = 100)

Table D.1: NUTS II Regions in Turkey

NUTS II REGION	PROVINCES
İstanbul	İstanbul
Tekirdağ	Tekirdağ
	Edirne
	Kırklareli
Balıkesir	Balıkesir
	Çanakkale
İzmir	İzmir
Aydın	Aydın
	Denizli
	Muğla
Manisa	Manisa
	Afyon
	Kütahya
	Uşak
Bursa	Bursa
	Eskişehir
	Bilecik
Kocaeli	Kocaeli
	Sakarya
	Düzce
	Bolu
	Yalova
Ankara	Ankara
Konya	Konya
	Karaman
Antalya	Antalya
	Isparta
	Burdur
Adana	Adana
	Mersin
Hatay	Hatay
	Kahramanmaraş
	Osmaniye
Kırıkkale	Kırıkkale
	Aksaray
	Niğde
	Nevşehir
	Kırşehir
Kayseri	Kayseri
	Sivas
	Yozgat

NUTS II REGION	PROVINCES
Zonguldak	Zonguldak
	Karabük
	Bartın
Kastamonu	Kastamonu
	Çankırı
	Sinop
Samsun	Samsun
	Tokat
	Çorum
	Amasya
Trabzon	Trabzon
	Ordu
	Giresun
	Rize
	Artvin
	Gümüşhane
Erzurum	Erzurum
	Erzincan
	Bayburt
Ağrı	Ağrı
	Kars
	Iğdır
	Ardahan
Malatya	Malatya
	Elazığ
	Bingöl
	Tunceli
Van	Van
	Muş
	Bitlis
	Hakkari
Gaziantep	Gaziantep
	Adıyaman
	Kilis
Şanlıurfa	Şanlıurfa
	Diyarbakır
Mardin	Mardin
	Batman
	Şırnak
	Siirt