

# Subsidiarity and Proportionality in the Single Market

An EU fit for inclusive growth

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## Imprint

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## Preface

The principles of subsidiarity and proportionality have been subject to intense debate. Which policy issues are best dealt with by central decision making at EU level, and which are best handled at member state level? This question takes on particular prominence when it comes to one of the EU's cornerstones: the Single Market. While there has been a broad consensus on the economic benefits of free movement of labour, capital, goods and services, there are concerns about unnecessary regulation that fails to take local structures sufficiently into account. The Austrian government has made this a key point during its presidency of the Council of the EU in the second half of 2018.

Bertelsmann Stiftung and Copenhagen Economics are here contributing to this debate with a study on the economic case for subsidiarity and proportionality in the EU. This report has been presented at the Presidency's conference "Subsidiarity as a building principle of the European Union" in November 2018. Analysing subsidiarity and proportionality, the study focuses on the role of internal market policies in spreading greater prosperity across all EU regions and provides a framework for the analysis of the current state of affairs. It outlines recommendations for increased focus on subsidiarity and proportionality to achieve sustained growth and prosperity across all EU regions.



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## Executive summary

This report offers a fresh perspective on the principles of subsidiarity and proportionality in the European Union based on a thorough-going economic analysis. Specifically, the report uses the EU Single Market as a case to discuss shortcomings and potential improvements in five key policy areas. It reviews how the principles of subsidiarity and proportionality can help boost growth in the EU at the aggregate country level – while at the same time allowing EU regions to benefit from growth. The report focuses on the regional level as economic growth has been uneven across the EU's regions over the last decade and, consequently, growing disparities between regions have emerged. This alone merits a review on how we can reconcile the twin objectives in the future.

### Internal market and economic cohesion

A central goal of the internal market is to boost productivity and real wages by allowing firms throughout Europe to market their products and services across borders, reaping benefits of scale and scope in developing, producing and selling. Yet, while there is a broad consensus on the positive overall growth effects of the EU's internal market policies, their impact on economic convergence between and within countries remains an open question. On the one hand, the Single Market facilitates a process of catch up, as less prosperous regions get access to markets and technology transfers from the best performing countries. On the other hand, it can boost the advantage of the best performing regions, as barriers to trade are reduced – leading to a widening gap between core and periphery regions within the EU. Moreover, there is little consensus on whether the Single Market is ready for the expected disruption from digitalisation/automatisation and its effects on convergence.

We argue that subsidiarity and proportionality, both general principles in EU law, can play a key role in mitigating growth imbalances across EU. Specifically, this study contributes to the current debate on the topic in four ways:

1. We provide a framework to assess the costs and benefits of central versus locally based decisions in internal market policies by recapping the principles of subsidiarity and proportionality in EU regulation (Chapter 1).
2. We set the scene on what has happened to regional growth performance within the EU over the last two decades and draw some lessons from the growth performance across regions, focusing on effective decision rules as regards centralisation vs. de-centralisation (Chapter 2).
3. We illustrate how our framework for applying the principles of subsidiarity and proportionality can be applied to illustrate shortcomings in the current policy approach in selected internal market policy areas (Chapter 3).
4. We put forward specific recommendations for any future regulation (Chapter 4).

### Subsidiarity, proportionality and economic growth: towards a common good perspective

The principle of *subsidiarity* lays down that tasks should be decided at the most appropriate level of governance and establishes the need to weigh the benefits of reaching central versus local decisions in the EU. Central regulation can be advantageous in coping with issues that have inherent cross-border effects, so-called externalities as well as economies of scale and scope. In particular, the creation of the Single Market ensures fair competition between companies from different member states and facilitates their international operations. In markets with a huge potential for economies of scale, this allows firms to reduce costs and speed up innovation as they can produce for a much larger group of consumers. Central regulation may be beneficial when public policies in an individual member state have substantial spill-overs to actors in other member states. For instance, this may call for rules preventing firms from causing cross-border air pollution as well as establishing joint funding in research areas with large common interest. In the absence of these factors, there is a strong case for regulation to rest with national and subnational regulatory bodies.

Moreover, subsidiarity needs to be combined with *proportionality*, which stipulates that benefits have to be large enough to justify central action and that the proposed instruments are sufficiently narrowly targeted to reap the desired results. Finally, the issue is not simply whether objectives for a given policy area should be determined at

central or local level. It is also about the latitude that central regulation offers local actors to choose the instruments best suited to their own circumstances. This suggests that regulation should focus, if possible, more on the *desired outcomes* of a given policy intervention, while avoiding overly narrow regulation that fails to capture underlying structural differences across countries and regions and that lock in place a status quo that might not be able to respond to future challenges.

We combine these three concepts to assess the need for central action and then, if action is justified, determine its precise form and any EU value added:

- Subsidiarity: is there a strong a priori case for decisions at central level?
- Proportionality: is it likely that centralised decision-making delivers an overall benefit to society in practice, taking into account complexity, loss of local autonomy and risk of unforeseen consequences?
- Outcome analysis: does a given regulation provide sufficient local latitude and avoid locking in specific technology solutions that are not fit for the future?

We argue that the sound application of the subsidiarity and proportionality principles can cater to a *common good perspective* of the European Union: the EU should act whenever its mandate is linked to a clear value added for citizens – a common good that would otherwise have been absent. Conversely, national and sub-national bodies should take the lead whenever any EU value added is uncertain or unlikely.

### **Economic growth and convergence in the EU: what happened?**

Since the year 2000 overall EU GDP has grown by some 24 percent (net of inflation), but with large variation across the Single Market. The picture is quite clear: economic dispersion *between* countries in terms of GDP per capita declined in the EU until the economic and financial crisis in 2008/2009, with no overall reduction since then. When reviewing the economic dispersion between regions, we find that divergence has in fact increased since the crisis, bringing dispersion levels back to those pertaining at around the year 2000.

We identify three key trends that have delivered this outcome:

- Declining contribution from catch-up process linked to 2004 enlargement: The Central and Eastern European member states that joined the EU in 2004 were catching up with the other EU countries in the pre-accession period and in the early years of EU enlargement. This process has slowed down in recent years. Lower hanging fruits are disappearing as the distance to the frontier of high-income countries is becoming steadily smaller.
- Increased dispersion within the “old” group of member states since 2008: Until 2008, countries such as Greece, Italy, Spain and Portugal were growing at a faster pace than the remainder of the EU15. Since the onset of the economic crisis, richer countries in the northern part of the EU have experienced much higher growth rates than those in the south.
- Rural-to-urban income gaps are arguably increasing: Across the EU, regions with a high population density have systematically higher GDP per capita. The income gap has not significantly widened but there has been a massive migration towards urban areas, particularly towards million-plus cities, since 2008. We are therefore witnessing a significant agglomeration effect, measured in an increase in the total GDP share of urban areas.

### **Internal market policies, subsidiarity and proportionality: Economic decision rules for regionally inclusive and balanced growth**

When (re-)launching the internal market process in the mid-1980s, policy-makers recognized the need to have in place policies underpinning convergence and broad-based growth across the EU. This can, however, only be achieved if regulation within internal market policies adds value at EU level, in line with the principles of subsidiarity and proportionality. We point to a simple decision rule based on economic analysis to evaluate where to delegate regulation: if any regulation exhibits large economies of scale or scope and if transnational spill-overs exist, the tendency should be to regulate at EU level. If spill-over effects and benefits are confined to the local

level or a region and local preferences and structures matter, then decisions should be taken locally. Based on our analysis in five policy domains, the study highlights three priorities for a re-orientation of subsidiarity and proportionality in internal market policies.

First, digitalisation of the economy has just begun and will, in future, become a more integral part of products and processes for the European and global economy. Technologies such as artificial intelligence, robotics, Internet of Things (IoT), nanotechnology, 3D printing and biotechnology are not only major growth factors – they are about to fundamentally change the way goods and services are being produced and distributed. In “doomsday” scenarios this could lead to even more concentration of production and population in the areas that have so far been the main beneficiaries, namely large metropolitan areas.

However, in our view, that is by no means a foregone conclusion. The key point is that digitalisation also allows firms, employees and consumers to interact increasingly over long distances at still lower costs and higher quality. An infrastructure policy emphasising the role that digital solutions can deliver in providing connectivity is central to foster growth across all regions. In this context, we stress two points:

- The digital economy is evolving rapidly, with new technologies and players providing alternative solutions: EU competition and sectoral policies encourage a multitude of solutions, best geared to local circumstances and innovation.
- Public service obligations linked to connectivity should be technology neutral and take local circumstances into account: EU minimum requirements should avoid locking in outdated technological solutions and allow obligations to be served by multiple players tailored to local circumstances. Subsidiarity is an important element here in the provision of digital infrastructure.

Second, we recommend a stronger focus on proportionality in regulation of products and markets with a focus on the spatial and geographical dimensions of growth. Throughout our analysis, we have highlighted several areas of focus.

Third, we suggest that EU policy-making should allow some targeted use of regulatory sandboxes to test alternative regulation models at the national and sub-national levels. So far, these have been applied mainly in the area of FinTech solutions. It may be favourable to allow capital market solutions – i.e. crowdfunding and risk capital funding – to supplement bank funding outside of urban areas where branch networks are increasingly being shrunk.



# 1 Subsidiarity, proportionality and economic growth in the Single Market

## 1.1 The EU's legal foundation of subsidiarity and proportionality

Subsidiarity and proportionality have been strongly debated general principles of European Union (EU) law. After all, these principles define EU responsibility in areas where it does not possess exclusive competence. Thus, they have not only been key concepts underlying the EU's formation – but also affect power-sharing between actors at the supranational, national and regional levels.

Subsidiarity is the principle that a central authority should only perform tasks that cannot be carried out efficiently by national or regional governments. When designing EU legislation, the subsidiarity principle sets out those domains in which there is an EU value added and where it is best left for national authorities to regulate. In other words, it is designed to set the optimal division of power between the EU and national governments.

The principle of proportionality is also key in the design of EU regulation as it ensures that actions undertaken by the EU are confined to what is necessary to achieve the policy objectives. This means that the extent of EU regulatory initiatives must match the aims pursued. *Box 1* gives an overview of the definitions of the two principles as stated in the EU treaties.

### Box 1

#### Subsidiarity and proportionality in the EU treaties

“Under the principle of **subsidiarity**, in areas which do not fall within its exclusive competence, the Union shall act only if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the member states, either at central level or at regional and local level, but can rather, by reason of the scale or effects of the proposed action, be better achieved at Union level.

Under the principle of **proportionality**, the content and form of Union action shall not exceed what is necessary to achieve the objectives of the Treaties.

The institutions of the Union shall apply the principle of proportionality as laid down in the Protocol on the application of the principles of subsidiarity and proportionality.”

Source: Consolidated Version of the Treaty on European Union, Article 5(3)

The principles of subsidiarity and proportionality have been enshrined in EU law-making. They have been given renewed attention by the current Commission led by Jean-Claude Juncker, who asked a task force chaired by Vice-President Frans Timmermans to review the effective application of the principles of subsidiarity and proportionality in the EU. In their final report of July 2018, the task force provided an assessment grid to identify whether a given legislative proposal or initiative in the EU is in line with the principles of subsidiarity and proportionality, *cf. Box 2*.

**Box 2****Timmermans task force: Assessment grid for “Active Subsidiarity”**

The Task Force on Subsidiarity, Proportionality and “doing less more efficiently” chaired by Commission Vice President Frans Timmermans provides an assessment grid as a tool to assess whether a given proposal or initiative from an EU institution is in line with the principles of subsidiarity and proportionality. The task force recommends that the following questions should be addressed when evaluating any new regulation:

**1. Can the EU act? What is the legal basis and competence of the Union’s intended action?**

- 1.1 Which article(s) of the Treaty is/are used to support the legislative proposal or policy initiative?
- 1.2 Is the Union competence represented by this Treaty article exclusive, shared or supportive in nature?

**2. Subsidiarity Principle: Why should the EU act?**

- 2.1 Does the proposal fulfil the procedural requirements of Protocol No. 2 on subsidiarity?
- 2.2 Does the explanatory memorandum (and any impact assessment) accompanying the Commission’s proposal contain an adequate justification regarding conformity with the principle of subsidiarity?
- 2.3 Based on a set of questions in the grid, can the objectives of the proposed action be achieved sufficiently by the member states acting alone (necessity for EU action)?
- 2.4 Based on the answers to a set of questions, can the objectives of the proposed action be better achieved at Union level by reason of the scale or effects of that action (EU added value)?

**3. Proportionality: How should the EU act?**

- 3.1 Does the explanatory memorandum (and any impact assessment) accompanying the Commission’s proposal contain an adequate justification regarding the proportionality of the proposal and a statement allowing appraisal of the compliance of the proposal with the principle of proportionality?
- 3.2 Based on the answers to the questions and information available from any impact assessment, the explanatory memorandum or other sources, is the proposed action an appropriate way to achieve the intended objectives?

Source: The task force on subsidiarity, proportionality and “doing less more efficiently” (2018). Active Subsidiarity – A new way of working.

**1.2 The economic case for subsidiarity and proportionality in the Single Market**

The debate on subsidiarity and proportionality has many dimensions, including those of sovereignty, political participation and political culture. In this study, however, we focus on the *economic* aspects of this debate. In other words, we stress the *economic case* for subsidiarity and proportionality with a special emphasis on their role in fostering regional economic growth. We specifically ask the following key questions: What are the costs and benefits of legislative and governmental centralisation for regional economic growth in the Single Market? Do benefits from central regulation outweigh the potential losses from local regulation? And do the proposed legislative measures adhere to the principle of *proportionality*, such that gains to the EU as a whole are sufficiently large to curtail locally based autonomous decisions?

Generally, there are no clear-cut answers to the optimal level of (de-)centralisation. Policy makers will have to assess a range of factors on a case-by-case basis in order to reap the full benefits of institutional complementarities and evaluate the potential value added of EU regulation. Consequently, empirical studies assessing the

economic impact of (de-)centralisation find mixed results as regards economic performance, underlying the importance of case-specific assessment.<sup>1</sup>

However, it is possible to derive guidance based on economic theory, empirical analyses and good practices when deciding on the right regulatory level for a given policy domain. For instance, Harvard economist Alberto Alesina and his co-authors suggest that for each policy domain, the economic benefits of centralised regulation can be assessed by analysing externalities and economies of scale.<sup>2</sup> Following this approach<sup>3</sup>, *centralisation* can be conducive to economic growth if the following conditions are met:

- Existence of spatial externalities: Simply put, externalities (negative or positive) can arise when the action of one economic actor affects another one. For example, there are positive externalities with research funding where the benefits from public and private research are also reaped by regions and parties that do not fund the efforts. By the same token, some areas of regulation can have positive cross-border implications, e.g. air pollution, or mobile roaming charges.<sup>4</sup>
- Large economies of scale and scope: When companies operate under a harmonised regulatory framework such as the Single Market, they can produce for a large group of consumers. This allows companies to exploit economies of scale so as to reduce transaction costs and speed up innovation.<sup>5</sup> This is one of the main economic arguments for the EU Single Market. Where lack of size could increase the cost of public service, or the cost of a policy is too great for a single member state to carry it out, there is, according to this criterion, a rationale for centralising.

Based on economic theory, delegation to a local or regional level is preferable under the following circumstances:

- Regionally heterogeneous preferences: Centralisation can be disadvantageous if preferences (of households and firms) vary a lot across countries, and when regions, local structures and special environments matter. Local authorities often have better regional specific knowledge on the preferences of citizens and structures of companies when it comes to fostering regionally balanced growth. In these cases, it can be efficient to de-centralise, as lower levels of governance can better cater to varying preferences.
- Scope for creating inter-jurisdictional competition: Making local authorities compete to offer citizens and companies the best level of infrastructure and public service can encourage policy innovation and public spending efficiency.

Based on these arguments, this report highlights a fresh perspective on how to think about subsidiarity and proportionality in economic terms. We argue that in some instances, there can exist a *trade-off* of the following kind: If strong agglomeration effects are present, reaping the full benefits from centralisation (e.g. through economies of scale) may increase the size of the “economic pie” for the whole of the EU but could come at the cost of some regions falling behind. That is, economic activity concentrates upon the already best-off centres as a result of centralised EU regulation. This could, for example, occur when EU-wide transaction costs fall because of harmonisation and it is easier for firms and services to choose the EU-wide location of the highest positive externality to their businesses. Thus, subsidiarity and proportionality could be seen as tools to balance this trade-off effectively: with these principles in mind policy-makers can find the right mix between making sure that the EU captures sufficient growth potential, while ensuring growth is inclusive for regions at the same time, *cf. figure 1*.<sup>6</sup>

<sup>1</sup> See Kim and Dougherty (2018). Fiscal Decentralisation and Inclusive Growth.

<sup>2</sup> Alesina and Wacziarg (1999). Is Europe going too far? and Alesina et al. (2005). What does the European Union do?

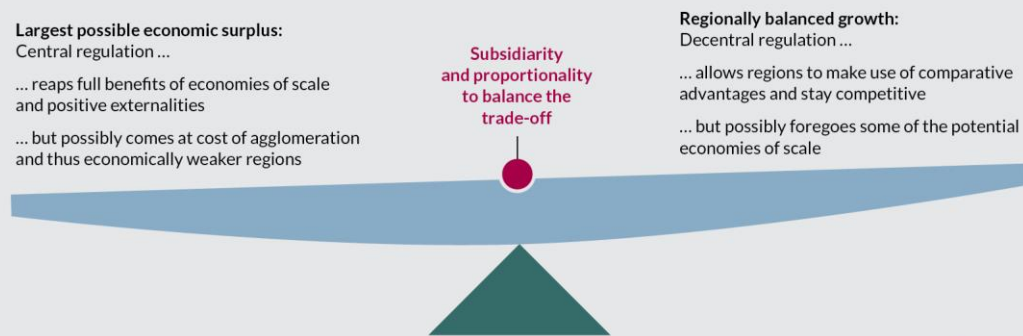
<sup>3</sup> See also Berger et al. (2017). How Europe can deliver: Optimising the division of competences among the EU and its member states.

<sup>4</sup> BAK Basel Economics (2009). From subsidiarity to success.

<sup>5</sup> LE Europe (2017). The EU Single Market: Impact on Member States.

<sup>6</sup> Implicitly, an assumption of this trade-off is that regions will always use their competencies as a result of de-centralisation to bolster their competitiveness – clearly, this need not be the case, but will be assumed for simplicity.

FIGURE 1: **Balancing the trade off between largest overall benefits and regionally balanced growth within the Single Market**



Source: Authors' depiction.

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In other words, applying subsidiarity and proportionality correctly can achieve the best balance between economic efficiency (largest output) and balanced growth (between regions) so that the EU's economic value added comes to the fore without exacerbating regional disparities.

That said, this report also highlights specific pieces of regulation that do not necessarily involve a trade-off between greater economic growth and inclusiveness across the regions. This is where the principles of proportionality and outcome-based regulation take centre place. Often the issue is not simply whether objectives for a given policy area should be determined at central or local level. It is also about the latitude offered for local actors to choose the instruments best suited to local circumstances. Regulation should be focused on the desired outcomes of a given policy intervention while avoiding at the same time overly prescriptive models that fail to capture underlying structural differences across countries and regions.

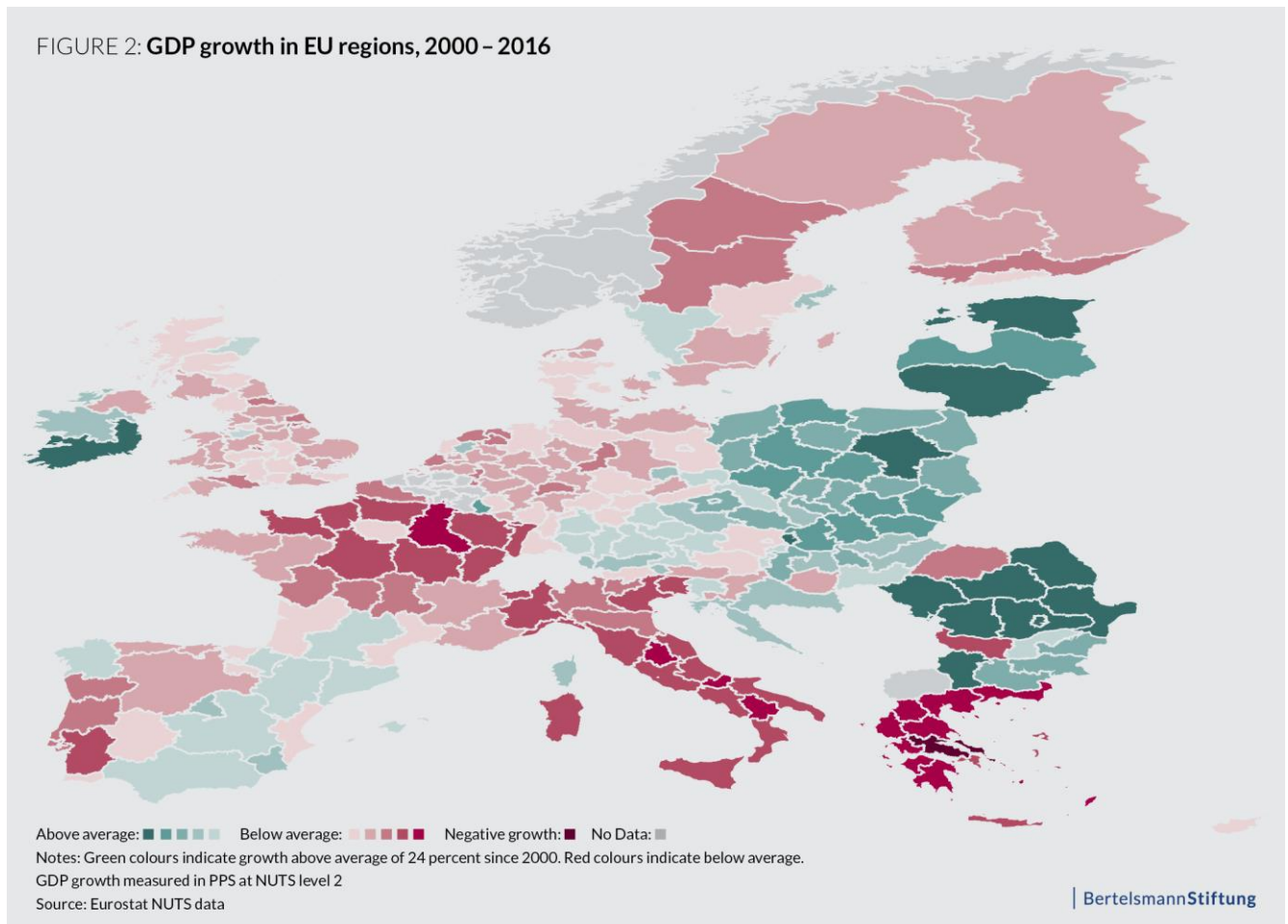
The remainder of this report is structured as follows. In chapter 2, the study discusses regional economic growth in the EU since the year 2000. This chapter shows that convergence has stalled and regional disparities have been growing. It also sheds light on winning regions and cities in more detail, indicating the factors conducive to their development. Chapter 3 suggests a decision rule based on economic theory for a better application of subsidiarity and proportionality geared to regionally inclusive growth and gives examples in five policy domains within the Single Market. The final chapter (4) highlights our conclusions.

## 2 Growth and convergence in the EU: Key trends

A central purpose of the EU's internal market and related structural policies is to facilitate growth through economies of scope and scale, but also to foster convergence by supporting the catch-up process in less prosperous regions. Before discussing the specific role that internal market policies play, we map out the key trends with respect to economic growth and convergence within the EU over the past two decades. First, we provide an overview of regional economic growth in the Single Market (2.1). We then take a bird's eye look at the ability of low-income countries and regions to catch up (2.2). Finally, we analyse how the income gap between cities and rural areas has evolved across the Single Market (2.3).

### 2.1 Growth across regions

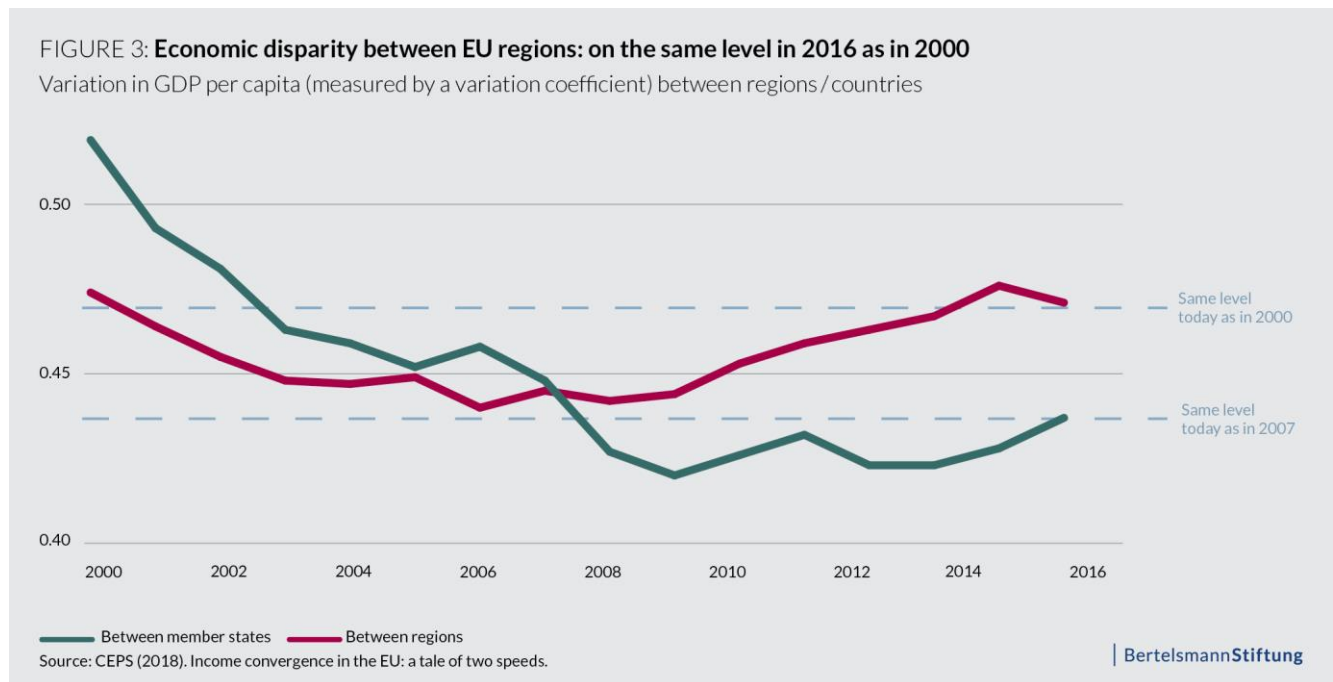
Since 2000 overall GDP in the European Union has grown by some 24 percent (net of inflation)<sup>7</sup> but with large variations across regions, *cf. figure 2*.



Central and Eastern European (CEE) countries that entered the EU between 2004 and 2007 have seen strong growth since 2000. In the “old” EU15, Ireland and parts of Spain and Sweden have also experienced above average growth rates. In contrast, large parts of France, Italy, the United Kingdom, Greece and Germany have experienced below-average growth, which in some areas has even turned negative. To see how these diverse growth dynamics translate into overall convergence or divergence, *figure 3* illustrates the dispersion of GDP per

<sup>7</sup> Not including Croatia, using chain-linked values. Source: Eurostat.

capita levels among EU member states and regions over time. At national level, we see reductions in divergence from 2000 to the start of the economic crisis around 2008, but no further convergence since then.<sup>8</sup> However, looking at GDP per capita between EU regions, variations in economic performance were as large in 2016 as they were in 2000 (for a definition of different kinds of economic convergence, *cf. box 3*).



### Box 3

#### Convergence in economics: beta and sigma convergence

**Beta convergence** is a process in which low-income countries show higher growth rates of GDP than high-income countries, implying that they are catching up over time. The concept is rooted in neoclassical growth models with diminishing returns where GDP growth decreases as countries approach their long-run steady states. If poor and rich countries converge towards the same steady state in terms of level and growth, there is absolute beta convergence. If, however, the countries exhibit different steady states due to diverse structural features such as factor endowments, convergence can take place only to the extent that each country moves towards its individual long-term levels (conditional beta convergence).

**Sigma convergence**, on the other hand, does not particularly focus on catching up processes, but simply measures whether the dispersion of GDP per capita decreases across countries over time.<sup>9</sup>

As these two graphs have evolved quite differently over the past two decades, we will in the following section focus more closely on the convergence between countries and the urban/rural income gap to explore regional heterogeneity in Europe.

<sup>8</sup> CEPS (2018). Income convergence in the EU: a tale of two speeds.

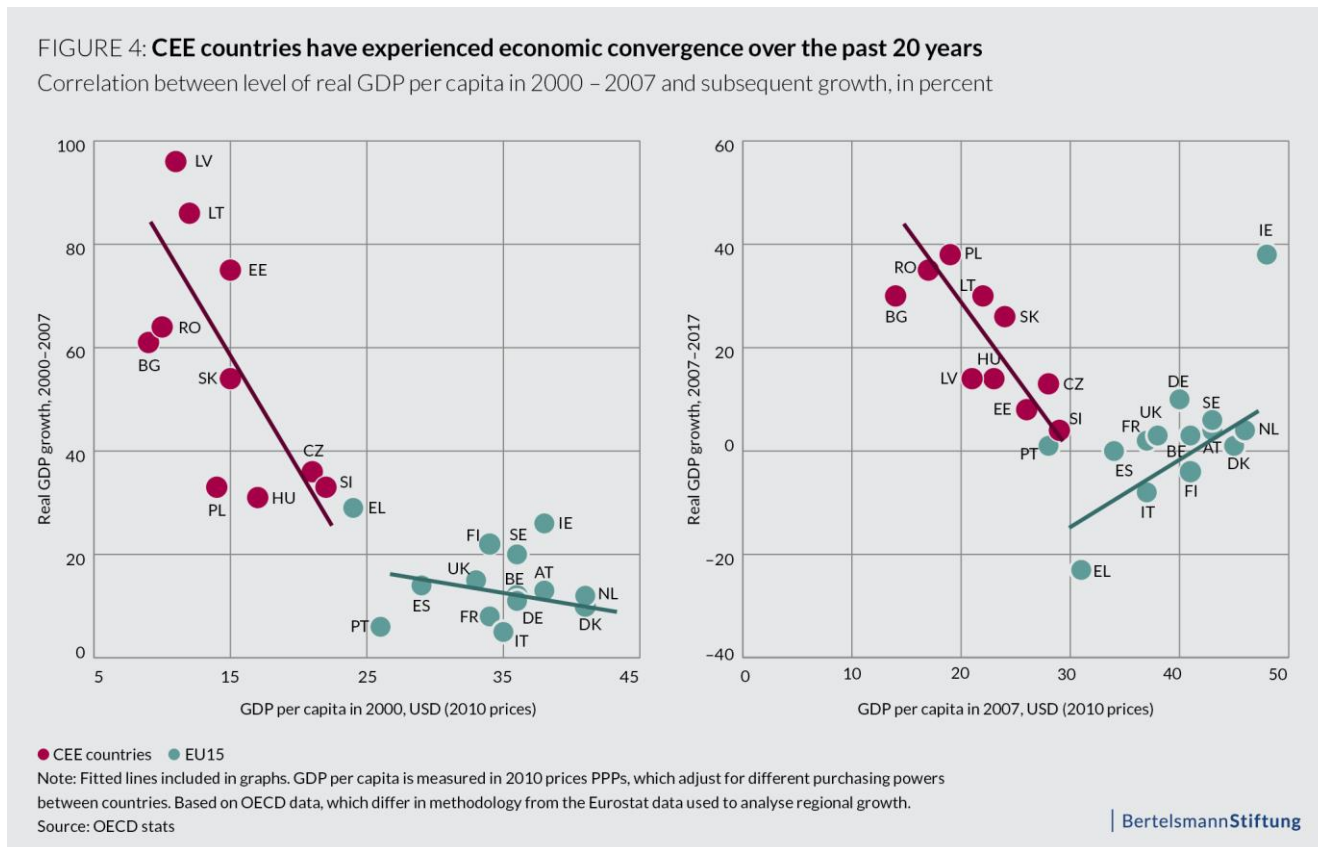
<sup>9</sup> See e.g. Monfort (2008). Convergence of EU regions: Measures and evolution.

## 2.2 Country convergence

Country convergence in the EU over the past decades is a story about two opposing factors:

First, looking across European economic development as a whole, perhaps the most apparent economic trend in recent decades has been the successful catch-up of the CEE countries, *cf. figure 4*.<sup>10</sup> Already in the period leading up to enlargement, these started to surpass the EU15 in economic growth, accelerating further in the run-up to the financial crisis, with, for instance, the Baltics achieving double-digit growth rates. Post-crisis, growth rates for CEE have, unsurprisingly, been more modest; the “easy” catching up gains have dried out as productivity gaps are reduced. Nevertheless, the CEE countries continue to have growth rates in the range of 3 to 5 percent per year. In this sense, economic convergence of the CEE is a success story and showcases the benefits of entering the Single Market.

Second, for the EU15, we see an entirely different picture. Indeed, the financial crisis led to increased economic disparity between the “old” member states; relatively rich countries, such as Germany and Sweden, had higher growth rates than poorer ones, while crisis-stricken countries in the South have been growing at very low levels over the past decade, *cf. figure 4*. Divergence in recovery from the financial crisis could be seen in light of structural issues within labour markets in many of the poorly-performing countries. Some views hold that this in turn gave rise to large fiscal deficits, which may have further destabilised these economies.<sup>11</sup> In the next section, we analyse how the growth dynamics differ at regional level, especially between rural and urban parts of the member states.



<sup>10</sup> This type of convergence is often denoted beta-convergence, *cf. box 3*.

<sup>11</sup> ECB (2012). Euro Area labour markets and the crisis.

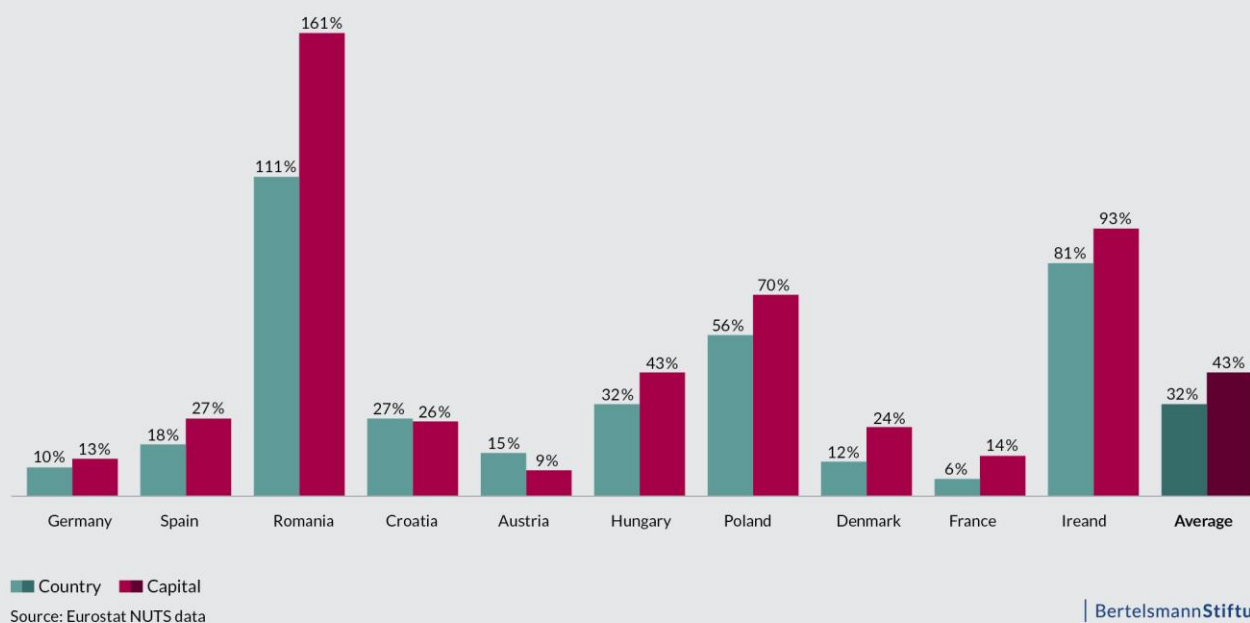
## 2.3 The urban-rural income gap

Within the Single Market, levels and rates of growth can also differ within countries and regions. For example, such a gap is prevalent between urban and rural areas: In particular in CEE countries, cities have been strong growth engines. Since 2000, for instance, almost all EU capitals had stronger GDP growth than the rest of the country, *cf. figure 5*. When analysing the relationship between population density and economic performance in EU regions since 2000, we find that clearly, on average, more populated areas have seen higher growth. At the same time, non-urban regions, especially in southern Europe, have been underperforming; almost all poor southern European regions (which had below average GDP in 2000) also had GDP growth below the EU average from 2000-2017.<sup>12</sup>

Similarly, job creation seems to be increasingly concentrated on urban regions.<sup>13</sup> For example, in Italy, the two urban regions of Milan and Rome represented some 60 percent of total job creation since 2000, although they only account for 25 percent of the total population. In general, 50 percent of the job creation since 2000 in the EU has been centered in regions that make up just a quarter of the EU population. The top performing regions in terms of GDP growth again point towards the role of cities as growth engines. For countries in Eastern Europe, the two highest growing regions are the capitals of Romania and Bulgaria, *cf. box 4*. In the EU15, city regions also top the list, *cf. figure 6*.

FIGURE 5: EU capitals outperform the rest of the country in GDP growth

Growth in real GDP in selected European capitals and rest of the country, 2000 – 2016



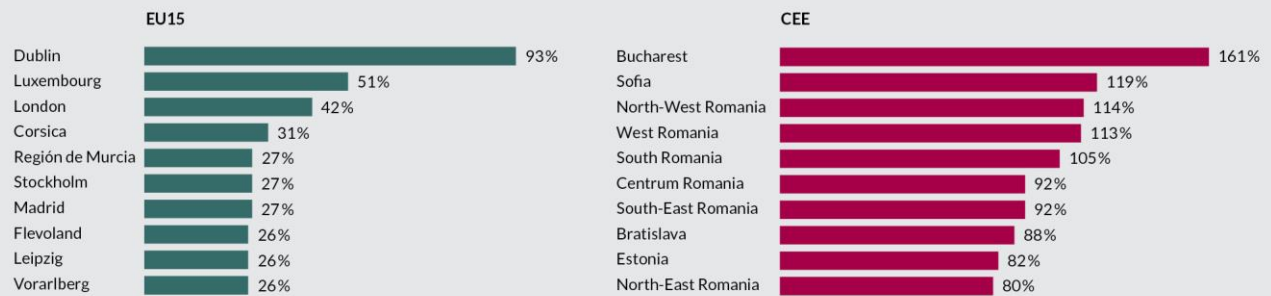
<sup>12</sup> Based on Eurostat NUTS data.

<sup>13</sup> PBL (2016). Cities in Europe: Facts and figures on cities and urban areas.



FIGURE 6: Top 10 fastest growing regions in EU in EU15 and CEE

Real GDP growth, 2000 – 2016



Note: The top 20 regions with the highest GDP growth since 2000 are heavily dominated by CEE countries due to the strong convergence process, as documented in chapter 2. We have therefore looked at the top-10 regions for the EU15 and CEE countries separately. Note that at NUTS 2 level Estonia is considered a region.

Source: Eurostat NUTS data

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#### Box 4

##### The growth miracle of Bucharest

Since 2000, 145,000 new jobs have been created in Bucharest, corresponding to an enlargement of the workforce of some 15 percent. The Romanian capital has achieved an average annual GDP growth rates above 6 percent since 2000, making it the fastest growing region in the EU.

The city's success is multi-faceted. Two important elements are:

- Building on top of a relatively well-educated workforce in sciences, the city has established a strong tech sector, currently employing some 145,000 people out of a total employment of 1.1 million.
- Strong manufacturing of electronics and cars is attracting a large amount of foreign direct investment, amounting to some 3 percent of GDP in 2016.

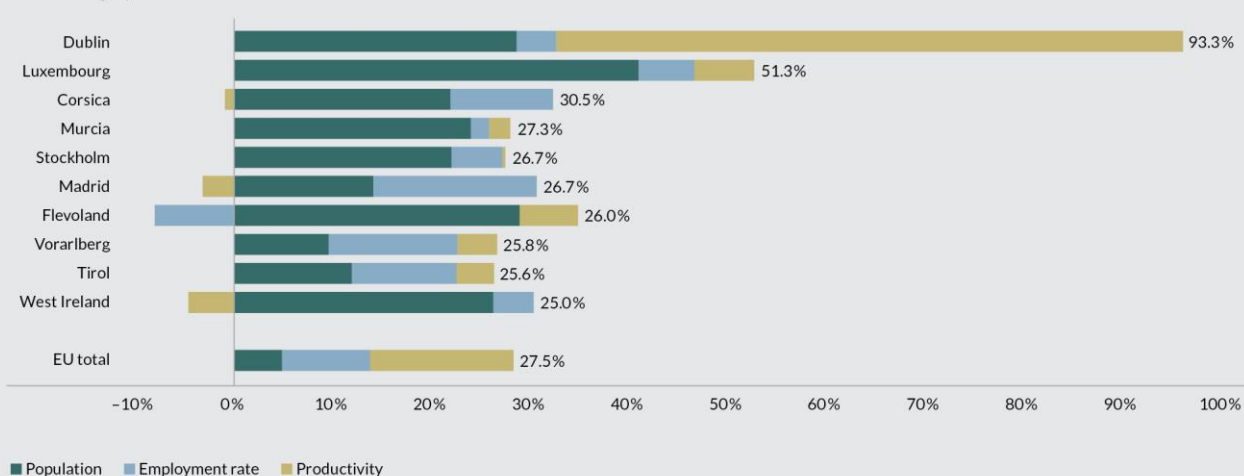
In the EU, GDP grew 24 percent from 2000 to 2016.<sup>14</sup> Of this, population growth contributed some five percentage points, *cf. figure 7*. However, for the top growing regions, population growth provided an average contribution of some 22 percentage points. Most regions also enjoyed a strong contribution from a higher employment rate. This points towards agglomeration effects with labour migrating to cities where jobs with high productivity and high wages are to be found. This is confirmed by a regression analysis, which suggests that cities with high productivity had, on average, the strongest population growth in the past fifteen years.<sup>15</sup> Nevertheless, there are cases where non-urban cities have managed to achieve strong growth, for example through a focus on high value added food production, *cf. box 5*.

<sup>14</sup> Measured with chain-linked values. Note that this might differ from *our* decomposition of growth, where we use current market prices deflated with HICP.

<sup>15</sup> We find a positive correlation between productivity growth and population growth for the past 15 years. In a regression that analyses population growth together with several factors, productivity also turns out to be highly significant.

FIGURE 7: Decomposition of growth in real GDP in selected EU regions, 2000 – 2016

Percentage points



Note: Some observations are missing, meaning that we cannot decompose growth for all top growing regions in figure 6. Decompositions for the regions are based on PPS deflated by HICP. This differs from EU total measure, which uses chain-linked values. Percentages next to bars indicate growth rates net of any positive and negative components. If negative components are involved, net growth does not correspond to horizontal scale on top.

Source: Eurostat NUTS data

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**Box 5****SMEs and high-value added food production secure economic growth in Castilla-La Mancha**

Castilla-La Mancha, located in the centre of Spain, is the third largest region measured in territory and consists mainly of rural land. Though it has traditionally been relatively poor compared to the rest of Spain, with high unemployment, it has in recent years been one of the country's fastest growing regions. Since 2000 the average real GDP growth rate has amounted to some 2 percent per year, above the EU average of 1.75 percent (based on Eurostat data).

This growth is largely driven by small- and medium-sized enterprises (SME) and industry based on the region's agricultural products:

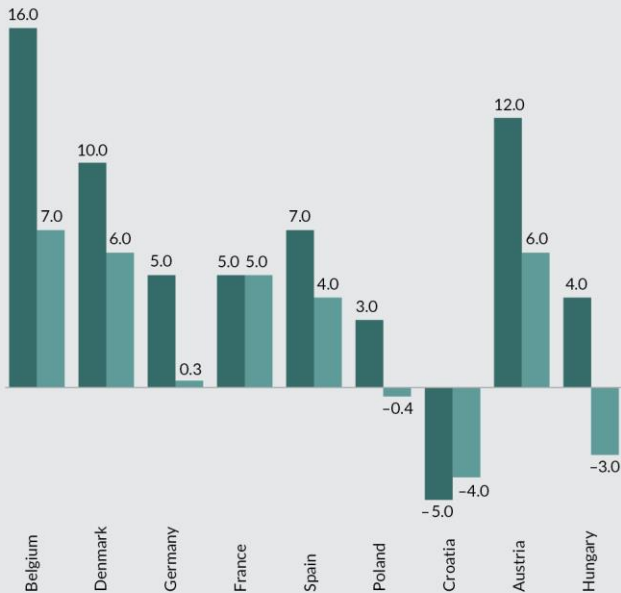
- In 2016, 96 percent of companies in the region had less than 10 employees.
- The primary sector holds a significant weight and accounts for more than 10 percent of Spanish agricultural companies, with a focus on high-value added food production such as olives, arable crops and wine.

Source: European Commission (2018). Report on Internal Market, Industry, Entrepreneurship and SMEs: <https://ec.europa.eu/growth/tools-databases/regional-innovation-monitor/base-profile/castilla-la-mancha>

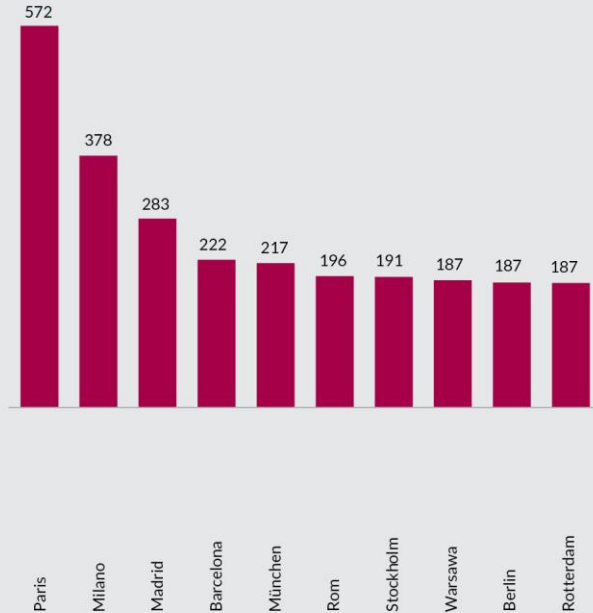
High productivity in major cities is clearly related to the strong concentration of knowledge-intensive sectors. For example, the top 10 EU regions with the highest employment in these sectors include most of the major EU capitals, cf. figure 8. Supporting the notion of EU-wide concentration within hubs, a study by the European Commission finds that high-growth regions in the EU had a large share of their businesses specialised in so-called Key Enabling Technologies, such as micro- and nanoelectronics, nanotechnology, industrial biotechnology and advanced manufacturing technologies.

FIGURE 8: Capital regions have high population growth – and knowledge intensive employment is concentrated on major cities

Population growth, 2007–2017, in percent



Top 10 regions of employment in knowledge intensive service sectors, in 1,000 people employed



■ Capital region ■ Entire country

Source: Eurostat NUTS data

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### National framework policies to improve regional performance

Growth between rural and urban regions is unevenly distributed, with large and still growing cities representing the leading growth hubs. What can be done to prevent underdeveloped regions from permanently falling behind? We find that much of regional success is built on strong national frameworks of education and employment policies, as well as on national infrastructure: For example, having a well-educated workforce is essential to attracting knowledge intensive jobs, which is key to becoming a high-growing region. Educational programmes that qualify one to work within fast-growing key enabling technologies are especially important. Moreover, it is vital (and increasingly so) to have a digital infrastructure if one is to exploit the potential of emerging technologies (see also the cases of Bucharest and Stockholm in *box 4* and *box 6*).<sup>16</sup> While national policies clearly count, what should be the role of the EU Single Market in promoting regionally balanced growth? The subsidiarity principle provides answers that will be discussed in the following chapter.

<sup>16</sup> Berger et al. (2016). Digitalization, jobs, and convergence in Europe: Strategies for closing the skills gap.

## Box 6

### The Nordic tech hub of Stockholm

Stockholm has the highest number of unicorns (start-ups with a market value of EUR 1 billion or more) per capita in the world outside of Silicon Valley and is ranked second in the European Digital City Index. Stockholm's success in its ability to attract and foster innovative start-ups is supported by sound structural economic and industrial policies over the last decades:

- In the 1990s the government invested heavily in its technology infrastructure, establishing high-speed internet, and giving tax breaks for citizens to buy computers. This nurtured a generation of people who grew up with the internet, supporting open access and entrepreneurial collaboration.
- The flexible labour market in Sweden makes the workforce adaptable to new technologies and business structures.
- Sweden unwaveringly prioritises education, with the highest government educational expenditure in the EU, measured as a share of GDP.<sup>17</sup>

Sources: Stockholm Business Region (2016). Stockholm, the Capital of Scandinavia: Annual report 2016, Davison (2015). How Sweden became the start-up capital of Europe, and Eurostat. The Telegraph

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<sup>17</sup> See: [https://ec.europa.eu/eurostat/statistics-explained/index.php?title=File:Public\\_expenditure\\_on\\_education\\_by\\_level\\_of\\_education,\\_2014\\_\(%25,\\_relative\\_to\\_GDP\)\\_BYIE18.png](https://ec.europa.eu/eurostat/statistics-explained/index.php?title=File:Public_expenditure_on_education_by_level_of_education,_2014_(%25,_relative_to_GDP)_BYIE18.png)

### 3 Internal Market policies and subsidiarity: Economic decision rules for regionally inclusive growth

Chapter 2 highlights a key finding: national policy frameworks play an extremely important role in boosting regionally balanced (and thus “inclusive”) economic growth. However, EU internal market policies are not toothless when it comes to affecting economic growth and prosperity across regions. They may not substitute for the national and regional policies that will ultimately drive the growth performance of any given region, as shown above. But they can boost both growth *and* convergence under certain circumstances.

As described in chapter 1, the decision to centralise as opposed to de-centralise is based on several criteria drawn from economic theory: positive externalities as well as economies of scale and scope suggest that centralisation may pay off collectively. On the contrary, whenever local preferences of citizens and governments vary a lot or when local structures are very different, economic theory suggests that there is little EU value added and it should be for the local unit to decide. For each policy domain the crucial question is how large the benefits are compared to the costs. For instance, if positive and negative externalities of policy measures in a given domain go beyond the national level, then this calls for a centralised approach. If, on the other hand, externalities are confined to the regional or local level – or simply do not exist – then responsibility should be delegated to these.

The aim of this chapter is to discuss when it is favourable to centralise and when to de-centralise – based on the analysis outlined above and consistent with a rigorous approach to the principle of subsidiarity. We focus on five selected policy areas of the Single Market: EU regional policy, the common agricultural policy and food regulation, financial market regulation, access to basic infrastructure and – arguably critically – the role of digital technology as the key enabling infrastructure for the future. In these areas we apply economic reasoning and illustrate, using examples, when delegation has worked favourably towards more inclusive growth and when it may not.

#### 3.1 EU Regional Policy

EU policies aim at speeding up economic convergence as well as providing access to a common market. Since the introduction of the Single Market programme in the late 1980s, a substantial part of the EU budget has been spent on boosting economic cohesion. Funding has been directly aimed at improving infrastructure in less prosperous regions, facilitating trade and participation in the internal market, *cf. figure 9*.

Post-enlargement, a large share of the funds has targeted regions in CEE countries. This has improved infrastructure there and is thus likely to have contributed to strong economic convergence. For example, European funds financed some 25 percent of an upgrade of Warsaw airport in 2009-2016.<sup>18</sup> As another example, the fund financed more than half of the Fričovce-Svinia motorway built in 2011-2015, in north-eastern Slovakia, that helps to connect the region to the capital.<sup>19</sup>

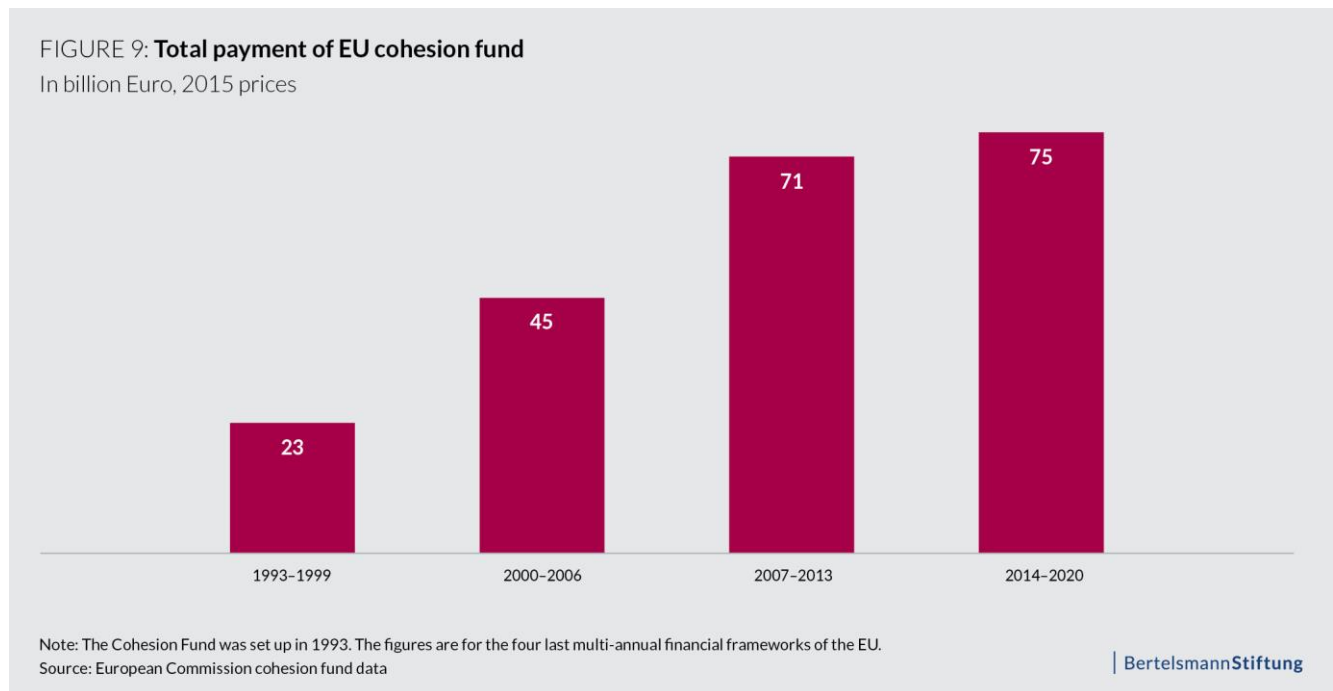
Analysing the two examples from a subsidiarity perspective, there are indeed economic arguments in favour of common EU action: in both examples, the infrastructure improvements did not only benefit the country where the investments took place, but also other European countries that enjoyed increased connectivity in EU. This can be applied to the entire scheme: there are often beneficial spatial spill-overs and positive externalities from the investments supported by the cohesion fund.

The focus of the cohesion fund on CEE countries after enlargement implies a net subsidy from the West to the East. This has boosted growth in these countries, paving the way for a larger and more productive Single Market,

<sup>18</sup> See: [https://cohesiondata.ec.europa.eu/projects/row-4i29.vham\\_8p7g](https://cohesiondata.ec.europa.eu/projects/row-4i29.vham_8p7g)

<sup>19</sup> See: <https://cohesiondata.ec.europa.eu/projects/row-pehx.r6u8.hxn8>

which in turn also benefits the original EU members. This justifies an EU-coordinated effort, i.e. once more one that is compliant with the principle of subsidiarity.



There do, however, exist cases of EU regional policy that entail only moderate or even negligible positive externalities: For instance, this policy instrument has been used to fund pedestrian walkways in parts of Germany. Clearly, the positive externality of investments of this type are fairly low. In such cases, regions and local areas should be given the responsibility to decide which type of project to fund. This could ultimately lead to more efficient use of funds, which do not necessarily have to be provided by the EU. Thus, in the spirit of subsidiarity and proportionality, projects with little positive and/or negative spill-over potential across the EU should be delegated to the local level. As outlined in chapter 1, another argument in favour of local decision-making is citizens' preferences: citizens' tastes may in fact be very different across EU regions. Hence, building specific local infrastructure may best be determined locally.

### 3.2 CAP and food regulation

EU policies that do not have an explicit geographical objective or target may nonetheless have undesired repercussions on the geographical location of economic activities. This is exemplified by the EU Common Agriculture Policy (CAP), a key EU policy since 1962. A main policy ingredient is direct subsidies to agricultural businesses, which take up around 40 percent of the total EU budget, corresponding to some EUR 50 billion per year.<sup>20</sup> There has been a long-standing debate if this funding could not be more productively deployed elsewhere, e.g. in supporting digital infrastructure to remote regions as described below.<sup>21</sup>

We first note that there are little to no cross-border positive externalities of the CAP that could justify an EU subsidy on this scale. On the other hand – and without going further into that discussion – we note that the funding could by itself hamper the transition of rural regions to other, potentially more productive sectors: The CAP is designed in a way that reinforces existing structures, holding back shifts to more effective use of land.<sup>22</sup> It creates

<sup>20</sup> European Commission (2018). CAP post-2013: Key graphs & figures.

<sup>21</sup> Berger et al. (2017). How Europe can deliver: Optimising the division of competences among the EU and its member states.

<sup>22</sup> Pe'er et al. (2017). Is the CAP Fit for purpose? An evidence-based fitness-check assessment.

dependencies on subsidies, which could block innovation and up-skilling of personnel in rural regions. The requirement for receiving CAP subsidies is fields fit for agricultural use. Consequently, some farms have fallow cropland simply to receive CAP funds. This means that the land cannot be used for other value streams, such as eco-tourism, or building infrastructure to facilitate highly-productive sectors.

Similarly, there are indications that the EU in some instances lost track of the proportionality principle in regulating agricultural products within the Single Market, as highlighted by the example of organic food regulation: The EU has recently implemented stricter rules on production to meet the expectations of consumers. Organic food production is an obvious opportunity for agriculture-based regions to shift to higher added value output. However, the new requirements make this shift more compliance-heavy and costly. This could delay the step up to ecological farming, especially in areas with small producers as they cannot utilise economies of scale in such a shift.

Finally, preferences of citizens and regional governments as regards supporting agriculture may be very different. In some EU countries, agriculture may be a particularly strong source of growth and employment (e.g. France and the Netherlands), whereas this sector plays a more moderate role elsewhere (e.g. in Germany and in the UK). Given this heterogeneity of preferences, economic theory suggests that decision-making should tend towards de-centralisation. In summary, the CAP could be deemed a case in point where delegation to a lower level of governance could be more profitable from a viewpoint grounded in economic theory.

### 3.3 Financial market regulation

The current design of financial regulation is set out to prevent big sophisticated banks from creating systemic risks. However, regulation has not sufficiently been scaled down to suit smaller local banks that primarily service SMEs and households in less populated areas. Consequently, compliance costs have soared for many smaller banks since the financial crisis – to a much larger extent than for the big banks.<sup>23</sup> These costs are to some degree passed on to customers, which may lead to increased funding costs in non-urban areas primarily serviced by small local banks. Thus, we argue that financial regulation has somewhat lost track of proportionality in recent years – and this could dampen economic growth in many regions.

We do not dispute that regulatory reform was needed and certainly see an EU value added in a harmonised regulation. That is, centralisation gives rise to economies of scale and scope as it eases the provision of goods and services by firms in the Single Market. But given the principle of proportionality, it is questionable as to why increased EU involvement should lead to an exponential increase in regulatory complexity especially when adverse spill-over effects are low, as in the case of local banking. If anything, a lesson from the financial crisis was that the regulatory system had become too complex, hampering transparency. For example, the regulatory checklist a bank needs to fill out to open a bank account, or the reporting requirement for liquidity sufficiency (to name but two) have increased substantially since the financial crisis. Larger banks can exploit automation and economies of scale to curb costs, an option less available for smaller banks.<sup>24</sup>

An example illustrates this: The recently implemented Markets in Financial Instruments Directive (MiFID II) imposes strong cost transparency requirements for different players on the financial markets, e.g. investment banks, mutual funds, asset managers, etc. Although costly, larger institutions have the capacity to implement the requirements, but there is a high risk of smaller, more specialised (and local) players being crushed by the requirements. Therefore, parts of financial markets regulation for small players could be delegated to the local level, too.

<sup>23</sup> Federal Reserve Bank of St. Louis (2018). Compliance Costs Economies of Scale and Compliance Performance.

<sup>24</sup> Carvalho et al. (2017). Proportionality in banking regulation: a cross-country comparison.

### 3.4 Access to basic infrastructure in the Single Market

The EU has implemented the Universal Service Obligation (USO), which ensures that all EU citizens have access to basic service infrastructure regardless of their geographical location. The principle has especially been relevant in the energy, telecommunications, and postal sectors, which were previously almost exclusively run by state monopolies, but then gradually liberalised between 1990 and 2010. From a strict commercial basis, in several instances, it was unprofitable to establish and maintain services for thinly populated areas. Yet EU directives have successfully implemented minimum standards across the Union, ensuring continued service for all citizens regardless.<sup>25</sup>

Beyond such minimum standards, however, there is considerable scope for the member states to define how they implement the USO and whether they want to go above the minimum requirements. Consequently, the implementation of USO in the three above-mentioned sectors varies nationally, both in function and quality.

For example, some member states have implemented price caps, others have set up Universal Service Funds, which compensate companies for servicing rural areas. In postal services, countries such as France have very detailed schemes on the permitted delivery time for different types of parcels and letters. Other countries place much broader and less restrictive requirements on their USOs.<sup>26</sup>

The benefit of this broad definition of USO at EU level resonates well with the subsidiarity principle. It provides member states with the freedom to implement it in a way that is adapted to national general standards of the service and the structures on the market for the particular USO.

The downside of this approach is, hardly surprisingly, that the level of these essential services differs between member states. With further integration of the Single Market, the different levels of quality in universal services across the EU could increasingly pose a hurdle to the freedom of production and provision of goods and services. Increasing mobility of labour and capital could mean that these will migrate to well-served regions, i.e. already highly productive regions, resulting in increased regional economic disparity.<sup>27</sup>

However, in pushing a broader level of connectivity within the Single Market it is important to aim for technology and institutional neutral solutions. This implies rules that ensure that local economic conditions are included when determining the most advantageous delivery systems. In particular, we suggest that regulatory options for future national USO should be evaluated at national level. The review of potential changes in USO requirements is best achieved using a cost-benefit approach that compares the impact on the USO's net cost to the impact on users and other stakeholders. A cost-benefit analysis gives a sound knowledge base for policy decisions. Such an analysis must take the specific circumstances of the member states into account and cannot simply be based on generic assumptions.

Again, there exists heterogeneity in preferences and local structures across countries – both of which require solutions that are different from the “one size fits it all” principle. That is, some countries are more likely to require changes to the national USO than others. As an example, the structures of the postal sector are rapidly changing owing to declining annual letter volume and a decrease in population density in already lowly populated areas. This makes the current USO standards increasingly expensive to uphold. However, these factors differ significantly from country to country. Thus, in order for the Postal Services Directive to stand the test of time, it should be considered to address this by introducing elements of flexibility into it. For example, lowering its minimum requirements or allowing for a greater use of exemptions might be considered.

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<sup>25</sup> Maziarz (2015). Universal Services in EU Law In The Era Of Liberalization.

<sup>26</sup> See Ambrosini et al. (2006). Universal Service Obligations in the Postal Sector: Economic Learnings from Cross-Country Comparison.

<sup>27</sup> This was demonstrated by the seminal paper by Charles Tiebout (1956). A Pure Theory of Local Expenditures. The mobility of residents creates a market-type mechanism that where communities compete to best meet the demand for local public services – “voting with the feet”. See also Kim and Dougherty (2018). Fiscal decentralisation and inclusive growth: An overview.



### 3.5 Digitalisation: A stronger role in internal market policies

The EU's handling of the digital transition is going to be vital for job creation and prosperity in the coming decades. Technologies such as artificial intelligence, robotics, Internet of Things (IoT), nanotechnology, 3D printing and biotechnology are not only major growth factors.<sup>28</sup> In what is often described as “the fourth industrial revolution”, these digital technologies are about to transform the way goods and services are produced and distributed across borders.<sup>29</sup>

The process holds many possibilities for inclusive growth. For example, digital connectivity in remote areas could enable households and firms outside the highly productive hubs to participate more extensively in the Single Market. This way, agglomeration effects can be mitigated (as discussed in chapter 1).<sup>30</sup>

Yet, digitalisation also entails risks of job redundancy; it requires an adequate digital infrastructure for a region to exploit the opportunities. Digital infrastructure can thus be regarded as a basic pre-requisite for growth and job creation in the coming decades.

Europe's digital infrastructure is currently inadequate to guarantee inclusive growth in the digital transformation. Studies show that the level of access and quality of connection vary greatly throughout the EU. National targets are often insufficient, e.g. they are based on current standards, thereby becoming gradually outdated.<sup>31</sup> Especially eastern European regions lack high-speed connectivity. Novel technological advancements could alleviate this weakness. For example, the satellite industry has recently made some significant advances, rendering the technology a viable alternative in thinly populated areas, where it could be unprofitable to establish broadband access.<sup>32</sup>

The absence of relevant infrastructure sets its clear mark on connectivity in the EU. Only 4 percent of internet traffic from EU countries goes to online services in another European country, whereas 54 percent of it goes to services in America. And only 15 percent of European consumers have ever crossed an EU border while shopping online.<sup>33</sup>

Overall, the role of the EU in building the future digital infrastructure highlights the dilemma in terms of subsidiarity and proportionality.

- On the one hand, broadband should be included as a USO at EU-level. Telecommunications and postal services were imposed as universal obligations, as these were essential for connectivity – so the very same argument could be applied to internet access. There could indeed be clear benefits from enacting minimum standards and harmonisation across EU to ensure that no region is left behind.
- On the other hand, such an approach entails the risk of, first, not taking local business structures sufficiently into account and, second, implementing standards that are already outdated when implemented. Consequently, if broadband is included as a USO, it should be through a very flexible scheme, containing broad recommendations, leaving out technical minimum standards and other details that could instead be set at the regional or national level.

<sup>28</sup> The Digital Economy is growing seven times faster than the rest of the economy, cf. European Parliament (2018). The regions in the digital Single Market.

<sup>29</sup> World Economic Forum (2016). The Future of Jobs Employment, Skills and Workforce Strategy for the Fourth Industrial Revolution.

<sup>30</sup> Ziemann (2017). Inclusive labour markets in the digital era: The case of Austria.

<sup>31</sup> OECD (2018). Bridging the rural digital divide.

<sup>32</sup> OECD (2017). The evolving role of satellite networks in rural and remote broadband access.

<sup>33</sup> See: <https://www.economist.com/business/2015/05/09/disconnected-continent>.

Failing to reap the benefits of widespread digital infrastructure would be a missed opportunity for job and productivity growth in more remote regions of the Single Market. The EU has seen increased migration of high-skilled labour to major cities and prosperous regions in the past decade in parallel with step-changes in information technologies that make physical proximity less relevant. This may reflect very strong agglomeration benefits for the high-tech sector but it also shows that the potential for connecting firms and employees across different physical locations has not been fully exploited.

The EU has taken a step in the right direction with the digital Single Market strategy. It aims to establish common rules for online purchases and remove geo-blocking for streaming services. However, the strategy has yet to be followed up by concrete initiatives to create a unified digital Single Market. When expanding across the EU, digital businesses need to deal with 28 sets of national contract laws. This prevents tech companies from getting sufficient scale in the early stages, which is vital in a market where first-mover advantage is everything. Consequently, the ability to grow large tech enterprises servicing the mass markets of the EU is lagging. At Thomson Reuter's top 100 list of leading tech companies, Europe is only represented with 14 companies. In comparison, North America (which has a smaller population) has 48 companies among the top 100.<sup>34</sup> Thus, these foregone opportunities of economies of scale and scope make the case for a centralised digital Single Market strategy.

In light of the above analysis of the current state of “digital” affairs in Europe, we can draw the following takeaways based on the subsidiarity principle. We clearly see an added value in solving these issues at EU level:

- Physical proximity matters little in the provision of digital services. Thus, different corporate and contract legislation related to digital service provision in each country is an unnecessary obstacle to a unified digital market. For example, too many different laws on digital products prevent companies from making use of economies of scope.
- Each member state has little negotiating power in regulating tech giants and large digital players with significant market power. Therefore, any viable regulatory solution should come from the EU level.
- The borderless nature of digital companies makes their workforces mobile and very dependent on an adequate digital infrastructure – this could be an argument for ensuring a minimal level in each country if the EU as a whole is to capitalise on technology-driven growth.

While the EU could provide the suitable (regulatory) framework for the Single Market, member states also possess distinct roles in the ever-digitalised economy. For example, regions may have different preferences for their strategy to provide a digital infrastructure: member states have broad scope for funding broadband services, e.g. through local players or large incumbents. Indeed, under the 2002 update of the Universal Service Directive (USD), member states have the flexibility to decide specifics such as the speeds, funding or pricing of broadband services.

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<sup>34</sup> Thomson Reuters (2018). The Top 100 Global Technology Leaders.

## 4 Recommendations: Subsidiarity and proportionality for a common good perspective

Based on economic analysis, we suggest that the principles of subsidiarity and proportionality should be applied by putting a stronger emphasis on three important questions:

- Basic economic rationale: Is there a basic justification for central policy decision making using the well-established criteria based on economic analysis (spill-overs, economies of scale and scope, preferences and local structures)?
- Cost-benefit analysis: Is the proposed measure likely in practice to have a net positive effect, bearing in mind regulatory complexity and possible adverse effects in specific locations?
- Long-term outcome assessment: Is the measure sufficiently focused on delivering the desired outcomes, recognising different local circumstances and a changing technological and market environment?

Applying the principles of subsidiarity and proportionality, these questions in fact envision an EU that is orientated towards a **common good** perspective: in areas where the EU can provide a value added for citizens, it should indeed act and, this way, provide a common good. The common good can take various forms, e.g., specific regulation in the Single Market or leadership in crisis situations. But any such EU-level action should be guided by the idea that member states and its citizens are provided with a clear-cut value added. Conversely, in areas where it may not be capable of providing such value added, national or subnational governing bodies should take the lead.

Keeping the common good perspective in mind and applying the principles of subsidiarity and proportionality, our findings imply a set of recommendations that follow from our review of several specific EU policy areas. Specifically, we propose:

- More flexibility in instruments to create a digitally connected EU
- More proportionality in regulation of financial markets and food production
- More innovation in developing regulatory regimes

### 4.1 More flexibility in creating a digitally connected EU

Digital transformation of the economy has the potential to be the main growth driver in the years to come and – if done right – could alleviate the widening gap between economically strong and weaker regions and thereby address the urban-rural gap. The EU will have to decide on the shape and scale of its involvement in this transformation. We recommend the following specific regulatory initiatives to reap the potential benefits of digital transformation and achieve regionally inclusive growth at the same time. In so doing, we highlight the need to focus EU regulation on areas where joint action has substantial value added while integrating “digital subsidiarity”.

#### Key priorities for action with high value added from EU level intervention

- No virtual borders: Digital service providers do not operate within physical borders – neither should the legal and contractual framework within which they operate. This calls for a single EU point of contact for compliance and legal purposes, which would also allow remote regions to participate with more ease in the digital Single Market.
- Promote subsidiarity to provide world-class digital infrastructure: EU cohesion funds have focused on transportation infrastructure, i.e. increased connectivity and mobility of physical goods. As the economy shifts to the digital realm, there is a growing need to target cohesion funds accordingly. This includes both setting up an adequate (physical) internet network, but also ensuring that corporate sector interactions with the public sector are digitalised. Promoting digital connectivity must be a priority for the EU – but the precise nature of implementation strategies should be up to countries because of different preferences and local

structures. Sufficient digital infrastructure in regions is also a key lever to more inclusive growth across regions – after all, we showed in the previous chapter that winning regions can also be characterised by an advantage in digital infrastructure.

## 4.2 Increased focus on proportionality

Case studies suggest that the EU in some instances lost track of the proportionality principle in regulation. This is also recognised in the Timmerman task force on subsidiarity and proportionality.<sup>35</sup> Two concrete examples highlight this shortcoming:

- Organic food regulation: The EU has recently implemented stricter regulation on organic food production that could slow down the shift to ecological farming. As we discuss in chapter 3, economic analysis suggests that preferences and local structures related to the role and economic importance of the agricultural sector vary a lot. Thus, in the spirit of subsidiarity and proportionality and given the low levels of spill-over effects and economies of scale from food regulation, a case for stronger national responsibility can be made.
- Post-crisis financial regulation: We recommend an increased focus on proportionality and simplicity in financial regulation. EU involvement should not equate increased complexity with an increased compliance burden. This will especially benefit rural areas, ensuring inclusive growth going forward. Small financial institutions often services less populated regions. They cannot utilise economies of scale in implementing new regulation.

## 4.3 Innovative regulation: The use of regulatory sandboxes

A concrete initiative to implement more proportionality in EU regulation can come through regulatory sandboxes targeted at start-ups. Comprehensive regulation imposes very high barriers of entry, hampering the emergence of new innovative players. As a solution to this problem, some countries have established regulatory sandboxes. So far, the concept has primarily been used in the financial sector. Small financial services start-ups (e.g. in FinTech) that are well below critical size face less restrictive and comprehensive regulation. The idea is that these players are still so small, that they provide no threat to financial stability. This allows these emerging players to gain sufficient scale before they are subject to full-scale regulation. Through product and business innovation these services are set to foster productivity growth at the regional level.

In addition, regulatory sandboxes provide guidance to new start-ups on how to be compliant with financial regulation. Many start-ups within finance are tech-based – often without a previous background in the sector – and thus have little knowledge of financial regulation. This aspect has become relevant to competition between different financial regulatory sandboxes aiming at attracting new start-ups.

Despite being a relatively new concept, the regulatory sandboxes have already proven successful in fostering new players within finance.<sup>36</sup> These positive experiences can be applied to EU regulation more broadly in two dimensions: First, they showcase the benefits of imposing a small compliance burden on start-ups to allow them to focus on gaining scale. Second, and maybe more interestingly, they show the benefits to be accrued if authorities, as well as ensuring compliance, help start-ups to overcome regulatory burdens. That is, the authorities partially act as mentors to the companies they regulate to guide them on the road to success.

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<sup>35</sup> See EU (2018). Report of the Task Force on Subsidiarity, Proportionality and “Doing Less More Efficiently”.

<sup>36</sup> See: <https://www.fca.org.uk/publication/research-and-data/regulatory-sandbox-lessons-learned-report.pdf>.

This report shows that subsidiarity and proportionality, both general principles of EU law, can play a key role in mitigating growth imbalances across EU. It focuses on key areas of the Single Market. Yet the recommendations are not meant to be comprehensive: challenges from digitalisation, external pressures of migration, greater global competition in high-value products from firms across the world, trade policy issues – these all call for a broader review of what could be done at EU level to boost growth both at the regional and the aggregate country levels.

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