**Financial compliance in the European Union: A cross-national assessment of financial correction patterns and causes in Cohesion policy.**

**Abstract.** EU compliance scholarship has expanded rapidly over the last decade but has neglected the financial dimension of compliance in terms of Member States' conformity with EU financial rules on the regularity and legality of EU spending. This article makes the case for a multi-dimensional approach to compliance research and provides a cross-national assessment of financial compliance in EU Cohesion policy, employing quantitative and qualitative methods. To account for cross-national variations in the application of financial corrections for non-compliant spending, several factors are explored, focusing on regional autonomy, administrative capacity and goodness-of-fit. The quantitative analysis finds strong support for the impact of administrative capacity on cross-national compliance patterns and some evidence for the role of goodness-of-fit. Contrary to expectations, regional autonomy is not associated with compliance in this critical case of EU multi-level governance. Qualitative analysis reinforces these findings and reveals additional factors of relevance.

## INTRODUCTION

Over the past two decades, financial compliance has increasingly become a salient priority for EU policy-makers. In November 2015, the European Court of Auditors (ECA) annual report on the EU accounts issued a negative statement of assurance – as it has done every year since 1995 when such statements were first issued - on the legality and regularity of payments on the basis that they were "materially affected by error" (ECA 2015). The persistently high level of irregularities in EU spending affects the reputation of the European Commission and its relations with the European Parliament; and it has been cited in European Council debates on the EU budget to justify reductions in expenditure and prompted criticism of the implementation of policies such as the CAP and Cohesion policy. The problems with financial compliance go to the heart of the relationship between the EU and Member States, and the balance between Commission oversight and national implementation of the EU budget, notably under budget headings subject to 'shared management'.

Consequently, since the early 2000s and particularly over the 2007-13 period, EU regulatory frameworks for financial management, control and fraud prevention have been progressively strengthened. The investigative and coordinative capabilities of the Commission have been enhanced, and Member States have been subject to greater accountability for their financial management and more coercive measures in the form of payment interruptions, suspensions and corrections (Mendez and Bachtler 2011; Porras-Gómez 2013).

EU compliance scholarship has mushroomed during the last decade (Mastenbroek 2005; Toshkov 2010; Angelova *et al*. 2012). However, the financial dimension has been overlooked

in these studies, which focus mainly on the legislative transposition of EU Directives across a range of regulatory policies. This may reflect the popularity of a regulatory conception of the EU, which downplays the EU's role in budgetary policies. Yet, the EU budget is substantial in some policy areas, plays a fundamental role in delivering the EU's regulatory objectives, and provides the political and financial underpinning for economic and monetary union, the single market, the Europe 2020 strategy and EU enlargements. Further, measures of financial regularity provide quantifiable and internationally comparable data on non-compliance during implementation. This has the potential to take compliance research beyond transposition and open up the 'black box' of the application of EU law (Hobolth and Martinson 2013), testing whether the cross-national compliance patterns and determinants in studies of EU Directives remain valid at the implementation stage.

Against this background, the aims of this article are two-fold. First, it makes the case for a multi-dimensional understanding of EU compliance by going beyond the legislative and legal dimensions (transposition or infringement proceedings) and introducing a financial dimension (the regularity and legality of EU expenditure). Second, it undertakes an empirical assessment of financial compliance patterns and determinants, using EU Cohesion policy as a case study, to establish whether and how the financial dimension of compliance differs from the legislative and legal dimensions.

EU Cohesion policy, implemented in all 28 Member States through Structural and Investment (Cohesion) Funds, is a relevant domain for investigating financial compliance given that it accounts for a third of the EU budget with an allocation of €347 billion in 2007-13. It suffers from a major compliance 'problem' reflected in the consistently higher level of 'irregularities' (infringements of financial rules) than in other areas of EU expenditure (Mendez and Bachtler 2011; ECA 2015).

Cohesion policy has a unique multi-level governance model of implementation encompassing EU, national and sub-national actors (Hooghe and Marks 2001). By contrast, subnational competences in the transposition of EU Directives are often secondary to the role of national governments (Falkner et al. 2007; Borghetto & Franchino 2010). If subnational autonomy matters in explaining non-compliance with EU Directives (Angelova *et al*. 2012; Borghetto and Franchino 2010; Toshkov 2010), it should matter even more in this paradigm case of multi-level governance.

Lastly, despite the increasing scholarly interest in compliance issues in Cohesion policy (Davies and Polverari 2011; Levy *et al.* 2011; Mendez and Bachtler 2011), there has been no theory-driven research of the cross-national variations and causes in this field. Does non-compliance in EU Cohesion policy vary across countries? If so, what are the underlying determinants? Drawing on cross-national data and employing qualitative and quantitative methods, this article explores the importance of financial compliance and provides the first comparative assessment of financial compliance patterns and determinants in EU Cohesion policy.

The next section develops hypotheses for investigating compliance performance in Cohesion policy, drawing on the compliance literature. The methodology is then presented, followed by an overview of the financial compliance regime. The empirical analysis maps out cross-national differences in financial compliance using a quantitative indicator (the rate of corrections associated with irregularities) and tests the explanatory power of three factors: regional autonomy; administrative capacity; and goodness-of-fit. The findings differ from the conclusions of transposition research, both in terms of compliance patterns and the influence of political decentralisation. Wider implications are presented in the conclusions.

**COMPLIANCE THEORY AND EXPECTATIONS FOR COHESION POLICY**

The academic literature on EU compliance has expanded greatly recently (for surveys, see Mastenbroek 2005; Toshkov 2010; Angelova *et al.* 2012), advancing our understanding of compliance and policy implementation, building bridges between qualitative and quantitative traditions in EU Studies and stimulating lively scholarly debates (Falkner 2007; Falkner *et al*. 2007; Thomson 2007; 2009; Toshkov 2007a; 2007b; Mbaye 2009; 2010; 2013). However, there are limits to the general applicability of the findings (Angelova *et al.* 2012; Toshkov 2010). The focus on Directives has diverted attention from compliance with Regulations, the more prevalent and directly enforceable legal instrument of the EU. Other well-known biases include the focus on legislative (transposition) processes or legal enforcement (infringement) proceedings - rather than implementation outcomes - in two EU policy areas (mostly social and environmental policies).

A less-recognised limitation is the narrow conceptualisation of compliance implicit in existing studies, which have excluded financial compliance with EU rules on the regularity and legality of expenditure. Nevertheless, the literature provides relevant insights and testable hypotheses for investigating financial compliance. A range of EU, domestic and policy-specific factors has been identified to account for variations in compliance (reviewed in detail in Toshkov 2007; Angelova *et al*. 2012). Drawing on this research, three main factors are empirically relevant to Cohesion policy.

*Regional autonomy.* Territorial governance arrangements can play a fundamental role in shaping compliance outcomes by determining the number and power of veto points in the policy process (Haverland, 1999; Steunenberg, 2006; König and Luetgert, 2009; Mbaye

2009). In political systems that grant subnational/regional governments greater autonomy (e.g. decentralised or federal political systems compared to centralised systems), there is a greater opportunity for regional governments to block compliance, while more centralised systems may be able to enforce compliance centrally. The negative relationship between regionalism/federalism and compliance is "well established" in quantitative studies of EU compliance (reviewed in Toshkov 2010) and is supported in qualitative case study research (e.g. Bursens 2002).

Going beyond general measures of regional autonomy at the level of the polity, it is appropriate also to consider policy-specific measures of autonomous subnational decision-making capacity. In the case of Cohesion policy, a distinction can be made between national and regional programmes, the latter granting greater decision-making autonomy for subnational actors tailored to regional contexts and interests. Following the same logic as regionalisation/federalism arguments in compliance studies, the implementation of regional programmes can provide opportunities for subnational actors to subvert or veto EU and national rules; and central oversight, coordination or enforcement may be more challenging in regional programmes compared to national programmes managed centrally. These considerations inform two hypotheses about the impact of regional autonomy and programming on non-compliance:

> **Hypothesis 1a: Non-compliance increases with the level of regional autonomy in the political system.**
>
> **Hypothesis 1b: Non-compliance increases with the level of programme regionalisation in Cohesion policy funding.**

Theoretically, the impact of regional autonomy on Cohesion policy implementation can also be positive (Tosun 2014). Political decentralisation could facilitate effective implementation if it promotes more accountability in policy delivery and may support financial compliance (Polverari 2015). Moreover, the rationale underpinning Cohesion policy's multilevel governance model of decentralised delivery and its partnership principle is that tailoring the policy to regional/local preferences and conditions supports effective implementation by eliciting local knowledge and increasing ownership (Barca 2009). These accountability considerations inform alternative hypotheses to the previous two by positing a negative relationship between non-compliance and regional autonomy and programming:

> **Hypothesis 2a: Non-compliance decreases with the level of regional autonomy.**
>
> **Hypothesis 2b: Non-compliance decreases with the level of programme regionalisation in Cohesion policy funding.**

*Administrative capacity.* Managerial approaches stress the role of administrative capacity in explaining compliance outcomes (Berglund *et al.* 2006; Falkner *et al*., 2005; Hille and Knill, 2006; Mbaye, 2001; Knill 1998). The theoretical reasoning is that smaller or ineffective bureaucracies lack the resources or capability to comply, to provide the information necessary to reduce compliance uncertainty or to coordinate and enforce compliance. A review of the first generation of studies found that 'the only factor that seems to find support in most quantitative analyses so far is various aspects of administrative capabilities' (Trieb 2008). Recent studies confirm the positive effect of administrative effectiveness on transposition timing (Toshkov 2010; Konig and Mader 2014), although a comprehensive meta-analysis reported mixed results and called for more empirical research (Angelova *et al.* 2012).

While the role of administrative capacity in Cohesion policy has received increased attention in recent years (European Commission 2014a), studies have examined the impact of capacity on economic performance (Becker *et al*. 2011; Rodriguez-Pose and Garcilazo 2013) and financial absorption (Tosun 2014) rather than compliance. Nor has the financial dimension of compliance been the primary focus of qualitative case studies of administrative implementation on a sub-set of regions (Milio 2007) or EU10 countries (Bachtler *et al*. 2013). Nevertheless, these studies do find a positive link between capacity and implementation performance. The importance of capacity for effective implementation is echoed in Cohesion policy evaluations (Bachtler *et al.* 2009) and is reflected in the 2013 reform of the policy, which established a new thematic objective for 'enhancing the institutional capacity of the public administration', and the creation of administrative capacity units in the Commission to support capacity-building. The third hypothesis therefore is:

> **Hypothesis 3: Non-compliance increases with the ineffectiveness of Member States' administration**

*Goodness-of-fit.* One of the most prominent explanations of EU compliance is the 'goodness-of-fit' between EU and domestic policies and goals (Haverland 2000), the expectation being that non-compliance increases with the level of 'misfit' between the domestic *status quo* and EU policies or goals (e.g. Heritier 1996). Many quantitative and qualitative studies have confirmed the positive effect on compliance performance of goodness-of-fit, measured with a range of variables including fit with national policies, legacies, structures and financial consequences (reviewed in Angelova *et al.* 2012).

A pertinent indicator of goodness-of-fit in EU Cohesion policy is the proportion of EU versus domestic funding for economic development. In countries where Cohesion policy funding

accounts for a major share of public investment, there is less scope to fund purely domestic policies, and EU frameworks/rules exert a powerful influence on the design of domestic regional development strategies, instruments and rules (EPRC & EUROREG 2010). Conversely, in more-developed countries with relatively small EU financial allocations, there may be less alignment between EU rules and established domestic rules for national regional policies, requiring managing authorities and beneficiaries to undertake dual compliance for projects (Davies and Polverari 2011). Formulated as a hypothesis:

- **Hypothesis 4: Non-compliance increases with the scale of domestic expenditure for development relative to Cohesion policy expenditure.**

## RESEARCH DESIGN AND METHODOLOGY

Employing a mixed methods approach, this study uses quantitative and qualitative data to examine the extent and causes of financial compliance in EU Cohesion policy across the EU25 Member States. The focus is on the European Regional Development Fund (ERDF) because it accounts for the majority of Cohesion policy expenditure and operates on a more decentralised basis than the other Social and Cohesion Funds within the remit of Cohesion policy, a necessary condition for assessing the impact of regional autonomy on compliance.

As Mbaye (2009) notes, the measurement of compliance is inherently difficult. Hence, for the dependent variable a measure of financial non-compliance is used in the form of data on financial corrections. These measure the amount of EU funding withdrawn from programmes because of 'irregularities' - defined by the EU as 'any infringement of a provision of EU law which has, or would have, the effect of prejudicing the general budget of

the European Union by charging an unjustified item of expenditure to the general budget' (article 1.7 of Regulation 1083/2006). This is a quantified and comparable measure of non-compliance at the implementation stage. By contrast, most studies of Directives examine indirect measures of the timing of transposition into national law with varying assumptions about the length of delay that constitutes non-compliance and ignoring implementation outcomes (Hartlapp and Falkner 2009; Toshkov 2010). Further, financial corrections are implemented in response to audits and checks by EU and national audit/control bodies and should be based on representative samples of projects and assessments of management and control systems. These provide some confidence in the reliability of the measure, notwithstanding some differences in the methodologies used (ECA 2013) and, importantly, potential bias due to differences in the audit practices of Member States (Cipriani 2010; NAO 2010; Nyikos and Talaga 2014).

As there are wide variations in the application of financial corrections for non-compliance in any given year, it is necessary to examine compliance over an extended timescale. The 2000-06 period has been selected because it has been subject to a full cycle of compliance assessment, based on final payments of allocations and the conclusion of financial corrections procedures at the closure of accounts for programmes in 2013. By contrast, the 2007-13 programmes have until 2015 to spend their allocations and several more years until formal closure.

Turning to the explanatory variables, regional autonomy is measured using the Regional Authority Index (Hooghe *et al.* 2008), capturing the authority exercised by regions across four aggregated dimensions (institutional depth, policy scope, fiscal autonomy and representation). An additional policy-specific indicator used is the regionalization of ERDF expenditure (the share of the ERDF managed through regional programmes as opposed to

national programmes), drawn from European Commission data on programming available online via the inforegio website. To measure administrative capacity, the World Bank's quality 'government effectiveness' index is used on the 'capacity of governments to effectively formulate and implement sound policies'. For the administrative capacity and regional autonomy variables the data are for 2006, on the basis that it is the final year of the 2000-06 period for committing funding to projects (see also Tosun 2014). Goodness-of-fit is measured by calculating the share of ERDF funding relative to national expenditure for economic development as an average over the eligibility period (2000-6 for the EU15 and 2004-6 for the EU12), drawn from official data on ERDF allocations on the Commission (DG Regio) website and Eurostat data on expenditure for economic development (ISMERI & APPLICA 2010).

The qualitative component of the methodology involved content analysis of EU documentary evidence relating to Cohesion policy compliance. This comprised systematic scrutiny of 20 financial management documents relevant to the 2000-06 period for evidence relating to the hypotheses and alternative explanations of compliance. The documents covered in the analysis were: the Commission's Annual Activity Reports from 2002 to 2012, which review Commission audit/control activities in all Member States and provide the main internal accountability mechanism for granting assurance within the Commission (for example, European Commission 2012); and the ECA's reports on the EU budget, also from 2002 to 2012, based on the audits of a sample of Member State systems and projects and providing the main source of information for the Parliament to approve the EU budget during the annual discharge procedure. In each case, the analysis examined (for each year's reports), the key risks or types of error identified, the effectiveness of authorities/systems, and the actions taken or recommendations made.

Subsequently, eight in-depth interviews were conducted with senior officials in Commission audit services and managing authorities in six Member States to validate and explain the findings (with a guarantee of complete anonymity in reporting the responses, including of the countries, to ensure reliable responses). The semi-structured interviews were carried out by the authors in 2014 and 2015 and focused first on explaining the findings of the quantitative analysis with previous compliance research and then exploring other explanations for financial compliance across the Member States.

## FINANCIAL COMPLIANCE IN EU COHESION POLICY

### Managing compliance in the Member States

To protect the EU's financial interests, the Treaty on the Functioning of the EU requires Member States to ensure that implementation of the budget accords with the principles of sound financial management (Article 317). These provisions are fleshed out in more detail in the EU's Financial Regulation (applicable to all EU expenditure) and sector-specific rules for different policies (European Commission 2013a). In Cohesion policy, these rules are specified in a General Regulation (Regulation 1303/2013) and pertain mainly to the adequacy of management and control systems and the eligibility and accuracy of expenditure, including conformity with cross-cutting EU laws, such as public procurement and competition policy rules, and certain national eligibility rules.

Under the shared management principle, the European Commission and Member States are jointly accountable for the use of EU Cohesion policy according to the EU's financial rules (Bachtler et al 2013). While Cohesion policy is delivered through multi-annual programmes designed in partnership between the Commission, Member States and sub-national authorities, implementation and compliance are primarily the responsibility of Member State authorities. However, the Commission is ultimately responsible for the EU budget and

is held accountable for compliance by the EU's budgetary authorities in the European Parliament and ECA under the budgetary discharge procedure (Mendez and Bachtler 2011; Davies and Polverari 2011).

The Commission builds its assurance over each seven-year programme period (European Commission 2009; European Commission 2014b; 2015). It begins with Commission approval of Member State management and control systems at the start of a period and involves regular audits and checks of systems and payments during the implementation period and following its closure. Member States are required to ensure sound financial management through effective (error-free) management, audit and control systems through a trio of institutions – managing, certifying and audit authorities - with functions specified by EU rules. In the first instance, national and regional Managing Authorities have the primary responsibility for ensuring compliance and carrying out first-level controls on applications for funding from beneficiary organisations. Institutionally separate Certifying Authorities are required to scrutinize the functioning of the Managing Authorities and to check payments made to beneficiaries before declaring 'certified expenditure' to the Commission. Independent national or regional Audit Authorities perform audits of systems and projects and report the results to the Commission, and the whole system is periodically assessed by the ECA.

Payments to the Member States by the Commission are made by way of reimbursements of declared expenditure statements several times a year. If EU institutions or Member States detect infringements of EU rules (irregularities), financial corrections are made to the statements by subtracting the non-compliant funding. Irregularities range from minor infringements of administrative procedures (e.g. rules on retention of paperwork or publicity requirements) and small overpayments to projects, to non-compliance with public

procurement rules in the award of contracts and ultimately fraud. Financial corrections do not necessarily result in a loss of funds to Member States because the withdrawn money can be reused to fund other projects during the eligible period. A net loss of funds only occurs when the Member State chooses not to withdraw ineligible expenditure or when corrections are made during programme closure by which stage replacement projects cannot be co-funded by the EU.

**Compliance performance – cross-national patterns of financial corrections**

Cross-national differences in the rate of corrections are illustrated in Table 1 drawing on European Commission data (European Commission 2013b). For the EU25 as a whole, the financial corrections on spending under the 2000-06 ERDF programmes were calculated to be 5.6% of total expenditure (€7.3 billion) at the end of 2012. The highest correction rates were in Ireland, Greece and Spain. At the other end of the spectrum, the five countries with the lowest corrections rates are Cyprus, Finland, Latvia, Hungary and Sweden. Surprisingly, these top-five compliance performers include three new Member States (Cyprus, Hungary and Latvia) with far less experience in managing Cohesion policy. Indeed, there are six 'new' Member States among the top-10 performers, and only three 'new' Member States in the bottom 10 ranked countries. On average, financial corrections were significantly lower in the EU10 (2.2%) than the EU15 (5.9%). Part of the gap is explained by the high level of corrections in Italy, Greece and Spain, although even excluding these countries still gives an EU15 error rate of 3.5%, significantly above that of the EU10.

The differences between the EU15 and EU10 are apparently not attributable to the relative brevity of the programme period for the EU10 (five years, compared to eight years for the EU15); or the comparatively small scale of EU funding in the initial years following accession, albeit a much greater scale of funding than the EU15 allocations in proportion to domestic

economic development expenditure (ISMERI & APPLICA 2010). Preliminary data for the 2007-13 period indicate that the financial corrections rate in the EU10 may again be less than half that for the EU15 during a period when the EU10 accounted for almost half of Cohesion policy funding (European Commission 2014b). The preliminary 2007-13 figures show much less variation among the EU15 group; the error rate for Ireland is again much higher than all other countries, but the rates for Greece and Spain are close to the EU15 average.

The existing literature points to two plausible explanations for the strong compliance performance of the EU10 in Cohesion policy (Bachtler *et al.* 2014). First, there was an intensive pre-accession aid programme to build Cohesion policy management capacities, especially with respect to financial management and control, in the new member states. Second, there was a stronger financial incentive for the new member states to comply in order to avoid providing net payer countries with reasons for cutting the overall Cohesion policy budget or reducing the relative share for new member states during the post-2006 EU budget negotiations.

[Table 1]

**Compliance performance – system and project audits**

Further insights on financial compliance by the Member States are provided by the separate meta-analysis of EU audit reports. These audits involve examining samples of projects and control systems and the identification of error, from which extrapolated percentages of non-compliant expenditure are produced. The results of the meta-analysis are presented in Tables 3 and 4.

The Commission audits of systems found serious compliance weaknesses across Member States throughout the period. In the first three years of audit carried out in 2006-8 while payments were still being made for commitments made during the 2000-06 period, only a minority of the systems were assessed as working well, while most needed improvements or significant improvements to provide reasonable assurance.[1] In the later retrospective system audits carried out in (2009-12), there was evidence of rapid improvement; most programmes were assessed as providing reasonable assurance, but with a 'moderate' or 'significant' level of risk of errors.

A similar story is told by the ECA whose audits highlight a continuous compliance deficit in Cohesion spending reflected in an error rate consistently above the threshold required for granting assurance on the regularity of spending.[2] Member State supervision and control systems were rated as ineffective or partially effective throughout the 2000s, albeit witnessing overall improvements in the reports from 2009 onwards.

In both Commission and ECA reports, the key shortcoming in control systems was judged to be insufficient and inadequate management verification of projects. Less frequently reported problems were a lack of segregation of management and control tasks and inadequate reporting of financial corrections. Non-compliance was most frequently associated with breaches of rules on eligible expenditure and public procurement. Eligibility errors included declaration of costs that were outside the eligible area and period or which were not reimbursable, incorrect co-financing rates and lack of supporting evidence for claimed costs. The most problematic public procurement issues were non-respect of the

[1] The 2002-2012 reports were analysed because the first audits of the 2000-2006 programmes began in 2002 and continued until 2012 for programme closure.
[2] The error rate must be below 2% to be classified as free from material error.

transparency/non-discrimination principle, irregular complementary works, illegal selection criteria and problems in tender evaluation.

## EXPLAINING FINANCIAL COMPLIANCE

### Quantitative analysis of financial compliance determinants

What explains the patterns of compliance? We turn now to the statistical analysis of the theoretical hypotheses for non-compliance across the EU25 Member States. The financial corrections rate is the dependent variable, and the explanatory variables measure administrative capacity, regional autonomy, and goodness-of-fit. As the outcome variable (financial corrections rate) is bounded at both ends (by 0 and 100 percent), standard OLS regression is not an appropriate estimation modelling method because it does not account for the fact that percentages are bounded leading to biased and inefficient results. The most appropriate estimation method is Beta regression because it models the distribution of the dependent variable using the beta distribution, which is bounded between 0 and 100 or 0 and 1 when transformed to a proportion (Ferrari and Cribari-Neto 2004; Cribari-Neto and Zeileis, 2010). Beta regression also benefits from the flexibility of accommodating non-constant variances and skewness, which are prevalent in bounded outcome variables.

The results of the Beta regression estimations are presented below (Table 4). The regional autonomy and regional programming variables were modelled separately because they are highly correlated (0.7). A dummy variable is included to control for the stronger compliance pressure in the EU10 upon accession (Bachtler *et al.* 2014).

[Table 4]

The key finding is that administrative capacity is the only statistically significant predictor of non-compliance across all models. For the regional autonomy and programming variables,

the direction of the association is positive in line with hypothesis 1a/2a, but the relationship is not significant. Similarly, the association between non-compliance with goodness-of-fit is in the expected direction (negative) but is not statistically significant. By contrast, government effectiveness is statistically significant (at the 0.1 percent level) in both models and the sign of the association is in the expected direction (negative).

An inspection of the model's residuals shows that one of the cases (Italy) has a high level of influence on the model distorting its accuracy (reflected in a very high value of Cook's distance). Accordingly, the models were rerun without Italy (in Models 3 and 4). When Italy is excluded, administrative capacity remains a significant predictor (at the same 1 percent level) but, unlike the previous models, the goodness-of-fit variable acquires significance (at the 5 percent level).

Models 1 and 3 were also rerun to distinguish between the two key components of the Regional Authority Index: 'self-rule' (the authority exercised by a government over those who live in its territory) and 'shared rule' (the authority exercised by regional authority in the country as a whole). The results did not change the substantive findings compared to the overall RAI, apart from increasing the statistical significance of the goodness-of-fit variable (from the 5% to the 1% level) when using the 'self-rule' component of the RAI.

Summing up, the analysis provides strong support for the impact of administrative capacity on the financial compliance performance of EU Member States confirming hypothesis 3, as well as support for the role of goodness-of-fit in line with hypothesis 4. Contrary to expectations, explanations of non-compliance stressing the role of regional autonomy are not supported by this analysis, allowing the rejection of the remaining hypotheses (1a/b and 2a/b).

**Qualitative analysis of financial compliance determinants**

Further insights on what determines financial compliance across the Member States are available from the meta-analysis of the audit findings in the Commission Annual Activity Reports (AARs) and ECA audit reports and interviews with informants drawn from national government authorities in six Member States and in Commission audit services.

The audit reports and interview research support the finding that weaknesses in administrative capacity are a key source of non-compliance in areas such as public procurement, eligible expenditure and State aids. Successive AARs concluded that there was a lack of assurance that the Member States scrutinized for audit had put in place all the "key elements of appropriate management and control systems which ensure the legality and regularity of the underlying operations" (European Commission 2002: 50; 2003:48; 2005:53; 2006:47), or there were reservations associated with "significant deficiencies" (European Commission 2007:74; 2009:97; 2010:57) and "systemic problems" (European Commission 2011:86). A similar critique of serious system weaknesses is contained in the annual ECA reports. For example, the ECA (2003: 165) noted that "[T]he management and control systems examined do not all yet satisfy the regulatory requirements, although the programming period 2000 to 2006 is already into its fourth year of operation". These problems persisted in subsequent years (ECA 2004; 2005; 2006), with the 2006 ECA report noting that Member State control systems were generally ineffective or only moderately effective (ECA 2007: 152).

In the course of the 2000s, the Commission AARs increasingly identified specific aspects of administrative capacity as weak (shortage of administrative personnel, high staff turnover, lack of political steer, organisational complexity, lack of control), and the need for capacity-

building measures feature strongly in the Commission's required corrective measures (European Commission 2007; 2009; 2011; 2012). ECA reports also refer to incomplete audit trails, lack of manuals, inadequate organisation of controls and insufficient independence of audit functions (ECA 2003; ECA 2004; 2005).

Some reports highlight the competing demands of financial absorption and compliance, as the need to spend the funds in a timely manner risked detracting from compliance (ECA 2006: 59; ECA 2008: 71). The ECA warned of ineligible expenditure being claimed to avoid decommitment, replaced by inadequately verified new expenditure, or 'parked' in financial engineering instruments, particularly as the eligibility period for 2000-06 came to an end in 2009 (ECA 2010: 99; ECA 2011: 113; ECA 2012: 97).

The interview research also found that the capacity effect differs between Member States. Among the countries with the highest number of corrections during the 2000-06 period (Ireland, Greece, Spain), the capacity problems were particularly acute at the national level. In Greece , they required the creation of a special technical management unit (MOU) outside the ministerial structure – whereas in Ireland and Spain, the capacity deficits were identified at a lower level among the large number of implementing bodies (agencies etc.) which were judged to be less knowledgeable in important procedural areas like public procurement and State aids (EC interviews 1 and 2). In the case of Spain, evidence from interviewees and implementation reports show that misfit between EU rules and domestic legislation on public procurement was one of the main reasons for the high level of financial corrections (EC interview 1), particularly the common practice in Spain of making modifications to contracted works or awarding additional complementary works during the course of implementation. Annual control reports published by Ireland's ERDF Financial Control Unit

also show that non-compliance with EU public procurement rules have accounted for a major share of irregularities in 2000-2006 (e.g. FCU 2007).

By contrast, regional autonomy rarely featured as explanations of non-compliance in the audit reports (Tables 2 and 3). The ECA reports do note that some characteristics of regionalisation - larger numbers of programmes, managing authorities and implementing bodies, and greater diversity of interventions - presented 'risks' for achieving compliance (e.g. ECA 2003). The multi-level governance model of shared management means that many actors are involved in policy implementation and may lack awareness or sufficient understanding of compliance rules. However, there is no direct evidence of regionalisation *per se* accounting for greater compliance problems. The substantive audit findings or recommendations do not identify or imply a causal link between compliance and decentralization in political or policy systems.

This was confirmed in the interview research, where informants noted that pressure for sound financial management is applied equally to managing authorities and implementing bodies at both national and regional levels (MS interviews 1, 3, 4, 5, 6). This was particularly the case in 2000-06 when, following the resignation of the Santer Commission, a range of new EU financial management and control regulations were introduced and applied consistently to all types of Cohesion policy programmes, and the Commission and ECA first began to publish data on error rates by Member State (Mendez and Bachtler 2011). A caveat to this general conclusion is that uniform compliance at sub-national levels depends on strong central coordinating institutions; where these are absent there is a greater risk of politicization of Cohesion policy spending and non-compliance (EC interview 1, MS interviews 1,2, 4, 5). Regardless of the extent to which the allocation of funding is politicized, there are strong pressures to ensure that the projects selected for EU support comply with

EU financial rules. There is arguably a loss aversion effect at play in Cohesion policy, a financial incentive to comply with EU rules to avoid losing funds irrespective of the level of politicization or political decentralization.

Looking beyond the variables used in this study, the documentary and interview research identified two other factors that may explain patterns of financial compliance. The first is regulatory complexity, both at EU level and in Member State rules. The complexity of EU rules is a common pressure felt by all Member States and therefore cannot be directly linked to variations in compliance performance, although an interactive effect with capacity is likely in that compliance with complex rules would be more challenging for countries with weak administrative capacity. In terms of domestic rules, the compounding effect of setting additional rules that go beyond EU requirements - a practice termed 'gold-plating' (e.g. Nyikos and Tatrai 2015) - on complexity is recognized to be a problem that varies across countries, but there are no available data measuring the extent of this across countries to permit a systematic analysis of the effects (SWECO 2013). Interviewees also identified the potential conflict between different regulatory requirements, noting that there are administrative trade-offs in ensuring financial compliance as well as complying with an increasingly complex set of rules on timely, efficient, thematically focused and effective spending (EC interview 2, reinforcing the conclusions of Bachtler and Ferry 2013).

A second additional factor relates to control mechanisms. The ECA argues that the control bodies in many Member States do not enforce EU rules effectively and has called for stricter oversight by the Commission over national bodies, particularly in terms of public procurement and the enforcement of sanctions. It also criticizes the limited use of audit findings and weak feedback mechanisms between audit, control and management bodies (ECA 2004, 2005).

As noted above, there are several layers of financial management and control, but the monitoring of financial compliance by Member States authorities varies significantly across the EU. Interview research revealed Commission concern about the independence of national/regional audit authorities which may underplay the level of financial irregularities in some countries. One official noted that "the independence of audit authorities is questionable in certain countries or regions, especially where management and audit responsibilities are in the same institution" (EC interview 2). Thus, a low level of financial corrections may in fact indicate poorly performing audit functions rather than compliant implementation.

Nevertheless, all Member States have been forced to adopt stricter approaches to compliance monitoring and assurance driven to a large extent by stricter supervisory pressure from the Commission since the mid-2000s, including the issuing of reservations on programmes, remedial actions plans and suspensions and interruptions of payments (Table 2).

**CONCLUSIONS**

EU compliance research has expanded over the last decade but has paid little attention to the financial dimension of compliance in terms of infringements of EU rules on the regularity and legality of EU expenditure, despite the increasing salience for EU policymakers and in the media. In advancing a more multidimensional approach to compliance research, this article has undertaken an innovative analysis of financial compliance patterns and determinants across EU countries using the case study of Cohesion policy to facilitate a new

research agenda. The findings have wider implications for compliance research and policy practice.

The article provides strong arguments for the adoption of a broader conceptualization of compliance to cover the financial dimension. The analysis has revealed distinctive cross-national compliance patterns that differ from those identified in studies of EU Directives. The evidence from the Cohesion policy case challenges the categorization of the new Member States as a "world of dead letters" (Falkner and Trieb 2008) in complying with EU (financial) legal obligations (see also Bachtler *et al.* 2013; Tosun 2014). Similarly, the weak compliance performance of Ireland (and Spain in 2000-06) in Cohesion policy contrasts with their strong performance in the transposition of EU Directives. The implication is that differences in compliance dimensions and policy types matter in explaining outcomes and should be factored into any comprehensive conceptualization or assessment of EU compliance.

However, the research provides mixed support for explanatory conclusions in the EU compliance literature. On the one hand, explanations of compliance stressing the role of political decentralization are not supported in the case of EU Cohesion policy. This is surprising because the ERDF is arguably the most decentralized EU policy instrument, representing an easy test for theories stressing the role of veto points as obstacles to compliance. The question arises as to why political decentralization does not impact on compliance. The most plausible explanation from the research is the different incentive structure of this budgetary policy domain. Cohesion policy is a redistributive policy that provides EU funding to national, regional and local governments for public investment, while regulatory policies tend to impose financial costs on different levels of government. There is arguably a loss aversion effect at play in Cohesion policy, a political pressure and financial

incentive to comply with EU rules to avoid losing funds irrespective of the level of political decentralization. This reinforces the need for a broader conceptualization of compliance covering different policy types and compliance dimensions to further understanding of compliance variations across the EU.

On the other hand, this study adds support to institutional explanations of EU compliance stressing the positive role of administrative capacity and goodness-of-fit in compliance (Angelova *et al.* 2012). The review of Commission and ECA policy reports showed that weaknesses in different aspects of administrative capacity were factors explaining financial non-compliance. Future studies on Cohesion policy compliance in more recent periods (2007-13 and beyond) could extend these findings to include the accession of Bulgaria, Romania and Croatia, all of which have relatively weak administrative capacity. The much larger volumes of funding allocated to the EU10 across a wider range of thematic priorities in 2007-13, and greater regionalization of resource allocation in some countries may change the compliance picture in Central and Eastern Europe – although the provisional data for 2007-13 show similar differences between the EU15 and EU10. It is also possible that the stricter compliance regime introduced in 2006 (for the 2007-13 period) and continued under the 2013 reform (for the 2014-20 period) and enforcement of punitive measures by the Commission may lead to an overall improvement in compliance and convergence across countries. Further analysis of differences in the institutional independence of national audit authorities/functions and the effects on compliance are also worth exploring.

An important finding is the way that Cohesion policy is being used as a boundary-spanning tool for enforcing Member State compliance in other EU policies. The cross-cutting enforcement role of Cohesion policy remains unexamined in the literature, but may explain some of the unexplained variations in compliance in other regulatory policies (such as Public

Procurement and Environmental Directives), given the differential scrutiny and oversight pressures emanating from Cohesion policy across countries and regions.

The boundary-spanning enforcement role of Cohesion policy has been strengthened under the 2013 reform in regulatory and macro-economic areas. New ex-ante conditionality provisions require compliance with EU Directives linked to Cohesion policy investments before programmes are approved or agreement on a compliance action plan with periodic monitoring and the possibility of sanctions. Implementing these provisions has been challenging, requiring the adoption of many actions plans to ensure compliance with EU Directives, notably on energy efficiency, environmental impact assessment and public procurement (European Commission 2014). Macro-economic conditionality has also been strengthened, providing for suspensions of Cohesion policy funding and revisions to programmes when EU economic governance rules are breached, namely the Stability and Growth Pact/Excessive Deficit Procedure, the Macroeconomic Imbalances Procedure, and the economic adjustment programmes for some Member States. The impact of ex-ante and macro-economic conditionality on state behaviour and the interactions with compliance dynamics and outcomes merits scrutiny in future studies.

Turning to the policy implications, the main lesson is the need to strengthen administrative capacity to improve compliance performance. EU policymakers have recognized this in recent years, reflected in the establishment of a new thematic objective 'enhancing the institutional capacity of the public administration' for 2014-20 and the creation of administrative capacity units in the Commission to support capacity-building in the Member States. However, it is not clear what impact this will have in practice given the culture of mistrust and fear of financial corrections that has been fostered by the explosion in Cohesion policy audit activity (Mendez and Bachtler 2011). Further, administrative capacity

is a wide-ranging term encompassing structures, systems and resources, and the relationship with implementation performance is far from clear.

As capacity deficiencies are likely to be compounded in a complex regulatory environment, a further policy implication is the need to reduce regulatory complexity, including harmonization of rules across EU policies/funds and the minimization of ‘gold-plating’ of EU rules with additional domestic legislation. This is easier said than done. Simplification has been pursued in the 2006 and 2013 reforms, yet both reforms also introduced new compliance requirements (and numerous Delegated and Implementing Acts for 2014-20) that have increased the regulatory complexity of implementation to the extent that (under Member State pressure) the Commission has been forced to set up a high-level review group chaired by a former EU Commissioner to re-assess the scope for regulatory and administrative simplification in Cohesion policy.

Finally, there are several avenues to develop the robustness and generalizability of the findings. Future studies should go beyond the analysis of national indicators because there are significant regional/programme-level variations in compliance measures and in explanatory variables such as administrative capacity. Another route is qualitative analysis of individual cases, comparing our findings with in-depth studies of specific countries, regions or programmes. Studies could compare compliance under the ERDF with other EU Funds and policies to deepen our understanding of financial compliance dynamics in the EU.

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**Table 1: Financial corrections in the 2000-06 programmes**

| Member State (EU-15) | ERDF Contribution (€ mill) | Financial corrections (€ mill) | Financial corrections (% of contribution) | Member State (EU-10) | ERDF Contribution (€ mill) | Financial corrections (€ mill) | Financial corrections (% of contribution) |
|---|---|---|---|---|---|---|---|
| Austria | 893.7 | 19.8 | 2.22 | Cyprus | 28.0 | 0.02 | 0.06 |
| Belgium | 865.3 | 15.6 | 1.8 | Czech Republic | 985.6 | 26.8 | 2.72 |
| Denmark | 15574.6 | 299.6 | 1.92 | Estonia | 232.8 | 1.0 | 0.44 |
| Finland | 147.0 | 1.1 | 0.23 | Hungary | 1239.4 | 4.2 | 0.34 |
| France | 28019.0 | 2700.1 | 1.66 | Lithuania | 583.9 | 2.7 | 0.46 |
| Germany | 916.2 | 2.1 | 0.77 | Latvia | 382.0 | 0.9 | 0.23 |
| Greece | 8270.0 | 137.4 | 10.06 | Malta | 46.7 | 1.1 | 2.28 |
| Ireland | 15176.6 | 1526.1 | 11.07 | Poland | 4972.8 | 128.6 | 2.59 |
| Italy | 1951.7 | 216.1 | 6.39 | Slovenia | 136.5 | 1.5 | 1.12 |
| Luxembourg | 18753.2 | 1197.4 | 3.97 | Slovak Republic | | | 4.75 |
| Netherlands | 44.0 | 1.7 | 2.35 | | | | |
| Portugal | 970.9 | 22.8 | 3.36 | | | | |
| Spain | 13249.3 | 445.6 | 9.64 | | | | |
| Sweden | 880.8 | 41.9 | 0.36 | | | | |
| United Kingdom | 8990.5 | 266.8 | 2.97 | | | | |
| *EU-15 average* | *114702.7* | *6894.1* | *5.99* | *EU-10 average* | *880.8* | *41.9* | *2.20* |

Source: European Commission (2013)

**Table 2: Synthesis of ECA audits of the 2000-06 ERDF programmes**

| | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **Key inherent risks** | | | | | | | | | | | |
| Complexity of rules, including other EU policies | | | x | x | | | | x | x | x | x |
| Shared management involving many levels/bodies | | x | x | x | | | | x | x | x | x |
| Competing management demands esp. financial absorption | | | | | | | | x | | x | x |
| **Regularity of payments** | | | | | | | | | | | |
| Materiality compliance (error rate < 5%) | N | N | N | N | N | N | N | N | N | N | N |
| Most likely error rate | na | na | na | na | 12%** | 12%** | 11%** | 3%** | 7.7% | 6% | 6.8% |
| Frequency of ERDF errors | na | na | na | na | 45% | 36% | 51% | 40% | 53% | 41% | 46% |
| **Types of errors** | | | | | | | | | | | |
| Occurrence | x | x | x | x | | | | | | | |
| Eligibility | x | x | x | x | x | x | x | x | | x | **x** |
| Accuracy | x | | x | x | | x | x | x | | x | |
| **Key errors** | | | | | | | | | | | |
| Incorrect grant rates | x | x | x | x | x | | | | | | x |
| Ineligible costs | x | x | x | x | x | x | x | x | x | x | x |
| Public procurement breaches | | | x | x | x | x | x | x | x | x | x |
| Failure to account for generation of revenue | | x | x | | | | | | x | | x |
| State aid breaches | | | x | x | | | | | x | | x |
| **MS supervision and control systems** | | | | | | | | | | | |
| Mainly ineffective | | | | | x | | | | | | |
| Mainly ineffective or partially effective | x | x | x | x | | x | | | | | |
| Mainly effective, some partially effective | | | | | | | x | x | x | x | x |
| **Recommendations** | | | | | | | | | | | |
| Training and guidance for project promoters | | | | | x | x | | | | | |
| Training and guidance for managing authorities | | | | | x | x | | | | x | x |
| Targeted guidance – eligibility and public procurement | | | | | | | x | | | | x |
| EC oversight – Member State managing/audit authorities | x | x | | x | x | x | x | | | | x |
| EC oversight – public procurement | | | | | | | | x | x | x | |
| EC oversight – sanctions enforcement | | x | | x | | | x | x | x | x | |
| EC/MS feedback mechanisms and use of audit findings | | | | | x | x | | x | | x | |
| Simplify procedures to reduce complexity | | | | | x | x | | | | | x |

**Notes:** * The payment audits during 2010-12 accounted for 10-15% of the total payments audited as the audits focused mainly on the 2007-13 programmes. The final systems audits of were undertaken in 2009 (recoveries/withdrawals) and 2011 (closure systems), but focussed on the 2007-13 programmes in 2010 and 2012. ** Minimum error estimates

**Source:** Own elaboration based on textual analysis of ECA Annual Reports (for financial years 2002-12).

### Table 3: Synthesis of Commission audits of the 2000-06 ERDF programmes

| | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **Key inherent risks** | | | | | | | | | | | |
| Large number of organisations/beneficiaries | | | | | x | x | x | x | x | x | |
| Many different types of projects and programmes | | x | | | x | x | x | x | x | x | |
| Complex eligibility rules at Community/national level | | x | | | x | x | | | | | |
| Multi-annual framework affects design/control systems | | | | | x | x | | | | | |
| Administrative capacity | | x | | | | | | | | | |
| **Assessment of control systems (No. OPs/% total payments)*** | | | | | | | | | | | |
| Reasonable (works well) | x | x | x | x | 124/35% | 147/28% | 157/28% | 208/29% | 212/13% | 269 | 317 |
| Qualified moderate (works, but needs improvement) | x | x | x | x | 152/40% | 50/11% | 133/33% | 143/58% | 146/52% | 80 | 53 |
| Qualified significant (works, but needs significant improvement) | | | | x | | 139/48% | 73/35% | 24/13% | 21/35% | 27 | 3 |
| Adverse (does not work) | | | | | 23/5% | 43/13% | 16/5% | 4/0.5 | 0/0% | 2 | 6 |
| **Key deficiencies** | | | | | | | | | | | |
| Insufficient or inadequate management checks by MAs | x | x | x | x | x | x | x | x | x | X | |
| Lack of separation of functions | | | | | x | x | | | | | |
| Public procurement | x | | | x | x | x | x | x | x | | |
| Lack of evidence of financial corrections | | | | | | | | | | X | x |
| **Actions taken** | | | | | | | | | | | |
| Actions Plans | | x | x | x | x | x | x | x | x | X | |
| Payment interruptions, suspensions or corrections | | | x | x | x | x | x | x | x | X | x |
| Reservations | x | x | x | x | x | x | x | x | x | X | x |
| Contracts of confidence | | | x | x | x | | x | x | | | |
| Guidance – controls | | | | | x | | x | | | | |
| Guidance – revenue generating projects | | | | | | | | x | | | |
| Seminars and/or guidance – assurance, closure, procurement | x | | | x | x | | x | | x | x | |
| Simplification of rules | | x | x | x | x | | x | x | | | |

**Notes:** The systems' assessment ratings changed over time. In 2000-2003, the focus of audit work was on the set-up of control systems (notably desk reviews of the descriptions of systems) rather than implementation. By 2004, assurance had not yet been granted for the set-up of systems in 2 Member States (Portugal, Greece).

**Source:** Own elaboration based on textual analysis of Commission Annual Activity Reports (for financial years 2002-2012).

**Table 4: Explaining non-compliance in EU Cohesion policy: Beta Regression results**

| | **Model 1** | | | **Model 2** | | | **Model 3 (excl. IT)** | | | **Model 4 (excl. IT)** | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | B (SE) | CIs | | B (SE) | CIs | | B (SE) | CIs | | B (SE) | CIs | |
| Regional autonomy | -0.01 (0.02) | -0.05 | 0.02 | | | | -0.02 (0.02) | -0.05 | 0.01 | | | |
| Regional programming | | | | -0.01 (0.01) | -0.01 | 0.00 | | | | -0.01 (0.00) | -0.01 | 0.00 |
| Administrative Capacity | -1.25*** (0.36) | -1.85 | -0.65 | -1.21*** (0.62) | -1.63 | -0.62 | -2.46*** (0.51) | -3.00 | -1.62 | -2.25*** (0.47) | -3.02 | -1.47 |
| Goodness-of fit (policy) | -0.01 (0.01) | -0.03 | 0.01 | -0.01 (0.01) | -0.02 | 0.01 | -0.03* (0.01) | -0.05 | -0.01 | -0.03* (0.01) | -0.05 | -0.00 |
| Control: NMS | -1.63*** (0.41) | -2.30 | -0.95 | -1.77*** (0.39) | -2.42 | -1.12 | -2.36 *** (0.41) | -3.04 | -1.68 | -2.40*** (0.39) | -3.04 | -1.75 |
| Intercept | -1.17 (0.81) | -2.50 | 0.17 | -1.21* (0.62) | -2.22 | -0.20 | 1.10 (1.01) | -0.56 | 2.76 | 0.84 (0.88) | -0.61 | 2.29 |
| Phi | 62.88** (19.17) | | | 65.52** (19.95) | | | 86.26** (26.58) | | | 88.03** (27.07) | | |
| Pseudo R2 | 0.45 | | | 0.45 | | | 0.49 | | | 0.51 | | |
| N | 25 | | | 25 | | | 24 | | | 24 | | |

Notes: Beta regression (precision model with identity link). Confidence intervals at lower and upper levels. Standard errors in parenthesis.
Significance codes: '***' 0.001 '**' 0.01 '*' 0.05