

Martin, Reiner

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Intereconomics

*Suggested Citation:* Martin, Reiner (1998) : Financing EU cohesion policy in Central and Eastern Europe: A budgetary timebomb?, Intereconomics, ISSN 0020-5346, Springer, Heidelberg, Vol. 33, Iss. 3, pp. 103-111

This Version is available at:

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Reiner Martin\*

# Financing EU Cohesion Policy in Central and Eastern Europe

## A Budgetary Timebomb?

*Following publication of Agenda 2000 the EU Commission has been criticised as overly optimistic on the budgetary consequences of the envisaged accession of a number of Central and East European Countries. This article briefly reviews the evolution of regional disparities within the EU and the impact of the Structural and Cohesion Funds on the present recipient regions. It then investigates whether it is financially feasible to extend EU regional policy to the five likely new CEEC member states without a major reform of the present system.*

In the early years of the next decade the first Central and East European Countries (CEECs) are likely to join the European Union (EU). This implies that the EU's policy of structural assistance for regions experiencing economic difficulties will also be adopted in the new member states. Since all potential new member states will still be relatively poor at the time of accession, they will all be eligible for the most intensive form of structural assistance which in turn increases EU expenditures significantly. In the eyes of many observers the Union's regional policy is therefore one of the key obstacles to enlargement.

Courchene et al. estimated the structural expenditures for the four Visegrad-countries (Poland, Hungary and the Czech and Slovak Republics) at ECU 26 billion per annum by the end of the decade.<sup>1</sup> The DIW estimated ECU 33 billion in structural transfers for the CEFTA5-countries (Visegrad-countries plus Slovenia) if the present arrangements are applied on an unchanged basis. A revised DIW estimation, based on the assumption that the CEECs should not receive more than 3% of their GDP in the form of structural transfers still arrives at an estimate of ECU 15 billion in the year 2000 and 20 ECU billion by the year 2010.<sup>2</sup> Baldwin et al., finally, using 5% of GDP as the maximum for structural transfers, arrive at an estimate of ECU 12.8 billion for the CEFTA5-countries in the year 2000.<sup>3</sup> These estimations contrast with the Commission's medium-term financial perspective (Agenda 2000) which expects the additional, enlarge-

ment-induced regional policy costs to be much less dramatic.<sup>4</sup> According to Agenda 2000 structural operations for the five countries with which the EU has agreed to open negotiations for accession (Poland, Hungary, Czech Republic, Slovenia and Estonia) will only amount to 11.6 billion ECU by 2006.

Following the publication of Agenda 2000 the Commission has been criticised for being overly optimistic. The present paper will therefore investigate the robustness of the Commission's medium-term financial estimations concerning:

- the potential for savings by means of redesignating present recipient regions,
- the additional resources that will be available for the Union due to economic growth and
- the absorption capacity in the CEECs.

### Recent Changes in Regional Disparities

Although economic integration within the European Union has made great strides forward during the 1980s and 1990s the results concerning regional convergence over that period are mixed. While a number of investigations have identified income

<sup>1</sup> T. Courchene et al.: Stable Money – Sound Finances, in: European Economy, No. 53, 1993.

<sup>2</sup> C. Weise: Der EU-Beitritt ostmitteleuropäischer Staaten: Ökonomische Chancen und Reformbedarf für die EU, in: Integration, No. 20, 1997, pp. 175-179.

<sup>3</sup> R. Baldwin, J. Francois, R. Portes: The Costs and Benefits of Eastern Enlargement: The Impact on the EU and Central Europe, in: Economic Policy, No. 24, 1997, pp. 125-170.

<sup>4</sup> Commission of the European Communities (CEC): Agenda 2000 – For a Stronger and Wider Union, Brussels 1997.

\* Hamburg Institute for Economic Research (HWWA), Hamburg, Germany, and Centre for European Policy Studies (CEPS), Brussels, Belgium. This paper is partly based on research jointly undertaken with Jørgen Mortensen, Senior Research Fellow at CEPS.

convergence across the level II of the NUTS (Nomenclature of Territorial Units for Statisticians), a significant number of "poor" regions does not benefit from this development.<sup>5</sup> Indeed, the European Commission's "Cohesion Report" showed that the gap between the 25 richest and the 25 poorest NUTS II regions of the EU remained approximately constant from 1983 to 1993.<sup>6</sup>

A closer examination of the statistical data shows further contrasting developments. The divergence in per capita income between member states has been significantly reduced, notably by the spectacular rise in Irish per capita income. Within a number of member states, however, notably in Belgium, Germany (even excluding the new Länder), Spain, and Portugal, regional income disparities have increased from 1983 to 1993. While the reasons for weakening internal cohesion are clearly not uniform, it is argued that the impact of allocative member states policies like Research and Development (R&D) strongly favours the core regions within the member states.<sup>7</sup> Moreover, Yuill et al. argue that national regional policy has been significantly reduced in some countries of the EU.<sup>8</sup>

Unemployment disparities have increased considerably between 1983 and 1995. The 1995 average rate of unemployment in the ten regions with the highest rate of unemployment (even excluding the French overseas departments) was 26.4%, almost seven times higher than the average of the ten regions with the lowest rate of unemployment (3.9%). In 1983 the spread for EU15 amounted to only about five. The

rates of labour force participation and employment show also a large dispersion between member states and between regions. The Cohesion Report established that the rate of employment (the number of persons in employment in proportion to the number of persons in the active age groups) in lagging (Objective 1) regions is on average significantly lower than in the highly developed regions.

### The EC Structural Funds and their Impact

For the period 1994 to 1999 the Community's Structural Funds (SF) and the Cohesion Fund will receive budget allocations amounting to a total of ECU 141 billion, corresponding to some 31% of the total commitment appropriations for this period. About 70% of the total appropriations of the Structural Funds would be allocated to "Objective 1"-regions, i.e. parts of the Union with a low level of per capita income. In Regulation (EEC) 2081/93, Art. 8 (OJ L 193, 31. 7. 1993) these are defined as follows:

"The regions covered by Objective 1 shall be regions at NUTS level II whose per capita GDP, on the basis of the figures for the last three years, is less than 75% of the Community average.

Northern Ireland, the five new German Länder, east Berlin, the French overseas departments, the Azores, the Canary Islands and Madeira shall also be covered by this Objective, as shall other regions whose per capita GDP is close to that of the regions referred to in the first subparagraph and which have to be included within the scope of Objective 1 for special reasons."

The second paragraph quoted above obviously introduces a large degree of discretion into the designation process. The remaining 30% of the SF budget are allocated to Objectives 2-6, covering industrial areas in decline, agricultural regions, areas that have a very low population density and various programmes aimed at labour-market problems. All these regions are less clearly defined than Objective 1 regions.

During the 1994-1999 period, about 26% of the EU population qualifies for Objective 1 assistance. Three member states, Greece, Ireland and Portugal, are fully designated as Objective 1 areas and so is the former German Democratic Republic. In Spain 59% of the population live in Objective 1 regions, making the Spanish programme the largest in absolute terms. Furthermore, due to the existence of some regions with a comparatively low level of income, Belgium, France, Italy, the Netherlands, Austria and the United

<sup>5</sup> Within the EU there are various levels of regional disaggregation ranging from NUTS 0 (member-state level) to NUTS V. Income disparities are usually measured at the NUTS II level. Relevant empirical studies are for example D. Neven, C. Gouyette: Regional Convergence in the European Community, CEPR Discussion Paper No. 914, London 1994; I. Thomas: Ein Finanzausgleich für die Europäische Union, Kieler Studien 285, Tübingen 1997 and R. Martin: Regional Convergence in the EU - The Importance of Macro-Economic Policies and Regional Policy Variables, HWWA-Discussion Paper No. 43, 1997.

<sup>6</sup> CEC: First Report on Economic and Social Cohesion, Luxembourg 1996.

<sup>7</sup> See CEC, op. cit. It is frequently argued that Community policies such as the Common Agricultural Policy and the R&D programmes also favour high-income regions (European Parliament: The Regional Impact of Community Policies, Regional Policy and Transport Series Vol. 17, Luxembourg 1991; J. Grote: Diseconomies in Space: Traditional Sectoral Policies of the EC, the European Technology Community and its Effects on Regional Disparities, in: R. Leonardi (ed.): The Regions and the European Community, London 1993, pp. 14-46). While this bias is clearly discernible for the CAP it is debatable with respect to R&D policy. More detailed investigations show that the relative involvement of peripheral regions in EU R&D programmes actually exceeds their R&D potential, expressed for example as a share of total R&D personnel in the Union (R. Martin: The Regional Dimension in European Public Policy - Convergence or Divergence?, Chapter 7, Houndsmill 1998 [forthcoming]).

<sup>8</sup> D. Yuill et al.: European Regional Incentives, London 1995.

Kingdom also receive funding under Objective 1.<sup>9</sup> German unification was the main reason for the rise in Objective 1 coverage vis-à-vis the 1989-1993 period when only 21.7% lived in areas assisted under Objective 1. However, the British and French coverage rate increased as well and Belgium and the Netherlands did not have any "lagging" regions during the 1989-93 planning period.

As illustrated in Table 1 the highest per capita "Objective 1" allocation is observed for Ireland (ECU 1572 per capita for the six years included or ECU 262 per year). For Greece and Portugal per capita allocations are somewhat lower, ECU 1350 (225) and 1410 (235), respectively, but their allocation as a percentage of GDP exceeds that of Ireland. National differences partly reflect prosperity gaps and partly administrative delays and absorption problems in implementing programmes during the 1989-93 period.

On average about 30% of this aid is attributed to infrastructure development, 30% to the development of human resources, mainly education and training, and 40% to support schemes for the productive sector.<sup>10</sup> The latter can take the form of direct investment aid but also business-related infrastructure like industrial estates or support for the transmission of R&D results. However, there are large differences in the functional allocation of SF support between the recipient countries.

As far as the economic impact of the Union's structural operations is concerned, there is a

fundamental difference between the redistribution effect (although the structural operations are not officially about redistribution but about strengthening the economic competitiveness of problem regions) and the growth effect of the structural funds.

Of the two, the redistribution effect is far easier to measure. According to the Cohesion Report Community structural assistance equalised per capita income by some 3% in the 1989-1993 period and by 4.5% in the 1994-1999 period. These figures seem very high but since the cohesion countries obtain up to 4% of their GDP from the structural and cohesion funds they are not unrealistic. After all, although EU regional policy is frequently and rightly blamed for supporting too many projects in too many regions, more than two thirds of the funding is allocated to low-income Objective 1 regions. A certain degree of concentration of the Union's structural operations is thus undeniable although it could obviously be higher.<sup>11</sup>

The growth effects of the structural operations can be estimated by means of regional or national macroeconomic models. According to an input-output model used by the Commission's Directorate-General for Regional Policy (DG XVI) GDP growth in Portugal, Greece, Ireland and Spain without the interventions of the Structural Funds would have been on average almost half a percentage point lower than the 2.2% that were actually achieved during the 1989-1993 programme period. The input-output model used for these estimations provides a high level of sectoral disaggregation but it suffers from the fact that it is comparative-static. Longer-term supply-side effects are not taken into account.<sup>12</sup>

According to estimates based on the QUEST II macroeconomic model, operated by the Commission's Economic and Financial Service (DG II), the growth effects of the 1989-93 programmes have not been negligible but less pronounced than suggested by the input-output analysis. The QUEST model

**Table 1**  
**Structural Funds Allocations for Objective 1**  
**Regions, 1994-1999<sup>1</sup>**

	Objective 1 (000)	Objective 1 % nat. pop.	EU Inter- vention (% of GDP) <sup>2</sup>	Objective 1 Allocation (mn ECU)	Annual p.c. Allocation (ECU)
Austria	225	3.7	0.19	162	120
Belgium	1279	12.7	0.18	730.0	95
Germany	15960	19.7	0.21	13640.0	145
Greece	10209	100.0	3.67	13980.0	225
Spain	23269	59.4	1.74	26300.0	188
France	2546	4.4	0.22	2190.0	143
Ireland	3503	100.0	2.82	5620.0	262
Italy	21134	36.4	0.42	14860.0	117
Netherlands	217	1.4	0.15	150.0	115
Portugal	9868	100.0	3.98	13980.0	235
UK	3310	5.7	0.25	2360.0	115
Total EU	91295	26.2	0.51	93810.0	170

<sup>1</sup> Funding for Community Initiatives not included; 1994 prices.

<sup>2</sup> Including Objectives 2 to 6, Community Initiatives and the Cohesion Fund.

Source: CEC: First Report on Economic and Social Cohesion, Luxembourg, 1996.

<sup>9</sup> Apart from Greece, Ireland and Portugal, most member states receive support through the above mentioned regional policy objectives targeted at industrial and rural change or unemployment (Objectives 2 to 6).

<sup>10</sup> For details see CEC, op. cit.

<sup>11</sup> It should be kept in mind that this figure does not provide any information about the inter-personal rather than inter-regional equalisation effects of EU regional policy. Under the present arrangements poor citizens in rich member states like Germany may "subsidise" rich citizens in poor member states.

<sup>12</sup> See J. Beutel: The Economic Impacts of the Community Support Frameworks for the Objective 1 Regions 1989-93, Report prepared for the European Commission, DG XVI, 1993.

distinguishes between demand and supply-side effects of the Structural Funds in the short, medium and long run. It is thus more sophisticated than the input-output analysis. It has to be kept in mind, however, that the QUEST II estimates are made on a national rather than regional basis and that the QUEST II model does not differentiate between different sectors of production.<sup>13</sup>

Simulations based on the HERMIN macroeconomic model yield an estimate closer to or above the input-output based estimates.<sup>14</sup> One of the key features of this model is that it assumes positive growth externalities of public investments in human capital and infrastructure, assumptions that are based on endogenous growth theory and research on the economic impact of infrastructure investments.<sup>15</sup>

A recent study by the London School of Economics (LSE), finally, has identified substantial positive spillover effects from Cohesion Fund investments. This evaluation exercise is based on a number of recent economic modelling techniques, but it is restricted to the economic effects of individual infrastructure projects like the Madrid ring road.<sup>16</sup>

To sum up, various estimates and simulations point towards positive growth effects in the recipient countries due to the Union's structural operations. This in itself, however, is not surprising given the very substantial amounts of money that are injected into the cohesion economies. As far as the key question is concerned, namely to what extent the structural operations will improve the competitiveness of peripheral regions in the long run and whether they will have lasting positive effects after the transfers will have come to an end, still awaits a definitive answer. However, it seems that aid from the Structural Funds can be a powerful "helping hand" if – and only if – the macroeconomic and microeconomic framework conditions in the recipient region are favourable to economic growth and entrepreneurship. The Funds have certainly helped countries like Ireland and Portugal to overcome some of their structural

problems, like the poor educational attainment of the workforce and insufficient transport infrastructure, more quickly than these countries could have done in the absence of support from the European Union. Other recipients like Greece, however, have so far "squandered" much of the assistance in useless projects, cost increases and business profits.<sup>17</sup>

Looking beyond the end of the current programme period (1994-1999), the EU will, through enlargement, face a significant increase in regional and social disparities. While policies addressing regional development problems will remain part and parcel of the panoply of the EU's policy instruments, it is frequently argued that the budgetary challenges of enlargement require major changes in the present policy package.

### Regional Policy After Enlargement – Still Affordable?

Per capita GDP in the Central and Eastern European countries that are likely to join the EU after 2000 will remain below 75 % of the EU-average for many years to come. Assuming that the main elements of the present system of structural operations remain in place, this implies that the CEECs will almost entirely qualify for Objective 1 status. Only some of the capital regions like Prague and Budapest will possibly be excluded from Objective 1 status.<sup>18</sup> As argued above, these stylised facts seem to indicate a very significant rise in the Union's regional policy bill. We will thus look at two issues:

- Which regions are likely to lose or gain Objective 1 status after 1999?
- How much are the CEECs likely to absorb if one assumes that the transfers going to these countries do not exceed the transfers going to the current cohesion countries?

In order to answer these questions it is important to look at the European timetable for regional policy and

<sup>13</sup> The modelling in this study is based on a number of different approaches. Vector autoregressive models (VAR) that try to identify the links between public investments, private investments and labour market variables are supplemented by computable general equilibrium (CGE) models and models of distribution dynamics which try to capture changes in relative regional income (LSE: Study of the Socio-economic Impact of Projects Financed by the Cohesion Fund - Modelling Report for the European Commission DG XVI, London 1997).

<sup>17</sup> See for example G. Alogoskoufis: The two faces of Janus: institutions, policy regimes and macroeconomic performance in Greece, in: *Economic Policy*, April 1995, pp. 147-192.

<sup>18</sup> This is argued by M. Hallett: National and Regional Development in Central and Eastern Europe: Implications for EU Structural Assistance, *Economic Papers* No. 120, Brussels 1997.

<sup>13</sup> For details of evaluations based on QUEST II see W. Roeger: *Macroeconomic Evaluation of the Effects of Community Structural Funds (CSF) with Quest II*, Paper presented at the European Conference on Evaluation Methods for Structural Funds Intervention, Berlin, 2/3 December 1996.

<sup>14</sup> J. Bradley et al.: *Regional Aid and Convergence*, Avebury 1996.

<sup>15</sup> On endogenous growth theory see, for example, R. Barro, X. Sala-i-Martin: *Economic Growth*, New York 1995; on the economic impact of infrastructure investments D. Aschauer: *Is Public Expenditure Productive?*, in: *Journal of Monetary Economics*, Vol. 23, 1989, pp. 177-200.

enlargement. Later in 1998 the Council of Ministers will draw up the list of regions eligible for structural support during the next programming period (2000 to 2006). This decision is unlikely to be taken before the German federal elections in September. According to Agenda 2000, the first CEECs will join the EU in 2002. Although this is a rather optimistic assumption, we will use it for the estimations below. The new member states will then be integrated into the on-going structural operations.

### Savings Resulting from De-designation

As argued above, the overall size of the Union's regional policy budget is largely dependent on the size and number of Objective 1 regions and the per capita allocations granted to them.<sup>19</sup> In late 1997 the European Commission's director-general for regional policy and cohesion revealed a provisional list of Objective 1 regions that are likely to lose or gain Objective 1 eligibility after 1995. These regions are listed in Table 2. We also provide an estimate of the costs which these regions would cause during the 2000-06 period if they retained their status as lagging regions.<sup>20</sup>

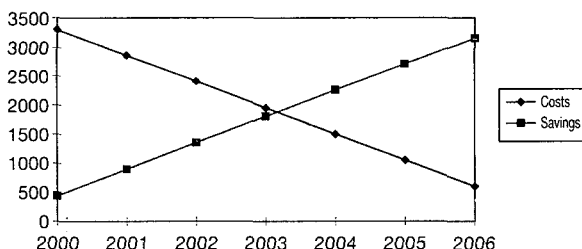
According to this – provisional – list eleven regions with a total of nearly 21 million inhabitants are likely to lose Objective 1 status after the end of the current

**Table 2**  
**Structural Funds Support for Regions that are Likely to Lose or Gain Objective 1 Status After 1999**

Regions to be De-designated	Average Rel. Income 1992-94	Population 1994 ('000)	Full Costs 2000-06 (mn ECU)	Costs with Phasing out (mn ECU)
Hainault (B)	81	1,300	865	432
Valencia (E)	75	3,800	5,001	2,500
Valenciennois (F)	87*	800	801	400
Corse (F)	77	300	300	150
Republic of Ireland	83	3,500	6,419	3,210
Sardegna (I)	78	1,700	1,392	696
Puglia (I)	73	4,100	3,358	1,679
Flevoland (NL)	75	200	161	81
Lisboa e. V. (P)	85	3,300	5,529	2,714
Highlands & I. (UK)	81	300	242	121
N. Ireland (UK)	79	1,600	1,290	645
<b>New Obj. 1 Regions</b>	<b>Average Rel. Income 1992-94</b>	<b>Population 1994</b>	<b>Additional Costs (mn ECU)</b>	
South Yorkshire	75	1,300	1,048	
<b>Net Effect</b>		<b>19,600</b>	<b>26,306</b>	<b>13,677</b>

Sources: REGIO-Database for data on population and income; CEC: First Report on Economic and Social Cohesion, Luxembourg, 1996 for data on costs; own calculations.

**Figure 1**  
**Development of Structural Expenditures in those Regions that are Likely to Gain or Lose Objective 1 Status after 1999**



Source: Own calculations.

programming period. Keeping them on the list and retaining the current level of per capita support would cost the EU around ECU 25 billion (at 1994 prices and per capita support levels) during the 2000-06 period. De-designating them will therefore reduce Community expenditures by the same amount. One region with a population of about 1.3 million, South Yorkshire in the UK, is likely to be newly designated.

In Agenda 2000 and other documents, the Commission has repeatedly emphasised that regions to be de-designated will not face a "hard landing" but that support from the Structural Funds will be gradually phased out, for example in annual steps. Looking at the 2000-06 period as a whole, de-designation combined with phasing-out will lead to a reduction of total costs by 50%, i.e. ECU 12.6 billion rather than the full amount calculated above. It has to be kept in mind, however, that due to the phasing-in procedure, annual savings will start from a fairly modest level and increase over time. This is depicted in Figure 1.

Even after deducting the additional costs for South Yorkshire, the de-designation of the above listed Objective 1 regions will reduce the EU's budget in 2006 by about three billion ECU. It has to be kept in mind that the above list of regions is preliminary and that it may well change before the Council takes its final decision. However, while the details of the new list remain to be seen, the magnitude of the de-

<sup>19</sup> At the moment around 30% of the total budget is allocated to other objectives and the Community Initiatives (CI). According to Agenda 2000 the population share eligible for Objectives 2 to 6 and the CIs should also be reduced. Given the significant differences between per capita allocations for Objectives 2 to 6, however, it is very difficult to calculate the budgetary effect of these reductions. They are thus not taken into account.

<sup>20</sup> The cost estimations are based on the assumption that the annual per capita support these regions enjoy during the 1994-99 period remains constant.

### Co-Financing EU Structural Operations

EU structural assistance is based on co-financing which means that eligible programmes are jointly funded by the EU, the member state concerned and, depending on the type of project, by private investors. Aid from the Structural Funds will typically cover 50% of the total project costs. However, in the case of particularly poor regions and/or socially justified projects the EU contribution may be as high as 75%. Keeping in mind that average public gross fixed capital formation in the EU member states was around 2.5% of GDP in 1995, Structural Fund transfers of 4% to the CEECs imply that the average EU public contribution in these countries will be above 60% or that public gross fixed capital formation in the candidate countries is considerably above the EU15 average.

The rate of Community assistance for Cohesion Fund projects is between 80 and 85% of public or equivalent expenditure. In contrast to the Structural Funds, the Cohesion Fund finances only transport infrastructure and environmental projects and its eligibility criteria differ from those for the Structural Funds. Eligible are Member States, rather than regions, with a per capita GDP of less than 90% of the Community average (Spain, Greece, Portugal and Ireland). Moreover, the countries have to respect the targets set by a programme leading to the fulfilment of the conditions of economic convergence which in turn are conditions for membership in European Monetary Union.

designation savings estimated above is certainly realistic.

Finally, there may be savings due to reductions in other Objectives. Agenda 2000 has presented figures for the total expenditures earmarked for structural action as well as the share of EU15 funding going to Objective 1 (two thirds). According to these figures Objective 1 funding in 2006 will be about ECU 4 billion below its 1999 level which is slightly above the savings potential we have estimated. Funding for the other objectives will be about ECU 2 billion below its 1999 level. How this reduction will be distributed across the different objectives and regions remains to be seen.<sup>21</sup> In light of the general principle of this paper, namely to make very cautious assumptions about the costs of regional policy after 1999, we decided not to include savings in regions outside Objective 1.

### Regional Policy Transfers to CEECs

In the following we estimate the likely regional policy transfers to those five CEECs with which the EU will soon start negotiations for accession, namely Poland, Hungary, the Czech Republic, Slovenia and Estonia. As argued above, it is optimistic to assume that enlargement will take place as early as 2002, but we leave this assumption unchanged. However, in order to get a longer-term perspective on the likely budgetary developments we estimate transfers until 2013.

The calculations are based on the assumption that annual structural policy transfers will be limited to 4% of GDP but no more than ECU 300 per capita at constant prices. These figures correspond with the

ceiling given in Agenda 2000 and with the maximum support levels in some of the current member states, notably Greece and Portugal (3.67 and 3.98%, respectively, of 1994 GDP). This limitation is important with regard to the new member states' capacity to

translate assistance from the Structural Funds into a genuine improvement of their growth potential. In other words, they have to be able to define and carry out projects liable for aid which in turn requires efficient national bureaucracies at the national and regional level. In light of experiences with present recipient countries, notably Greece, the implementation of the Structural Funds can be a major problem. The member states must also

provide the required cofinancing of projects receiving Community assistance. The cofinancing obligation puts rather severe limits on the capacity of new member states to absorb aid from the EU's Structural Funds (see box):

As far as growth in the CEECs and in EU15 is concerned, we use two different scenarios, a "high growth" and a "low growth" scenario. In the high growth scenario, real growth in the CEECs is assumed at 7%, in the low growth scenario at 4%; the corresponding figures for the EU are 2.5% and 1.5%. The population in the CEECs as well as in the EU15 is assumed to be constant. A growth rate of 7% for the CEECs may seem overoptimistic but one has to take the real exchange rate appreciation into account. In low-income countries the prices of domestically produced goods and services are almost always lower, relative to the prices of internationally traded goods and services, than in high-income countries. Polish per capita income in 1995, for example, was nearly twice as high expressed in purchasing power standards than in ECU at the current exchange rate. Once these countries catch up in terms of income and

<sup>21</sup> The current discussion certainly shows that it is important to develop more precise designation criteria for the new Objectives 2 and 3 which are supposed to replace the current Objectives 2 to 6 after 1999.

integrate further into the European and world economy this difference will become smaller.

Under the high growth scenario Hungary and the Czech Republic soon pass the ECU 7,500.- threshold beyond which structural aid will be awarded on a ECU 300 per capita basis instead of the 4% of GDP. For the Czech Republic the turning-point is 2005, for Hungary 2008. For Poland, which receives about two thirds of all CEEC5 assistance, however, the turning-point is not reached until 2012. Regional assistance for Slovenia will be granted on an ECU 300 per capita basis from the beginning. Under the low growth scenario the 4% rule will be applied to the Czech Republic until 2011 and to Hungary and Poland during the whole period under review, i.e. beyond 2013. For Estonia, the 4% rule will be applied throughout, regardless of the growth assumption.

There are two arguments which suggest that EU transfers to the CEECs might be much lower than anticipated on the basis of the above calculation:

□ By the time of accession some CEEC regions may have a per capita income of more than 75% of the EU average. Especially capital regions like Prague and Budapest may well be excluded from Objective 1 status. In 1993, the only year for which internationally comparable regional per capita income data are available, Prague already had a relative income level of 75% of the EU average (Czech average 49%) and the value for Budapest was 63% (Hungarian average 35%). None of the Polish regions came close to the 75% mark. Warsaw City, the richest region, had a value of only 46% compared to a national Polish average of 27%.<sup>22</sup>

□ Average per capita income in EU20 will be lower than in EU 15. This might not only lift more CEEC regions above the 75% threshold but also a number of present recipient regions in EU15.

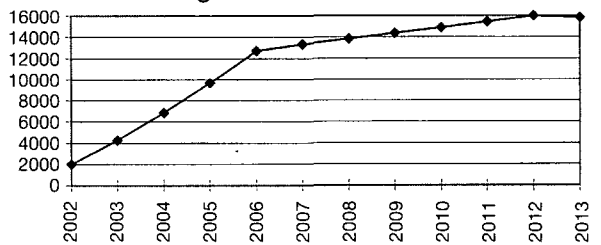
As mentioned above, we want to make sure that the results of this paper are not based on overoptimistic assumptions. It does not seem likely, however, that the present recipient countries would fully accept a new EU20 per capita average income as reference value for the designation of Objective 1 regions in EU15. It is more likely that a significant drop in the average value will result in two different reference values, one for EU15 and one for the new member states and/or in significant adjustment

periods. In this paper we will thus disregard possible changes in the reference value. Moreover, we will assume that the new member states will be fully eligible for Objective 1 status even including regions such as Prague.

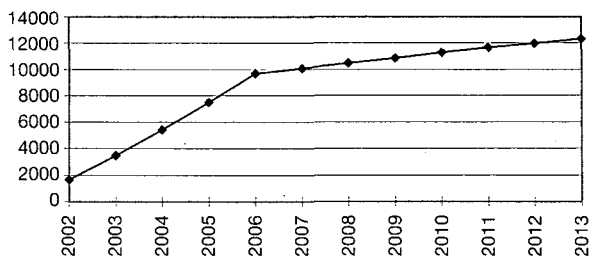
Given these assumptions it is possible to calculate the annual structural transfers to the CEEC5 during the 2002-13 period. In order to establish the net budgetary costs for the EU, the new member states' contributions to the EU structural policy budget (according to Agenda 2000 this amounts for the old and new member states to 0.46% of their GDP) are deducted from the transfers to which they are entitled.<sup>23</sup> Contributions as well as transfers are gradually phased in over the 2002-2013 period, using an approach that is similar to the phasing-out procedure for Objective 1 regions that will be de-designated. Figures 2 and 3 show the evolution of structural transfers to the new member states according to the high growth and the low growth assumption.

Between 2003 and 2006 the phasing-in of transfers to the new member states leads to rapidly increasing transfers to the CEECs, reaching about ECU 13 billion (high growth case) and ECU 10 billion (low growth case) respectively in 2007. The lower figure for the second scenario is due to the slower economic expansion and hence the more restricted absorption capacity of the CEECs. After CEEC5 transfers are fully

**Figure 2**  
**Structural Transfers to the CEECs – High Growth Scenario**



**Figure 3**  
**Structural Transfers to the CEECs – Low Growth Scenario**



<sup>22</sup> See the data reported in M. Hallett, *op. cit.*

<sup>23</sup> As in the case of the present recipient regions the 4% threshold for structural operations is a gross rather than net value. The maximum net transfers are thus 3.54%.



phased-in, the transfers increase more slowly. Moreover, in the high growth case structural fund transfers in some of the new member states are no longer calculated as 4% of GDP but on a per capita basis. Contributions of the CEECs to the EU structural policy budget, however, continue to be 0.46% of their GDP. By 2013, transfers in the high growth case are forecast to be virtually constant at around ECU 16 billion; the corresponding figure for the low growth case is ECU 12 billion.

Throughout the period under review about two thirds of CEEC5 transfers go to Poland, by far the largest of the new member states. Hungary and the Czech Republic will share most of the remaining third while the transfers to the small countries Estonia and Slovenia taken together account for just about 5% of total regional policy transfers to CEEC5.

In order to see whether the present system of regional policy is affordable in the future, the “natural” growth of the EU’s resources due to the expansion of the member states’ economies has to be taken into account. Since there are two different growth scenarios for EU15 as well as for the CEECs a total of four combinations is possible:

- (1) high growth in EU15 and CEEC5;
- (2) low growth in EU15 and CEEC5 (the scenario used in Agenda 2000);
- (3) high growth in EU15 and low growth in CEEC5;
- (4) low growth in EU15 and high growth in CEEC5.

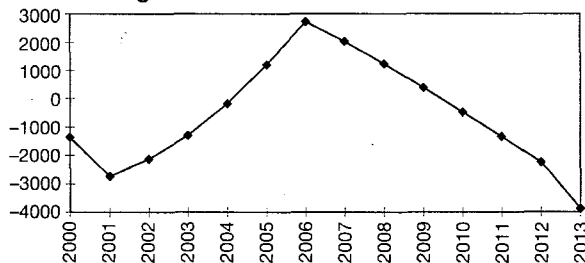
Table 3 shows the net regional policy transfers to CEEC5 at the end of the next programming period, namely in 2006. It also shows the different sources of funding for these transfers, namely, de-designation-

**Table 3**  
**Sources of Regional Policy Funding for the New Member States in 2006<sup>1</sup>**

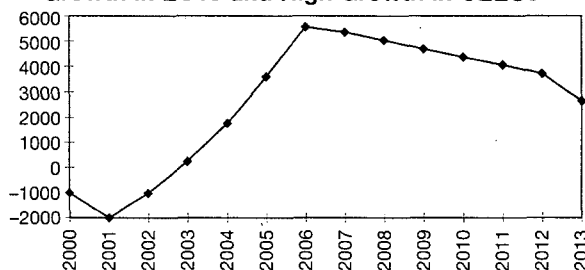
		High Growth CEEC (7%)		Low Growth CEEC (4%)	
		mn ECU	%	mn ECU	%
High Growth EU15 (2.5%)	Net Transfers to CEEC5 <sup>2</sup>	12,689	100	9,716	100
	Savings	3,157	24.9	3,157	32.5
	EU15 Growth	6,812	53.7	6,812	70.1
	Other Sources	2,720	21.4		./.
Low Growth EU15 (1.5%)	Net Transfers to CEEC5 <sup>2</sup>	12,689	100	9,716	100
	Savings	3,157	24.9	3,157	32.5
	EU15 Growth	6,965	31.2	3,965	40.8
	Other Sources	5,567	43.9	2,596	26.7

<sup>1</sup> All figures refer to transfers in this year only. <sup>2</sup> CEEC5 contributions to the EU Structural Funds budget are already deducted.

**Figure 4**  
**Enlargement-induced Regional Policy Costs not Covered by Savings or Growth in EU15 – High Growth in EU15 and CEEC5 –**



**Figure 5**  
**Enlargement-induced Regional Policy Costs not Covered by Savings or Growth in EU15 – Low Growth in EU15 and High Growth in CEEC5 –**



savings, economic growth in EU15 and the residual, i.e. that part of the enlargement-induced regional policy expenditures that is not covered by savings or growth in EU15. This part of structural operations in CEEC5 has to be covered by other sources, for example reductions of CAP expenditures or margins in the overall financial framework.

It turns out that even in the “worst case” scenario for the budget, i.e. low growth in EU15 and high growth in CEEC5, the regional policy costs that cannot be covered by means of savings and growth are comparatively small, about 16% of the 1999 appropriations for structural operations or 0.05% of Community GDP.

Generally speaking the incorporation of the CEECs into the EU’s structural operations will be easier if growth in EU15 is high and growth in CEEC5 is low which limits absorption. As far as the candidate countries are concerned, however, this is a short-run perspective. In the long run it is obviously much cheaper if they catch up rapidly to EU15.

While Table 3 looks at the situation in the year 2006, Figures 4 and 5 show the development of the “residual” over time.<sup>24</sup> Figure 4 shows the development according to scenario (1), high growth in EU15 and CEEC5 while Figure 5 depicts the development

according to scenario (4), low growth in EU15 and high growth in CEEC5. The 1999 expenditure level for structural operations, expressed as a percentage of EU15 GDP, is the benchmark in Figures 4 and 5 ("0"). Changes in annual expenditures, expressed in million ECU, are regarded in comparison to this level.<sup>25</sup>

Both figures show that the changes compared to this starting-level take place in three phases. During the first years following enlargement structural expenditures as a percentage of GDP will remain below their 1999 level. According to Scenario 1 additional resources due to growth and the savings from de-designations keep the structural operations budget below the 0.46% benchmark until 2005. According to Scenario 4 (Figure 5) structural expenditures are above their relative 1999 level from 2003 onwards because there are fewer additional resources from growth in EU15. Due to the phasing in of transfers to the new member states uncovered expenditures rise rapidly until 2006 where they will be about ECU 3 billion (Scenario 1) and ECU 6 billion (Scenario 4) respectively above the 0.46% GDP share. Beyond that peak the growth in regional policy transfers is overcompensated by growing contributions by the old and new member states to the EU budget. If growth in EU15 is sluggish, however, (Figure 5) the gap closes more slowly.

### Conclusions

We have briefly investigated the evolution of regional disparities within the EU and the impact of the Structural and Cohesion Funds on the present recipient regions. Two broad conclusions emerge from this:

- during the last decade income disparities between the member states have narrowed but they have increased within a number of member states. While some lagging regions have caught up with the EU average, others stagnated or fell even further behind, which indicates the emergence of a "divergence club" within the EU periphery.
- Structural and Cohesion Fund transfers helped to reduce income disparities across the Union but it is

difficult to assess to what extent these transfers have raised the potential for self-sustained growth in lagging regions. It seems that the Structural Funds can be a powerful "helping hand" for lagging regions but only if the framework conditions in the recipient areas are favourable to economic growth and entrepreneurship.

We then proceeded to investigate whether it is financially feasible to expand EU regional policy to the five likely new CEEC member states even without a major reform of the present system. This is in essence the approach mapped by the Commission's Agenda 2000 document.

Taking into account that a significant number of the present recipient regions will lose their eligibility at the end of 1999 and that the absorption capacity in the new member states is limited, it turns out that EU cohesion policy in Central and Eastern Europe is indeed very unlikely to be a budgetary timebomb in the foreseeable future. Although there may be a temporary shortfall of funding compared to the Commission's medium-term financial planning it is likely to be relatively small and short-lived. Even on the basis of very pessimistic assumptions concerning savings potential and growth in EU15 and rather optimistic assumptions about growth in CEEC5 the shortfall will not exceed 7 billion ECU or 0.05% of EU GDP. Moreover, our assumptions concerning potential de-designation 'savings were very cautious and expenditures in the new member states were based on the pessimistic assumption that they would be in their entirety eligible for Objective 1 support.

Despite these results the EU should not only maintain but reinforce its efforts to make the current system of structural operations more efficient and effective. While enlargement is unlikely to entail a major budgetary threat, the restructuring and development of large parts of the CEECs is a major challenge for structural policy, possibly even bigger than the development of some of the present cohesion countries. Towards the end of the next decade the group of regions that are likely to be eligible for European support will have changed dramatically. Many of the present recipients will have advanced sufficiently in order to stop or at least to scale down support but at the same time a large number of regions in the new eastern member states will have become eligible. Their problems and development needs, however, may be rather different from those of the "classic" lagging region and they may require very different solutions.

<sup>24</sup> In order to calculate possible savings beyond the year 2006 we projected, on the basis of past regional growth performance, which regions might lose their eligibility after the end of the 2000-06 period (Asturias, Castilla-Leon, Castilla-La Mancha, Canarias, Sicilia) and calculated, on the basis of current transfers and a phasing-out procedure, the potential savings. Given the time horizon involved, this calculation is obviously of a purely indicative nature.

<sup>25</sup> A value of 3000 on the Y-axis thus means an expenditure level that is 3000 million ECU above 0.46% of Community GDP.