Joint ICEG – IMF Workshop

EU Funds in the New Member States: *Opportunities and Challenges*

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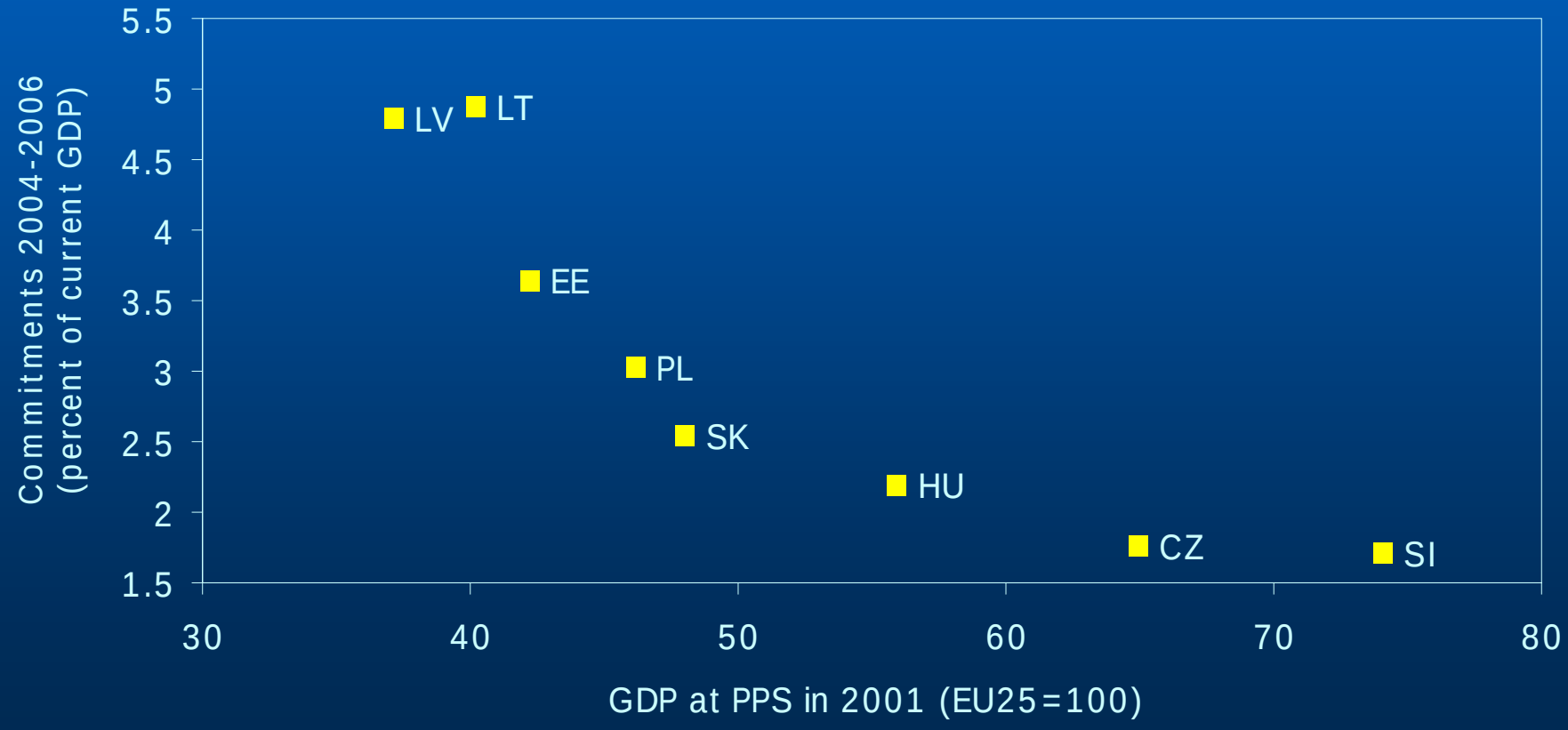
Outline

- EU funds available to the new member states
- Budgetary impact of EU funds
- Demand impact of EU funds to date
- Structural funds
- Supply-side effects and broader macro implications: Model based approaches

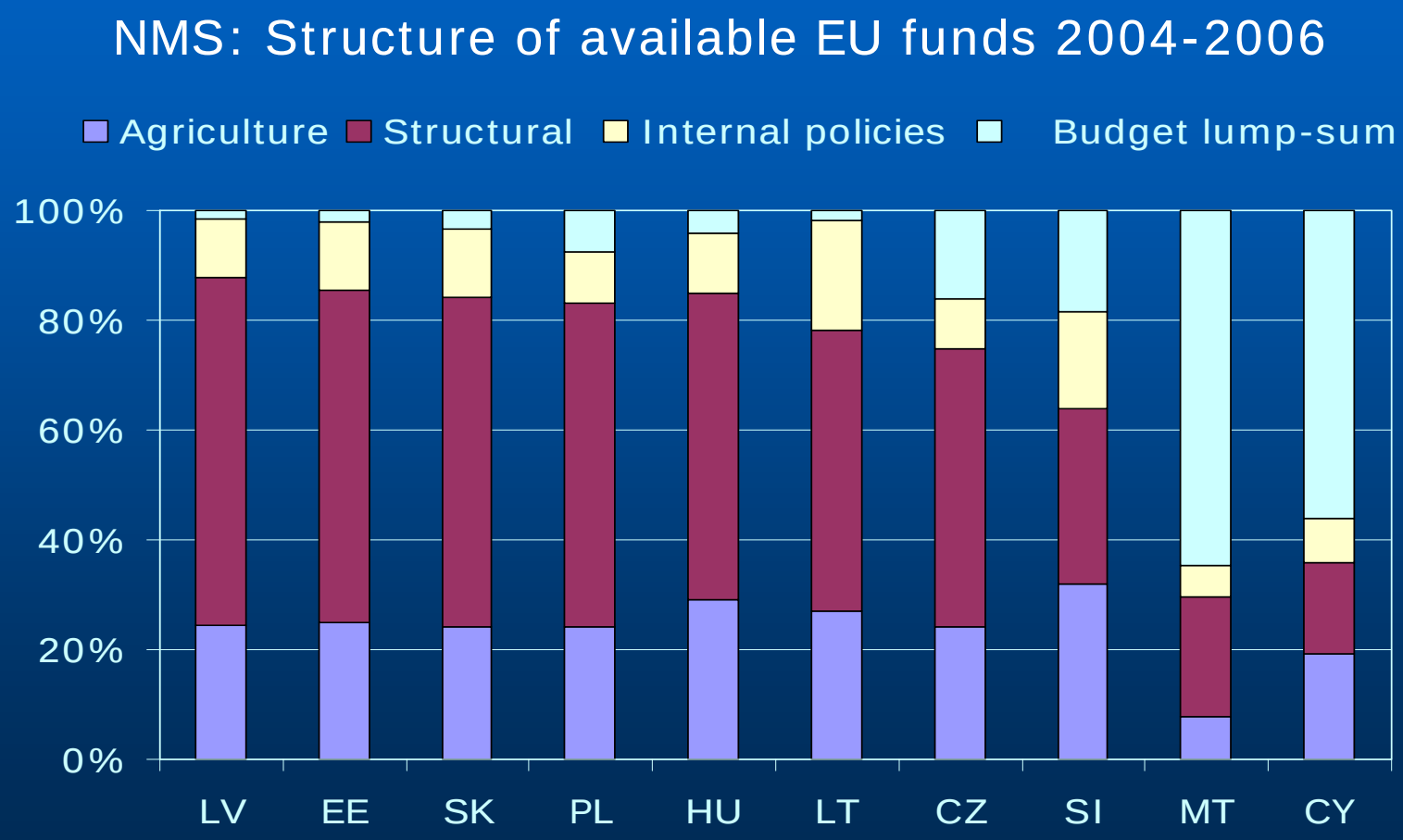
Commitments largely reflects countries' catch-up needs

EU8:
Average annual commitments for EU funds and real convergence



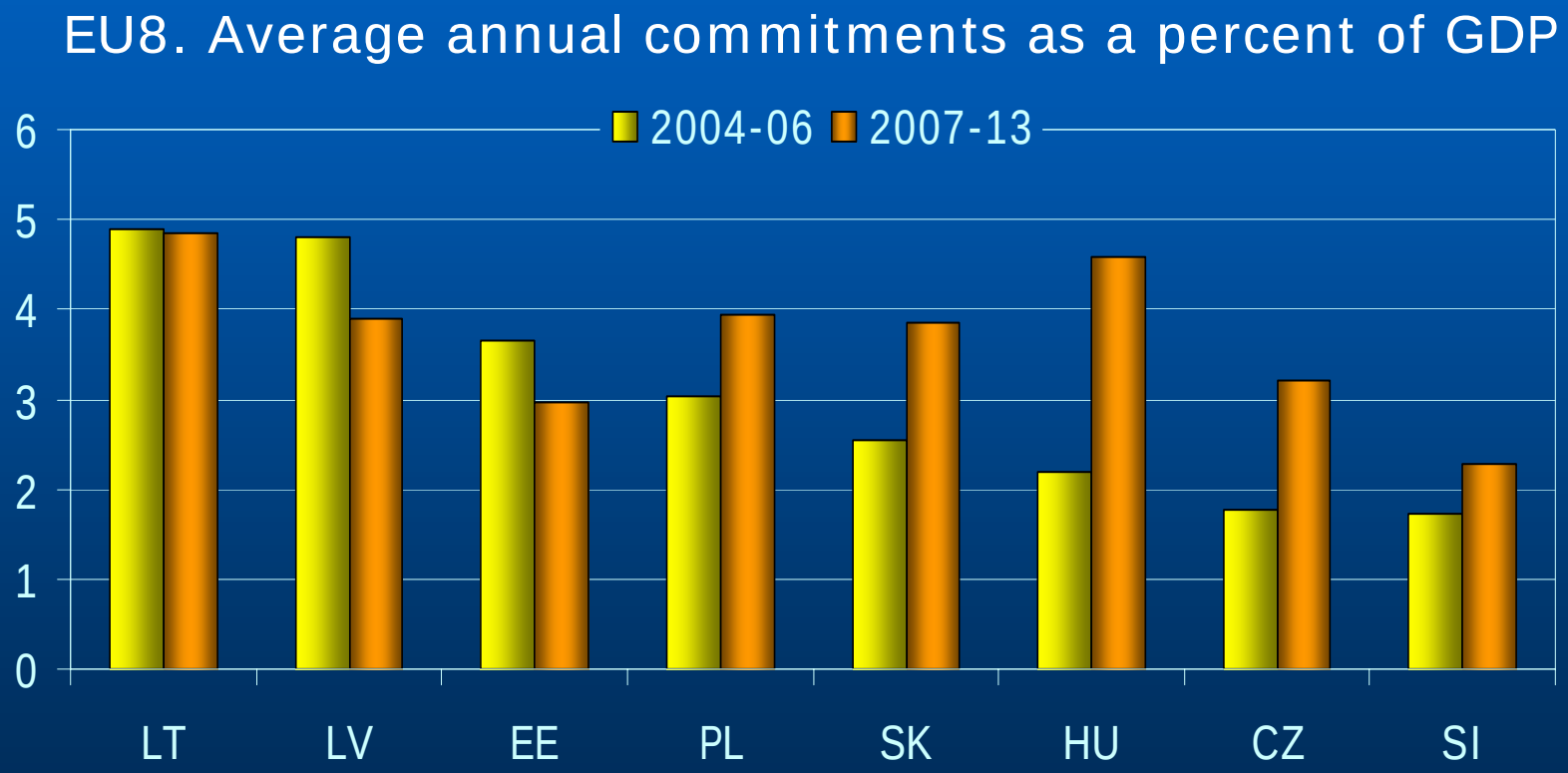
Source: EC, Eurostat.

Structural funds are the EU's main instrument to support real convergence



Source: European Commission.

In 2007-13, the relative importance of EU funds will likely increase in Central Europe and decline in the Baltics



Source: European Commission, national authorities, staff estimates.

Fiscal impact: Methodological issues

ESA95 vs. National cash-based statistics

- Sectoral coverage (e.g. transfers to farmers)
- Timing of recording
- Treatment of advances

Estimation of items often not directly observable in national fiscal accounts

- National co-financing
- Substituted spending

Example: Hungary

Estimation of the fiscal impact of EU-related funds, ESA95 methodology, 2004-2006, HUF bn

	2004 Actual	2005 Estimated	2006 Budget
(1) EU related receipts (1)	**79**	**95**	**173**
o/w budget compensation	43	8	8
transfers to government beneficiaries	36	86	165
(2) EU related expenditures	**190**	**361**	**523**
spending on EU projects/policies	36	86	165
contribution to EU	120	186	217
national co-financing	35	89	140
(3) Substituted spending 1/	**45**	**112**	**191**
Net fiscal impact = (1)-(2)+(3)	**-66**	**-154**	**-158**
(in percent of GDP)	**-0.3**	**-0.7**	**-0.7**

Source: National authorities, staff estimates.
1/ Includes all co-financing, agricultural, and cohesion spending

Fiscal impact: Policy challenges

- Reduce the negative impact on already excessive deficits (Central Europe)
- Reduce hidden fiscal impulse (Baltics)

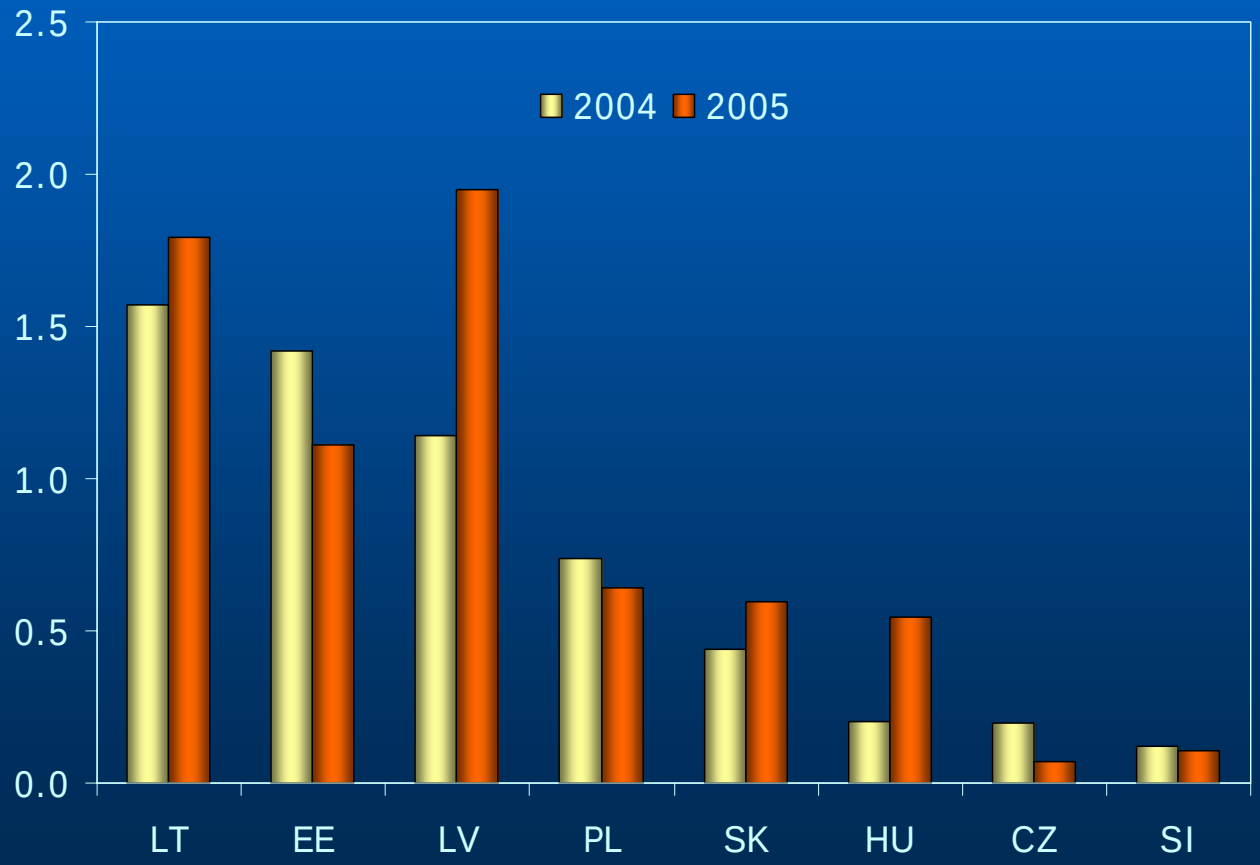
By:

  - Reducing current spending elsewhere in the budget
  - Substituting domestically funded spending to the extent possible

- Ensure transparent recording of all EU related funds in the budget (below and above the line)

Demand impact: all NMS were net beneficiaries of EU transfers.

Net EU transfers in 2004-05 (percent of GDP)



Source: National authorities, staff estimates.

Demand impact: Methodological issues

- Advance payments: no relation to economic activity
- Timing: demand impact does not coincide with the time of reimbursement
- Additionality: are EU funds augmenting or crowding out domestic spending?
- Multiplier effects: depend on consumption propensities
- Second round and general equilibrium effects

Demand effects: a very simplified approach

$$D = \alpha (T + NC - C - A) ; \alpha \in \{0,1\}$$

D - demand impact

T - transfers received from EU

NC - national co-financing of EU funds

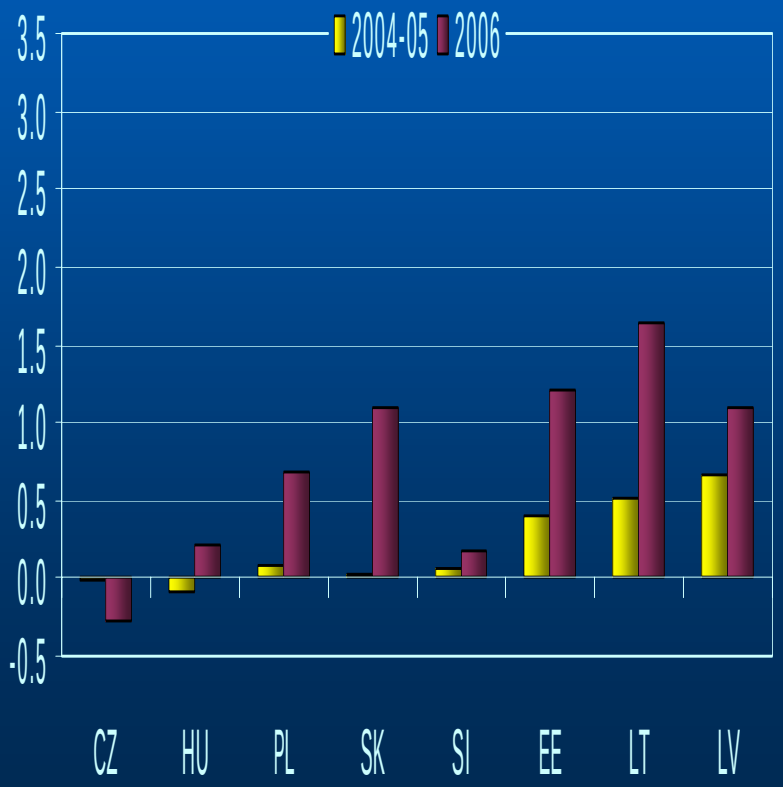
C - contributions paid to EU

A - advances received

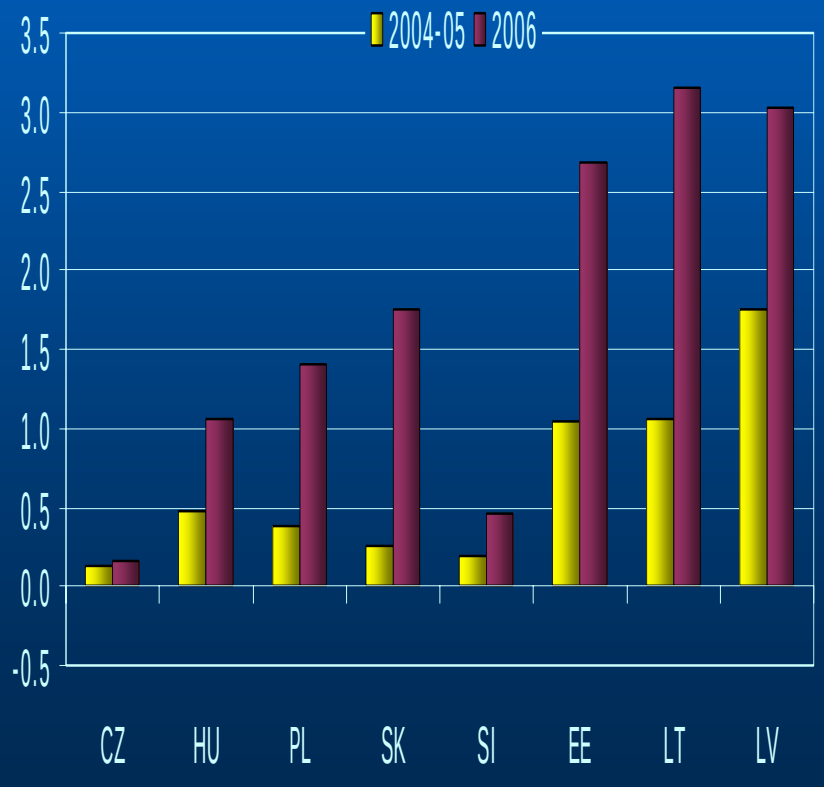
α - degree of substitution between EU- related projects and domestic spending that would have happened anyway (depending on the implementation of additionality guidelines)

Demand impact depends on additionality assumptions

"Official" additionality
(percent of GDP)



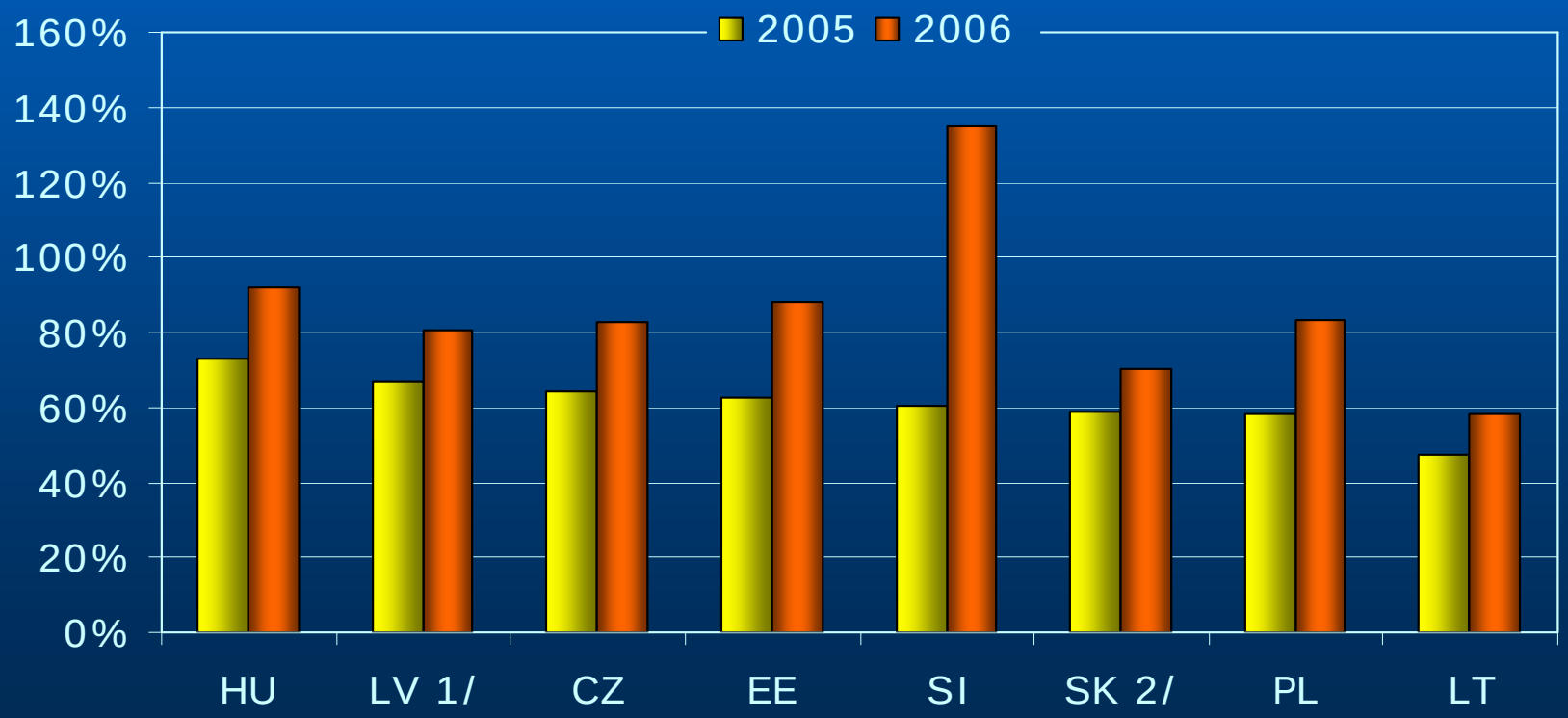
Full additionality α=1
(percent of GDP)



Source: National authorities, staff estimates.

Structural Funds
Demand is high across NMS and most funds are already contracted…

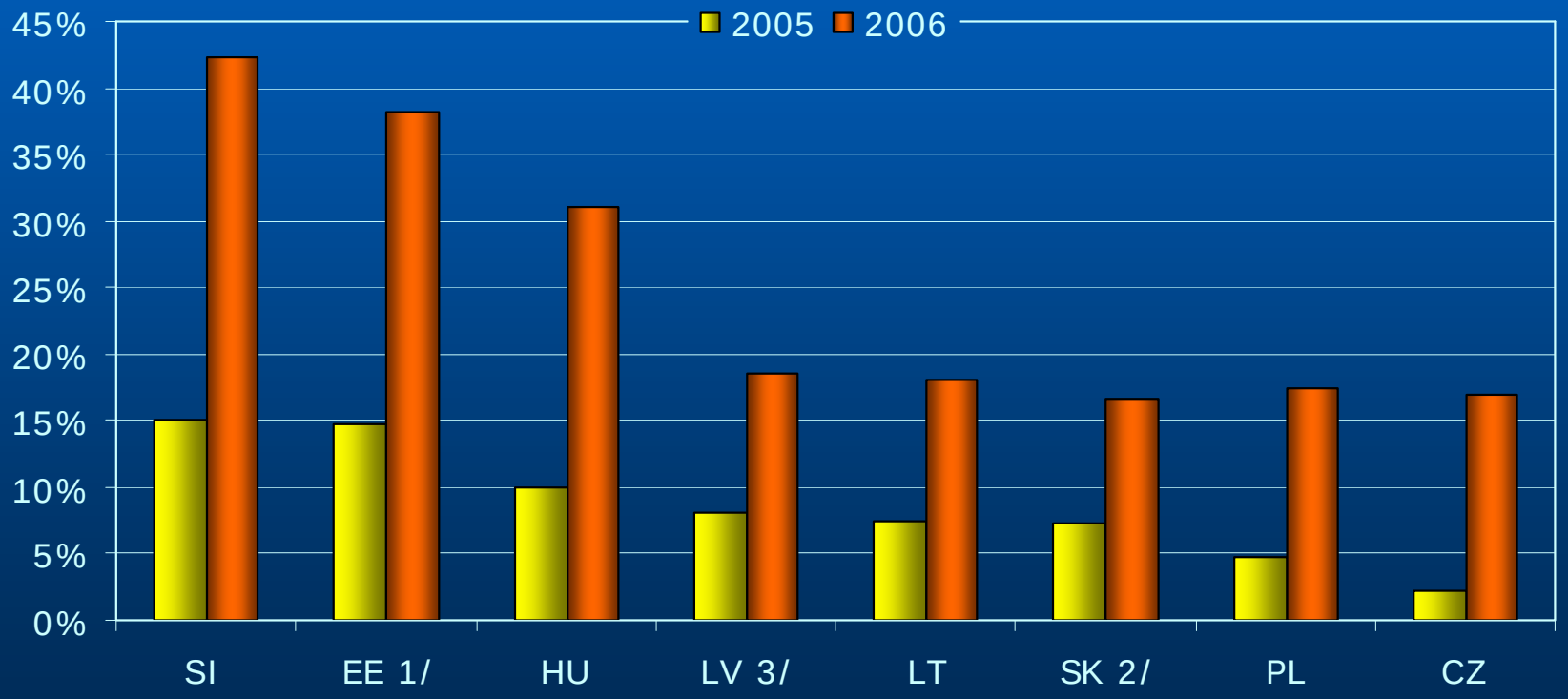
Contracting of structural funds
(end of October 2006, percent of 2004-06 commitments)



1/ Data for end of September 2006.
2/ Data for end of June 2006.
Source: Data from national authorities.

…but absorption rates differ significantly

Requests for interim payments
(end of October 2006,percent of 2004-06 commitments)



1/ Actual refunds from EU.
2/ Data for end of June 2006.
3/ Data for end of September 2006.
Source: Data from national authorities.

Structural Funds: Could institutional frameworks explain absorption?

- NMS have developed two models:
  - BALTIC MODEL: Single institution acting as both managing and paying authority; this role is played by the Ministry of Finance
  - CE5 MODEL: MoF acting as payment institution, but not as a central managing authority

- Observations:
  - Leaders in absorption represent both models
  - In both cases there seem to be quite strong central coordination in the management of EU funds
  - Initial frameworks were initially over-regulated and NMS are streamlining their regulations
  - Well-functioning payment systems and proper incentives for beneficiaries are needed to translate high contracting into high disbursements

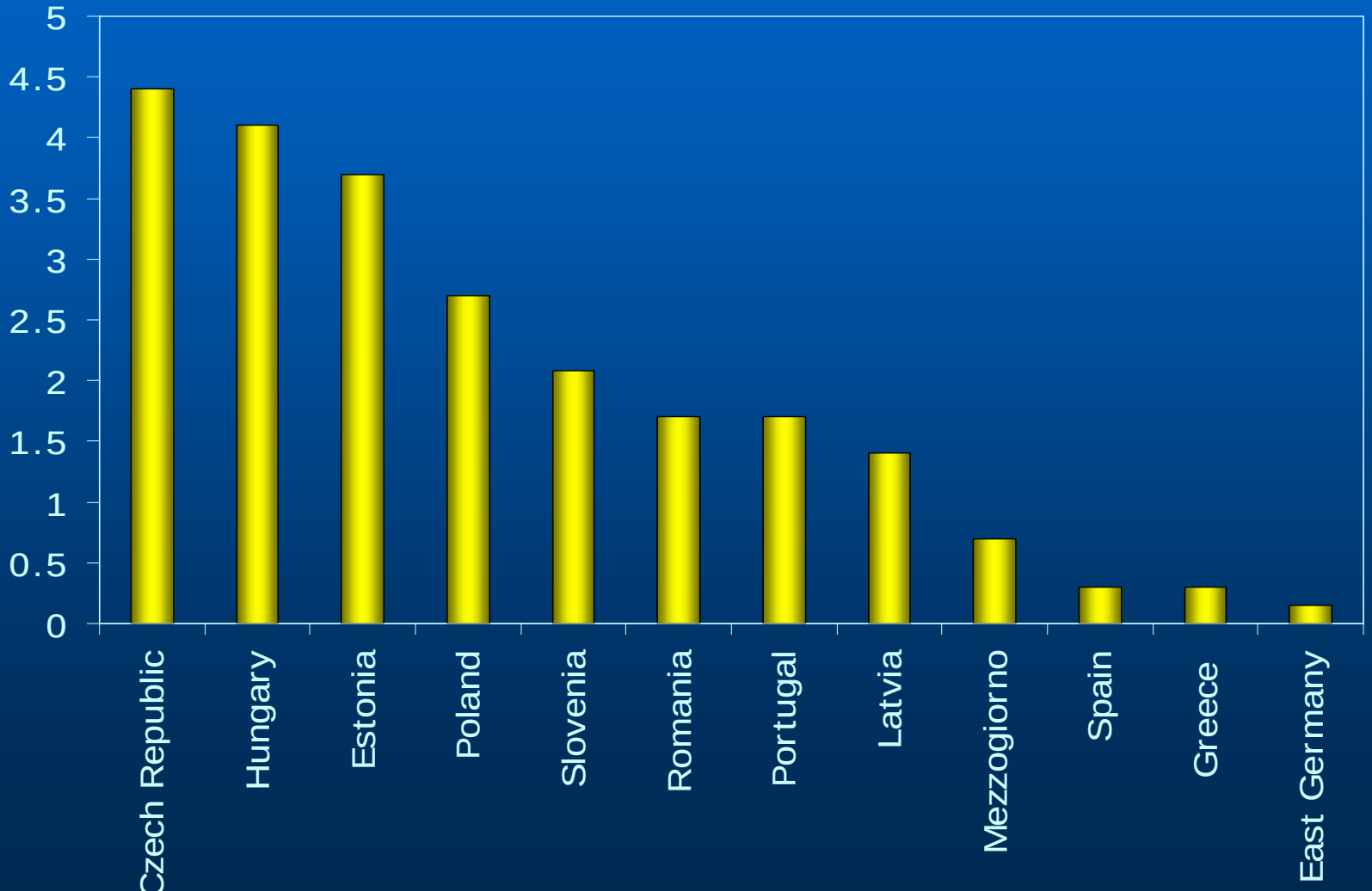
Modeling the impact of structural funds: Methodological issues

- Defining a baseline without SF
- Calibration: rapid structural changes, few comparator countries for panel regressions
- Measuring distortions caused by SF
- How to refine the concepts of stock in human capital and physical infrastructure
- Incorporating the quality of program design and implementation
- Actual vs. projected payments

Macro models applied to the NMS

- HERMIN: First cross-country results in Bradley et al (2004), application to Poland
- QUEST: European Commission's macro model for policy analysis – application to NMS possible (done for some old member states)
- GEM: IMF micro-founded global simulation model - application to EU funds in NMS is underway.

HERMIN: Increase in the level of GDP by 2020 (% over no-SF baseline level)



Source: Bradley, J.: EU Cohesion Policy: The debate on Structural Funds, 2005

Key Messages

- Macro effects of EU funds are small to date, but are likely to grow
- Work program: develop analytical models
- Policy challenges:
  - Increasing absorption
  - Avoiding unwarranted fiscal stimulus
  - Using SFs to enhance growth