

The Potential Impact of EU Cohesion Policy Spending in the 2007-13 Programming Period: A Model-Based Analysis

By Janos Varga and Jan in 't Veld

The European Union directs through its Cohesion Policy Programmes large fiscal transfers from the richer EU Member States to the countries and regions that lag behind in terms of income per capita. These European Cohesion and Structural Funds target public and private investment in physical and human capital, and are designed to increase economic and social cohesion among member states, enhancing a faster catch-up process of the less developed member states. With a budget of 336 billion euro for the 2007-13 programme period it represents more than a third of the EU budget. Just over half of the total, 174 billion euro, is available for the New Member States that joined in 2004.

This paper uses a micro-founded Dynamic General Equilibrium (DGE) model to evaluate the potential impact of Structural and Cohesion Fund programmes for the largest recipient Member States of the European Union for the period 2007-2013. The model employed is based on the QUEST III model. We use here an extended version of this model with human capital accumulation and endogenous technological change. This version of the model has been used extensively for the analysis of structural reforms in the EU (Roeger, Varga and in 't Veld, 2008) and is particularly suitable for an evaluation of the type of structural policies that form the core of Cohesion Policy interventions. The model incorporates productive infrastructure investment that captures the productivity-enhancing effects of public capital. It also employs the product variety framework proposed by Dixit and Stiglitz (1977) and applies the Jones (1995) semi-endogenous growth framework to explicitly model the underlying development of R&D. The endogenous modelling of R&D allows us to analyse the impact of R&D promoting policies on growth. Furthermore, the endogeneity of human capital accumulation in the model can capture the effects of policies promoting vocational education and training. The model covers each of the EU27 member states, plus one region representing the rest of the world. The explicit modelling of cross-country linkages through bilateral trade relationships allows us to capture spillovers of cohesion spending and interactions between EU member states, both for the beneficiaries as well as the donor countries.

We consider two further issues relevant for EU Cohesion policy. First, the conditions of co-financing and additionality have been called into question due to the financial crisis. The European Union only pays up to 85 percent of each funded programme, and governments have to add to this from their own budgets. However, due to the economic crisis several Member States have had little room for manoeuvre to co-fund additional projects, and changes in the regulations allow for acceleration and advance payments from EU funds to

ensure the availability of financial resources during the crisis although Member states will still have to pay back the required co-financing at a later stage within the 2007-2013 framework. We use the model to examine the impact of this co-financing condition and how it affects overall results. A second issue is the long delays in spending due to implementation lags. While each country is allocated funding ("decided amounts") over the period 2007-13, past experience has shown spending is much delayed and typically spread over many more years. In fact, spending in the first three years of this programming period has been extremely low. These delays may be inevitable due to the strict conditions which projects are subject to, but it means potential benefits of this funding are not reaped to the full.

There are potentially significant long run benefits from EU Cohesion Policy spending in the less developed regions of the EU. These positive benefits become stronger in the medium and long run and will be able to deliver a significant improvement in incomes and output in the regions supported. In the short run, these interventions boost spending and raise output. However, they also raise inflationary pressures and could lead to real appreciations and crowd out productive private investment. R&D promoting policies could drive up wages of researchers and crowd out high skilled employment in other sectors, while training and other human capital investments could lower output in the short run if it leads to a reduction in the active labour force. Significant effects from these policies should only be expected some years after implementation. But in the medium term the productivity enhancing effects of infrastructure investment, R&D promoting policies, and human capital investments become gradually stronger and generate large output effects in the long run. Even when the funding is terminated and spending discontinued there are permanent positive output gains.

The conditions of co-financing and additionality are shown to have no detrimental effect on GDP. The gains from more productive spending soon outweigh the costs of financing a share of the programme from their own budget, and long run GDP effects are larger. The rationale for these conditions is to act as an insurance that EU funds are not misspent on unproductive projects. The costs of the long delays in implementation are found to be significant. Speeding up the allocation of available funding for productive investments could considerably raise potential output effects.