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Sixth report on economic, social and territorial cohesion: Investing in Europe's Future

{COM(2014) 473 final}

1.8. Preserving growth-enhancing investment

Adequate levels of investment are a precondition for competitiveness and development. Public investment tends to increase the rate of return of private capital, boosting economic growth in the long-run. In times of recession, characterised by sluggish demand, loss of output relative to potential and low private investment, public investment can stimulate growth in the short as well as long-run through its effect on demand. As indicated in Chapter 5, both public and private investment has declined significantly over the past few years reaching record low levels in some countries. Tight budget constraints and spending cuts have seriously affected growth-enhancing expenditure.

The Commission's Annual Growth Surveys of 2012 and 2013 recommended maintaining an adequate pace of fiscal consolidation while preserving investment aimed at achieving the Europe 2020 goals for growth and jobs. In 2012, the Communication from the Commission, *A blueprint for a deep and genuine economic and monetary union - Launching a European Debate*' (COM (2012) 777 final/2) emphasised that public investment is one of the relevant factors to be taken into account when assessing the fiscal position of a Member State, notably when deciding to open an Excessive Deficit Procedure (EDP). It also proposed that, when assessing Stability and Convergence Programmes, non-recurrent public investment with a proven impact on the sustainability of public finances could qualify for a temporary deviation from the medium-term budget objective or the adjustment path towards it

Government investment projects co-financed by the EU Structural and Cohesion Funds (as well as Trans-European-Networks and Connecting Europe Facility) were considered the natural candidates in this regard, as they fall into the category of productive spending. They, therefore, support GDP potential in the medium-term and contribute to increasing growth-enabling infrastructure, human capital (through training and education), and total factor productivity (through innovation and institutional reforms). This proposal is particularly relevant in a context where a number of Member States report difficulties in continuing to co-finance Cohesion Policy programmes when they have to meet the fiscal targets under the Stability and Growth Pact (SGP).

Accordingly, an 'investment clause' for Member States has been included as part of the preventive arm of the Stability and Growth Pact (SGP), i.e. for Member States which are not in an Excessive Deficit Procedure (EDP). It constitutes a specific application of Article 5(1) of Regulation 1466/97 on the surveillance of budgetary positions and the surveillance and coordination of economic policies of Member States and is related to the existence of a large negative output gap. It allows Member States to temporarily deviate from their medium-term budgetary objective (MTO) or the required adjustment path towards this in specific adverse economic circumstances and in a context of increasing public investment. The "investment clause" is implemented in 2013 and 2014.

In addition to the 'investment clause', the SGP includes several provisions concerning the treatment of government investment. In the preventive arm of the SGP, investment receives special treatment under the new expenditure benchmark. In particular, general government gross fixed capital formation is averaged over a number of years, in order to avoid Member States being penalised if their

investment fluctuates markedly from year to year. Moreover, all expenditure, including investment spending, on EU programmes fully matched by EU funding is also excluded from the increases in government expenditure under consideration.

As regards the corrective arm of the SGP, the specific Protocol on the EDP annexed to the Treaty envisages that budgetary discipline is assessed against reference values for the general government deficit and debt which do not differentiate between different kinds of expenditure. Nevertheless, public investment is one of the relevant factors that have to be taken into account in the Commission's assessment prior to the launch of an EDP. In particular, the Commission has "*to take into account whether the government deficit exceeds government investment expenditure and all other relevant factors*". The list of the other relevant factors includes "*developments in primary expenditure, both current and capital (...) the implementation of policies in the context of the common growth strategy of the Union, and the overall quality of public finances*".

1.9. Linking additionality verification to the stability and convergence programmes

Additionality is a core principle of Cohesion Policy intended to ensure that the funding it provides generates added-value. It means that the EU Structural Funds should complement but not replace equivalent public expenditure undertaken by Member States. Additionality is respected if the average national development expenditure in real terms per year in 2007-2013 is at least equal to the level determined at the beginning of the period, so that EU funding adds to national investment.

For the 2007-2013 period, verification in the Convergence regions (including phasing-out regions) in the 20 Member States¹ occurs at three points:

- *ex-ante* when the level of public expenditure to be maintained (the 'baseline') is set;
- mid-term when the level of actual expenditure in 2007-10 is determined and the baseline is reviewed;
- *ex-post* when the level of actual expenditure in 2011-2013 is determined and related to the baseline.

The mid-term verification gave rise to three main findings:²

- The overall level of national spending on development in the Convergence regions in 2007-10 was 7% higher than the *ex ante* level, largely because of an increase in particular Member States, mainly as a result of government efforts to mitigate the impact of the crisis or, in some cases, because of the strong economic expansion before the crisis.

¹ Belgium, Bulgaria, Czech Republic, Germany, Estonia Greece, Spain, France, Italy, Latvia, Lithuania, Hungary, Malta, Austria, Poland, Portugal, Romania, Slovenia, Slovak Republic, and the UK

² See: Communication from the Commission: Results of the mid-term verification of additionality 2007-2013, COM(2013)104 final.

- A significant number of Member States asked for their baselines for 2007-13 to be reduced, mostly because of fiscal consolidation, though in two cases, it was because of the *ex-ante* calculation being corrected. All of these requests were considered to be justified.
- Shortcomings were identified in the method for verifying additionality, which did not produce fully comparable results across Member States. The *ad-hoc* process required considerable resources both for the Member States and the Commission, and it was not aligned with the review of Member State fiscal plans under EU economic governance procedures.

As a result, the verification process has been reformed for the 2014-2020 period, linking it closely with EU economic governance procedures as well as simplifying it. A single indicator of total public investment (General Government gross fixed capital formation) has been chosen to measure the investment effort of national authorities, so enabling verification to be carried out transparently in the light of the room for fiscal manoeuvre of each Member State. The reform makes verification simpler, more comparable and less burdensome. Whereas up until 2007-2013, additionality was verified in every Member State with a Convergence region, in 2014-2020, it will be verified only in those where there are significant regional disparities and where a large proportion of the population live in less developed regions. This will reduce the number of countries concerned from 20 to 14.³

1.10. Increasing the role of financial instruments

Financial instruments represent a potentially resource-efficient way of deploying Cohesion Policy resources by providing repayable support for investment through loans, guarantees, equity and other risk-bearing instruments. Besides the obvious advantage of recycling funds over the long term, they help to reduce the dependence of firms on (non-refundable) grants and to mobilise additional private co-investment, so increasing the impact of EU funding.

Financial instruments have increased markedly in importance. By the end of 2012, Cohesion Policy support for them amounted to EUR 12.6 billion in 25 Member States as against only EUR 1.2 billion in 2000-2006. In October 2013, the European Council concluded that programme negotiations should be used to increase significantly the support from the ESI Funds for leverage-based financial instruments for SMEs in 2014-2020 and at least doubling support in countries where access to finance remains tight.

In order to encourage the use of financial instruments, the new framework increases the extent to which EU funding can be used to support them. In practice, this means that programme managers have the possibility of employing financial instruments to pursue all 11 thematic objectives instead of being limited to three areas as in 2007-2013 (enterprise support, urban development and energy efficiency).

³ The 14 are Bulgaria, Croatia, Czech Republic, Estonia, Greece, Italy, Latvia, Lithuania, Hungary, Poland, Portugal, Romania, Slovenia and Slovakia.

Standardised, ‘off-the-shelf,’ financial instruments are also being provided for Member States with less experience of them, with pre-defined terms and conditions to facilitate rapid roll-out. Some incentives are available for financial instruments: for contributions from Operational Programmes to an EU-level financial instrument under Commission management, up to 100% of the support can come from the ERDF, ESF or Cohesion Fund, and for funding allocated to national or regional instruments under shared management, the EU co-financing rate is increased by 10 percentage points if a priority is fully carried out by such means.

The Commission and the EIB are jointly setting up a new risk-sharing instrument which combines financing from ESI Funds, Horizon 2020 and the COSME programme with EIB loans to generate additional lending to SMEs (the ‘SME Initiative’).

Financial instruments can potentially increase access to finance for a wide range of organisations and individuals, including enterprises investing in innovation, households seeking to improve their energy efficiency and people pursuing their business ideas. They can also help to fund public infrastructure or other projects that comply with the strategic objectives of Cohesion Policy and at the same time yield a financial return.

Nevertheless, financial instruments are not suitable in all circumstances. This is why their use has to be justified on the basis of an *ex ante* assessment to identify *inter alia* the market failure or sub-optimal investment situation which they are intended to correct and to verify investment needs and that a critical mass is likely to be achieved.

1.11. Reinforcing cooperation across Europe

European Territorial Cooperation (ETC) is one of the two main goals of Cohesion Policy in the present period, providing a framework for joint action and policy exchanges between national, regional and local actors in different Member States. The challenges faced by Member States and regions increasingly cut across national and regional boundaries and cooperation at an appropriate territorial level is needed to tackle them effectively. ETC can accordingly contribute to furthering the Treaty objective of territorial cohesion:

- trans-border problems (such as pollution) can be overcome most effectively by all the regions concerned cooperating to avoid disproportionate costs for some and free-riding by others;
- cooperation provides a means of sharing good practice and know-how;
- cooperation can realise economies of scale and help to achieve a critical mass, such as in relation to clusters of a particular activity;
- cooperation can improve governance through coordination of policy measures and investment which span national borders;
- cooperation with EU neighbouring countries can contribute to safety and stability and establish mutually beneficial relationships;

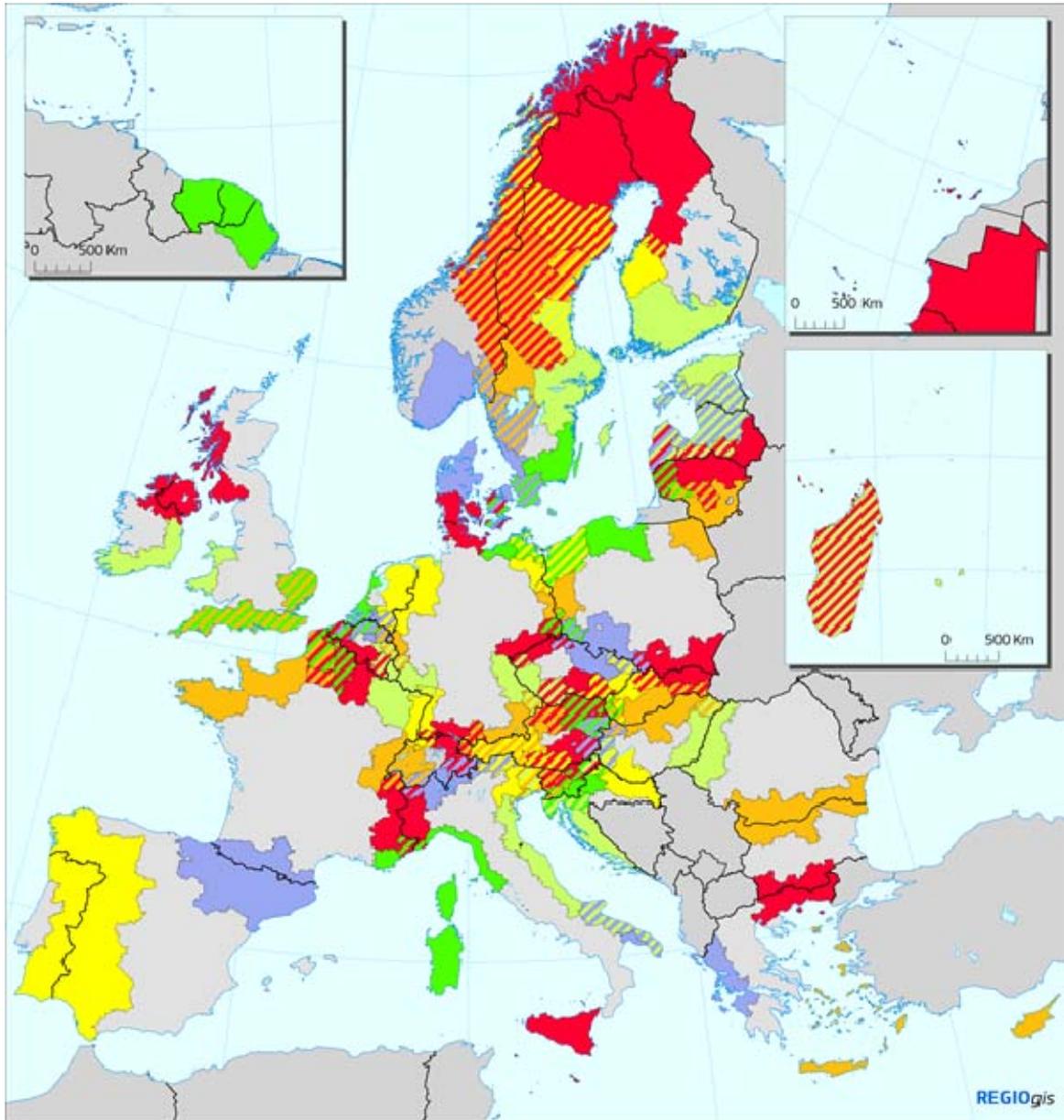
- cooperation between countries is essential in macro-regions, such as those around the Baltic Sea, to manage eco-systems in support of sustainable growth and employment.

The new ETC legal framework also envisages concentration of investment in particular policy areas as well as an increased focus on results, including the establishment of programme-specific milestones against which progress can be assessed. It contains new provisions to facilitate programme implementation, in particular:

- strictly defined selection criteria to ensure that funding is given to genuinely joint operations;
- a reduction in the number of authorities involved in programme implementation and a clarification of their respective responsibilities;
- simplification of the rules on eligibility and prior-written confirmation in this regard by all Member States participating (and, where applicable, third countries) for each programme to help avoid the legal uncertainties which could arise as it is carried out.

In the 2007-13 period, at the request of the European Council, two macro-regional strategies were adopted by the Commission, one for the Baltic Sea and one for the Danube. Another two, for the Adriatic-Ionian and Alpine Regions, are under preparation. Each of these covers several Member States and regions and is aimed at increasing the coherence of policy and the overall impact of public funding.

Map 1 Cross-border cooperation programmes 2014-2020



ERDF Cross-border cooperation programmes 2014-2020

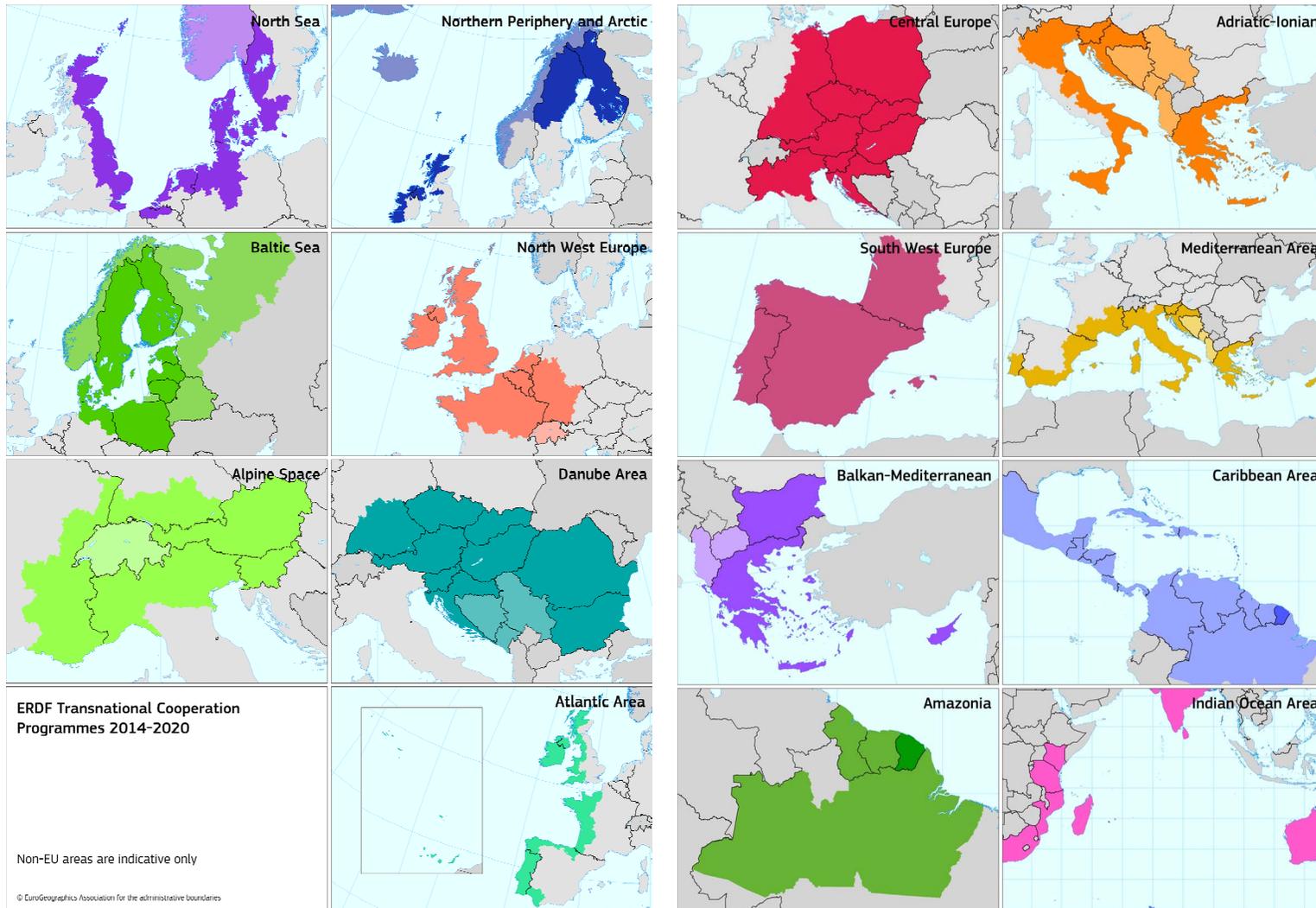
This map shows the areas of the cross-border programmes co-financed by the ERDF. Each programme area is shown with a specific colour. Hatched areas are part of two or more programme areas simultaneously.

Source: DG REGIO

0 500 Km

© EuroGeographics Association for the administrative boundaries

Map 2: Transnational cooperation programmes 2014-20



2. PRELIMINARY ASSESSMENT OF THE PROGRAMME NEGOTIATIONS 2014-20

The Commission has adopted a proactive approach in the new period to try to ensure a timely start of programmes. As early as autumn 2012, the Commission sent position papers to all Member States outlining its views of the development needs and funding priorities for each of them. In addition, an informal dialogue took place in 2013 with most Member States to identify funding priorities at an early stage and accelerate the adoption of the programming documents as soon as possible in 2014.

At the time it adopted this report, the Commission had received all 28 Partnership Agreements (PAs) though only just over 150 of the 400 or so expected Operational Programmes (OPs). Negotiations with Member States and regions are ongoing. The following, therefore, provides only a preliminary indication of the extent to which the main elements of the reform have been incorporated in the new strategies and programmes.

2.1. Funding priorities in 2014-20

Overall, around EUR 336 billion are allocated to national and regional programmes under the Investment for growth and jobs goal.⁴ The resources are divided as follows: EUR 187.5 billion to the ERDF, EUR 63 billion to the Cohesion Fund, and EUR 85 billion to the ESF which is higher than the legally required minimum ESF allocation of EUR 80 billion.⁵

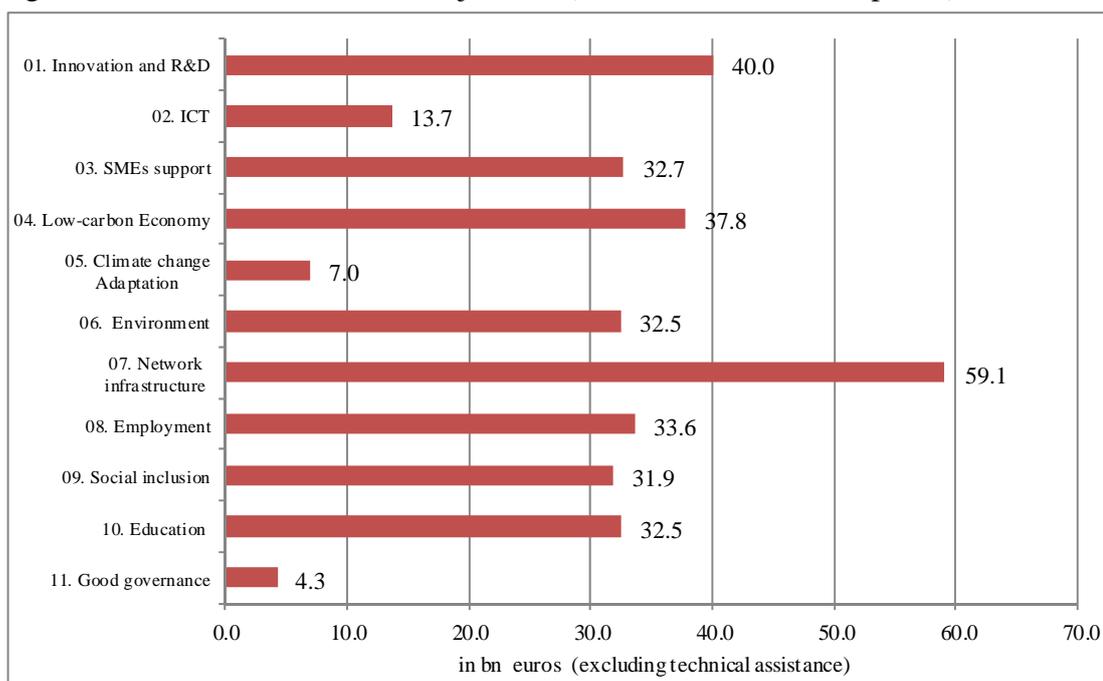
(i) Allocation by thematic objective (TO)

The largest allocation from the three funds is foreseen for support for transport and energy infrastructure (TO7) (EUR 59.1 billion or 18.2% of the total), followed by strengthening R&D and innovation (TO1) (EUR 40 billion, 12.3% of the total) and support for a low carbon economy (TO4) (EUR 37.8 billion, 11.6% of the total).

⁴ The financial resources for this goal cover the ERDF (excluding support for European Territorial Cooperation), the ESF and the Cohesion Fund. Resources allocated to technical assistance are not considered in this analysis.

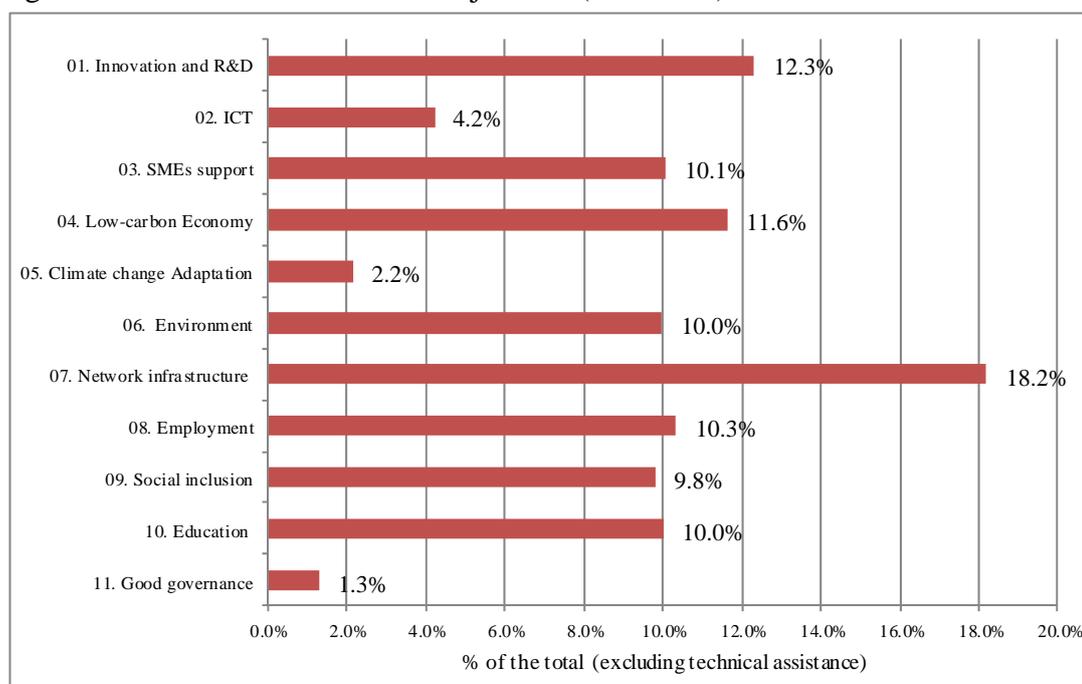
⁵ The figures mentioned in this section are preliminary (state of play: 1 June 2014) and may change in the context of the ongoing programme negotiations between the Commission and Member States.

Figure 1 : Allocation to thematic objectives (EUR billion at current prices)



Financial allocations to support employment (TO8), SMEs (TO3), education and training (TO10), environmental protection (TO6), and social inclusion measures (TO9) are on much the same scale, around EUR 32-33 billion (or around 10% of the total), while allocations to support the digital agenda (ICT; TO2), adaptation to climate change (TO5) and good governance (TO11)⁶ are much smaller (Figures 91 and 92).

Figure 2 : Allocations to thematic objectives (% of total)

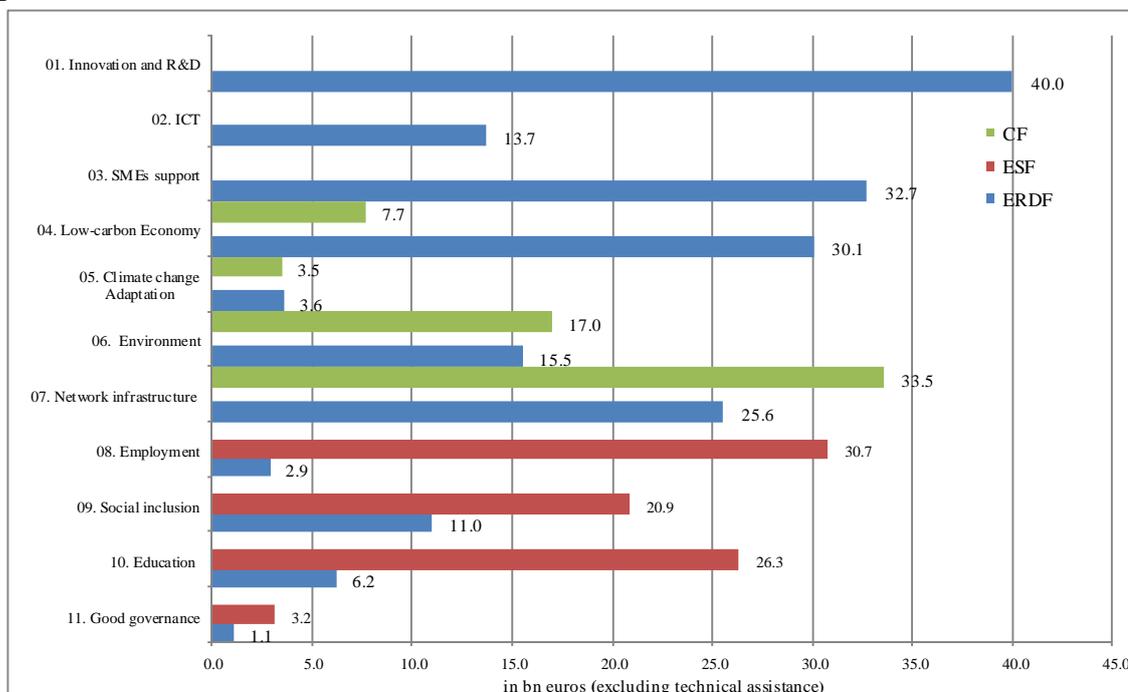


⁶ Investments in enhancing institutional capacity of public authorities and stakeholders and efficient public administration is considered as good governance.

(ii) Allocations to thematic objectives by Fund

The allocation to thematic objectives from each Fund reflect the provisions of the new regulatory framework, in particular the priorities on which they are concentrated (see Figures 93 and 94):

Figure 3 : Allocation to thematic objective by Fund (EUR billion at current prices)

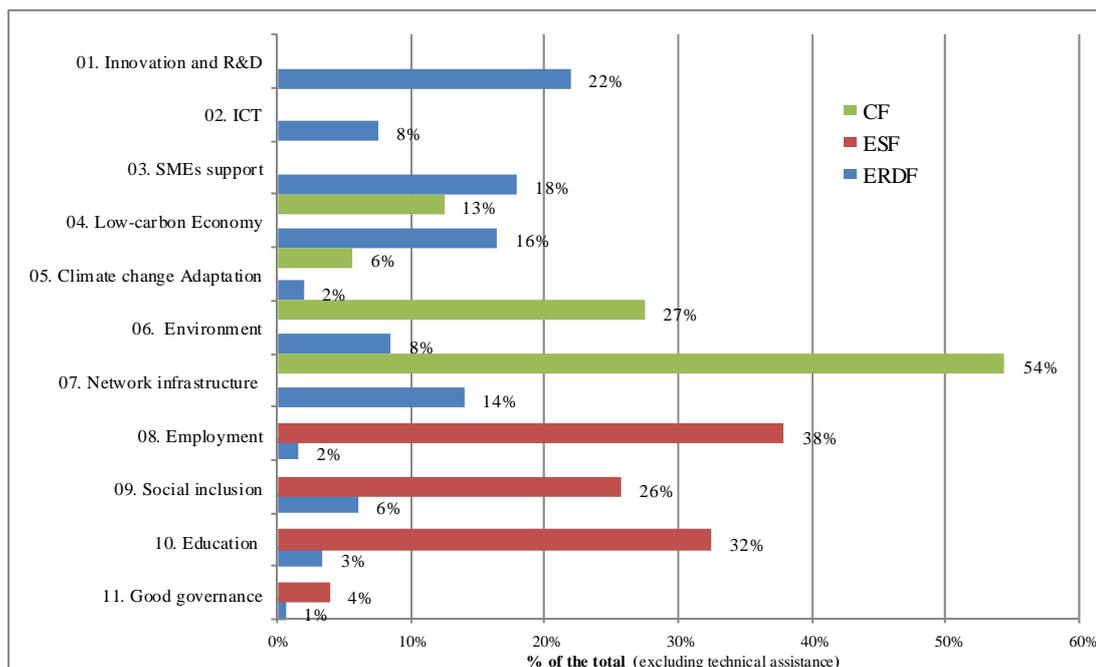


The ERDF will be used to pursue all 11 thematic objectives (see Figure 94), but resources are concentrated on support for R&D and innovation (EUR 40 billion, 22% of the ERDF total), SMEs (EUR 32.7 billion, 18% of the total), a low carbon economy (EUR 30 billion, 16.5% of the total), and transport and energy infrastructure (EUR 25.6 billion, 14% of the total).

Support from the Cohesion Fund is concentrated on four objectives only (i.e. 4-7), just over EUR 33 billion being allocated to investment in transport and energy infrastructure (54% of the total), EUR 17 billion (27.5% of the total) to environmental protection and EUR 7.7 billion (12.5% of the total) to low carbon economy.

Like the Cohesion Fund, financial support from the ESF is focused on four objectives, almost EUR 31 billion (38% of the total available) being allocated to employment, EUR 26.3 billion (32.5% of the total) to education and training and EUR 20.9 billion (26%) on social inclusion measures.

Figure 4 : Allocations to thematic objectives by Fund (% of Fund total)



(iii) Allocations to thematic objectives by group of countries

The relative allocation of funding to the different objectives varies significantly between more and less developed Member States⁷, reflecting their different levels of economic development and investment needs, though there will equally be variations between countries in each of these categories for the same reasons.

In the more developed Member States, the share of investment in R&D, innovation, ICT, SMEs and a low carbon economy (44.5% of the total) is significantly larger than in less developed ones (35%).

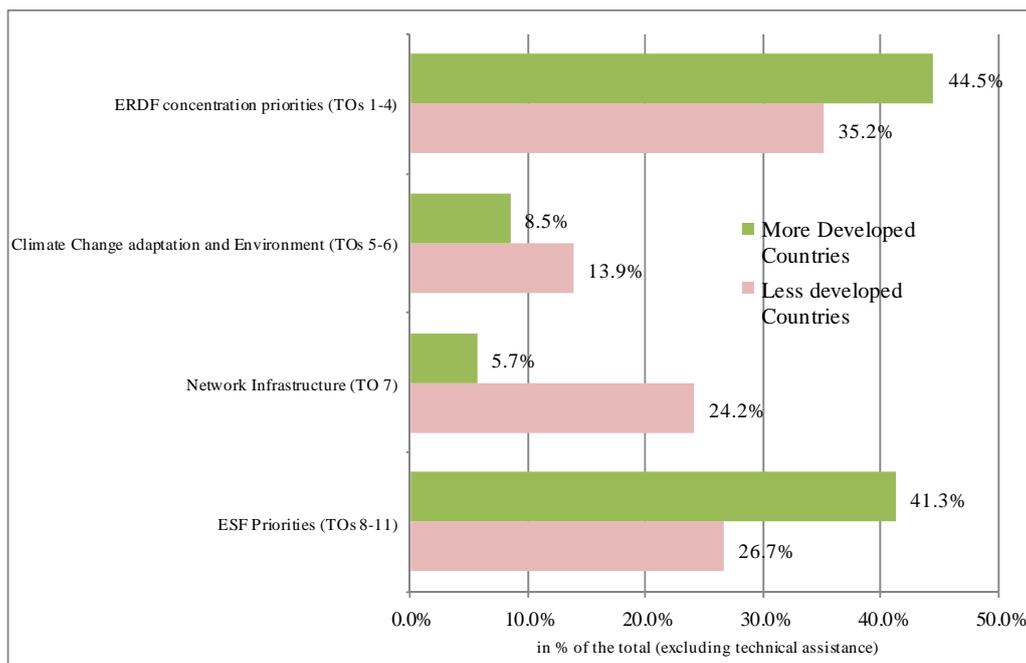
The same is true for investment in employment, social inclusion, education and training and administrative capacity building (41% of the total in the more developed countries, just under 27% in the less developed).

Less developed Member States, on the other hand, have earmarked a larger share for investment in environmental protection and adaptation to climate change than more developed ones (14 % as against 8.5%).

The difference is even more pronounced for transport and energy infrastructure, for which the share is almost 5 times larger in the less developed Member States than in more developed (24% as against just under 6%).

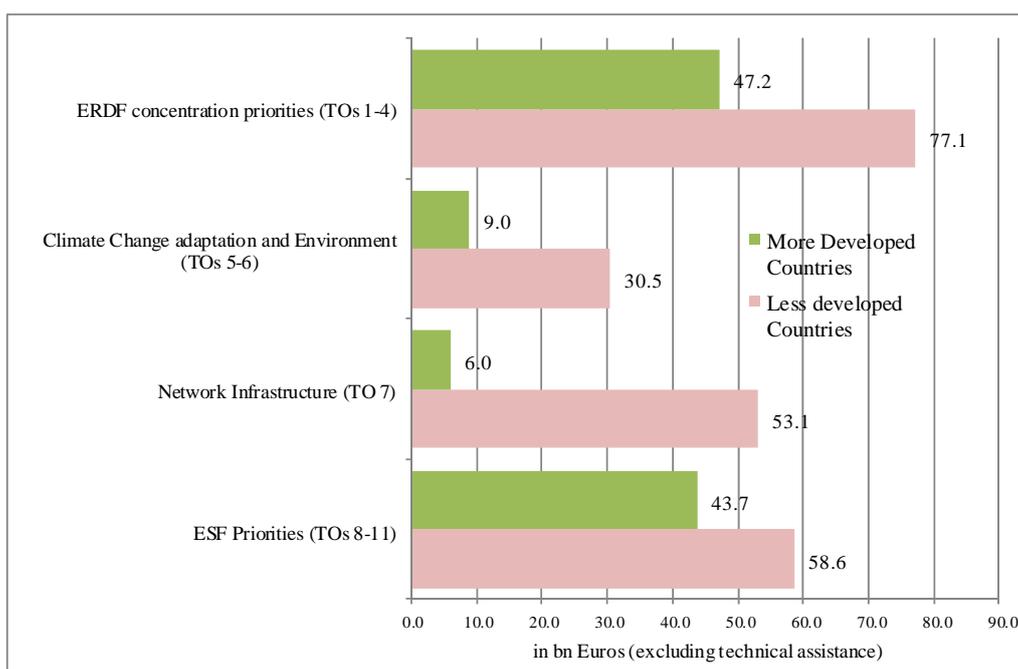
⁷ For the purpose of this analysis the less developed Member States are taken as the countries eligible for the Cohesion Fund in 2014-20. These are Bulgaria, Croatia, Cyprus, Czech Republic, Estonia, Greece, Hungary, Latvia, Lithuania, Malta, Slovakia, Poland, Portugal and Romania, and Slovenia. More developed Member States are those countries which are not eligible for Cohesion Fund support.

Figure 5 : Allocation to thematic objective by group of countries (% of total)



The situation is of course different in terms of the absolute amounts allocated to the various objectives because of the much larger scale of funding going to the less developed countries. Whereas the share of investment allocated to innovation, ICT, SMEs and a low carbon economy as well as to employment, social inclusion, education and administrative capacity building is smaller in less developed Member States than in the more developed ones, the amount of funding going to these objectives is significantly larger (Figure 96). It is larger still in relation to the population in these countries, which is only around a third of that in the more developed ones.

Figure 6 Allocations to thematic objectives by group of countries (EUR billion at current prices, excluding technical assistance)



(iv) Funding priorities 2014-20 as compared with 2007-13

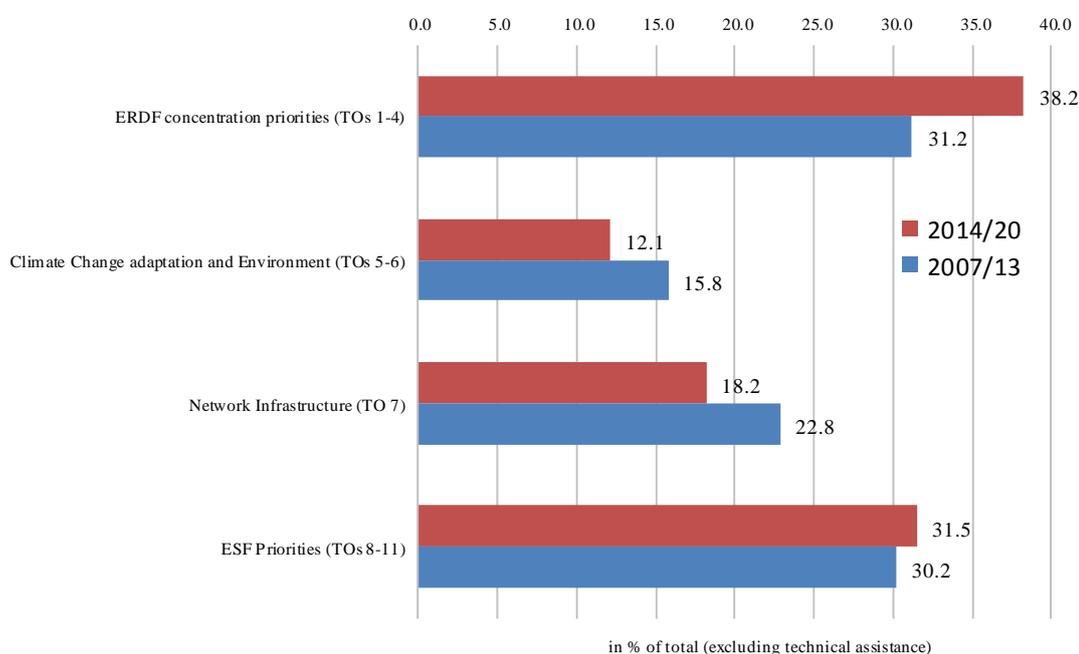
The new programming period brings a shift of funding priorities compared with 2007-13 reflecting the close link between Cohesion Policy and the Europe 2020 strategy.⁸

Around EUR 124 billion is allocated to R&D and innovation, ICT, SMEs and a low-carbon economy, an increase of almost 22% compared with 2007-2013. EUR 98 billion is to be invested in employment, social inclusion and education and training measures, slightly more than in the previous period, while almost EUR 4.3 billion is allocated to good governance (institutional capacity building and the efficiency of public administrations), 72% more than before.

On the other hand, EUR 59 billion is allocated to transport and energy infrastructure, a reduction of 21% from 2007-2013, while investment in environmental protection is down by 27%.

In short, Member States and regions will invest more in the areas identified as ERDF priorities (R&D and innovation, ICT, SMEs, and a low-carbon economy) and ESF priorities (employment, social inclusion, education and training and good governance). In turn, less funding will go to transport and environmental infrastructure.

Figure 7 : Allocations by thematic objective 2014-20 vs. 2007-13 in the EU-28 (% of total)



These changes are common to both less developed and more developed Member States, though the shift to ERDF and ESF priorities is more pronounced in the latter as is the reduction in funding for transport and energy infrastructure.

⁸ For 2007-13 the categorisation of expenditure by Member State, objective and Operational Programme has been used to compare with 11 thematic objectives in 2014-20.

Figure 8 : Allocations by thematic objective 2014-20 vs. 2007-13 in more developed Member States (% of total)

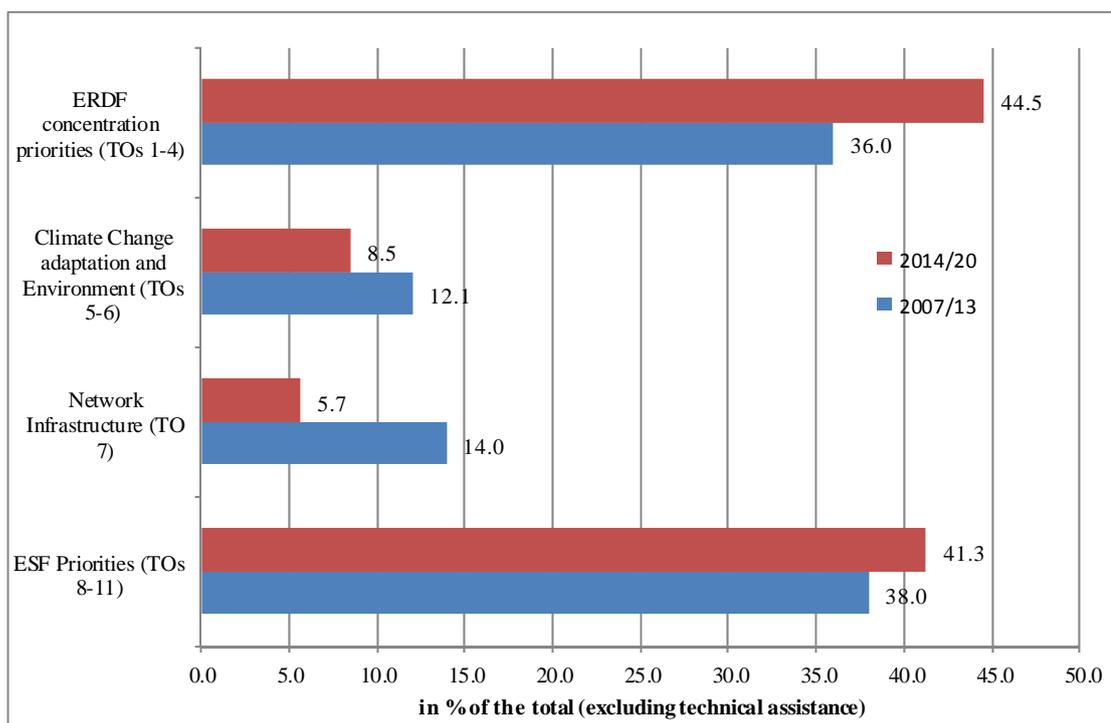
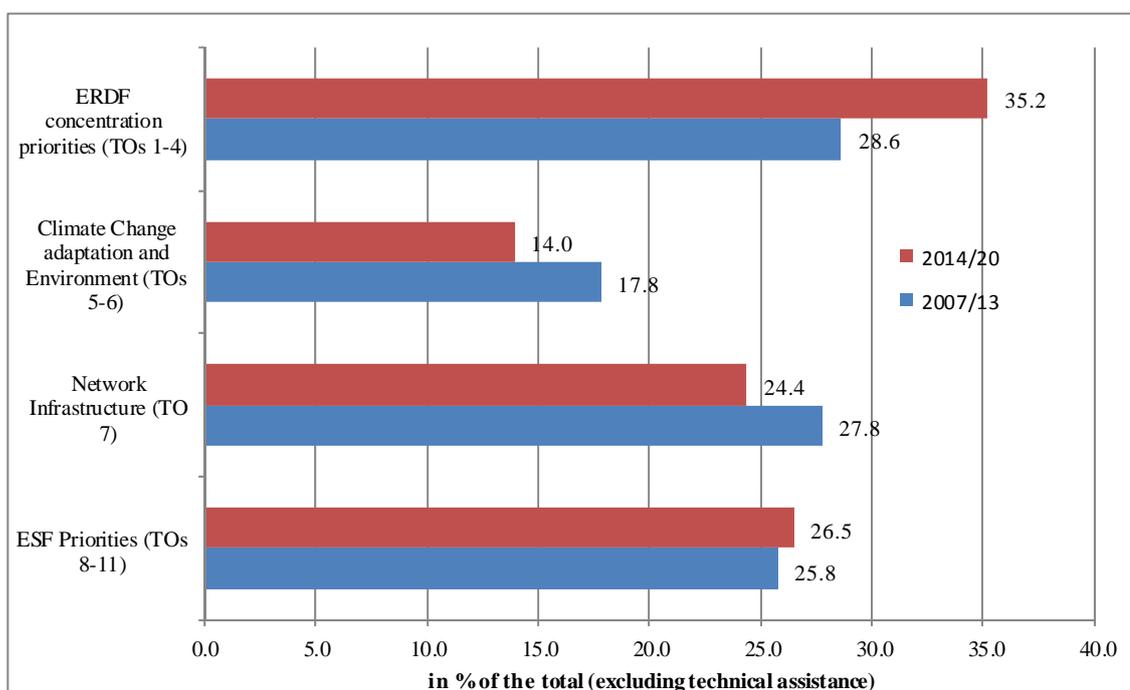


Figure 9 : Allocations by thematic objective 2014-20 vs. 2007-13 in less developed Member States (% of total)



2.2. Aligning investment with Country Specific Recommendations

Many Country-Specific Recommendations (CSRs) relate to medium and long term challenges which need to be tackled through a combination of structural reforms and investment. Several of them are directly linked to the thematic objectives of the ESI

Funds such as the reform of labour markets, educational systems and public administration, the promotion of science and innovation, the provision of high quality social and health services or the upgrade of transport and energy infrastructure.

The Partnership Agreements (PAs) and draft Operational Programmes (OPs) generally reflect the relevant CSRs by identifying the related development and investment needs. But only in some cases are the results expected from the investment supported by the funds clearly related to the CSRs specified and there is a need for more detail on the way that the CSRs concerned will be put into effect in the programmes. Some recommendations clearly require more than one Fund to support the intervention needed and Member States should ensure that the relevant Funds will do so.

Most Member States and regions have prepared innovation strategies for smart specialisation to accelerate economic development and to narrow the knowledge gap. It is important that these strategies focus on investments which reach a critical mass and best reflect regional potential. More emphasis needs to be put on ‘soft’ forms of support, on promoting market-driven research and cooperation with the private sector instead of funding predominantly research infrastructure and equipment.

Some Member States have brought forward programmes that establish clear links between the digital economy and innovation. This is important as investment in high speed broadband and ICT is needed to overcome particular bottlenecks and to encourage market-driven solutions. For example, it is essential to focus investment in broadband on next-generation networks to ensure that less developed regions do not fall further behind. Coordination between Cohesion Policy, Horizon 2020 and other EU programmes is also critical as regards smart specialisation strategies at national and regional level.

Many Member States consider the strengthening of the competitiveness of SMEs to be central to their growth strategy and it is expected that financial instruments will play a major role in this regard. However, there is limited interest so far in the new SME Initiative. Moreover, there is a risk of ‘business-as-usual’ support for SMEs regardless of the sector and the activities in which they are engaged. Support should be tailored to the needs of enterprises and their growth potential to ensure a large leverage effect and a quick take-up of funding.

In the PAs of a number of Member States, energy, climate change and the environment are well integrated into their economic development strategy. Several have put specific emphasis on energy efficiency or developing renewable energy as a means of creating new businesses, jobs and export opportunities, while also reducing greenhouse gas emissions. However, the link between investment and the expected results in relation to the climate change objectives needs to be made clearer in some cases.

Given the challenges of high unemployment and increasing poverty, the focus on the inclusive growth objectives could be stronger in some PAs. The Commission is also of the view that the funding allocated to education is as yet not sufficient to achieve the priorities identified. In some PAs, low priority is given to active measures for social inclusion. To ensure better social outcomes and investment that

is more responsive to social change, social policy reform needs to be more taken account of in programming.

Moreover, as regards the Youth Employment Initiative (YEI), relevant information in some PAs and OPs is relatively general and does not set out how this new initiative will be delivered and if and how it will support the implementation of Youth Guarantee schemes. In some programmes, the actions supported by the YEI need to be more focused on employment creation.

Despite the existence of a CSR on the integration of the Roma minority, some Member States do not plan to have a specific priority for marginalised communities, making it more difficult to assess how much funding will be allocated to this policy area. Some Member States do not sufficiently address the needs of this target group, while others need to develop their strategy and intervention logic further.

It is also important to be precise on how support from the ERDF and ESF will be coordinated, given that there is a need for an integrated approach by the two funds. This applies, for example, to education where investment in infrastructure needs to be combined with teaching and training measures to ensure that the infrastructure is used effectively.

In 2014-20, some 88 programmes in 16 countries are multi-fund programmes, combining resources from the ERDF, Cohesion Fund and ESF. This is expected to encourage a more integrated approach and more coherence between policies, funding and priorities.

Public administration reform, with the aim of improving governance, is not another policy area as such. Rather, the quality of public administration is often key to a region or Member State being able to develop.

Administrative modernisation and the quality of justice are recognised as key factors for competitiveness and inclusive growth. Many Member States are planning measures to strengthen their public institutions and to improve their capacity to deliver effective policies, better administrative services, speedier judicial proceedings, increased transparency and integrity of public bodies and wider participation of the public in the various phases of policy-making. Yet, in a number of Member States where a need for reform of public administration has been identified to support jobs, growth and increased competitiveness, a clear strategy is missing and objectives are incomplete and unclear. Moreover, in some of these Member States a clear political commitment to such reform is lacking.

2.3. Increasing the impact of investment and delivering results

Most Member States have made significant efforts to adopt measures to satisfy *ex-ante* conditionalities. It is essential that relevant criteria are met at the start of the programming period to eliminate potential obstacles to the investment undertaken being as effective as possible. The process has not been easy and, in many cases, the Commission will need to agree action plans to ensure full compliance with the requirements within well-defined deadlines.

Conditions, which Member States have found particularly difficult to meet, concern areas where coherent strategies are important such as in relation to smart specialisation. Difficulties are also evident in areas where EU Directives need to be

implemented (e.g. as regards energy efficiency or environmental impact assessment) or where EU regulations need to be applied effectively (e.g. in relation to public procurement).

In some countries substantial efforts are still needed to tackle bottlenecks relating to administrative capacity. It is of key importance for the efficient management of EU funding that a clear and stable institutional and regulatory framework is in place, that skilled and motivated staff are attracted and retained and that the tools and instruments used are appropriate for the effective deployment of the funds.

Setting clear objectives is at the heart of the orientation of Cohesion Policy towards results and will be the basis against which its success will be measured. This represents a real step change. Member States and regions, however, have found it difficult to formulate well-defined specific goals which the policy is aimed at achieving. Many draft programmes have continued the practice of expressing vague general aims and of listing a large number of possible actions in order to maintain maximum flexibility in the selection of projects at a later stage.

Until the objectives are expressed in an understandable and clear way, it is difficult to assess whether the intervention logic of a programme is sound and that there is a reasonable chance of the funding allocated producing the expected outputs and making the intended contribution to the pursuit of ultimate policy aims.

The performance framework is another new element. This can only be drawn up when the intervention logic of a programme, its financial structure and outputs for each priority have become clear, i.e. relatively late in the drafting of each programme. So far only drafts of these have been received by the Commission. The main challenge when formulating performance frameworks is to fix quantified targets for the indicators used at a sufficiently ambitious, but realistic, level – i.e. at a level that can be achieved if the programme performs as planned.

Partnership Agreements have in most cases been drafted after reasonable consultation with partners, although in some cases there are indications that this dialogue has been insufficient. Important stakeholders were not involved or their comments are not reflected in the versions of the documents submitted. The Commission will look very carefully at how Member States have applied the Code of Conduct on Partnership to ensure genuine participation by stakeholders.

Last but not least, the new period requires strong governance and coordination at the national and regional level to ensure consistency between programmes and support for Europe 2020 and the CSRs as well as to avoid both overlaps and gaps in expenditure. This is important in view of the overall increase in the number of regional programmes (for ESF programmes it is almost 60% compared to 2007-13).

ESTIMATED IMPACT OF COHESION POLICY 2014-2020

As indicated in the previous chapter, estimating the impact of Cohesion Policy investment is difficult, not least because it affects a wide range of macroeconomic variables, including GDP, employment, productivity, the budget deficit and the trade balance which are also affected by a large number of other factors. Interventions have an impact on demand since programmes generally result in increased public expenditure though also increased private spending in many cases. They also have an impact on the supply-side since they add to investment in infrastructure, plant and equipment and technology as well as human capital – indeed, their central purpose is to increase development potential through boosting such investment.

Interventions, in addition, have direct and indirect effects. For example, transport projects boost demand directly in the short-term while improving communication links, which should, indirectly, have a positive effect on the expansion of businesses and so GDP in the longer-term. At the same time, interventions might increase the demand for labour and materials which could lead to higher wages and prices, so reducing cost competitiveness and adversely affecting GDP.

Equally, as already emphasised, the fact that economic performance is affected by a wide range of other factors means that the impact of Cohesion Policy cannot be identified simply by looking at the data for GDP and other economic variables. To do so, it is necessary to compare how the economy would have developed in absence of Cohesion Policy with how it developed in practice. This is why the use of macroeconomic models, which capture the way that economies function, is needed. (Specifically, they are used to generate a ‘baseline scenario’ – representing what would have happened without the policy - which can then be compared with the actual course of the economy.)

Macroeconomic models enable both the short-term impact of policy to be estimated and the longer-term effects which take account of improvements in the supply-side of the economy which continue after the programming period is over. They also enable the interaction between direct and indirect effects to be taken into account.

In the analysis presented below, two models are used to simulate the expected impact of the 2014-2020 programmes. The first is the QUEST III model developed and used by the Directorate General for Economic and Financial Affairs (DG ECFIN)⁹. Since this produces results at the national level, it is supplemented by a second model, RHOMOLO¹⁰, which is designed to estimate the impact of policy at the NUTS 2 regional level.¹¹ This incorporates several elements borrowed from economic geography. In particular, it takes a number of spill-over effects into

⁹ This incorporates the latest techniques in Dynamic Stochastic General Equilibrium (DSGE) modelling, which is founded on micro-economic principles of how individuals, enterprises and other organisations are assumed to behave.

¹⁰ This has recently been developed jointly by the Joint Research Centre-Institute for Prospective Technological Studies and DG Regional Policy.

¹¹ See: Andries Brandsma, D'Artis Kancs, Philippe Monfort, Alexandra Rillaers, 2013, *Rhomolo – A Dynamic Spatial General Equilibrium Model for Assessing the Impact of Cohesion Policy*, Working Paper N°1/2013, DG Regional and Urban Policy, European Commission, http://ec.europa.eu/regional_policy/sources/docgener/work/2013_01_rhomolo.pdf.

account to capture the fact that interventions have an impact not only in the region where they are implemented but also in other regions. Such spill-over effects arise from trade linkages between regions as well as from the dissemination of technology.

Box –Constructing the simulations

To carry out the simulations, Cohesion Policy interventions are grouped into five broad categories:

- Infrastructure investment, which includes investment in transport, telecommunications, energy and environmental infrastructure and is treated in the model as government investment. This is assumed to raise productivity in the medium-term through output enhancing effects, which are in turn assumed to decline slowly as the infrastructure ages.
- Expenditure on human resources, which includes spending on education and vocational training as well as on other labour market measures. This is assumed to improve the skills of the work force, though the effects of this take time to build up and the gains only become apparent in the long-term, but they are assumed to be significant and persistent. The effects decline in the longer-run as people retire.
- Support to R&D, which includes the establishment of networks and partnerships between businesses and research centres. This is assumed to reduce the fixed costs of production. It is also assumed that high-skilled workers are moved from production to R&D which initially reduces the output of goods and so GDP, but over time increases in productivity are assumed to dominate which raises output and stimulates investment. While it takes time for these effects to become apparent, the output gains in the longer-run are assumed to be significant and to continue to increase.
- Aid to the private sector, which includes support for SMEs, tourism and cultural activities. These are modelled as reductions in the fixed costs of production and have the effect of boosting growth in the short-run when spending occurs, but they are also assumed to have long-lasting effects on productivity.
- Technical assistance, which is modelled as government spending. This is assumed to have no effect on output in the medium- and long-run (irrespective of any improvement in the governance of policy which results).

The models incorporate both short-term demand effects and longer-term supply side effects. The former arise during the period when expenditure takes place when most of the impact comes from the increase in demand, which is assumed to be partly crowded-out by increases in interest rates, wages and prices. In the medium and long-run, the productivity enhancing effects materialise, so increasing potential output and allowing GDP to grow free of inflationary pressure. The effect of the interventions, therefore, progressively builds up over time.

In RHOMOLO, investment in transport, as well as increasing productivity, is also assumed to reduce transport costs between regions which facilitates trade in goods and services and hence boosts economic activity.

It is assumed, in addition, in both models that Cohesion Policy expenditure is financed by contributions to the EU Budget by Member States which are proportional to their GDP and that these contributions are in turn financed through increases in taxes. The positive impact of the interventions on output and employment is, therefore, partly offset by the negative impact of these.

The two models have been used to simulate the expected impact of Cohesion Policy programmes for the period 2014-2020. Since most of the new programmes have yet to be adopted, funds are assumed to be distributed between the broad investment categories listed above in the same way as in the 2007-2013 programming period, though adjusted to take account of the features of the new period that are already known, such as the amount of

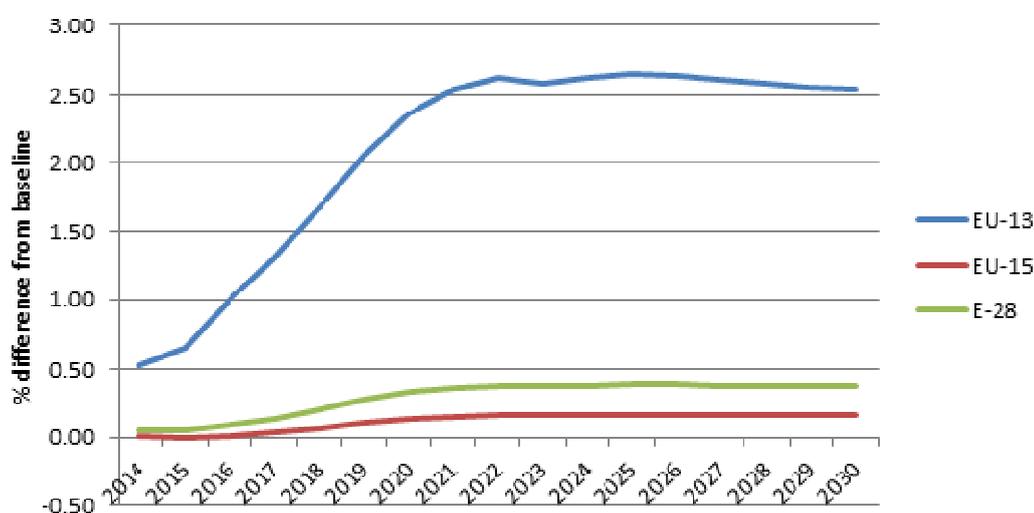
funding allocated to Member States and categories of region, the concentration of the ERDF on particular objectives and the minimum shares of the ESF going to different countries.

In order to ensure coherence between the outcomes of the two models, RHOMOLO has been aligned with QUEST so that its regional estimates are consistent with the QUEST national estimates.

3.1. Estimated impact at the national level

The estimates generated by QUEST of the effects of Cohesion Policy in the 2014-20 period cover all 28 Member States. They indicate that the investment funded could lead EU GDP to be 0.4% higher compared with the baseline (i.e. the non-policy scenario) level by the end of the programming period in 2023 and EU-13 GDP to be 2.6% higher. EU-15 GDP, however, is estimated to be only 0.2% higher relative to the baseline (Figure 100).

Figure 10 : Estimated impact of Cohesion Policy on GDP

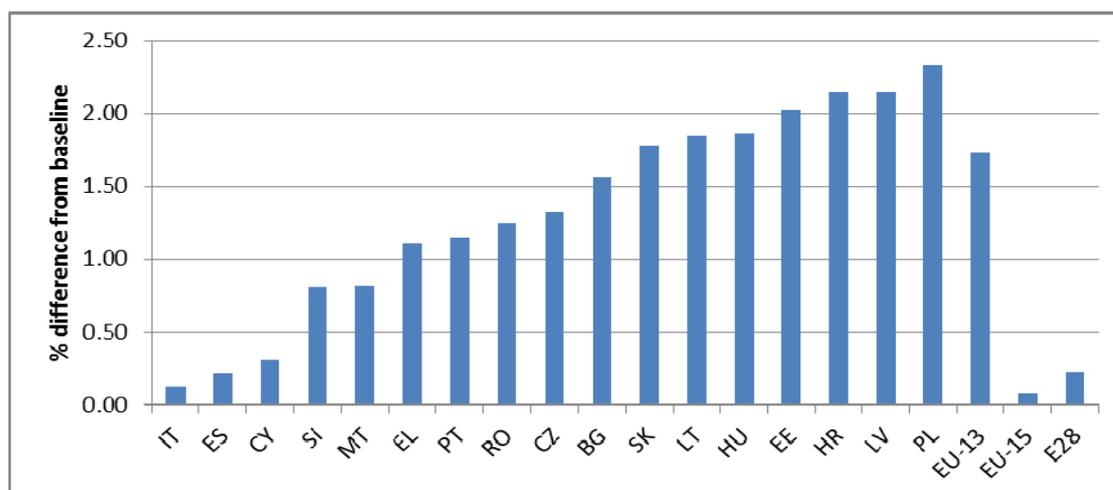


Source: QUEST3R&D simulations, % deviations from baseline GDP.

The estimates for individual countries include spill over effects from developments in other countries. Accordingly, they do not only include the effects of the Cohesion Policy programmes carried out in the country itself but also take explicit account of the indirect effects of the programmes carried out in other countries in the form of increased exports to them.

They take account too of the need to finance Cohesion Policy expenditure, which is assumed to lead to taxes being higher in all Member States as compared with the situation without Cohesion Policy. These higher taxes together with the modest Cohesion Policy investment in the EU-15 explain the limited impact in the latter (which is negative in some countries where the depressing effect of taxes more than outweighs the expansionary effect of investment) (Figure 100).

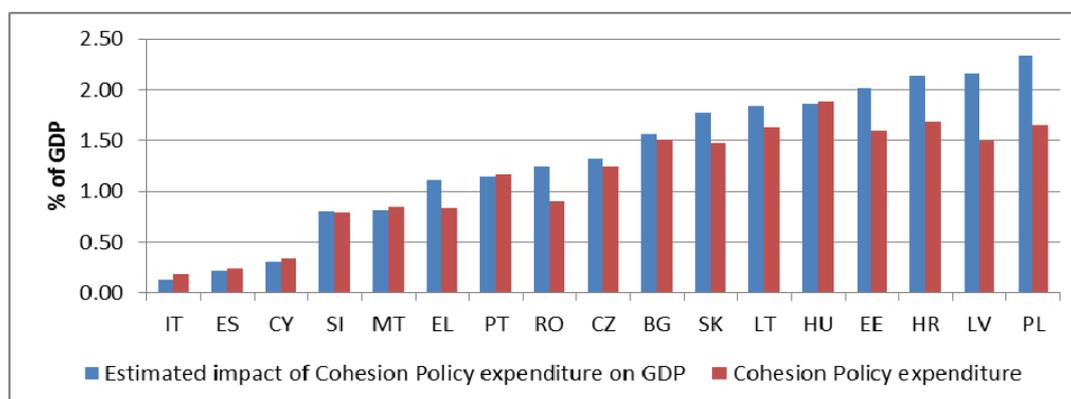
Figure 11: Estimated impact of Cohesion Policy expenditure on GDP in main beneficiary countries, average 2014-2023



Source: QUEST3R&D simulations, % deviations from baseline GDP.

The estimated impact of Cohesion Policy programmes on the GDP of the main beneficiary countries vary considerably, largely reflecting the differing amounts of funding received (Figure 101). The relationship, however, is not proportionate, reflecting other factors such as the composition of programmes. For example, the impact of programmes on GDP is estimated to be largest in Poland, where funding is less than in Hungary where the impact is estimated to be only the fifth largest. Similarly, funding in Croatia is much the same in relation to GDP as in Lithuania but the impact is estimated to be significantly larger.

Figure 12 - Cohesion Policy expenditure and impact, average 2014-2023



Source: QUEST3R&D simulations, % deviations from baseline GDP, DG REGIO Cohesion spending projections and DG ECFIN Spring 2013 GDP projections.

The results of the simulation also highlight the fact that the impact is estimated to build up over the years and to continue after the programme comes to an end. Most of the increase in GDP during the period, therefore, comes from higher demand, which is assumed to be partly ‘crowded-out’ by increases in interest rates, wages and prices. It is only in the medium and longer-term that the productivity enhancing effects of Cohesion Policy materialise, increasing potential output and enabling GDP to grow free of any inflationary pressure (Figure 102). By 2030, the effect is to increase GDP in Poland - where the effect is largest – by an estimated 3.6% above what it otherwise would be in the absence of Cohesion Policy.