CHALLENGES OF EU AND NEW MEMBER STATES IN 
FINANCIAL PERSPECTIVE 2007-2013:
CONVERGENCE AND ABSORPTION OF AVAILABLE
COHESION RESOURCES

MOJMIR MRAK  VASJA RANT

Working Paper n. 2006-09
FEBBRAIO 2006

JEAN MONNET CHAIR
Economics of European Integration
Challenges of EU and new member states in financial perspective 2007-2013: convergence and absorption of available cohesion resources

Mojmir Mrak\textsuperscript{1} and Vasja Rant\textsuperscript{2}

Abstract
The recent agreement on financial perspective 2007-2013 provided new member states with substantial cohesion resources to speed up their real convergence process. The primary objective of the paper is to explore key policy issues, faced by new member states, if they want to successfully absorb available cohesion resources in the next financial perspective and outline their key policy choices and possible outcomes in terms of convergence and stability. The secondary objective is to provide an overview of the financial perspective deal achieved under the UK presidency in light of the main economic challenges of the EU. The main conclusions are: first, new member states need to focus on restructuring their national budget expenditure, if they want to implement cohesion policy in the next financial perspective without compromising fiscal stability and, second, the deal achieved under the UK presidency is a far cry from the original proposal by the European Commission and from proclaimed key economic challenges of the EU for the future (particularly competitiveness), however, it still provides significant convergence support for new member states for a 7-year period.

JEL codes: F36, H50, H77, O10

Keywords: new member states, absorption capacity, cohesion policy, financial perspectives, economic challenges of the EU

1. Introduction\textsuperscript{*}

Accession on 1 May 2004 signaled the start of a new period for ten new member states both in terms of their role in the decision-making process at EU level and in terms of the conduct of their economic policies.

\textsuperscript{1} Mojmir Mrak is full time professor of International finance at the Faculty of Economics, University of Ljubljana, a regular visiting professor at the University of Sienna, Italy and Wirtschaftsuniversität Wien, Austria. He has advised Slovene government on financial aspects of EU accession and financial perspective 2007-2013.

\textsuperscript{2} Vasja Rant is assistant at the Faculty of Economics, University of Ljubljana. He has advised Slovene government on financial perspective 2007-2013.

\textsuperscript{*} Paper presented at the 4\textsuperscript{th} Milan European Economy Workshop, University of Milan (2005)
Leaving increase in formal powers aside, the main change for new member states has been the need to coordinate their economic policies in full respect of the economic and monetary union. The result is that national monetary and exchange rate policies have lost their impact, while fiscal and structural policies have gained importance.

One of the reasons for increased importance of fiscal and structural policies has also been integration of new member states into the EU budgetary framework. Enlargement package in years 2004-2006 was determined by the old member states in 1999, when the current EU financial perspective, covering the period 2000-2006, was negotiated. The next financial perspective, covering the period 2007-2013, is different, because new member states are for the first time fully participating in the decision making process.

At the outset of negotiations, financial perspective 2007-2013 was envisaged as an instrument that should contribute to resolving two crucial economic challenges of the European Union: competitiveness of the EU as a whole (and particularly the old EU core) and convergence of new member states. These challenges have been expressed in the Lisbon strategy (Council of the EU, 2003) and the Sapir report (Sapir et al., 2003) and included in the Commission proposal of the financial perspective (European Commission, 2004a, 2004b and 2004c). The compromise achieved by member states in the Council under the UK presidency in December 2005 (Council of the EU, 2005) is without a doubt less ambitious with respect to the above mentioned challenges compared to the original Commission proposal. It can be viewed as the least common denominator which both net payers and net recipients could agree to in a Union of 25 (soon to become 27) nations. Nevertheless, the compromise still poses significant challenges to new member states, if they want to use the allocated funds to speed up convergence.

In light of the changed circumstances for new member states after accession and the agreement on financial perspective 2007-2013, this paper has three objectives. The first objective is to link key priorities of the EU with the budget deal achieved for the period 2007-2013. The second objective is to explore key policy issues, faced by the new member states, if they want to successfully absorb available convergence resources in the next financial perspective. The third objective is to outline key policy choices and possible outcomes faced by new member states as they decide how to deal with absorption of EU convergence funds in the future.

The structure corresponds to the objectives described above. In addition to introduction and conclusion, this paper consists of five chapters. Second chapter
describes twin economic challenges of the European Union and their reflection in the EU financial perspective. Third chapter presents main changes for new member states after their accession to EU. Fourth chapter compares the next financial perspective deal achieved under the UK presidency with the original Commission proposal. Fifth chapter focuses on domestic challenges likely to be faced by new member states when they try to absorb cohesion resources in the next financial perspective. It starts with examining the concept of absorption capacity, then proceeds with analysis of the increase in cohesion transfers to new member states in the next financial perspective, and concludes with discussion of key absorption related issues in new member states. Sixth chapter outlines policy choices available to new member states in light of potential absorption problems and discusses (in qualitative terms) potential outcomes in terms of convergence and budget balance of new member states in the period beyond 2006.

2. Twin economic challenges of the European Union and the EU financial perspective 2007-2013

Basically, European Union faces two key economic challenges today: (1) competitiveness of the EU as a whole and (2) convergence of new member states to the EU average. This does not undermine other challenges, including those in the area of justice, security and defense, but it does say that a robust EU economy is more conducive for considering any other challenges on the EU level. In the following subchapters we try to provide some basic rationale behind both key economic challenges and their link to the EU budget.

2.1 Competitiveness

Sapir report highlights competitiveness as the key problem of the European Union, particularly of the core old member states. Potential output growth in the European Union in the past 15, 20 years has declined from around 3% to 2% (Sapir, 2003). Low potential output growth and consequently low actual growth rates endanger fulfillment of other common EU goals, both economic and political. At the same time, low growth rates hinder the attainment of national objectives, such as employment and social security. They can also lead to a fiscal deficit trap that has troubled some old member states, among them Germany. Recognition that growth and sustainable development are key conceptual priorities for the future and preconditions for all other priorities has been reinforced in the recent economic slowdown.

There are several mostly structural reasons for low potential output growth in the EU. In order to understand them, one has to understand the foundations of growth in Europe in recent history. According to Sapir report, postwar growth pattern in Europe can basically be classified into two periods:
1. *Growth in the period prior to 1970’s* was faster than in the US. During this period the European economy was converging towards the US, mostly based on assimilation of existing US technologies and demand driven growth caused by increasing incomes of European households.

2. *Growth in the period after 1970’s* slowed down as virtually all existing US technologies have been adopted and the European economy has come close to the world’s technological frontier. Convergence towards the US slowed down and eventually stopped. As the pace of globalization accelerated in the 1990’s, innovation and development of new technologies, the main drivers of growth in countries approaching the world’s technological frontier (Acemoglu et al., 2002), became crucial relative advantages of technology leaders (developed economies) compared to the low labor cost advantage of technology followers (fast growing developing economies). In the latest battle for technological supremacy, European Union has been thus far unable to keep up with the US in expanding the technological frontier, which resulted in the loss of competitiveness and divergent patterns between the EU and the US in the recent years.

An important symptom of lower growth potential in the European Union is the productivity-employment trade-off trap. Decomposition of European economic growth shows that while productivity levels in the EU have been catching up with the levels in the US, labor input has decreased (Sapir et al., 2003). Increased productivity in the EU has therefore come at the expense of lower labor participation. Particularly inexperienced, unskilled, young (first job seekers) and old (early retirement) workers have been pushed out of the workforce. This pattern can to some extent be explained by slower advances in R&D in the EU compared to the US and to some extent by the incentives of the European Union’s social model that puts relatively more value on leisure (higher retirement and unemployment benefits) than work (lower net to gross salary ratios) compared to the US model. The diagnosis is that EU labor is not able to keep pace with technological progress.

### 2.2 Convergence

In addition to potential output growth, Sapir report also stresses the importance of *convergence* in the European Union, in particular convergence of the new member states. In contrast to the general problem with competitiveness and potential growth in the European Union, the solution to convergence of new member states is not dependant only on expanding the technological frontier. The problem is more complex and also involves:
• **Modernization of existing technologies** – on average, new member states’ economies have not yet reached technological excellence. Existence of old technologies suggests that there is still potential for modernization and adoption of existing technologies and increase in productivity from this source.

• **Completion of restructuring** – even though new member states (with the exception of Cyprus and Malta) are now in final or advanced stages of their transition process, they still face or could face serious problems as the structure of their economies continues to adjust to the market structure. Despite significant increases in the relative importance of services in the last 15 years, the legacy of high industrialization, employing low-skill, low-cost labor is still present in new member states (Raiser et al., 2003). As countries develop, higher labor costs will lead to decreasing demand for these industries due to competition of cheap labor in the rest of the world. New member states will therefore have to carefully substitute industries that employ low skilled labor with services and industries that employ high skilled labor. At the same time, they will have to deepen the labor market for high skilled labor by developing high quality education and better linking public and private research with economic activity. They will also need to think about alternative employment and training of the unemployed unskilled labor, if they want to make this transition socially acceptable.

• **Investments in infrastructure** – new member states also have substantial investment needs in the field of infrastructure, both regarding improvements of the existing infrastructure and investments in new infrastructure. Infrastructure investment would enable new member states to restructure their existing networks in the fields of transport, energy and telecommunications in a way that would be conducive to economic activity and would reflect changes in demand for these services but at the same time aim at preserving the environment (Carbajo and Fries, 1997).

Achieving convergence, however, will not be easy. Upon entrance of ten new member states, the differences between the least and the most developed countries within the EU have increased more than ever. Enlargement to 25 member states lowered the average GDP per capita of the European Union, measured in purchasing power parities (PPP), by around 9 percent, while enlargement to 27 states would decrease this average even further, for a total of around 13 percent compared to the average of a 15 member Union (Mrak and Rant, 2004). The least developed regions in the new member states only produce between 30% and 40% of average GDP per capita of the enlarged Union, measured in PPS, while the expected entrance of Bulgaria and Romania in the year 2007 will increase these differences even further (regions in these two member states will fall short of 30% of the Union average).
2.3 Link between EU challenges and EU financial perspective

In order to meet both challenges, Sapir report recommends that European Union and member states should focus on a mix of market regulation and market intervention measures that have the best potential to deliver the objectives set out in the Lisbon strategy. In the context of market interventions, EU budget should play an important role.

Currently, the model of EU public finance is based on two strategic documents:

- EU budget expenditure is based on an inter-institutional agreement\(^3\) about the ceilings and broad structure of expenditure in a multi-annual (7-year) plan, called financial perspective.

- EU budget revenue is based on a Council decision about the ceilings and structure of revenue resources, called Own resources decision.

These strategic documents are annually implemented by the EU budget. Due to the balanced budget principle, the global financial perspective (expenditure) ceiling is ex-ante always lower or equal to the global own resources (revenue) ceiling in order to ensure ex-post budget balance without compromising financial discipline.

Financial perspective is technically aimed at strengthening EU budget discipline, controlling growth of EU expenditure and simplifying the annual budget procedure, while conceptually, it supports the priorities and objectives of the European Union, agreed at political level. Economic priorities have always been at the center of financial perspectives and represent around 85% of planned expenditure under the current financial perspective, also called Agenda 2000.\(^4\)

The current financial perspective will be replaced by a new one in 2007. Since both key economic challenges of the European Union, *competitiveness* and *convergence*, have been identified as priorities for the future by EU policy makers, they are reflected in structure of expenditure in the next financial perspective.

Expenditure ceilings in financial perspective 2007-2013 are grouped under five broad headings. The first of them, named Sustainable growth, (divided into two subheadings – 1A and 1B) is devoted to both key economic challenges of the EU discussed earlier. Heading 1A, called Competitiveness for growth and employment,

\(^3\) Involving European Commission, EU Council and European Parliament

\(^4\) Most of economic expenditure is split between two common policies of the EU – agriculture and cohesion policy. Agriculture receives 45% and Cohesion policy 34% of total (economic and non-economic) expenditure in Agenda 2000.
will finance mostly R&D, infrastructure and knowledge expenditure. Heading 1B, called Convergence for growth and employment, will finance mostly investments in new member states aimed at speeding up their convergence. Apart from heading 1, the main financial perspective item remains heading 2 (Natural resources), related to the financing of the Common agricultural policy. Heading 3 is divided into subheadings 3A (Freedom, Security and Justice) and 3B (Other internal policies) and will finance non-economic objectives in the EU. Heading 4 (EU as a global partner) is the financial arm of the EU’s foreign policy, both to EU neighborhood (existing and potential candidate countries and other partner countries in the region) and beyond (peacekeeping missions, regional development aid to third countries, etc.). Heading 5 (Administration) are the costs of EU bureaucracy (all institutions). Headings 3-5 are more or less dwarfed by headings 1 and 2, which give the main message about the content of the EU budget. The mix between these two priorities determines the extent to which EU budget can be regarded as “development” or “agriculture” oriented.

3 Changes for new member states after accession

In the following two subchapters we briefly focus on two key changes for new member states after their accession to the EU.

3.1 Increase in decision-making rights and responsibilities at EU level

The role of new member states has changed with their accession to the European Union. While negotiations for the EU accession required that new member states adjust to *acquis communautaire*, membership entails new rights as well as new responsibilities. Instead of passively adjusting to the legal and institutional framework of the European Union, new member states now have a chance to actively participate in the evolution of the *acquis*. In this respect, next financial perspective is one of the first tests of new member states in co-determining common EU policies (Mrak, 2004b). Considering a relatively short time period available until the beginning of the next financial perspective, new member states had to actively participate in the negotiations from the start of their formal EU membership, if they wanted to ensure that priorities of the next financial perspective would also reflect their own development objectives.

3.2 Shift in relative importance of economic policies at domestic level

Apart from active involvement in decision-making process at EU level, accession has also signaled a shift in relative importance of economic policies in new member states. While monetary and exchange rate policies have been important tools for macroeconomic stabilization in these countries in the course of transition, their importance has declined after accession due to the fact that monetary and exchange
rate policies become "a matter of common concern" for countries joining the European Union. Because of limited monetary and exchange rate autonomy and integration of new member states into the EU budgetary framework, the relative importance of fiscal (macro) and structural (micro) policies has increased substantially. Subject to constraints of the Stability and Growth Pact, they are therefore becoming the main tools that new member states can use to offset adverse economic shocks and stimulate growth in the future (Jepma et al., 1996). There is a close link to the next financial perspective. If new member states want to make best use of their membership they should align fiscal and structural policies with the expected transfers from the EU budget. If new member states are able to do that, they will meet an important precondition for successful absorption of resources available to them in the EU budget. If, on the other hand, new member states do not align their policies, they could lose the opportunity offered by the EU budget, but would still have to pay the "fee" for their membership.

The challenge for new member states is therefore to get used to being active both on the EU as well as domestic front.

4 Agreement on financial perspective 2007-2013

The initial proposal of the next financial perspective was presented by the European Commission in February 2004 and then discussed at various levels in the EU Council until December 2005, when a compromise among the highest representatives of EU member states was reached. In addition to the Commission and the EU Council, the agreement must also be endorsed by the European Parliament to become operational. The expectations of all sides in these negotiations were significant, seeing as the current financial perspective does not sufficiently reflect some of the agreed goals of the Union and is on average also relatively modest in allocation of funds to new member states in the years 2004 to 2006.

Proposal for the next financial perspective put forward by the European Commission addressed both key challenges of the European Union while at the same time respecting the existing agreements among member states, particularly about development of agricultural expenditure. Due to constraint of the existing agricultural agreement, the Commission suggested a gradual restructuring of EU budget expenditure in line with the new priorities which would result in (European Commission, 2004b):

\[^5\] Member states have agreed in October 2002 that first pillar CAP expenditure (direct payments and market measures) shall be kept at their 2006 level, corrected by 1% nominal growth annually until year 2013.
• More than 30% increase in the total level of planned expenditure compared to the current financial perspective.

• Roughly the same weight of economic priorities as in the current financial perspective (around 85% of total planned expenditure).

• Gradual shift of economic expenditure away from agriculture towards sustainable growth (54% of economic expenditure for sustainable growth and 46% for agriculture in the next financial perspective as opposed to 48% for sustainable growth and 52% for agriculture in the current financial perspective).

• Greater focus on increasing competitiveness of the European economy by stimulating innovation and research (Commission proposed a nearly threefold increase in competitiveness expenditure compared to the current financial perspective).

• Greater focus on convergence, particularly convergence of new member states, by strong support for cohesion policy (most of new member states would receive transfers of convergence resources in the amount of 4% of their GDP under Commission proposal).

The approach advocated by the Commission was less radical than the one proposed by Sapir group, but was deemed more politically feasible. However, the main net payers into the EU budget were critical and argued for a financially restrictive approach, whereby total expenditure of the EU budget should be limited to 1% of EU’s Gross National Income. This is less than even the current levels of the EU budget expenditure and would, given the agricultural agreement constraint, require significant reduction in financing of EU’s key priorities – competitiveness and convergence. Due to greater negotiating power of net payers, the final compromise, reached under the UK presidency, bears much more resemblance to the financially restrictive approach, than to the original proposal by the Commission. The table below gives the main highlights of both. In order to make them comparable, European development fund and Solidarity fund were added to the final UK compromise (they will be financed outside of the budget, but were included in the budget in the Commission proposal).
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<tr>
<td></td>
<td>billions of EUR</td>
<td>% of total</td>
<td>billions of EUR</td>
</tr>
<tr>
<td>1 Sustainable growth</td>
<td>462</td>
<td>45%</td>
<td>380</td>
</tr>
<tr>
<td>1 A Competitiveness</td>
<td>122</td>
<td>12%</td>
<td>72</td>
</tr>
<tr>
<td>1 B Cohesion</td>
<td>340</td>
<td>33%</td>
<td>308</td>
</tr>
<tr>
<td>2 Natural resources</td>
<td>400</td>
<td>39%</td>
<td>371</td>
</tr>
<tr>
<td>of which: CAP first pillar</td>
<td>301</td>
<td>29%</td>
<td>293</td>
</tr>
<tr>
<td>3 Citizenship, freedom, security and justice</td>
<td>21</td>
<td>2%</td>
<td>16</td>
</tr>
<tr>
<td>of which: Solidarity fund</td>
<td>6</td>
<td>1%</td>
<td>6</td>
</tr>
<tr>
<td>4 The EU as a global partner</td>
<td>85</td>
<td>8%</td>
<td>72</td>
</tr>
<tr>
<td>of which: EDF</td>
<td>22</td>
<td>2%</td>
<td>22</td>
</tr>
<tr>
<td>5 Administration</td>
<td>58</td>
<td>6%</td>
<td>50</td>
</tr>
<tr>
<td>TOTAL APPROPRIATIONS FOR COMMITMENTS</td>
<td>1.025</td>
<td>100%</td>
<td>889</td>
</tr>
<tr>
<td>Appropriations for commitments as % of GNI</td>
<td>1,25%</td>
<td></td>
<td>1,08%</td>
</tr>
<tr>
<td>TOTAL APPROPRIATIONS FOR PAYMENTS</td>
<td>942</td>
<td>-</td>
<td>838</td>
</tr>
<tr>
<td>Appropriations for payments as % of GNI</td>
<td>1,14%</td>
<td>-</td>
<td>1,02%</td>
</tr>
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</table>

Source: European Commission, 2004b; Council of the EU, 2005.

As can be seen from the figures, the most significant cut in absolute and relative terms in the final compromise was for Competitiveness expenditure. There are two possible explanations. First, there are no national envelopes and hence vested interests in this subheading and, second, even the reduced amounts are still higher compared to the current financial perspective, making them politically “sellable”. Cohesion expenditure was also significantly reduced in absolute terms. The first pillar of common agricultural policy was only cosmetically reduced by including Bulgaria and Romania under the ceiling, agreed in 2002. Most of the reductions under this heading are therefore due to rural development (the second pillar of CAP), which is the more “progressive” part of EU agricultural policy. Reductions in other headings are less impressive in absolute size, though some of them are significant in relative terms.

We can therefore conclude that the achieved compromise on financial perspective 2007-2013 is a significant step away from the proclaimed key priorities of the EU in the future. This can also be seen from the structure of the expenditure: the share of agricultural, and, even more so, first pillar CAP expenditure, has increased compared to the original Commission proposal, while the share of sustainable growth
expenditure has decreased. Such a budget deal will offer limited support to both key challenges of the European Union.

Nevertheless, new member states are still expected to receive significant positive transfers from the EU budget to support their real convergence in the period of the next financial perspective. This presents new challenges for them in the years to come.

5 Absorption of cohesion resources in new member states in the new financial perspective

Given the UK compromise, the key challenge for new member states is how to speed up convergence in real terms by absorbing the available cohesion policy resources in the next financial perspective without jeopardizing convergence in nominal terms. In this chapter, we first describe the concept of absorption capacity and then discuss the possible extent of absorption problem in new member states in the period of the next financial perspective.

5.1 Concept of absorption capacity

Within the context of EU public finance, absorption capacity is defined as the extent to which a member state is able to fully spend the allocated financial resources in an effective and efficient way. With experience gathered over time, the European Commission arrived at conclusion that countries have a limited capacity to absorb external investment support effectively and efficiently.

Generally speaking, we can say that a member state’s absorption capacity is determined by three main factors – macro-economic, financial and administrative (Boeckhout et al., 2002):

1. Macro-economic absorption capacity. Macro-economic absorption capacity relates to the overall ability of the economy to generate viable investment opportunities that could be financed by external investment support. Since this ability depends on the overall level of development of the economy, it is defined and measured as percentage of GDP. Based on experience, the European Commission concludes that EU member states have a limited macro-economic capacity to absorb external investment support effectively and efficiently. In line with this assessment, the ceiling for total cohesion policy transfers (Structural funds and Cohesion fund) to individual member states during the current financial perspective has been set to 4% of their respective national GDPs. This ceiling has been reduced and differentiated in the next financial perspective (with the ceiling gradually increasing in level of development). This was also one of the
main reasons for reduction of cohesion expenditure in new member states in the final deal compared to the Commission proposal.

2. *Financial absorption capacity.* Financial absorption capacity can be defined as the ability to co-finance EU supported programs and projects, to meet additionality requirements, to plan and guarantee any national contributions in multi-annual budgets and to collect these contributions from several partners interested in a program or project.

3. *Administrative or institutional absorption capacity.* Administrative absorption capacity can be defined as the ability or skill of central and local authorities to prepare suitable plans, multi-annual programs and projects in due time, to decide on programs and projects, to arrange the co-ordination among principal partners, to cope with administrative and reporting requirements and to finance and supervise implementation properly, avoiding irregularities as far as possible. More specifically, administrative absorption capacity is composed of two parts:

   a) On the *demand side,* administrative capacity is determined by the ability of project applicants to generate projects that meet the bidding requirements of the public ordering procedure used.

   b) On the *supply side,* administrative capacity is determined by the ability of the authorities to manage Structural Funds and Cohesion fund entrusted to them effectively and efficiently in all stages of the programming process – from initial planning to implementation and evaluation of projects. The supply side of administrative capacity can be described by three design variables – structure, human resources and tools. *Structure* relates to the clear assignment of tasks and responsibilities to institutions involved in the management process. *Human resources* relate to the ability to detail tasks and responsibilities at the level of job description and train or recruit a suitable number of staff to fill the identified job posts. *Tools* relate to the availability of various job-aids, such as instruments, methods, guidelines, manuals, systems, procedures, that can enhance the functioning of the system.

5.2 Scale of cohesion transfers to new member states

In the next financial perspective, EU budget will provide significant financial support for real convergence of new member states through EU cohesion policy. The enlargement posed a challenge to the principle of solidarity in recent negotiations due to the fact that new member states as a group were eligible for an increasingly higher share of cohesion resources at the expense of lowering the level of aid to the current EU member states (European Commission, 2004d). Despite some
concessions given to the old member states (particularly Spain) for the loss of resources, solidarity principle has been preserved and cohesion policy in the next financial perspective will have a strong focus on convergence of new member states.

In the period 2004-06 new member states are gradually being phased into support from the instruments of cohesion policy – the Structural funds and the Cohesion fund. During this period, ten new member states as a group will on average receive cohesion policy transfers of around 1,60% of their gross national income, which represent around 6,8% of the total EU budget expenditure in 2004-2006 (Rollo, 2003).

Compared to the levels of support in the initial three years of membership, the relative importance of cohesion policy for new member states in the period after 2006 is expected to increase, despite the cutbacks in the course of negotiations. In the final agreement on financial perspective 2007-2013, new member states negotiated average annual cohesion envelopes of around 3,12% of their gross national income. Bulgaria and Romania received envelopes in the range of 3,04% of their GNI. Taken together, cohesion policy resources for ten new member states and Bulgaria and Romania represent some 18% of total budget expenditure in the next financial perspective. In absolute figures, this translates to more than a doubling of available annual cohesion resources for new member states in real terms compared to the 2004-2006 period. Chart 1 and Table 2 give some more insights into these numbers.

Chart 1: Allocation of cohesion policy resources in the next financial perspective (appropriations for commitments, expressed in million EUR and 2004 prices)\(^6\).

\(^6\) See table 4 in Appendix 1 for detailed figures.
As can be seen from the graph above, next financial perspective will bring about a significant shift in the focus of cohesion policy resources. While a large majority of available resources in the 2004-2006 period still goes to the old member states (EU-15), this situation will change in the 2007-2013 period. The share of old vs. new member states in 2004-2006 is 81% vs. 19% on average over the 3 year period, while in the next financial perspective it becomes 49% vs. 51% on average over the 7 year period (if Bulgaria and Romania are added to EU-10). There is no major change in the overall level of cohesion policy resources, only a slight increase.

From the figures in table 2, expressed in real EUR terms, it is evident, that the absolute annual level of cohesion resources going to the EU-10 will on average more than double in the next financial perspective (in fact it will increase by a factor of nearly 2.4). Allocations to the EU-10 are rising throughout the period 2007-2013, while at the same time, the level of resources, going to the EU-15 is declining. Allocations to EU-10 and EU-15 catch up in 2012, and in 2013 EU-10 receive more transfers than EU-15, while on average over the 7-year period they still receive slightly less cohesion resources annually (18.9 billion EUR) than the old member states (21.6 billion EUR). Nevertheless, EU-10 represent only around 5.2% of expected total GDP of the 27 member EU in 2007-2013, so the fact that on average, 43% of all cohesion resources in the next financial perspective go to ten new
member states (additional 8% go to Bulgaria and Romania), implies significant redistribution. This can also be seen from relative figures, expressed as % of GNI, where new member states and Bulgaria and Romania far exceed the average relative level of cohesion aid going to the old member states.

From table 2 it can also be seen that despite a slight absolute increase in the average annual cohesion resources for EU as a whole in the period 2007-2013 compared to the period 2004-2006, available resources have actually decreased in relative terms from 0,40% to 0,38% of GNI. This is the result of cutbacks in the course of negotiations.

Table 2: The annual average level of cohesion policy resources in old member states (EU-15), new member states (EU-10) and Bulgaria and Romania (EU-2) in the period 2004-2006 and 2007-2013, expressed in thousand EUR (2004 prices) and as % of GNI

<table>
<thead>
<tr>
<th>All EUR figures in 2004 prices</th>
<th>2004-2006 annual average</th>
<th>2007-2013 annual average</th>
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<tbody>
<tr>
<td></td>
<td>in million EUR</td>
<td>as % of GNI</td>
</tr>
<tr>
<td>EU-15</td>
<td>33.895</td>
<td>0,34%</td>
</tr>
<tr>
<td>EU-10</td>
<td>7.989</td>
<td>1,60%</td>
</tr>
<tr>
<td>EU-2</td>
<td>0</td>
<td>0,00%</td>
</tr>
<tr>
<td>Total (EU-27)</td>
<td>41.884</td>
<td>0,40%</td>
</tr>
</tbody>
</table>

Source: simulations based on model of financial flows in FP 2007-2013 (Government of RS, 2005)

The main issue for real convergence of new member states in the context of the EU budget is therefore how to cope with significantly increased level of cohesion support in the period of the next financial perspective 2007-2013. If new member states can absorb the allocated funds effectively and efficiently, cohesion policy will contribute to convergence process between the new and the old member states. In addition, convergence can also contribute to the attainment of Lisbon goals, if the whole process is conducive to innovation and development of new technologies. The Commission proposal suggested that investments in R&D and human capital, stimulation of innovativeness and transfer of knowledge between research and academic institutions and the economy should play a central role in cohesion policy after 2006 and Lisbon orientation of cohesion policy has also been reaffirmed by the European Council (European Commission, 2004d; Council of the EU, 2005).
5.3 Key issues faced by new member states

There are three aspects of cohesion policy that will influence absorption of available cohesion policy resources and therefore the final impact on convergence (Council of the EU, 1999; European Commission, 2004a):

1. **Additionality** – according to EU regulations transfers from Structural funds may not replace public or other equivalent structural expenditure by the member state. The principle of additionality is aimed at increasing the leverage effect and economic impact of cohesion policy and is preserved in the next financial perspective. Therefore, new member states must maintain national level of public structural support in the new financial perspective that is at least equal in real terms to the existing level in the current financial perspective. This rule applies only to the Structural funds and not to the Cohesion fund, where EU expenditure may replace national expenditure (Backe, 2004).

2. **Co-financing** – in order to provide incentives for responsible management of cohesion policy transfers from the EU budget and prevent potential moral hazard and adverse selection problems, the European Union co-finances only part of the total expenditure eligible for funding from the Structural funds and the Cohesion fund. The rest has to be financed from national sources, either public or private. Co-financing from public sources and the principle of additionality are compatible, since member states can use existing national structural expenditure to cover cohesion policy co-financing requirements, providing that they are able to reprioritize existing expenditure in line with cohesion policy priorities (Hallet, 2004).

3. **Programming** – before member states can access cohesion policy resources that have been pre-allocated to them, they must prepare a comprehensive multi-annual development plan and programming documents that outline key strategic investment priorities on national and regional levels. Programming documents contain descriptions of concrete measures, available financial resources (both EU and national) and implementation structure with the objective of addressing the defined investment priorities (Government of RS, 2003).

Based on the increase in allocated EU cohesion policy support in the course of the next financial perspective and the described three aspects of cohesion policy, we can conclude that the new member states face two important domestic issues, if they want to use cohesion policy as a tool to achieve convergence and therefore contribute to the solution of key economic challenges of the European Union:
1. *Fiscal policy issue* – This issue is related to potential problems with *financial absorption capacity* of new member states, since they must secure sufficient national financial resources for co-financing of cohesion policy related expenditure and respecting additionality principle. Structural funds and Cohesion fund support can only be used once this precondition is met. In order to meet requirements of cohesion policy alongside with all other aspects of the new financial perspective, new member states will either have to restructure their budget expenditure to accommodate additional EU expenditure, or they could risk deterioration in their budget balance and crowding out of existing investments. Taking into account a significant increase in co-financing and additionality requirements in the next financial perspective, other national budget flows related to the new financial perspective (agriculture, contributions into the EU budget, etc.), high amounts of “fixed” current expenditure in their national budgets and considerable budget imbalances in many of the new member states, restructuring task might not be very easy for some of these countries.

2. *Investment issue* – This issue is related to potential problems with *administrative* and *macro-economic absorption capacity* of new member states, since they must identify priorities for the use of resources available for cohesion policy in the next financial perspective based on the needs and capabilities of their economies. The administrative choice is made somewhat easier as the European Commission provides general guidelines about the priorities that member states should follow. The guidelines more or less correspond to the neoclassical economic framework that stresses the importance of supply side factors in building the long-term growth potential of the economy (Barro and Sala-i-Martin, 2003). In addition to following these guidelines, the defined investment priorities should also be able to generate sufficient added value in order to justify national public spending and should consider absorption capacities of new member states’ economies. Even if all administrative problems are resolved, new member states might still not be able to fully absorb cohesion policy resources, if their economies are not able to generate sufficient investment opportunities. The uncertainty about absorption and costs associated with ex-post low absorption might be a reason for some new member states to ex-ante target lower than full absorption.

Both of the issues defined above are addressed to fiscal and structural policies in new member states, which have gained relative importance with the entrance of new member states into the European Union. The decision about how to tackle both issues and what should be the overall objective of new member states regarding cohesion policy in the next financial perspective is therefore more or less in the hands of each individual country. However, if new member states are for some reason unwilling or unable to make their fiscal and investment planning homework, they could be missing an important opportunity of their full EU membership for a
considerable (7-year) time period, which could slow down their convergence. In the following chapter, we discuss the options available to new member states.

6 Available policy options in new member states

The main messages of the previous chapter has been that high absorption of cohesion policy resources can aid new member states to speed up their convergence process and that budget expenditure restructuring will be necessary in order to avoid additional fiscal pressures stemming from cohesion policy and other items in the next financial perspective. If we narrow the policy options available to new member states to extremes, we can basically say that they can make two different choices regarding absorption of cohesion policy resources and two different choices regarding restructuring their budget expenditure (Mrak, 2004a):

1. New member states can choose either high or low absorption of cohesion policy resources. In the case of high absorption the objective of new member states is to speed up convergence, while in the case of low absorption they are negligent about convergence.

2. New member states can choose either to restructure their budget expenditure or to leave them as they are. In the first case new member states pay attention to the budget balance and nominal convergence, while in the second case they are ambivalent to potential fiscal impact of the next financial perspective on the budget balance.

These four policy options define four possible stylized outcomes for new member states in the future. By saying that all four outcomes (including the negative ones) are possible, we implicitly assume that there are financial and political considerations that might force new member states to act in a manner that is not “economically optimal”.

Table 3: Policy options available to new member states in the new financial perspective

<table>
<thead>
<tr>
<th>Restructuring</th>
<th>No restructuring</th>
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</thead>
<tbody>
<tr>
<td>High absorption</td>
<td>A. High growth, budget balance</td>
</tr>
<tr>
<td>Low absorption</td>
<td>C. Low growth, budget balance</td>
</tr>
</tbody>
</table>

Option A is the best policy choice, because it focuses on both real as well as nominal convergence. In this option a country is committed to keep its budget balance unchanged, but wants at the same time to use all the available resources in the EU budget to achieve convergence and also has the absorption capacity to do this. According to the conclusions in the second part of this paper a country that chooses this policy option will have to restructure its budget expenditure if it wants to achieve both objectives (high growth and budget balance) at the same time. When
restructuring its budget expenditure, the country can leave some EU related budget expenditure as additional budget expenditure and still keep the budget balance unchanged so long as EU transfers to the national budget are equal or greater to the additional EU expenditure from the national budget.

Option B describes a policy choice that focuses mostly on real convergence. In this option a country is committed to use all the available resources in the EU budget to achieve convergence and has the absorption capacity to do this, however it does not pay much attention to the budget balance and is either unwilling or unable to restructure its budget expenditure. Such a country can achieve high growth but will also incur higher budget deficits. If growth strategy is successful the country can later repay the debt, however if growth doesn’t materialize for some reason, the country risks getting into an unsustainable public debt dynamics.

Option C involves a country that subjects real convergence to achieving nominal convergence, either because it deliberately targets low absorption of EU funds or because its absorption capacity is low. In this option the country is therefore not committed to using all the funds available in the EU budget but is willing to restructure its budget expenditure in order to accommodate EU transfers it does absorb.

Option D is the worst policy choice because it disregards both real and nominal convergence. A country applying for this option neither has the will or the ability to successfully utilize transfers from the EU budget (low absorption), nor sufficient budget discipline to keep the budget balance unchanged (no budget expenditure restructuring). Such a country would have a much harder time to achieve high growth and therefore convergence and would also incur double deficits – both national budget balance as well as net financial position of this country vis-à-vis the EU budget would deteriorate. The problems of such a country would be compounded by a very likely fact that its debt dynamics would become unsustainable due to low growth.

In their attempt to address the problem of convergence and domestic fiscal issues, related to the transition between the current and the next financial perspective, new member states will be faced with a set of policy options similar to those described above. The outcome of their convergence path may well depend on the policy choices they make within such a set of options. Since the next financial perspective will be a daily reminder of decisions made now for a period of seven years, it is very important that new member states clarify their objectives with respect to the challenges of the European Union and with respect to the next financial perspective itself. If new member states consider the next financial perspective as an important tool for meeting their own challenge of convergence they should align their actions
accordingly. The analysis in this paper has shown that in order for new member states to be able to achieve real as well as nominal convergence, it is very important that they start thinking about restructuring of their budget expenditure. New member states should make their budget expenditure compatible with EU expenditure in the next financial perspective, especially with items such as cohesion policy which are expected to generate growth in the new member states in the future.

7 Conclusions

In this paper we have explored key policy issues and outlined key policy choices and possible outcomes, faced by the new member states, if they want to successfully absorb the increase in the available cohesion policy resources in the next financial perspective.

In the first part of the paper we have made a link between cohesion policy and the key challenges of European Union today. The first challenge is competitiveness that requires improvements in innovation, research and development and human resources in order to expand the EU’s technological frontier. The second challenge is convergence of new member states that requires further modernization and restructuring of new member states’ economies.

In the context of these twin challenges of growth in the European Union, cohesion policy, particularly in the period of the next financial perspective, is seen as an important tool for convergence of new member states. Cohesion policy will reach its objective (convergence), if new member states are able to effectively and efficiently absorb the expected substantial increases in available resources for this purpose from the EU budget in the period of the next financial perspective.

When trying to address absorption of available cohesion policy resources in the new financial perspective, new member states are faced by a two issues: a fiscal and investment issue. Fiscal issue relates to their financial absorption capacity whereby new member states must secure sufficient public financial resources from their national budgets and restructure their budget expenditure in order to accommodate the expected increase in additionality and in co-financing requirements in the next financial perspective. Investment issue relates to administrative and macro-economic absorption capacity of new member states whereby they must clarify their strategic investment priorities and prepare a multi-annual investment program based on the needs and investment opportunities in the economy and subsequently manage this program.

Based on their financial, administrative and macro-economic absorption capacities, new member states have four policy choices available: they can either restructure
their budget expenditure or leave it as it is and they can either target full or low absorption of available cohesion policy resources in the next financial perspective. These four choices define four possible outcomes. If new member states restructure their budget expenditure and opt for full absorption of cohesion policy resources, they could keep their budget balances unchanged and at the same time accelerate convergence. If, on the other hand, new member states do not restructure their budget expenditure but still pursue full absorption, they could achieve faster convergence with a worse fiscal outcome. The third option is if new member states restructure their budget expenditure but for stability reasons decide for low absorption, in which case they would retain an unchanged budget balance, but at a slower pace of convergence. The worst possible outcome can happen if new member states neither restructure their budget expenditure nor absorb the available cohesion policy resources. In this case member states could see a deterioration of their budget balance position even at a slower rate of convergence.
### APPENDIX 1

Table 4: Cohesion policy resources in 2004-2013 period in million EUR (2004 prices)

<table>
<thead>
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</thead>
<tbody>
<tr>
<td>EU-2</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>1.813</td>
<td>2.486</td>
<td>3.226</td>
<td>3.654</td>
<td>3.849</td>
<td>4.057</td>
<td>4.269</td>
</tr>
<tr>
<td>Total</td>
<td>41.035</td>
<td>41.685</td>
<td>42.932</td>
<td>42.840</td>
<td>43.288</td>
<td>43.820</td>
<td>43.801</td>
<td>43.995</td>
<td>44.634</td>
<td>45.241</td>
</tr>
</tbody>
</table>

Source: simulations based on model of financial flows in FP 2007-2013 (Government of RS, 2005)
REFERENCES


