Economic analysis from the European Commission's Directorate-General for Economic and Financial Affairs

Volume 2, Issue 2

03.02.2005

ECFIN COUNTRY FOCUS

Highlights in this issue:

- The new Member States receive transfers, but contribute less to the EU budget
- Some EU funds also trigger national expenditure
- The fiscal effects are positive conditional on expenditure reform

Budgetary transfers between the EU and the new Member States: manna from Brussels or a fiscal drag ?

By Martin Hallet and Filip Keereman***

Summary

Member States receive funds for agriculture, structural development (e.g. infrastructure works) and internal policies (e.g. training, research, environmental protection), but in exchange have to make a contribution to the EU budget. Given the overall low level of income per head as compared to the rest of the EU, the ten new Member States receive a considerable amount of transfers with a view to fostering their catching-up process. While it is often argued that EU accession increases a country's budget deficit, the calculations show that the fiscal impact of the EU financial flows in the medium-term should be favourable. Nevertheless, the challenges in restructuring budgetary and administrative procedures to be able to absorb the projected payments in the EU financial framework should be recognised.

EU transfers and national budgets: a controversial issue

New Member States are expected to be helped in their catching-up process by the considerable EU transfers they receive, but are also required to respect the Stability and Growth Pact. Some argue that accession leads to a deterioration of the budgetary situation in the new Member States, because in addition to their contribution to the EU budget, these countries face increased expenditure triggered by certain accounting rules governing EU funds and by the efforts to improve the functioning of the economy.

The literature is inconclusive on the fiscal effects of accession

Kopits and Székely (2002) arrive at an estimate of a negative net budgetary effect of accession "conservatively estimated in the range of 3 to 4¾% of GDP" for the Czech Republic, Estonia, Hungary, Poland and Slovenia. Antczak (2003) foresees "fiscal deficits deteriorating by up to 3 % of GDP in the first few years after accession. For Slovenia, Mrak (2003) calculates the overall fiscal effect to "be negative at a level of around 1 % of GDP." Backé (2002) makes a similar – albeit more cautious – estimate and concludes that "in the short run, membership of the European Union will add to the fiscal strains on accession countries. In the medium run, overall effects can be expected to be broadly neutral or slightly positive, while some uncertainty prevails on the magnitude of several individual effects, in particular on future public investment needs." On the other hand, Hallet (2004), on which this country focus is based, concludes that "on balance, and in contrast to what the literature often concludes, accession should rather reduce the fiscal strains in the new Member States" and that "accession itself is not a very convincing justification for higher budget deficits in the new Member States".

*Directorate for International Economic and Financial Affairs ** Directorate for the Economies of the Member States, respectively.

The Copenhagen package

Payments of 2% of their GDP are foreseen for the new Member States

As a part of the accession negotiations, the Copenhagen Package (named after the European Council meeting of December 2002) set the financial framework 2004-2006 for the new Member States (European Commission, 2003). It was agreed that for this 3-year period total expenditures could amount to EUR 40.9 billion (at 1999 prices). These so-called appropriations for commitments indicate the total available budgetary envelope. However, the amounts actually paid out in a given period of time are smaller, because projects may extend over several years as a result of a limited absorption capacity of the countries. Therefore, the package also presents estimates of the actual annual payments and makes an adjustment for inflation (so-called payment appropriations in current prices for 2004-2006). On this basis, after correction for the increased administrative costs of the enlarged European institutions, but including pre-accession aid, an estimate of what the new countries may expect to receive in 2004-2006 is EUR 31.4 billion or, on average, an injection into their economies of 2 % of GDP per year.

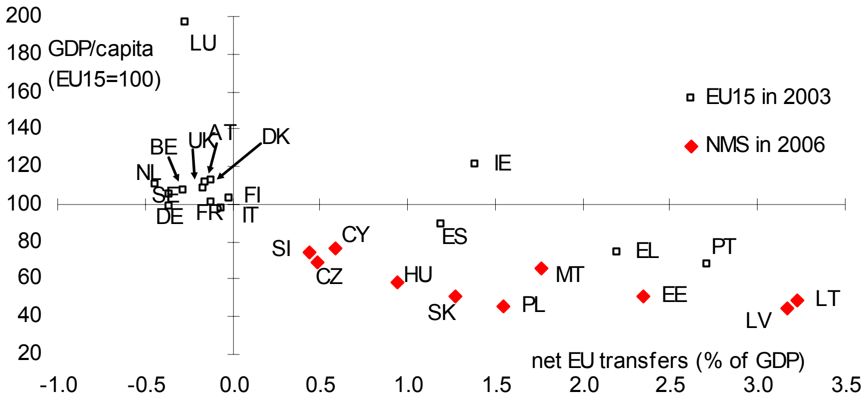
From 1 May 2004, the new Member States also pay a contribution to the EU budget, which is based on the so-called traditional own resources (agricultural levies, custom duties), VAT receipts, gross national income and a share in the UK rebate. For the period 2004-2006, the joint contribution (excluding traditional own resources which cannot be allocated to individual countries) is estimated at EUR 14.5 billion in current prices, which represents, on average, an effort of 0.9 % of GDP per year for the new Member States.

Poor countries receive more transfers

A negative correlation between income and net transfers

On balance, taken together or individually, the new Member States are net beneficiaries from the EU budget. For the group as a whole, the average net EU transfers amount to 1.1 % of GDP per year in 2004-2006, behind which is an ascending path. Net EU transfers reach on average 1.3 % of GDP in 2006 ranging from 0.4 % of GDP for Slovenia to 3.2 % of GDP for Latvia and Lithuania (chart 1).

Chart 1: GDP per capita and net EU transfers to Member States



Note: Net EU transfers after deduction of UK rebate; methodology not fully comparable between old and new Member States
Source: Commission services

Comparing this outlook with the latest information on the old Member States (adapted from European Commission (2004) providing a so-called "operational budgetary balance after UK correction" relative to Gross National Income) reveals a negative correlation between income and the amount of net transfers. Wealthier countries are net contributors to the EU budget and poorer countries are net recipients. With respect to the situation of the old Cohesion Countries (Greece, Spain and Portugal) in 2003, the new Member States seem to have a less favourable position in 2006. Ireland is set to see a deterioration of its position in the coming years due to diminishing payments from Structural and Cohesion Funds and higher contributions to the EU budget.

Additionality and co-financing requirements: triggers for national expenditure

Additionality is monitored for Structural Funds

A very relevant question is to what extent EU transfers not only increase the revenue side of the national budget, but also the expenditure side. If EU transfers are "additional", they may not substitute existing expenditure, but should lead to new projects. In this case the budget balance will not improve; the effect is rather neutral. Which of the EU transfers should be considered additional? Pre-accession aid is subject to the additionality requirement as well as rural development, but in practice, especially for the latter, it is a soft condition implemented at project level which is difficult to verify. Structural Funds in the less developed regions "(…) may not replace public or other equivalent structural expenditure by the Member State" (Article 11(1) of Council Regulation No 1260/99, OJ L 161 of 26.6.1999). This is verified by looking at the relevant national expenditure, which includes both co-financed and non co-financed EU projects, compared to its level in the past. A similar explicit additionality requirement does not exist for the Cohesion Fund, internal policies or transitional expenditure. Finally, the budgetary compensations for the new Member States were specifically designed to improve the government balance and do not lead to extra spending.

Table 1: EU financial framework and budgetary effects in new Member States 2004-2006

	Fin. Framework*		**Budgetary effects**			**Co-financing**
% of GDP			addition-	final	total	
(except otherwise indicated)	bn EUR		ality	user	(5)=	
	(1)	(2)	(3)	(4)	(2)+(3)+(4)	(6)
Total EU transfers (I + II)	**31.4**	**2.0**	**-0.5**	**-0.2**	**1.3**	**-0.4**
Pre-accession aid (I)	**4.9**	**0.3**			**0.3**	**-0.1**
Copenhagen Package (II)#	**26.5**	**1.7**	**-0.5**	**-0.2**	**1.0**	**-0.3**
Agriculture (a)	9.4	0.6		-0.2	0.4	-0.1
Common Agricultural Policy	*5.3*	*0.3*		*-0.2*	*0.2*	
Rural development	*4.0*	*0.3*			*0.3*	*-0.1*
Structural actions (b)	10.1	0.6	-0.5		0.1	-0.2
Structural Fund	*8.2*	*0.5*	*-0.5*		*0.0*	*-0.2*
Cohesion Fund	*2.0*	*0.1*			*0.1*	*0.0*
Internal Policies and transition (c)	3.2	0.2			0.2	
Existing policies	*1.7*	*0.1*			*0.1*	
Nuclear safety	*0.3*	*0.0*			*0.0*	
Institution building	*0.3*	*0.0*			*0.0*	
Schengen	*1.0*	*0.1*			*0.1*	
Administration	(1.9)	(0.1)		-(0.1)	(0.0)	
Compensations (d)	3.8	0.2			0.2	
Own EU resources (III)#	**-14.6**	**-0.9**		**0.1**	**-0.8**	
Traditional own resources	-(2.0)	-(0.1)		(0.1)	(0.0)	
VAT resource (e)	-2.0	-0.1		0.1	0.0	
GNP resource (f)	-11.1	-0.7			-0.7	
UK rebate (g)	-1.5	-0.1			-0.1	
Balance (I+II+III)	**16.9**	**1.1**	**-0.5**	**0.0**	**0.5**	**-0.4**
Average impact in % of GDP		**net transfers**			**net budgetary effect**	

* Financial framework, payment appropriations in current prices
# excluding administration and traditional own resources (unallocated to MS); (II) = (a+b+c+d); (III) = (e+f+g)
(3) = (2) for Structural Fund additionality
(4) = (2)*0.5 for CAP; (4) = (2) for traditional and VAT resources
(6) = (2)*0.25/0.75 for rural development, structural fund and pre-accession aid
(6) = (2)*0.20/0.80 for Cohesion Fund

Source: Commission Services (DG BUDG for financial framework, DG ECFIN for budgetary effects)

Co-financing is designed to increase fiscal responsibility

Certain EU transfers require national co-financing, which may come from public or private sources, in order to foster an efficient use of the money. In the domain of pre-accession aid and rural development, EU funds can in general be used to finance up to 75 % of a project. For Structural Funds (Article 29(3) of Council Regulation No 1260/99), the standard rate is 75% of the total eligible costs, which may rise to a maximum of 80% in some exceptional cases. For the Cohesion Fund, (Article 7(1) of Council Regulation No 1164/94, OJ L 130 of 25.5.1994) stipulates that EU funds can finance 80% to 85% of a project. Table 1 shows the estimated budgetary effects. In the table, the standard maximum rates for the EU contribution are applied, leaving 25% national co-financing for pre-accession aid, rural development and Structural Funds projects (50% for structural funds in Cyprus) and 20% for Cohesion Fund projects. Hence, two simplifying assumptions were made, which may offset each other to some extent. On the one hand, the national co-financing could be underestimated because the maximum rate of EU financing is applied. On the other hand, co-financing is assumed to come from public money, while also private sources could be tapped. Whatever the exact magnitude, co-financing expenditure should not be considered to be a direct budgetary effect since it is not necessarily additional and can come from already existing budget lines.

Not all EU budget transactions affect the national budget

Part of the EU budget transactions are treated as direct payments between the rest of the world and domestic residents without affecting national budgets. Like for the old Member States (ECB, 2004), at the revenue side, the direct agricultural subsidies fall into this category, while at the expenditure side there are the traditional own resources (import duties and agricultural levies) and the VAT resource. On average these flows represent 0.2 % of GDP and cancel each other out.

Pressure in the short run: absorption capacity and advancing payments

Actual absorption of payments from the EU budget could be below projections

The Copenhagen package assumes that, on average over the period 2004-2006 and for all new Member States, payments are 62% of the appropriations for commitments, with an ascending profile of 44% in 2004 and 68% in the years 2005 and 2006 respectively. Because of the relative importance of budgetary compensations which are easier to absorb, these percentages are substantially higher for Cyprus and Malta as well as, to a lesser degree, Slovenia. Apart from the technical point of a shorter EU budget year 2004 for the new Member States, this profile over time is to some extent driven by concerns about the absorption capacity of new Member States with a view to their administrative capacity to smoothly and efficiently manage EU funds. If actual payments turned out much lower than this in some new Member States, the balance of budgetary transfers would look different.

Pre-financing of direct payments to farmers was only important in 2004

In the context of the Common Agricultural Policy (CAP), direct income payments to farmers are only reimbursed from the EU budget in the subsequent year. This will have two ways of affecting the new Member States' budgets. First, payments in 2004 had to be fully pre-financed. Second, the phasing-in of direct payments in the new Member States over 10 years starting at 25% of the amounts paid in the EU-15 Member States in 2004 and rising by five percentage points per year implies that for a given year the reimbursements are likely to be short of actual payments in this transitory phase. Based on the 2005 figure from the Copenhagen package, the new Member States will have to advance 0.26% of GDP in 2004, the highest figures being 0.40% for Lithuania, 0.34% for Hungary and 0.28% for Poland. Assuming the difference between EU payments in 2006 and 2005 as the required national pre-financing in 2005 the average decreases to 0.04% of GDP with little variation across countries and in the subsequent year. Hence, there can only have been a visible cash effect in 2004 and only for those countries where no similar support scheme existed before so that expenditure would be truly additional. However, in the accrual-based ESA95 budget methodology this should not have any effect.

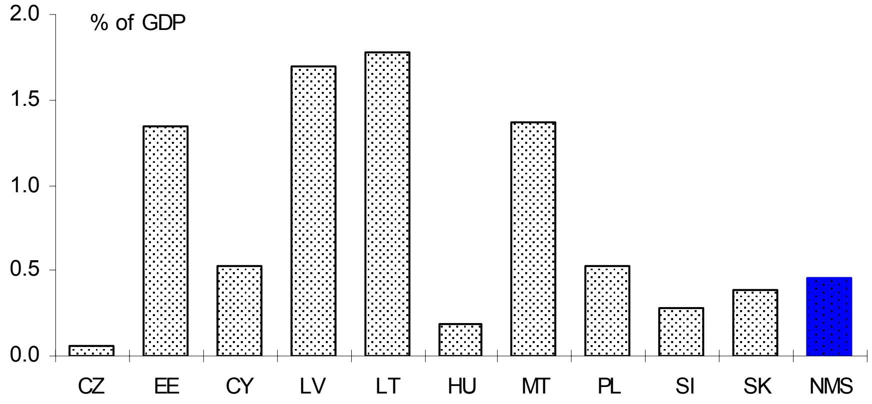
Top-up payments to farmers are at the country's discretion

The direct income payments to farmers may be topped up from the national budget by 30 percentage points, but may never exceed 100 % of the incomes paid out to old Member States. While the top-up payments represent an additional budgetary pressure, the latter should not be linked to accession, as the decision lies with the national authorities. Furthermore, in 2004-2006, part of the top-up payments can be financed from the rural development budget.

Why do others arrive at negative fiscal effects of accession ?

All in all we estimate the net budgetary effects to be positive and amount to 0.5 % of GDP for the new Member States as a whole in the period 2004-2006, ranging from 0.1 % of GDP for the Czech Republic to 1.8 % for Lithuania.

Chart 2: Budgetary effects of EU transfers to new Member States 2004-2006



Source: Commission services

Accounting versus economic approach to budgets

Five factors explain why the budgetary impact of EU transfers can be differently assessed. First, one can deal with the wider consequences of accession beyond the implications of the EU transfers. Other accession-related expenditures can be quantified and added to the budgetary figures. This is likely to be misleading since some of the obligations have been fulfilled before accession, some are eligible to EU funding (e.g. infrastructure, environment, and administration) and some are private sector responsibility (e.g. environment). Second, contrary to a static accounting approach, in a dynamic economic approach a direct transfer from the EU budget to a private beneficiary could substitute previous funding from the general government budget and, as a result, have a positive net impact. Third, problems with absorption capacity can be assumed. Fourth, a payment mismatch can be taken into account leading to the pre-financing of direct payments to farmers with the consequence of a more negative impact. Finally, national co-financing of EU programmes is not subject to an additionality requirement and can be taken from existing expenditure lines limiting the budgetary impact. Ultimately, this reflects two different "budget philosophies" depending on whether accession related expenditure is considered to be additional expenditure or to be financed from restructuring the budget.

EU transfers: medium-term budgetary benefits and short-run challenges

It is often argued that EU accession increases a country's budget deficit due to the costs associated with the implementation of the acquis communautaire, national expenditure to co-finance EU funds, insufficient absorption capacity of the allocated EU transfers or the obligation to advance EU payments to farmers.

Favourable effects with budgetary challenges

According to this Country Focus, the EU transfers represent an important injection into the economy of the new Member States. Thus, the fiscal effects of the EU financial flows in the medium-term should be favourable. Nevertheless, especially in the short term, the challenges in restructuring budgetary and administrative procedures to be able to absorb the projected EU payments should be recognised. This is consistent with the application of the excessive deficit procedure to the new Member States which emphasises the 3 % of GDP reference value, but accepts the need for a longer period, compared to old Member States, to reduce the deficits in view of the high government deficit at which some new Member States joined the EU and in view of transition related expenditure.

References

Antczak, M. (2003), Do acceding countries need higher fiscal deficits?, Center for Social and Economic Research, Studies and Analyses No 260, Warsaw

Backé, P. (2002), "Fiscal effects of EU membership for central European and Baltic EU accession countries", *Focus on Transition,* No 2/2002, pp.151-164, available from: www.oenb.at

European Commission (2003), Final financial package agreed in Copenhagen on 13 December 2002 - Indicative allocation of Commitment and payment appropriations, European Commission, Directorate-General Budget, available from: http://europa.eu.int/comm/budget/pdf/financialfrwk/copenhagen_package/webtablesEN.pdf

European Commission (2004), Allocation of EU operating expenditure by Member State, 2002, European Commission, Directorate-General Budget, available from: http://europa.eu.int/comm/budget/pdf/agenda2000/allocrep_en2002.pdf

European Central Bank (2004), "Transactions involving the EU budget", *Monthly Bulletin*, Box 3, August

Hallet, M. (2004), Fiscal effects of accession in the new Member States, European Commission, Directorate-General for Economic and Financial Affairs Economic Papers No 203 available from: http://europa.eu.int/comm/economy_finance/publications/economic_papers/economicpapers203_en.htm

Kopits, G. and I. P. Székely (2002), Fiscal policy challenges of EU accession for the Baltics and central Europe, paper presented at a conference organised by the Oesterreichische Nationalbank in Vienna, 3-5 November 2002

Mrak, M. (2003), Preliminary assessment of EU accession on fiscal position of Slovenia, Hungarian Foundation of European Studies Bulletin Europe 2002, Budapest, December

The *ECFIN Country Focus* provides concise analysis of a policy-relevant economic question for one or more of the EU Member States. It appears fortnightly.
Chief Editor: Marco Buti, Director of the Directorate for the Economies of the Member States.
Coordinating Committee: Ronald Albers, Nathalie Darnaut, Jens Matthiessen
Layout: Vittorio Gargaro, Karl Gradinger, Johannes Kattevilder
E-mail: ECFIN-CountryFocus@cec.eu.int
Website: http://europa.eu.int/comm/economy_finance/publications/countryfocus_en.htm