EU Investment Grants Review

Iain Begg
Recent World Bank Technical Papers

No. 370 Dejene, Shishira, Yanda, and Johnsen, Land Degradation in Tanzania: Perception from the Village
No. 371 Essama-Nsah, Analyse d’une répartition du niveau de vie
No. 372 Cleaver and Schreiber, Inverser la spirale: Les interactions entre la population, l’agriculture et l’environnement en Afrique subsaharienne
No. 373 Onursal and Gautam, Vehicular Air Pollution: Experiences from Seven Latin American Urban Centers
No. 374 Jones, Sector Investment Programs in Africa: Issues and Experiences
No. 375 Francis, Milimo, Njobvo, and Tembo, Listening to Farmers: Participatory Assessment of Policy Reform in Zambia's Agriculture Sector
No. 376 Tsunokawa and Hoban, Roads and the Environment: A Handbook
No. 377 Walsh and Shah, Clean Fuels for Asia: Technical Options for Moving toward Unleaded Gasoline and Low-Sulfur Diesel
No. 378 Shah and Nagpal, eds., Urban Air Quality Management Strategy in Asia: Kathmandu Valley Report
No. 379 Shah and Nagpal, eds., Urban Air Quality Management Strategy in Asia: Jakarta Report
No. 380 Shah and Nagpal, eds., Urban Air Quality Management Strategy in Asia: Metro Manila Report
No. 381 Shah and Nagpal, eds., Urban Air Quality Management Strategy in Asia: Greater Mumbai Report
No. 382 Barker, Tenenbaum, and Woolf, Governance and Regulation of Power Pools and System Operators: An International Comparison
No. 383 Goldman, Ergas, Ralph, and Felker, Technology Institutions and Policies: Their Role in Developing Technological Capability in Industry
No. 384 Kojima and Okada, Catching Up to Leadership: The Role of Technology Support Institutions in Japan's Casting Sector
No. 385 Rowat, Lubrano, and Porrata, Competition Policy and MERCOSUR
No. 386 Dinar and Subramanian, Water Pricing Experiences: An International Perspective
No. 387 Oskarsson, Berglund, Seling, Snellman, Stenbäck, and Fritz, A Planner's Guide for Selecting Clean-Coal Technologies for Power Plants
No. 388 Sanjayan, Shen, and Jansen, Experiences with Integrated-Conservation Development Projects in Asia
No. 390 Foster, Lawrence, and Morris, Groundwater in Urban Development: Assessing Management Needs and Formulating Policy Strategies
No. 391 Lovei and Weiss, Jr., Environmental Management and Institutions in OECD Countries: Lessons from Experience
No. 392 Felker, Chaudhuri, György, and Goldman, The Pharmaceutical Industry in India and Hungary: Policies, Institutions, and Technological Development
No. 394 Hill and Shields, Incentives for Joint Forest Management in India: Analytical Methods and Case Studies
No. 395 Saleth and Dinar, Satisfying Urban Thirst: Water Supply Augmentation and Pricing Policy in Hyderabad City, India
No. 396 Kikeri, Privatization and Labor: What Happens to Workers When Governments Diversify?
No. 397 Lovei, Phasing Out Lead from Gasoline: Worldwide Experience and Policy Implications
No. 398 Ayres, Anderson, and Hanrahan, Setting Priorities for Environmental Management: An Application to the Mining Sector in Bolivia
No. 399 Kerf, Gray, Irwin, Lévesque, Taylor, and Klein, Concessions for Infrastructure: A Guide to Their Design and Award
No. 400 Benson and Clay, The Impact of Drought on Sub-Saharan African Economies: A Preliminary Examination
No. 401 Dinar, Mendelsohn, Evenson, Parikh, Sanghi, Kumar, McKinsey, and Lonergan, Measuring the Impact of Climate Change on Indian Agriculture
No. 402 Welch and Frémond, The Case-by-Case Approach to Privatization: Techniques and Examples
No. 403 Stephenson, Donnay, Frolova, Melnick, and Worzala, Improving Women's Health Services in the Russian Federation: Results of a Pilot Project

(List continues on the inside back cover)
# Contents

Foreword ................................................................. v  
Acknowledgments ...................................................... vi  
Executive Summary .................................................. 1  

I. EU Investment Grants Review ................................... 2  
   How the Structural Funds Operate ............................... 2  
   The Cohesion Fund ................................................ 5  
   The Agenda 2000 Proposals ...................................... 6  
   Major Questions for Central and Eastern European Countries .......... 7  

II. Theoretical Issues ................................................ 8  
    Introduction .......................................................... 8  
    Efficiency, Equity and the Design of Intergovernmental Transfers .......... 8  
    Unconditional Block Grants ..................................... 9  
    Conditional Grants .............................................. 9  
    Grant Design ................................................... 10  
    Implications for Central and Eastern European Countries .............. 10  

III. Arrangements for Intergovernmental Transfers for Capital Investment .... 11  
    Introduction .......................................................... 11  
    Transfer Systems .................................................. 12  
    Insights on Transfer Systems .................................... 13  

IV. Experience of the Structural Funds .......................... 15  
    Formal Auditing .................................................. 15  
    Academic Studies ................................................ 16  

V. Case Study Summaries ............................................ 17  
    United Kingdom .................................................. 17  
    Sweden ............................................................... 19  
    Spain ................................................................. 21  
    Ireland ............................................................... 22  
    Poland ............................................................... 24  
    Romania ............................................................. 25  
    Conclusion ......................................................... 26  

VI. Conclusions: Methodology for Country Analyses ......................... 27  
    Summary of Key Findings ....................................... 27  
    Elements of a Methodology ..................................... 31  
    The Nature and Characteristics of Intergovernmental Transfers Currently in Place ... 32  
    Effectiveness of Public Investment and Impacts ....................... 32  
    The Flexibility of the System .................................... 32  
    Need for Change to be Suited to the Structural Funds .................... 33
Acronyms and Abbreviations

CEECs  Central and Eastern European Countries
CSF    Community Support Framework
EAGGF  The European Agricultural Guidance and Guarantee Fund
ERDF   The European Rural Development Fund
ESF    The European Social Fund
EU     European Union
FIFG   The Financial Instrument for Fisheries
GDP    gross domestic product
RITAs  receipts taken into account
PPS    purchasing power standards
PFI    private finance initiative
SRB    single regeneration budget

Tables

Table 1  Assistance from the Structural Funds 1994-99 by Member State and Fund .... 4
Table 2  Assistance from the Structural Funds 1994-99 by Objective and Fund .......... 4
Foreword

The Poverty Reduction and Economic Management Unit in the World Bank's Europe and Central Asia Region has been undertaking a series of analytical work on issues pertinent to the economies in the region. These issues include: transition issues; issues of economic integration pertinent for the Central and Eastern Europe countries which are candidates for accession to the European Union; poverty issues; and other economic management issues. The analytical work has been conducted by staff of the unit, other Bank staff as well as specialists outside of the Bank.

This technical paper series was launched to promote wider dissemination of this analytical work, with the objective of generating further discussions of the issues. The studies published in the series should therefore be viewed as work in progress.

The findings, interpretations and conclusions are the authors' own and should not be attributed to the World Bank, its Executive Board of Directors, or any of its member countries.

Pradeep Mitra
Director
Poverty Reduction and Economic Management Unit
Europe and Central Asia Region
The World Bank
Acknowledgments

This report follows a framework proposed to the World Bank’s Europe and Central Asia Poverty Reduction and Economic Management Sector Unit provided by Iain Begg. The report was prepared by a group directed by Mr. Iain Begg, Professor of International Economics at South Bank University, London. The contributors to this report were Messrs./Mmes:

Svetlana Andrianova, Iain Begg and Panicos Demetriades, South Bank University; Ulf Arvidsson, Mike Barrow, Peter Holmes and David Young, University of Sussex; and Andrzej Jablonski, University of Wroclaw

The report has benefited from helpful comments by Mr. Carlos Cavalcanti and Mr. Stanislas Pottier of the World Bank’s Europe and Central Asia Poverty Reduction and Economic Management Sector Unit.
Executive Summary

Over the next few years, several Central and Eastern European Countries (CEECs) are expected to accede to the European Union (EU). Prior to joining the Union, these countries are expected to have transformed their economies and institutional structures sufficiently to conform to the body of rules and procedures that have been adopted by the existing Member States—the so-called acquis communautaire. Upon accession—and in some respects during the negotiating period—the new members of the EU will be entitled to benefit from common policies of the Union, although from the experience of past enlargement of the EU, derogations for a limited period is conceivable. In particular, the CEECs can expect to receive sizeable transfers from the central EU budget to support agriculture and to advance economic and social cohesion.

Assuring cohesion is a fundamental aim of the EU, articulated in Article 2 of the European Union Treaty. The Structural Funds, which account for around a third of the expenditure of the EU institutions, are the principal instrument for advancing it. Since the early 1980s, the scale of EU spending on “structural operations” has increased substantially as the budget itself has increased to the present ceiling of 1.27 percent of EU gross domestic product (GDP). Spending by the EU on agricultural policy, which used to dominate the EU budget, has also increased in real terms but has seen its share of the total fall to just below half.

The purpose of the Structural Funds is, in the Commissions words, to “co-finance actions to help reduce the gaps in socioeconomic development between the various regions and Member States of the Union.” The Funds “are mainly used to finance improvements in infrastructure, productive investment, local development, human resources and the environment.”

For the Central and Eastern European Countries (CEECs) that accede to membership of the EU in the next few years, the Structural Funds will be an important addition to resources available for public investment. They will be intergovernmental transfers that complement current sources within individual CEECs. But they will also pose a challenge to existing administrative structures and procedures, and are likely to require that these be reformed, in some cases quite radically.

The present study is the first stage of a three-stage research programme that might investigate institutional arrangements for local and regional capital investment in selected CEECs and assess whether these arrangements provide appropriate signals to economic agents. The aim of the overall study is to “provide policy recommendations to improve the transparency, accountability, consistency and allocational efficiency of local and regional public investment in CEECs. The EU accession and the prospective use of EU financial support are the context for the study.

The study concentrates on the institutional dimension of intergovernmental transfers and is not intended to provide a comprehensive description of the capacity of the CEECs to absorb transfers from the Structural Funds. Therefore, it does not address other important factors that will bear on the ability of the CEECs to make optimal use of the Structural Funds, such as their ability to manage economic constraints, market or government failures and to adopt an efficient policy mix. Specifically, the principal purpose of this first stage is to provide a methodology for analysing intergovernmental transfers for capital investment. This
methodology could then be used in detailed work on specific countries to be carried out in the second phase of the overall study.

The report is organised as follows: Section II surveys relevant economic theory and is followed by a review and discussion of the various arrangements for intergovernmental transfers in section III. Section IV summarises the experience of the Structural Funds, drawing on official documents and other studies. This is followed by more detailed case studies of arrangements in four EU and two CEEC countries for intergovernmental transfers in section V. Section VI closes the report by drawing a methodology to be used in future studies. This methodology aims at providing guidelines for detailed studies of selected CEECs that will serve two purposes. First, the compatibility of the existing systems of institutions with the relevant rules governing the Structural Funds has to be assessed. This involves analysis of existing systems and of prospective reforms of these, and an appraisal of the problems that might arise in effecting the changes that will be required to assure compatibility. Second, the subsequent research will need to assess the nature of public investment arrangements to ascertain how these might be made more effective and what tradeoffs are implied in the choices with which CEECs are confronted.

I. EU Investment Grants Review

How the Structural Funds Operate

The purpose of the Structural Funds, as the name implies, is to facilitate structural change and economic development, thereby increasing GDP in the future rather than providing a boost to current income. The operating principles governing the Funds, intended to ensure that this aim is respected, include the following:

- Concentration so that the support from the Funds goes where it is most needed.
- A programming approach which calls for the elaboration of a strategic plan, known as a Community Support Framework (CSF). Besides CSFs, several so-called Community Initiatives are administered directly by the Commission.
- Additionality which is the condition that the funding from the EU should complement rather than replace indigenous spending.
- Partnership both in the sense of shared responsibility with the Member State and, where appropriate, lower tiers of government, and cofunding from the Member State of the programme. This cofunding is set at 50 percent for some assisted regions and 75 percent for the least-favoured regions.

Four separate Funds, each administered by a different Directorate-General of the European Commission, constitute the Structural Funds. These are as follows:

- The European Rural Development Fund (ERDF).
- The European Social Fund (ESF).
- The European Agricultural Guidance and Guarantee Fund (EAGGF).
- The Financial Instrument for Fisheries (FIFG).
The Structural Funds have six objectives, three and a half of which are explicitly regional. The remainder are open to other areas, but biased towards the less-favoured regions. These objectives, often used as shorthand for the classes of regions, are as follows:

- **Objective 1 (O1)**—To promote the development and structural adjustment of regions whose development is lagging behind. O1 regions are, in principle, those with a level of GDP per head less than or close to 75 percent of the EU average. Most of the regions designated as O1 are in the southern periphery of the Union, but 11 Member States receive some allocation under O1.

- **Objective 2 (O2)**—To promote development of regions seriously affected by industrial decline. Most of these O2 regions are traditional industrial areas in the Northern Member States, although the eligibility extends to other industrialised regions such as the Basque country in Spain.

- **Objective 3 (O3)**—To combat long-term and youth unemployment and to facilitate the integration into working life of those exposed to exclusion from the labour market.

- **Objective 4 (O4)**—To facilitate the adaptation of workers to industrial change, was introduced in 1993. O4 is a new objective. This was opposed by the United Kingdom, which did not implement any O4 projects in the period 1994-96 (although it has since relented), on the grounds that it was better to focus on O3. However, supporters of O4 see it as an innovative approach to anticipating problems from future structural change.

- **Objective 5a (O5a), 5b (O5b)**—To promote rural development, either by speeding-up adjustment in agriculture and in fisheries—O5a—or by facilitating structural change in rural areas—O5b.

- **Objective 6 (O6)**—To develop regions with low population density. O6 was prompted by the accession of Finland and Sweden.

Of these objectives, 1, 2, 5b and 6 are explicitly territorial in that only designated regions are eligible for them. "Regions" in this sense are defined in diverse ways. Entire countries or large swathes of territory are designated for O1, whereas the designations for O2 can be very narrowly defined, smaller areas (see the regulations). Objectives 3, 4, and 5a apply throughout the EU, although within individual programmes there are disproportionate allocations to regions eligible for O1 and O2. In total, the targeted areas contain 51 percent of the population of the EU. However, for many of the O1 regions, the flows of resources from the Structural Funds represent sizeable proportions of GDP, as high as 6 percent for those that receive the most. Tables 1.1 and 1.2, taken from the 1997 Commission Annual Report on the Structural Funds, show the distribution of the Funds by, respectively, Member State and by Objective.

Table 1.1 shows that the allocations go disproportionately to the four "cohesion" countries—Greece, Ireland, Portugal and Spain, and consequently represent a substantial cross-border flow. (These countries are called the "cohesion" countries because they are the beneficiaries of the Cohesion Fund, discussed below.) Greece and Portugal, for example, each receive bigger nominal receipts than France or the UK, both six times as populous. Spain benefits most overall, although its per capita receipts are below those of the other cohesion
Table 1: Assistance from the Structural Funds 1994-99 by Member State and Fund (ECU Million at 1997 Prices, as of 31 December 1997)

<table>
<thead>
<tr>
<th>Country</th>
<th>Total</th>
<th>ERDF</th>
<th>ESF</th>
<th>EAGGF</th>
<th>FIG</th>
</tr>
</thead>
<tbody>
<tr>
<td>B</td>
<td>1850.11</td>
<td>852.43</td>
<td>727.23</td>
<td>244.81</td>
<td>25.64</td>
</tr>
<tr>
<td>DK</td>
<td>755.26</td>
<td>118.07</td>
<td>343.65</td>
<td>151.00</td>
<td>142.54</td>
</tr>
<tr>
<td>D</td>
<td>19793.76</td>
<td>8516.06</td>
<td>6803.41</td>
<td>4285.49</td>
<td>188.80</td>
</tr>
<tr>
<td>EL</td>
<td>13902.33</td>
<td>9367.05</td>
<td>2585.07</td>
<td>1818.41</td>
<td>131.80</td>
</tr>
<tr>
<td>E</td>
<td>30543.85</td>
<td>16860.49</td>
<td>8455.94</td>
<td>4089.39</td>
<td>1138.03</td>
</tr>
<tr>
<td>F</td>
<td>13044.61</td>
<td>5362.53</td>
<td>4724.80</td>
<td>2219.18</td>
<td>228.10</td>
</tr>
<tr>
<td>IRL</td>
<td>5708.42</td>
<td>2603.95</td>
<td>2009.10</td>
<td>1047.67</td>
<td>47.70</td>
</tr>
<tr>
<td>I</td>
<td>19561.72</td>
<td>10821.80</td>
<td>4982.09</td>
<td>3384.54</td>
<td>373.30</td>
</tr>
<tr>
<td>L</td>
<td>85.49</td>
<td>15.62</td>
<td>26.84</td>
<td>41.93</td>
<td>1.10</td>
</tr>
<tr>
<td>NL</td>
<td>2172.70</td>
<td>598.07</td>
<td>1379.16</td>
<td>140.37</td>
<td>55.10</td>
</tr>
<tr>
<td>A</td>
<td>1482.12</td>
<td>352.84</td>
<td>539.30</td>
<td>587.98</td>
<td>2.00</td>
</tr>
<tr>
<td>P</td>
<td>14106.82</td>
<td>8762.63</td>
<td>3183.93</td>
<td>1952.11</td>
<td>208.15</td>
</tr>
<tr>
<td>FIN</td>
<td>1549.58</td>
<td>417.23</td>
<td>523.80</td>
<td>581.56</td>
<td>27.00</td>
</tr>
<tr>
<td>S</td>
<td>1217.55</td>
<td>314.88</td>
<td>652.48</td>
<td>204.73</td>
<td>45.46</td>
</tr>
<tr>
<td>UK</td>
<td>11355.00</td>
<td>5431.30</td>
<td>5215.84</td>
<td>583.98</td>
<td>123.88</td>
</tr>
<tr>
<td>TOTAL</td>
<td>137629.34</td>
<td>70394.95</td>
<td>42152.63</td>
<td>22343.15</td>
<td>2738.60</td>
</tr>
</tbody>
</table>

Source: European Commission.

countries. Germany, usually cast as the paymaster of Europe, is shown to be the second biggest recipient, largely because of the substantial transfers to the former DDR. Italy, similarly, is a major beneficiary because of the continuing problems in the Mezzogiorno. Table 1.2 shows that the bulk, some two-thirds, of spending goes to the Objective 1 regions.

The operation of the Structural Funds is given substance in Article 130A of the European Union Treaty which relates cohesion to disparities between regions. The scale of the Funds has grown progressively as the EC/EU itself has evolved, and for the poorer Member States the gross receipts from the Funds contribute significantly to public investment. In principle, the purpose of the Funds is to support economic development, which means boosting the

Table 2: Assistance from the Structural Funds 1994-99 by Objective and Fund (ECU Million at 1997 Prices, as of 31 December 1997)

<table>
<thead>
<tr>
<th>Objective</th>
<th>Total</th>
<th>ERDF</th>
<th>ESF</th>
<th>EAGGF</th>
<th>FIG</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>93428.55</td>
<td>55441.67</td>
<td>22358.15</td>
<td>13790.85</td>
<td>1857.89</td>
</tr>
<tr>
<td>2</td>
<td>15063.99</td>
<td>11671.79</td>
<td>3392.20</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>3</td>
<td>12895.88</td>
<td>—</td>
<td>12895.88</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>4</td>
<td>2284.72</td>
<td>—</td>
<td>2284.72</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>5(a-agriculture)</td>
<td>5418.11</td>
<td>—</td>
<td>—</td>
<td>5418.11</td>
<td>—</td>
</tr>
<tr>
<td>5(b-fisheries)</td>
<td>892.61</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>892.61</td>
</tr>
<tr>
<td>6</td>
<td>6033.57</td>
<td>2986.36</td>
<td>1032.00</td>
<td>2895.21</td>
<td>—</td>
</tr>
<tr>
<td>6</td>
<td>711.90</td>
<td>295.14</td>
<td>160.68</td>
<td>238.98</td>
<td>8.10</td>
</tr>
<tr>
<td>TOTAL</td>
<td>137629.34</td>
<td>70394.95</td>
<td>42152.63</td>
<td>22343.15</td>
<td>2738.60</td>
</tr>
</tbody>
</table>

Source: European Commission.
growth rate of assisted regions so that they are able to achieve “real” convergence, not to subsidise the current standard of living. This has a number of implications for the operation of the Funds. First, it means that programmes have to be constructed as economic development (or regeneration) packages. Second, the emphasis is on public investment in the broad sense of the term. Investment can be in infrastructure, in training and in boosting the productive potential of businesses in the region. Third, subsidies to individual firms, or income support for the poor or the unemployed, are not acceptable uses of the Funds. Fourth, programmes must fit into and reinforce other economic development initiatives in recipient regions.

EU Member States design the programmes that they wish to support and seek to have them approved and adopted by the European Commission for cofinancing from the Structural Funds. Agreements are reached between the competent Member State authorities and the Commission on the priority measures for action and the amount of financial assistance to be provided. Whether initiated at the national or EU level, all programmes cofinanced by the Structural Funds are put together by the appropriate authorities in the Member States. Once approved and adopted by the Commission, they are then implemented by the competent national or regional authorities.

Implementation of the measures and projects is supervised by Monitoring Committees, which are made up of representatives of the regions, the Member State, the responsible bodies and the Commission. These committees oversee the implementation of the programmes on a regular basis and set guidelines where necessary. Once the programme has been approved, the Member State authorities managing the programme are responsible for informing potential project promoters of the assistance that is available through, for example, public calls for tender. Organisations that are active in social and economic life (local authorities, associations, enterprises, and so forth) can propose projects and apply to receive support from the Structural Funds. The selection of projects is carried out by the national or regional authorities competent for each programme, not by the European Commission.

All projects that receive EU financial assistance must also be cofinanced from another source, either from the public or private sector.

The Cohesion Fund

As part of the deal that was agreed upon at the December 1992 European Council (held in Edinburgh under the British Presidency) to set the EU budget for the period 1993-99, a further and entirely separate Cohesion Fund was established. It is not part of the Structural Funds despite the fact that it adds to the transfer of resources to the four least-favoured Member States. The Fund has two main aims: to upgrade transport networks, and to encourage environmental improvements consistent with the EU’s environmental policy aims.

Eligibility for the Cohesion Fund is determined by national rather than regional indicators of GNP per capita, measured in purchasing power standards (PPS), with the threshold currently set at 90 percent of the EU average. This effectively limits the Fund to the four “cohesion” countries (Greece, Ireland, Portugal and Spain), although if one of these were to move above the limit (as Ireland is expected to do very soon if its recent extraordinary growth persists), its entitlement to the Fund could end. Compared with the Structural Funds, the
resources available to the Cohesion Fund are modest. The annual funding in 1999 will be ECU 3 billion at 1999 prices.

The Agenda 2000 Proposals

In March 1998, the European Commission published a communication “Reform of the Structural Funds” (EC, 1998) in which it set out its proposals for how the Structural Funds should function beyond the expiry of the current regulations in 1999. This communication elaborated on the proposals first published in Agenda 2000 (EC, 1997) in which the Commission mapped out its programme for the coming years and put forward proposals for enlargement and a new financial framework for the period 2000-06.

The current regulations governing the Structural Funds have been in force since 1993 and follow principles that were introduced in a major reform undertaken in 1988. The recasting of the Structural Funds for the next “programming” period has to contend with a number of factors, perhaps the most important of which are the inception of stage 3 of the European Monetary Union (EMU) and the expected eastwards enlargement of the Union. Budgetary politics must also be expected to intrude as the EU seeks simultaneously to agree to the new Financial Perspective.

The Commission proposals have a number of aims:

Simplifying the “Objectives” of the Funds. Objectives would be reduced from the current six (3.5 of which are spatial, 2 social, and the remaining 0.5 sectoral—concerned with restructuring agriculture and fisheries) to three: help lagging regions, provide support for other problem regions, and develop labour market initiatives.

Reducing the number of areas eligible for support. Eligibility for support will be reduced from the present 51 percent of the EU population to 35-40 percent. This is to be secured mainly by enforcing the criteria more strictly. It inevitably means that some current recipients must lose. The aim is that roughly 20 percent of the EU population will be eligible under Objective 1 (currently 25 percent) and the same in the new Objective 2. The criteria are as follows:

- For Objective 1: a level of income below 75 percent of the EU average (in terms of GDP per head measured in PPS). The remote French, Portuguese and Spanish islands and the Arctic regions of Finland and Sweden will also be eligible as a right of membership. The regions concerned will be defined at the NUTS II level (the level of subregional groups of counties in the United Kingdom). (NUTS: French acronym for “nomenclature of territorial units for statistics.” This administrative classification of territorial units is used in an ad hoc fashion by the EC for the SF management.)
- For Objective 2: high unemployment or evidence of “structural problems of socio-economic conversion” in the form of a loss of industrial employment. The definition of regions here is at NUTS III.
- For Objective 3: assistance will be confined to all other parts of the EU.

Anticipating the enlargement of the EU. All the candidate countries are less prosperous than current Member States, so that under current rules they would all be eligible for Objective 1 status. This, in turn, has a number of consequences:
• There will be preaccession aid to the CEECs while negotiations are in progress.
• Subsequently, the new entrants will be eligible for Structural Funds, but with a cap on their net receipts of 4 percent of GDP.
• Transfers to existing recipients will diminish, so that the overall cost of the Structural Funds remains at 0.46 percent of EU GDP.

Various administrative reforms. The most notable reforms will be reduction in the number of “Community Initiatives” and improvements in monitoring and evaluation.

Major Questions for Central and Eastern European Countries

There is no doubt that the CEECs all have structural problems that will make them eligible for substantial support from the Structural Funds and, if it continues, the Cohesion Fund. Some commentators argue (for instance, Hallet, 1997) that the structural challenges confronting most CEECs are similar in character, though possibly greater in magnitude than in EU-15. But it can also be argued (Begg, 1997) that there are qualitative differences, raising questions about whether the approach embodied in the Structural Funds is well suited to deal with them.

Given the Agenda 2000 timeframe and the fact that cohesion policy is bound to feature in the accession negotiations, changes in the Structural Funds can be anticipated by the time any of the CEECs is ready to draw on them. Whether the existing rules (objectives, cofinancing, administration, monitoring and evaluation) can be transplanted or how they should be recast will be issues resolved in negotiations. The scale of likely funding and its relationship to the broader framework of structural policy in individual countries will also have to be agreed upon.

At the same time, the CEECs will have to prepare themselves in a number of ways to receive transfers from the Funds. They will have to sort out how to integrate the Structural Funds into the public investment system and link the use of the funds to other industrial development or indigenous cohesion policies. This will require development of institutional capacity, review of public expenditure control, monitoring and evaluation, and training of staff to enhance their ability to access EU transfers. Particular attention will need to be given to the incentive policies of the public investment system.

The administration of transfers from the EU has plainly influenced the reform of subnational government in Poland and is a consideration in other countries, such as Romania, where reform of regional development is underway. Given the important conclusion from elsewhere that effective use of the Structural Funds requires the involvement of the social partners, voluntary groups and others, a key question for CEECs is how to build on local government reform to create these wider partnerships for economic regeneration.

A further set of questions turns on the development of programmes and on the mix of different kinds of projects and initiatives within these. This will involve not only working out priorities within regions, but also relating the transfers anticipated from the Structural Funds to wider questions of public investment.

More generally, the challenge for the CEECs is not only to ensure that their institutional arrangements conform to the regulations and procedures governing EU transfers, but also that their reform programmes result in an enhancement of the quality of public investment. Clearly, there will be mutually beneficial situations such as better evaluation and monitoring, but also shortcomings to be avoided. Prospective reform in regulatory domains, such as cor-
porate governance, the legal framework, accountancy, and standard setting, are bound to affect the implementation of public investment programmes, as are changes in the indigenous financial system. Such matters, though plainly important, are beyond the scope of the present study.

II. Theoretical Issues

Introduction

This section provides the theoretical background necessary for establishing a methodology to analyse intergovernmental capital transfers to CEECs. Our guiding principle is that public policy interventions should be targeted towards the removal of market distortions or failures, be conducive to long-term macroeconomic stability, ensure a satisfactory level of investment, and not cause further distortions. To this end, we first discuss the efficient and equitable provision of public goods within the context of a multi-layered government, with particular emphasis on externalities and spill-outs. We then explain how different types of grants are geared towards achieving allocative efficiency and equity, and discuss grant design. Finally, we show some implications for CEECs.

Efficiency, Equity and the Design of Intergovernmental Transfers

The EU has objectives concerning redistribution and cohesion that resemble those of a federal state. According to the literature on fiscal federalism, these can be addressed through efficient provision of public goods by various levels of government, supported by an appropriate system of transfers between them (Gordon, 1983; Bell, 1989; Oates, 1991).

Efficient provision of public goods in a federal state normally dictates that public goods subject to supra-regional benefits, or spill-overs, be provided centrally (for example, macroeconomic stability, environmental protection, transportation and telecommunications). This is because local provision is likely to be suboptimal when residents of one jurisdiction benefit from a public good or service provided by another jurisdiction, since the jurisdiction providing the good or service does not take into account the benefits that accrue to outside residents. Other public goods (for example, refuse collection, fire protection, health care and local schools) should be provided at lower levels of government because of: (i) heterogeneity of preferences across jurisdictions (Oates, 1972); (ii) information costs, which make it prohibitively costly to provide public goods centrally (Tresch, 1981); and (iii) cost effectiveness of local provision due to electoral accountability (Cornes and Sandler, 1986).

Besides efficiency, a federation normally wishes to achieve equity amongst its citizens. Redistributive issues within a federation cannot be ignored because fiscal inequalities might have serious implications for migration. Where large inequalities persist and labour mobility is unrestricted, people “vote with their feet.” The migration argument is of particular relevance for EU enlargement since there are considerable differences in the standards of living between CEECs and EU member states. Therefore, policies aiming at fiscal equalisation, that is, providing similar levels of local public goods at similar levels of tax effort, are likely to surface on the EU policy agenda in the longer term, even though they have consistently been rejected before now.
Adhering to these principles may give rise to the following problems, which intergovernmental transfers typically target:

(a) **Horizontal imbalance:** Because of differences in costs of provision, endowments of natural resources, and differing tax bases, jurisdictions may face horizontal fiscal imbalances. For these reasons, the level of public goods and services provided net of tax contribution (net fiscal benefit) may differ depending on residence.

(b) **Vertical imbalance:** Fiscal gap (vertical imbalance) arises when there is a mismatch between tax revenue and spending at a given level of government. Typically, higher levels of government have greater taxing powers than lower levels; as a result, the latter tend to face an excess of spending over revenue.

Broadly speaking, there are two categories of grants: unconditional, aimed at addressing fiscal imbalances, and conditional, which target externalities. These are briefly summarised below.

**Unconditional Block Grants**

These grants aim at equalising net fiscal benefits across jurisdictions (fiscal equalisation), increasing residents' welfare or ensuring minimum common standards of public goods provision across jurisdictions. Block grants are lump sum transfers, and as such they are nondistortionary. Even though they are justified on grounds of both equity and efficiency, these grants nevertheless have attracted criticism because of a number of undesirable side effects. First, an unconditional block transfer may reduce the incentives of a recipient government to fully utilise its own tax base. Second, grants aimed at closing fiscal gaps may induce local governments to engage in strategic games with the central government (for example, governments that do not receive grants may reduce their tax collection efforts in order to qualify). Finally, unconditional block grants to local governments tend to result in additional spending instead of reducing the tax liability of local residents (the so-called "fly-paper effect"—money sticks where it hits).

**Conditional Grants**

Externalities and spill-out effects are addressed by conditional grants, which stipulate specific uses of the funds. The advantage of this kind of grant is that it ensures that funds are directly channelled into the provision of the targeted good or service. However, these grants are typically much more complex than unconditional grants, which may introduce new distortions. To begin with, safeguarding that the recipient government adheres to the conditions of the grant necessitates monitoring, which entails additional administrative costs. Further, depending on grant design, conditional grants may affect relative prices which, unless taken into account, may lead to suboptimal outcomes. Moreover, ineffective or inappropriate conditionality may have undesirable income effects, in the form of increased expenditure on public goods besides the targeted one(s).

Conditional grants may or may not require the recipient government to contribute to the cost of provision of the targeted public good or service. **Conditional block (nonmatching) transfers** do not require the recipient government to match any of the costs of providing the targeted good. These are appropriate when a given activity is considered high priority by a
higher level of government, but low priority by a lower level of government, in that it generates a high degree of spill-over (for example, common, minimum standards in health and education). Because these grants do not lead to changes in relative prices, the targeted activities are financed without distorting local priorities or inducing inefficient allocations. In contrast, conditional matching transfers require the recipient to match the funds to some extent. If no limit is placed on the amount of assistance, the grant is referred to as “open-ended conditional matching.” Alternatively, if there is a limit, the grant is closed-ended and is equivalent to a pure subsidy on spending for a targeted activity up to a certain limit. Open-ended conditional matching grants are typically used to correct inefficiencies in public goods provision arising from benefits spill-overs, with the extent of matching determined by the benefit spill-out ratio (for example, cultural, recreational and transportation facilities, state care, state welfare, and state universities).

Matching grants make the targeted public goods or services relatively cheaper and therefore encourage recipient governments to increase their level of provision. However, these grants may result in lower expenditure on other public goods and services because these will become relatively more expensive. Furthermore, the required matching expenditure may also lead to a decrease in the amount available for spending on other public goods or services—a negative income effect that reinforces the substitution effect. To ensure that expenditure on other public goods or services is not reduced, additional conditions may need to be imposed; however, their enforcement may be problematic. A related issue is that poorer jurisdictions might find it difficult to comply with the matching ratios and, therefore, be unable to utilise matching grants. As a result, these grants may exacerbate inequalities across jurisdictions or horizontal fiscal imbalances. Therefore, conditional nonmatching grants, besides being simpler and requiring less monitoring, are more advantageous in cases where such inequalities exist.

Grant Design

The above discussion highlights the general principles that grant design should obey, namely allocative efficiency and distributional equity. In addition, they should prevent destabilising macroeconomic consequences by ensuring sound fiscal management (Musgrave, 1965). To accomplish this, it should not adversely affect the incentives to raise own-revenue or manage own-expenditures efficiently.

In cases where a large number of intergovernmental transfers are expected to take place, as is likely to be the case with the accession countries, a comprehensive evaluation of their overall effects should be carried out and implemented. It will then be appropriate to consider the effects of individual grants in the context of the overall package. For example, even where open-ended conditional matching grants are concerned, there will normally be opportunity costs in the form of foregone projects, which a partial equilibrium analysis is unlikely to reveal. These may, in turn, have incentive or strategic effects, which will need to be fully taken into account in the evaluation of the overall package.

Implications for the Central and Eastern European Countries

The process of convergence of CEECs to the EU is likely to be accelerated by a system of transfers that would fund investment in public infrastructure (for example, roads, railways, ports and airports, telecommunications) and human capital, areas which the EU’s Structural
Funds are geared towards. These investments are likely to have spill-out effects on both existing EU members and CEECs, by promoting trade between CEECs and EU members as well as amongst CEECs. It is, therefore, important to undertake a comprehensive evaluation of the current state of public infrastructure and human capital in CEECs. Such a study should also attempt to identify and prioritise these needs in the light of the degree of market failure, by estimating the spill-out benefits that would emanate from these investments for CEECs at regional, national and international levels. It should also quantify the output and employment effects of these investments for these countries and the rest of the EU. In this context it should aim at estimating the spill-out benefits for the EU from such investments, so that appropriate matching ratios could be determined where necessary.

As explained above, intergovernmental transfers usually address equity considerations. The extent to which the EU is prepared to aim for equitable net fiscal benefits and, consequently, fund horizontal or vertical imbalances in CEECs is still unclear. Some attempt to improve the provision of public goods and services in CEECs may have to be contemplated in order to curtail possibly large population outflows. The costs of providing minimum standards in health care, education and welfare in CEECs will need to be empirically assessed. Only then can firm decisions be taken about the extent to which the EU can contribute, if only through supporting relevant public investment, towards securing these standards in CEECs.

Once the precise investment priorities have been determined, a system of transfers will need to be put in place that obeys the three general principles of grant design: allocational efficiency including addressing specific market failures, distributional equity, and macroeconomic stability. This system should take into account local considerations and conditions in CEECs, including electoral accountability and corruptibility of government officials.

III. Arrangements for Intergovernmental Transfers for Capital Investment

Introduction

This section provides an overview of the various arrangements used for mediating intergovernmental transfers, and attempts to categorise the different approaches and to draw out the main characteristics of each one. We focus, as far as possible, on capital expenditure, and try to examine the link between various forms of public financial arrangements and the market failures that public investment is intended to address.

The principal aim is to highlight issues that are relevant to the development of a methodology for an in-depth study of transfers for capital investment. We also aim to synthesise a number of key stylised facts, given the available information, on which CEECs may wish to draw. In particular, we will ask what kinds of different arrangements exist that could be emulated in an emerging decentralised public finance regime in order to avoid or limit the potential incentive problems that could arise.

Institutional arrangements are important, particularly in the context of this report, since the CEECs are making changes in their institutional arrangements, partly in order to facilitate access to EU Structural Funds. However, access to EU funds is only one of many issues
under discussion, and may not be regarded by some in the CEECs as the most important objective of local and regional public finance reforms. It should also be pointed out that arrangements for intergovernmental transfers are only a small subset of the issues faced by applicant countries in negotiating EU enlargement.

Transfer Systems

In appraising intergovernmental transfer systems, there are general principles to consider, building on the insights from theory outlined above. An important point here is that systems of transfers must always be assessed in context, not only in terms of aims (economic efficiency, for instance, may not always be the main objective), but also in terms of wider institutional arrangements. Naturally, we focus here on arrangements for capital transfers, but it may be impossible to define causality between these arrangements and outcomes without considering other country institutions (such as the legal framework and accounting standards).

Many different arrangements for intergovernmental transfers can be envisaged, and it is clear that these have varied properties in terms of incentives and efficiency. A key point to emerge in this section is that strategic behaviour on the part of lower-level authorities may have important implications for the incentive effects of fiscal arrangements. For instance, under a system of specific matching grants, when there is a fixed total pool of money available, additional local expenditure will attract additional funds, but only at the expense of other local authorities. There may thus be a danger of excessive competition for funds. Strategic behaviour at local level may also make it very difficult to ensure that the central share of matching grants satisfies the requirement of additionality. Unfortunately, no coherent analytical approach is available which compares the differential impact of grants with loans.

Variants on only some of these theoretical models are actually used in different parts of the world. Further research will certainly be required for an in-depth study in order to provide a comprehensive picture of systems for capital transfers. However, we provide a table of arrangements for capital transfers in 16 countries, including arrangements for monitoring and auditing. This allows some general characterisations to be made, although it also highlights the diversity of systems in operation.

The detailed discussion of institutional arrangements also focuses on issues relating to incentives for effective use of public funds in practice, and considers the implications of adding a further tier of funding, such as EU funds. Key issues here again include the concern that local authorities may treat funds with very low matching requirements as nearly “free” (in the sense of having no opportunity cost for the recipient), and that there could be excessive competition for funds when the total available amount is fixed. However, if there is a fixed pool of EU funding for a given country, then from the national government’s perspective, the opportunity cost of any project is 100 percent, even if local matching requirements are low. A further problem that can arise is that when external funds are available with different degrees of cost for different kinds of expenditure, there may be incentives to change priorities. This may lead to distortions unless the degree of subsidy attracted by different kinds of funds truly reflects overall social benefits and serves to underline the importance of effective selection, control, and monitoring procedures. These issues, too, are discussed in the light of the empirical information.
Insights on Transfer Systems

This review has attempted to provide an overview of arrangements in use for mediating intergovernmental transfers for capital investment. It is clear that even on the basis of existing comparative empirical material, each system has quite finely detailed characteristics. Moreover, the impact of any financial system depends on many more factors than the limited set of parameters we have been able to consider here. Any true categorisation of transfer arrangements must run into many dimensions, so that any simple classification is likely to generate as much variation within as between categories.

Therefore, one clear conclusion is that much detailed research will be required in order to assess the impact of an apparently well-specified system of transfers for any country. On the one hand, there are significant shortcomings in the data that are available. For instance, it is often hard to distinguish between current and capital expenditure projects. On the other hand, even if detailed data are available so that the system of transfers is well-specified, additional factors have to be taken into account to determine its impact. Equivalent systems in different countries might have quite different effects depending on, for instance, the legal system or accounting standards (not to mention even less tractable factors such as business or political culture).

This being said, specific institutional arrangements for transfers (type of grant, matching requirements, selection and monitoring procedures, restrictions on subnational borrowing, and so on) clearly are the key determinant of outcomes. Subject to the above qualifications, it is possible to draw useful conclusions from a comparative overview and to indicate the type of broad classification of transfer systems that may provide a useful starting point for an in-depth study, and to highlight issues that merit further investigation in such a study.

Intergovernmental transfers aimed specifically at capital investment will come, almost by definition, with conditions of some sort attached (if only to prevent funds being used for current expenditure). Theory suggests strongly that hypothecation (earmarking of funds) alone is not necessarily an effective way for higher levels of government to influence spending. Therefore, our attention is focused on matching grants or loans. (With one qualification, however: if subnational level borrowing is restricted, we may wish to examine potential inefficiencies arising from the use of general grants for capital projects at the expense of current spending). In grants from central to local government, there is a question of incentives versus equity. Trying to equalise fiscal potential might give an incentive to excessive expenditure because of a high subsidy rate to those local governments that are worst off.

There is always an information asymmetry between central and local government that the latter is likely to try to exploit. Some mechanisms for giving grants might help reduce this, bidding being an example where authorities are effectively competing with each other. A simple formula for distributing funds might be better than a system where the higher tier of government has wide discretion that might be influenced by local government or elected representatives of localities. Formulae (such as transparency formulae) are being used more and more for this kind of reason. Moreover, additionality is hard to guarantee because of the information asymmetry. This may oblige central government to impose and enforce some kind of minimum standard or level of expenditure instead of (or as well as) hypothecation (earmarking) of funds, since the latter can easily be avoided by local governments.
In the context of EU transfers to CEECs, EU or national influence over how funds are used at local level is arguably justified in many cases by supra-local market failures, EC interest, or regional development objectives, as well as concerns over possible inefficiency, corruption, and so forth, at local level. If these arguments are valid, then matching requirements should enhance efficiency. However, a number of problems remain. Even where matching requirements are high, strategic behaviour on the part of local authorities may make it impossible to ensure that transfers are in effect spent on the intended projects. Local authorities may divert their own funds from roads and bridges, for instance, to build shopping centres, in the knowledge that the EU is prepared to fund roads and bridges. The additional expenditure that EU transfers effectively give rise to may be on items which are harder to justify in terms of efficiency.

It is incumbent on higher levels of government to ensure that the types of projects which qualify for matched funds are in fact justified (on grounds of supra-local market failure, EC interest and so forth). Otherwise, the effect of transfers may not be to correct market failures, but to distort spending away from economic efficiency. A similar point applies to the administrative and lobbying effort at the local level to secure funds, especially if the matching proportion required of local authorities is low (as is likely to be the case with EU funds). If local authorities regard funds as virtually “free” (low opportunity cost), there may be overspending or (if the total pot is limited) excessive competition for funds, and administrative resources may be diverted from activities where a higher proportion of total cost is funded locally.

On the other hand, if there is a fixed limit to total EU transfers to each country, then from the national perspective, the opportunity cost of each project is 100 percent. In this sense, competition among local governments to maximise the efficiency of proposed projects is positive. However, this point highlights the importance of effective project selection, control, and monitoring procedures at the national level in order to employ EU funds to best effect.

It is clear from the available comparative literature that specific grants are used extensively for capital investment projects in many countries. The variety of purposes and the diversity of systems in use are notable, although functions such as roads, transport, water and sewage, education and public buildings are common. Grants are usually matching and closed. Arrangements for monitoring and auditing are similarly diverse. These are rather strict in some countries, with detailed technical plans required in advance and auditing specific to each project. While prior approval is almost always required, some systems are much less stringent in terms of prerequisites and planning requirements. Transparency is frequently achieved through the prior specification (often in legislation) of detailed criteria for the assessment of grant applications. In some countries (such as the Nordic countries), it appears that a high degree of trust between tiers of government allows for relaxed monitoring and auditing arrangements. In the case of EU transfers to the CEECs, this could not be relied upon, given the likely high level of transfers and low local matching requirements (also the fact that the grant-giving body is supra-national, while many local authorities will have been recently restructured).

Comparative empirical material provides some support for the classification of systems outlined in section 6 of the report. We have not looked at revenue raising and sharing in this section, and our empirical material focuses on transfers only to local (as opposed to regional) governments, so there is little information about the two models typical of federal arrange-
ments. However, arrangements in the Nordic countries clearly correspond to a system of centralised finance but with considerable local autonomy, and this is reflected in the relatively loose monitoring and control arrangements. Systems such as the United Kingdom, but also Belgium and the Netherlands, for instance, where a wider range of specific matching grants are employed, conform to the “top-down” model where central government exercises considerable control over allocation of local spending. Monitoring and control, both ex ante and ex post, is correspondingly strict.

IV. Experience of the Structural Funds

Since the Structural Funds were reformed in 1988, considerable experience of their operation has been accumulated. Formal evaluations have been somewhat limited, but following the 1993 reform of the Funds, much more systematic procedures for evaluation were put in place in the 1994-99 regulations. As a result, the body of work on evaluation is progressively increasing, although it is neither as comprehensive nor as coherent as might be hoped.

IV. Experience of the Structural Funds

Since the Structural Funds were reformed in 1988, considerable experience of their operation has been accumulated. Formal evaluations have been somewhat limited, but following the 1993 reform of the Funds, much more systematic procedures for evaluation were put in place in the 1994-99 regulations. As a result, the body of work on evaluation is progressively increasing, although it is neither as comprehensive nor as coherent as might be hoped.

Academic studies, formal evaluations and audits, and reports on different facets of the funds do, however, provide information on the application of the Funds that is potentially useful for the CEECs. This section draws on such work to identify problems in the operation of the Funds and in the relations between the different bodies involved in their administration. Because the available material is from very disparate sources, no attempt is made to cover all countries or issues to the same depth. Instead, we have tried to pick out elements that provide insights into the prospective use of the Funds in the CEECs. The material is documented in greater detail in section 2 of the appendix.

Although the formal role of the Funds is to advance “cohesion” in the EU, the term itself is ill-defined and it soon becomes clear that the allocations of resources and the regulations are the outcome of an elaborate political process (Begg, 1997; House of Lords, 1998). This involves, on the one hand, mediation between Member States and, on the other hand, careful attention to constituencies within countries. At the political level, therefore, the Funds have to reconcile several political economy aims, some of which are mutually contradictory. It is also clear that although there is a veneer of objectivity in the rules governing eligibility and the sizes of allocations to different regions, the aggregate flow to each Member State is the outcome of protracted bargaining.

Commission regulations for the Structural Funds spell out in considerable detail the procedures that have to be used to access the Structural Funds. These detailed regulations, however, are not immutable and have, in fact, changed significantly in successive iterations of the Funds. Further changes that will bear on the operation of recipients’ public investment systems are in the pipeline for the 2000-06 period, and still more changes must be expected beyond then.

Formal Auditing

Valuable insights into the operation of the Funds can be gleaned from reports of the Court of Auditors. These reports detail breaches of regulations and errors in procedures, but also serve as a guide to good practice. Most problems are revealed to stem from Member States’ failures to appreciate the rules regarding eligibility of projects and the timing of disbursements. Problems arose because national and final beneficiary accounting systems do not
provide for separate identification of expenditure of EC funds and because of data on underlying transactions is incomplete or inadequate.

Substantial differences in practice were also found between Member States, resulting largely from the character of domestic systems of public finance and expenditure control. One of the reasons for this is that operational programmes cofinanced by the Member States are often managed and accounted for on the basis of preexisting national arrangements and these may conflict with European rules. A specific problem arises where charges are levied for the use of assets.

Although matters are improving as a result of better documentation, the eligibility issue continues to worry the European Court of Justice, though here again, the fact that the procedures are a moving target has to be stressed. A conclusion to draw from this is that Member State procedures for dealing with receipts from the Structural Funds in the CEECs will need to be scrutinised and adapted to ensure that they accord with what is demanded. This will involve both technical assessment of accounting methods and training of staff involved in the complexities of the procedures. Second, the fact that the EU system itself is subject to periodic change means that candidate countries need to pull off the conjuring trick of preparing for a system that is not yet fully known. While the broad architecture of financial control may not alter much, national systems will need built-in flexibility to cope with changes in detail.

Academic Studies

Similarly, many of the academic studies of the operation of the Funds point to problems of financial management, including difficulties in cofinancing, the need to demonstrate additionality, and (at least in the richer Member States) thinly spread support. Limited scope for flexibility in the management of finances is also seen as a constraint on effective use of the Funds, and easier virement between years is advocated in Programmes. Regional boundaries for EU assistance which do not coincide with existing administrative structures are troublesome. Big differences exist between countries in project selection methods: Spain, for example, selects projects under Objective 2 to fulfil strategic needs, whereas the United Kingdom operates largely through competitive bidding. Strategic priorities are, however, the outcome of protracted and often fraught negotiations between the Commission, the Member State, and the regional level.

The skills and alertness of the local level are also important influences on effective use of the Funds. Within a country such as France, there is evidence of some regions doing significantly better than others for these reasons. Differences in the imaginativeness of "financial engineering" played a part in this. Other financial problems identified include poor anticipation of when funds would be needed, inadequate data (notably on the distinction between fixed and recurrent costs) and vagueness on aims and objectives. It is, also, often difficult to relate ends and means. There is evidence that the EU's financial contribution had exceeded the prescribed limit of 75 percent in several Objective 1 programmes.

Much can be learned by the CEECs from the experiences of the Structural Funds—good and bad—of the EU-15 Member States. Even the limited review presented here shows the range of different approaches that have been followed and the broad scope for using the Funds. It can be argued that the implication of this for CEECs is that in spite of the seemingly daunting regulations that have to be adhered to, there is a fair degree of flexibility in practice. This means that radical overhaul of internal structures may not be necessary purely to
accommodate the Funds—though such reform may well be desirable for other reasons. Instead, the aim should be to adapt constructively.

One key conclusion exemplified by the rather negative assessments of the Hainaut region of Belgium is that there is much more to structural policy than intergovernmental transfers. It is a finding that is consistent with the relatively disappointing outcomes of the Funds in the 1988-93 period in a number of regions. But it is also clear that where Structural Fund programmes fit well with indigenous programmes, as in parts of Germany, the synergies can be valuable.

A third inference to draw from the review is that the Funds and the regulations governing them are constantly evolving so that the system and structures to which CEECs will have to conform is a moving target. Understanding how decisions are made on reform and the balancing of interests that invariably occurs will be a vital part of the learning process for CEECs.

A further conclusion is that the importance of policy learning in making use of transfers from the EU has to be stressed. It will be all too easy for CEECs to repeat some of the mistakes of the past ten years. To avoid this, timely training of administrators and practitioners is indicated, as well as institutional development and imaginative use of the options available under the Funds.

V. Case Study Summaries

To give more details of the operation of the structural Funds in different contexts, case studies of selected countries were carried out. The case studies cover four contrasting EU Member States and two CEECs. In examining the four EU Member States, the aim is to bring out the diversity of arrangements rather than to provide direct comparators for the CEECs. Here, we summarise salient points.

United Kingdom

During the period in which Structural Funds have been available to the United Kingdom, many significant changes have been made to the structure and operation of local government, as part of wide-ranging public sector reform aimed at increasing the efficiency and effectiveness of public operations. The transfers to the United Kingdom of European financial resources for capital investment have coincided first with a decline in local public sector capital spending and second with major organisational innovation.

The decline in real terms in the overall rate of capital investment by local authorities and other public bodies has been associated with an increased emphasis on the participation of the private sector in capital investment projects, as exemplified by the Private Finance Initiative (PFI).

At the same time, the United Kingdom has advanced further, in terms of institutional and organisational innovation at the local level, than other European systems of local government. Not all Structural Funds are awarded to local authorities, as a consequence of the growth of semi-public development agencies such as the UDCs, TECs, and LECs; partnership arrangements; and other organisational frameworks. These alternative local organisations also undertake expenditures eligible for financing under the regulations of the Structural Funds. This indicates that cross-national differences in the function and organisation of local and decentralised government and public sector are of central importance to the way Struc-
tural Funds programmes are implemented. Differences in operating rules and management of different bodies in the UK case also highlight the importance of the difference between local authorities and development agencies of various kinds. Local authorities have been more extensively monitored and audited than the semi-public agencies. Whether or not this balance will change once the semi-public agencies acquire more permanent status remains to be seen. It is also worth noting that in the case of the UK, the recipient areas are divided between two legislative and institutional frameworks. Scotland and Northern Ireland have separate legal systems and procedures for financing decentralised expenditures, especially in terms of the distribution of grants from the Scottish office. England and Wales operate under a single framework. In addition, the English system now incorporates devolved central administration in the form of the Government Offices for the Regions, which coordinate central government departments.

Since 1988, there have been several disagreements between the Commission and the UK government on the interpretation of the principle of additionality. The central government has tried to resist the use of Structural Funds, which leads to additional borrowing to arrange matching funding, not always successfully. There is little firm evidence that Structural Funding has caused a shift in local expenditure priorities. The PFI and other national programme funds are probably more influential in directing local priorities.

Concerning the capital finance system, the key development in recent years is the introduction of competitive bidding for resources. This procedure, where local authorities, in partnership with other bodies, are required to submit project proposals within the framework of public investment programmes such as the Single Regeneration Budget (SRB), is intended to improve the efficiency and effectiveness of capital investment projects. The PFI works in a similar manner. It should be noted however, that the combination of SRB and competitive bidding also serves as an instrument of cutback management and an instrument of central government control over the direction and form of local capital investment policy. This arrangement has also been applied to the national administration of Structural Funds in the designated areas, such as Merseyside.

In the United Kingdom, local authorities have four main sources of funds for capital expenditure:

- **Credit approvals.** Credit approvals are central government permission to borrow or enter into other types of credit arrangements for capital spending; most of the debts incurred here (about 80 percent) are processed through the Public Works Loan Board which in turn is supplied by the financial market.
- **Capital grants.** Capital grants are provided by central government departments to finance specified proportions of expenditures for capital investment programmes; here capital grants are calculated on the basis of five “blocks”. In principle the local authority is free to allocate the aggregate as it wishes; however, it has become more common for central government departments to protect their own blocks of local authority spending so that local discretion is in practice limited.
- **Revenue contributions to capital outlays.** These are financial resources drawn from the revenue fund and accountable to the local electorate.
- **Capital receipts.** Capital receipts are financial resources drawn from the sale of land, housing stock and other assets. Some of these have to be set aside for debt redemp-
tion (currently 75 percent of council housing receipts and 50 percent of other); a proportion of the remaining funds is subtracted from the calculation of capital grants (known as Receipts Taken Into Account, or RITAs).

The United Kingdom experience shows that systems of local government finance and financial equalisation are not only systems to provide and channel resources to and between decentralised public bodies, but are also the main instrument for influencing the mode of operation of these bodies. By incorporating comparatively strong incentives for local authorities to manage resources efficiently and maximise tax effort, the United Kingdom case is probably where equalisation is most explicitly built into the system, especially in the capital finance system. The rigour of the system is provided by the comparatively strict accounting system that covers resources at the local level.

In principle, it is central control, financing, and auditing that provide the main incentives for efficient management of own resources and maximising tax effort. Local authorities in the United Kingdom are highly fiscally dependent on central government (around 80 percent in England and Wales, 84 percent in Scotland). This means that it is relatively easy, because of the gearing effect, for central government to put pressure on local authorities to improve local management. This fact, in combination with the absence of a local income tax, means that the link between local financial management and local economic development and growth—the main eventual aim of capital investment—is comparatively weak.

**Sweden**

Sweden has received a comparatively small amount of Structural Funding, mainly because of the short time that Sweden has been a Member State, and also because of its relatively high and even level of economic development by European standards. However, the accession of Sweden, Austria, and Finland led to the creation of an additional Objective 6 for sparsely populated areas in the Structural Funds framework. In the case of Sweden, these areas, mainly located in the northern part of the country, have traditionally been the main targets of a national policy of regional development as well. Sweden receives some funding from the URBAN and INTERREG programmes, though there has been a lack of eligible local projects.

Sweden has two levels of local government. The primary tier of local authority is composed of unitary multipurpose organisations, responsible for the administration of national policies to a large extent; the secondary tier is responsible mainly for health care and some educational programmes. Sweden has virtually no alternative organisations UK-style at the local level, except for the emerging public-private partnership in the area where the Sweden/Denmark bridge is being constructed. This is now one of the main recipients of Structural Funding in Sweden, both directly and in terms of supporting, complementary projects.

In comparison to the United Kingdom, local authorities in Sweden are financially very self-sufficient. Around 60 percent of local finance is provided by local income tax, which is the main income tax paid in Sweden. The remaining expenditure is made up by a general grants regime (block grant). An additional element of equalisation is achieved through horizontal transfers (the so-called “Robin Hood charge”). This has the advantage that more equalisation can be achieved with a lower total amount of transfers. Since 1990 there have been no local business taxes. The Swedish system is usually described as highly autonomous with wide local discretion in terms of financial management. In practice, however, central
government sets the tax rate; local authorities can vary this within a narrow band, but not so as to cause major regional variations within the national economy in terms of the total income tax paid. Exceeding the set rate leads to increased contributions to central government budgets; thus, local taxation is in effect “capped” in Sweden. Since local income tax rates are set locally within the band, stimulating the economy through capital investment can be an attractive option for Swedish community government. Additional revenue raised through capital investment attained from European sources can be used relatively freely to lower local taxes, but the system sets a limit to this practice, just as it does for tax increases to replace lost revenue. The system of financial redistribution is connected with the system of local finance in that the surplus revenue generated is partly absorbed by horizontal transfers; the remainder of financial equalisation is achieved by a general grants regime put in place around 1990-92.

Some additional points should be noted. First, with the intention of introducing more flexibility, the distinction between capital and current accounts has been abolished, both in central and local budgets. However, this change has not caused major variations over time or regionally in expenditure and investment patterns; on the contrary these have remained remarkably stable. This indicates that there are important factors, outside the system of financing decentralised expenditures, that regulate local authorities’ expenditure and investment, including past expenditure patterns and on-going commitments. In the case of Sweden, however, the main influence on expenditure is the high level of policy integration between local government horizontally and between local and central government. Change in the system in recent years probably stems from the reorientation of macroeconomic policy priorities at the national level during the 1990s. This fact, in combination with the size of the public sector and the financial problems associated with it, has caused increasing, albeit unevenly distributed, financial pressure on local government. It is also worth noting that Sweden has undergone one of the most extensive public sector reform programmes in Europe in the last decade, intended as a support to the establishment of efficient public sector management, in which the role of local authorities has been highly significant due to the size of the public sector located and managed at the local level.

Second, the incorporation of local government into a coherent national macroeconomic strategy is hard to achieve in Sweden, since local authority borrowing is not regulated by central government; local authorities are free to borrow and enter into other financial arrangements, subject only to the restrictions of the financial market. Indebtedness has increased, but unevenly; those authorities whose debt ratios have increased are mainly located in the metropolitan areas with better access to financial markets. In this case, some debt has been incurred as part of capital investment projects. Other local authorities have faced service cuts instead. These divergences have caused increased problems in the negotiation of a joint policy framework.

Third, monitoring and auditing in Sweden is provided by a decentralised organisation, mainly through the local authority auditors. The system is thus based on internal self-assessment, subject to approval by the local council; only if major irregularities occur is the matter referred to the Swedish National Audit Office. In the past, this system has provided enough monitoring. However, with increasing financial pressure and regional disparities, reform of this system might be hastened.
Spain

As one of the cohesion countries, Spain is a major beneficiary of the Structural and Cohesion Funds. At the highest organisational and institutional level, the administration has two tiers. The central government deals directly with the 17 Autonomous Communities. Within these communities, the public sector, and thereby Structural Funding, is divided between the Autonomous Communities themselves, the Provinces, and the municipalities. There are further variations to this structure; the Statutes of Autonomy are 17 bilateral, renegotiable accords between central government and the regions, which vary with respect to fiscal and policy autonomy. The Spanish constitution thus diverges from mainstream federal practice, which usually sees a uniform distribution of competencies between federal and state government.

Internally, the Autonomous Communities are varied as well. In the uniprovincial Communities (those with only one province), regional government can assume the competencies of the province; in the other cases, the province remains under the decentralised administrative care of the central government, which is charged with the co-ordination of the different bodies and public sector organisations. This has led to conflicts along several lines, between regional and local government in the pluriprovincial communities and between central and regional governments in the case of the uniprovincial ones. In the context of the Structural Funds, the uniprovincial regional authorities often claim that they are adversely affected by having assumed the competencies of the province. The local government system is similarly complex. Spain, as part of the so called "Napoleonic" system of local government has not gone through the phases of consolidation and organisation into bigger units, which occurred in Sweden and the United Kingdom. As a result there is wide variation in population of municipalities (44 percent under 500 inhabitants; 86 percent under 5,000). Municipal functions are not strictly defined but allocated according to population size. Also, there is some leeway for municipalities to take on nonstatutory functions. The result is that municipalities vary in the kind and scale of expenditure undertaken, revenues raised, and grants received from higher levels of government. Also, as a result of this range of size variations, there is a range of subordinate and intermediary bodies that include metropolitan areas, voluntary intermunicipal associations, and submunicipal entities.

In the context of this multitiered administrative structure, the main policy priorities that have influenced the handling of European Funds are those of central government. It should be noted here that the Cohesion Funds are allocated to the national government, rather than to the decentralised local level. The main emphasis in capital investment in Spain financed through European resources has been for major infrastructure projects, outside the direct control of local authorities. However, even if the share of local government in overall spending is small by European standards (some 13 percent in 1989), Spain’s share in capital formation is larger (around 30 percent of public sector gross fixed capital formation in the same year). This has remained stable since the late 1970s, when the central government role was reduced in favour of the Autonomous Communities. The importance of the municipalities in this area is due to their active role in urban infrastructure and transport. Spain, therefore, seems to be a good case for further assessment of the relationship between the Structural Funds and local capital formation. At present though, the main share of these funds are used for the major, transurban, and transregional infrastructure projects, with
the municipalities taking a less active role. One area in which the latter are important is
investment in environmental infrastructure, especially water provision and treatment plants.

The financing of Spanish local government has, as elsewhere, undergone continuous re-
form in the last decade and a half. The main sources of finance are, as in all systems, a
combination of taxes, charges, grants, and loans. The revenue side has been reformed in
stages to allow for a more simplified structure, especially in the case of taxation. The struc-
ture now combines obligatory and optional or discretionary taxes. Rates are set nationally,
with variations allowed by a system of multipliers. The distribution of grants to municipalities
is made by both the central government and the Autonomous Communities, giving rise to
further complexity. In the case of Spanish local government, around 23 percent of total
finance is from borrowing and other types of credit and treasury operations, possibly because
of a shortfall of revenue sources in relation to the statutory functions of local government.

However, the Spanish system, by prioritising the creation of the Autonomous Communities
and their associated public sector organisations, may have postponed reconstruction of the
local financial and expenditure system. It has also generated a series of ambiguities and an
extensive degree of leeway for activist local authorities, especially in metropolitan and urban
areas, to develop functions and incur expenditure beyond their revenues. Also, costs are
affected by the extreme fragmentation and variation in the system, which makes the attain-
ment of economies of scale more difficult.

There have been several attempts to tighten the regulation of financial operations during
the 1990s; local borrowing and other credit relations have been identified as a key problem.
In 1983, central government committed itself to repayment of local debt, but this has not
curbed the growth of debt. Reforms have also been attempted in the area of fiscal policy,
principally the practice of a "joint fiscal effort" of central government and the Autonomous
Communities. This has been somewhat unsuccessful, because the latter do not necessarily
want to share the political risk of being seen as the tax collector for central government. Also,
a standard argument in the Spanish context against the assignment of income tax locally is its
very sensitivity to economic fluctuations.

Auditing, monitoring and evaluation in this system has naturally become very difficult,
especially from the perspective of the eventual need for a uniform or coherent system. At
present, the Tribunal de Cuentas (Court of Auditors) is the main institution of financial con-
trol. For municipalities, the main auditing organisation is the Province, with its Diputacion. In
practice this resembles a kind of prefectoral system, similar to those in place elsewhere. How-
ever, even here there is considerable variation. For historical reasons, some uniprovincial
authorities (Navarra, Rioja and the provinces of the Basque Country) operate under differ-
ent fiscal and financial arrangements. There are also pressures from some Autonomous Com-
munites to assume the powers of the provinces and thus to gain control of the municipali-
ties. Recent years have seen the creation of more uniprovincial authorities of this kind.

Ireland

In the last decade, Ireland has enjoyed rapid economic growth. Transfers from the EU under
the agriculture and structural fund budgets have contributed to, but do not explain this
success. It is important to distinguish two effects in analysing the impact of the Structural
Funds. The first is the immediate impact of the unrequited transfer on Irish income, which is
to raise the latter, other things being equal, by the amount of the transfer. The second is the
dynamic effect of the transfer which, by boosting public investment, could lead to an increase in the growth rate. It is estimated that the Irish Community Support Framework (CSF) raised GDP by one percentage point, so that with half of the funding attributable to the EU, it appears that half a percentage point of the growth rate is attributable to the Structural Funds. To put this in perspective, Irish growth this year is expected to be around 8-9 percent.

Coordination is assured by a CSF Monitoring Committee (MC), which meets at six-month intervals and brings together representatives of the various government departments, the Commission, and other major players. The Irish CSF contains major developments in the use of quantitative indicators to monitor implementation.

The overarching strategy for public investment in Ireland is derived from a National Development Plan passed in 1993; this plan, following exchanges of views with the Commission, became the foundation of the CSF (EC, 1994). The CSF has ten Operating Programmes (OPs), each with its own Monitoring Committee, which is the main decision-making body; these MCs are in turn under the overall CSF MC which is responsible for multilateral decisions. The CSF has four broad priority areas:

- Direct support for productive investment.
- Infrastructure spending to offset geographic and structural disadvantages.
- Spending on human resources to augment human capital.
- Harnessing the potential of local initiatives.

The Structural Funds are well integrated into overall public investment. There is, nevertheless, evidence that account has been taken of the capacity of market or near-market operators to self-finance. A recent evaluation suggested, moreover, that “medium-term planning of public expenditure has come much more to the fore, allowing more systematic and effective programming in many areas. Capacity and capability has been increased in the productive sectors; there has been a quantum leap in the provision of public infrastructure; education and training attainment forges ahead; and experimental institutional arrangements have galvanised local initiatives” (Honohan and others, 1997).

The evaluation is, however, critical of some of the microeconomic aspects of the Irish CSF, especially a tendency to neglect analysis of the opportunity cost of public funds. Although the EU contribution to a particular investment project might be as high as 85 percent (for Cohesion Fund projects) it is wrong in principle for the sponsor of the investment to argue that the true cost of the project is the remaining 15 percent. Because EU money spent on one project is denied to the next one due to aggregate budget constraint, only the full opportunity cost should be used in determining the rate of return on a project.

Other problems identified include the following:

- One programme offsetting the distorting effects of another.
- Structural Fund spending being used where simpler alternatives would be preferable.
- Investment decisions being distorted because price signals are wrong.
- Lack of competition between agencies responsible for policy delivery, which leads to inappropriate decisions, especially where such agencies exploit a “quasi-monopoly” position.
Overall, the evaluation is positive about the functioning of the partnership in Ireland, noting that "indeed it is widely accepted and acknowledged that, relative to the experience with other countries the position of Ireland, in terms of openness of approach, willingness to share information and communicate openly with the Commission is considered to be very good."

There is some evidence that projects are being undertaken because they are allowable under the regulations rather than as a response to the most pressing needs; nevertheless, many large environmental projects are undertaken to ensure compliance with EU directives—for instance, on water quality, which would have been a low domestic priority. The evaluators advocate these being done at the lowest possible cost to conform to rules.

Ireland, arguably, illustrates many of the virtues of the Structural Funds and shows how they can complement national public investment and economic development strategies. The transfers from the EU have not only meant more resources, but also seem to have had acted as a catalyst to encourage partnership and to set priorities. EU rules and the input from the Commission appear to have been valuable in this process, but it is important to recognise that this is not just "technical assistance" in the sense of expertise parachuted in from above. It is more an enhancement of the skills and capacity of Irish policymakers and administrators.

The Irish case is probably most relevant to the smaller CEECs, which share such characteristics as national coherence and sense of purpose. But it is also important to note that the successful implementation of the Structural Funds in Ireland is the outcome of many years of experience and learning. This argues for caution in drawing lessons from Ireland and suggests that institution building and development of administrative capacity will be needed to take full advantage of transfers from the EU.

Poland

In Poland, the reinstatement of the local authority as an effective level of government has been a central part of the transition to democracy. The reestablishment of autonomous local government, regulated by legal statutes and governed by elected bodies and executives accountable for the budgetary and fiscal policies, has constituted one of the most substantial reforms in the process of democratising public administration in Poland after 1989. The construction of a comprehensive system of financing and controlling local revenue and expenditure is part of the modernisation of the structure of government, and is also important in relation to future EU membership, including the extension of the Structural Funds.

Decentralisation of state administration and budgetary authority has also been one of the most controversial issues in the post-1989 reforms. At the time of writing, legislative work on a new structure of intergovernmental relations was approved by the Polish parliament, and became effective in January 1999. However, the exact configuration of the financing of decentralised expenditures remains unclear, as is the overall framework for monitoring and auditing. The main objective of the reforms is to improve the effectiveness and efficiency of the public sector through the creation of a coherent system of intergovernmental relations, and to promote democratic control over the fiscal policies of the intermediate level (about 300 counties) and the larger "voivodships" (15-17—the exact number remained uncertain at the time of writing). It is likely that the lowest level of local government will not lose the
powers and financial resources that they possess at present. But new budgetary units will be created, at the powiat (county) and voivodship level.

The main shortcoming of the new structure is the shortfall of local revenue. This has created a trend towards dependence of local government on central grants, special purpose funds, and other forms of central financial support for local government. Throughout the past five years, the proportion of transfers in local budgets has been increasing. In 1993, own revenues constituted on average 80 percent of local budgets. By 1997, this proportion had fallen to 44 percent. In terms of grants and equalisation systems, investment expenditure—still regulated through special purpose grants—constitutes half the grant budget available and is supervised by ministries and central state agencies. The present share of local spending in overall public expenditure, and the constraints this puts on the development of capital investment strategies, is perceived as insufficient in regard to the economic burdens put upon local government. For this reason, financial transfers from central to local level of government have been a major cause of conflict between local government and central government departments.

In the past, PHARE programmes in Poland had a potentially large impact on local capital formation. However, in terms of their effects on capital expenditures by Polish local government, both rural districts and municipalities, it should be noted that the latter are not the major recipients of financial resources from the programmes concerned. Instead, these are allocated nationally to different branches of industry, agriculture, environment, infrastructure, energy, transport, telecommunications, and education and training. The PHARE assistance projects have been mostly oriented towards the need for restructuring and privatisation of selected industrial sectors such as steel, automobiles, glass, agriculture, and finance. Many of the concrete projects are conducted in designated cities and small agricultural districts, but distribution and the control over the projects is supervised by the relevant central government ministry. In cases where programmes are addressed to local government, the central government ministries concerned announce an open bidding procedure, inviting tenders for grants that will finance selected local initiatives. Participation by local government in these projects is rather modest, because most projects are supervised by central government and distributed mainly on a sectoral basis, with cabinet ministers being responsible for their share of available finance.

The effectiveness and efficiency of PHARE projects in Poland is very difficult to assess since many projects are still under implementation. Existing research on the topic is also scarce. However, there are some indications that the degree of preparation and potential efficiency of the projects currently underway is highly variable.

Romania

Romania is the second largest of the CEECs after Poland, with a population of some 22 million. It was not selected in 1997 as one of the candidate countries favoured for an early start to EU entry negotiations because of concern that it had not yet made sufficient progress towards a market economy and would have trouble withstanding the competitive pressures associated with EU membership. Unlike Poland, which can be compared in certain respects with Spain, no current EU Member State much resembles Romania either in size or economic characteristics.
Like several other CEECs, Romania has a county and municipal level of government, but no intermediate regional tier. A legacy of central planning, which sought to develop all regions, is that regional disparities are comparatively limited, although they are widening. Moreover, experience suggests that as transition proceeds, regional disparities increase. That Romania’s transition moved more slowly than some other CEECs up to 1996 may have limited the emergence of specifically regional problems in Romania. In 1997, a Green Paper on regional development in Romania was produced with support from the European Commission’s PHARE programme. This mapped out a strategy for creating new institutions to promote regional development, thus paving the way for Romania to use the Structural Funds.

At present, there are various intergovernmental transfers within Romania, principally from the central government to the county and municipal level. The three main types of transfer are as follows:

- A share of direct taxes on incomes based on a formula comprising a variety of population and infrastructure needs. This distribution tends to favour populous areas with substantial public infrastructure at the expense of less-developed areas.
- Transfers for specific social policies.
- Funding for investment targeted at specific capital projects. These projects cover nine identified objectives in the areas of water and sewage, energy, and transport.

Overall the local level is self-sufficient to 61 percent, but since it is legally obliged to maintain fiscal balance, the share of revenue coming from central government has risen to offset decline in own revenues.

The upheavals of recent years in the governance of Romania have resulted in a radical redesign of the government machinery, based on a constitution enacted in 1991. The constitution provides for local and municipal government, and for a county level which co-ordinates local government and carries out public services of county interest. Public administration is, however, flagged in the Commission report as a weakness, although it is one that the government elected in 1996 professes to be anxious to address. It has proposals to devolve power to specialised agencies and departments as well as to local public administration. There are also plans to improve the management of senior civil servants and to launch much more flexible policies in the field of salaries and employment conditions. An important part of these plans is to enhance efforts to decentralise in favour of financially supported local administrative autonomy and to build up regional development programs. The Commission verdict in 1997 was, however, that “on regional policy Romania has barely started to put in place the structures needed to use effectively the Union’s structural funds. It will also need to establish effective systems of financial control.”

**Conclusion**

The case studies show that the Structural Funds intersect with highly varied national arrangements for fiscal transfers and that they have been flexible enough to accommodate evolving governmental structures. In general, the Funds assimilate specific matching grants, with the requirement that detailed plans, including budgets, are submitted before any financial assis-
tance is given. Consequently, there is an element of discretion for central government and
the monitoring bodies in the sectoral and organisational allocation of funding. This is also
the basis for central administrative control of the management of the funds.

All national systems of intergovernmental fiscal relations incorporate some system of cen-
tral control and supervision, motivated partly by macroeconomic policy imperatives. They
have converged on a system of general and block grants. For local authorities, especially in
Scandinavian systems, the case for this switch has been argued on the basis of increasing local
autonomy and flexibility. However, general grants may moderate but not abolish central con-
trol, as the United Kingdom case shows. In fact it is possible to argue in this case that the
movement towards a general grant has in practice been driven primarily by the desire of
central government to enhance its control over local government spending and investment.
The preceding multiple structure of special grants did not easily lend itself to a general
cutback. In Sweden, the functional responsibilities have remained the same independently
of the reorganisation of the grants regime, and expenditure patterns have been little changed.

The incentive effects of any particular arrangement for intergovernmental fiscal relations
will also be influenced by macroeconomic policy priorities. Systems for supervising and moni-
toring regional and local government expenditures are often designed with the aim of curbing
their expenditure and borrowing. Some national systems supervise local government
through a “vertical” prefectoral system of devolved national administrations, including at
times the use of the legal system. Apart from the United Kingdom, all European countries
have adopted some sort of prefectoral system to control the fiscal behaviour of subnational
government, albeit with mixed results.

VI. Conclusions: Methodology for Country Analyses

This section brings together the various elements of the report in the form of a draft method-
ology and terms of reference for detailed country studies that could be conducted in a sec-
ond stage. Before doing so, however, it is worth drawing out some key findings of this first
stage to be borne in mind in conducting subsequent research. The first part of this conclud-
ing section does this. It is followed by an exposition of the proposed methodology and then
a checklist of qualitative and quantitative data that the subsequent studies should seek to
collect.

Summary of Key Findings

Why Have Intergovernmental Grants?

There are many justifications for transfers between tiers of government, some of which are
apt to be conflated in the arrangements in different countries. Hirsch and Rufolo (1990)
summarise much of the literature to put forward six main reasons for intergovernmental grants:

- To promote redistributive goals.
- To avoid excessive differences in tax rates that would give rise to distortions associ-
  ated with competition for the tax base.
- To internalise externalities arising from non-excludability of consumption of public
goods. This happens if residents of a community cannot prevent non-residents from
taking advantage of assets for which only the residents have paid. Matching grants from the higher tier help to address this.

- To accommodate differences between tiers in fund-raising capability—the presumption being that the higher tier has greater access to progressive taxes.
- To ensure that lower tiers have incentives to make investments that they would not otherwise fund.
- To allow local administration of activities that the higher tier is responsible for, but which the lower tier does better.

**Funding Models**

At a theoretical level, there is a wide variety of arrangements for intergovernmental transfers. These have varying incentive properties, depending on such attributes as conditionality, the requirement to cofinance, and other features. Most models assume that the central government not only controls the principal revenue instruments, but also has a strong influence on the spending priorities of subnational government. As a rule, however, theoretical approaches such as fiscal federalism do not distinguish between current and capital spending. Although this does not greatly matter from the perspective of policy assignment between tiers of government, it means that the theory provides only limited insights into how to design policy machinery to ensure that transfers from the EU for investment purposes are used optimally.

**Models Used in Practice**

The research suggests that, although the theoretical variants are many, there are perhaps four distinctive models of intergovernmental fiscal relations in use in different mature economies. In making this categorisation, it is important to recognise that details differ significantly and, moreover, that these details matter. The first two models are essentially characteristic of unitary states, while the latter two are typical of federal arrangements:

- A top-down structure in which the central government is dominant, not only in controlling funding but also in dictating the composition of local expenditure. The United Kingdom, especially since the mid-1980s, typifies this structure.
- Centralised finance, but meaningful local autonomy in deciding how to allocate expenditure, a system found, notably, in Scandinavia, but also recently introduced in Spain.
- Substantial local ownership of taxes with top-up funding provided by the central level, as in the United States and in certain other federal systems.
- Revenue-sharing between central and subnational levels and corresponding autonomy in decision-making. Business taxes in Germany conform to this model, as do personal taxes in Switzerland.

**Diversity**

One of the main findings about public investment systems and the use of the Structural Funds in the EU is the diversity of experience. The EU-15 comprises countries with very different structures of government and constitutional frameworks. Germany is quintessentially
federal, as is Belgium now; Denmark and Sweden set great store by local democracy; and Italy and Spain could be described as recently regionalised. On the other hand, Greece, Ireland, and the United Kingdom (with the exception of Scotland, Wales, and Northern Ireland) remain largely centralised unitary states. France (and possibly the Netherlands) is a unitary state with strong centralised powers in parallel with significant decentralisation. Diversity also manifests itself in arrangements for transfers between tiers of government, with variants on several of the theoretical models in different countries. An aspect of diversity that emerges clearly from the research is that "the devil is in the details" of funding arrangements. As a result, broad typologies may be misleading and detailed analyses are essential to clarify the incentive and other effects of ostensibly similar systems. Moreover, the evidence that some regions in France have been more successful than others or the contrasts between the constituent territories of the United Kingdom in the administration of the Funds points to the potential for variability within a country.

There are two main implications of these findings on diversity for CEECs. First, that the Structural Funds are able to cope with such diversity means that, within reason, there is no obligation for subnational government reforms to follow a narrowly-defined path. As a result, other ways of restructuring intergovernmental relationships can be considered. Allowing for grants and loans from international organisations and optimising the use of FDI, for example, might influence choices. Second, the CEECs can build on the experience of EU Member States and, indeed, other countries to put in place arrangements that avoid some of the pitfalls evident elsewhere in relation to incentives, quality of administration, and so on.

**Evolution of the Structural Funds**

The changes being contemplated for the Structural Funds for the period 2000-06 can be seen as the first stage in a reform aimed at accommodating the CEECs. The proposals envisage holding the budget for "structural operations" at 0.46 percent of EU GDP, a ratio that should allow an increase in the real value of the Funds provided that growth is as predicted. The main thrust of the reforms is to reduce the present coverage of EU-15 regions, decreasing it from 51 percent of the EU population to around 40 percent. This, together with the increase in financial resources, should create the leeway to allow a build-up of transfers to the CEECs. Despite some simplification of the regulations and various administrative changes, the proposed reforms will largely preserve the Funds in the form they took in the 1988 reform. Nevertheless, there have been important changes over the years in the way the Structural Funds have operated, often triggered by the accession of new Member States or further steps in European integration. The 1988 reform saw a concentration of effort on the least developed regions, many of which were in the Iberian countries, while one outcome of the Maastricht Treaty was the creation of the Cohesion Fund targeted at poorer Member States. The arrival in 1995 of the two Nordic countries resulted in dealing with sparsely populated regions becoming an additional objective of the Funds.

In the light of this, it must be expected that further changes will occur as the CEECs join the EU. There might, for instance, be a case for targeting a greater proportion of support explicitly at nations (the Cohesion Fund approach) rather than regions as at present. In some respects, this would mean a shift in the philosophy of the Structural Funds, as the aim of advancing cohesion is articulated in regional terms both in the Maastricht Treaty and in the Funds' regulations. Eligibility to receive support from the Structural Funds is assessed
using regional indicators, going down to fairly disaggregated levels for the current Objective 2 and 5b regions. However, three Member States (Greece, Ireland and Portugal) were designated in their entirety for support in 1988 and have retained that status since then. This means that there would be a precedent for designating newly-acceding countries in their entirety. It is, however, noteworthy that this approach was not adopted for Spain, the one larger “less-favoured” Member State.

The other form of change that can be envisaged is for the Structural Funds to target new priorities in areas such as environmental policy, industrial development, or institution building. In the past, a sizeable proportion of spending has gone on infrastructure, but more effort of late has been devoted to training and business development. The key point is that the Funds do adapt, so that for the CEECs, what is negotiated in the accession agreements will matter and it cannot be assumed that the rules now in force will remain once the CEECs accede.

**Functioning of the Structural Funds**

Systematic evaluation of the Structural Funds has been limited, but even at the level of monitoring and auditing of the Funds, it is clear that there are substantial variations in the manner and effectiveness of their functioning. The EU Court of Auditors regularly identifies irregularities and has been critical of the vagueness of the rules on eligible expenditure. Studies on different countries and programmes reveal an array of different experiences and approaches to using the Funds. Ireland stands out as an economy in which the Funds have, on the whole, been well used and where the public investment system has evolved to make good use of the transfers from the EU. In some other regions, the evidence suggests that project choices and implementation have been disappointing, with the result that the transfers from the EU have not achieved as much as they could or should. Problems include deficiencies in subnational institutions and administrative capacity, poorly developed local partnerships, and a lack of economic development experience. There is much scope for learning-by-doing, but it is also apparent that the learning process can be a protracted one, measured in “programming periods” rather than months or years.

**Central and Eastern European Country Structures**

Most CEECs, as formerly centrally planned economies, have been accustomed to central control of public investment decisions. Although the planning process in some, such as Romania, meant that efforts were made (whether successful or not) to ensure regionally balanced economic development, this should not be confused with regional autonomy of the sort now found in several EU-15 countries. In Poland and in Romania, the two most populous CEECs, the prospect of EU membership and of receipts from the Structural Funds has prompted reform of subnational government. Although Poland is more advanced in this process, the difficulties the reform of the voivodships have encountered demonstrate that any such change will involve major dislocation and protracted political battles.

EU-15 experience implies that although appropriate government structures are a necessary condition for making good use of the Structural Funds, more is needed to ensure that the Funds achieve their potential in promoting economic development. In particular, the quality and coherence of regional partnerships will have to be nurtured. Many of the studies of the
use of the Funds show that this has been a two-way street; the regulations oblige partnerships to come together, and where they gel, the best use of the Funds is achieved. In many cases, the Structural Funds have been instrumental in bringing together local economic actors who have hitherto been hostile or, at best, remote from one another. These include the voluntary sector, business, financial interests and union representatives as well as the government and public agencies. Economic development expertise, too, is vital. Misguided initiatives in many EU-15 regions have diminished the impact of the Funds and, in some instances opened the door to “clientilist” allocation of resources or even fraud. The learning curve will be steep, and although the experience of recent years in the EU-15 should allow some of the more obvious pitfalls to be avoided, an appreciation of the programming approach will take time for CEECs.

Prospective Central and Eastern European Country use of European Union transfers via the Structural Funds and the Cohesion Fund

The broad operating principles governing the Funds are likely to remain, certainly for the period 2000-06, and quite possibly beyond. CEECs will, however, be subject to a cap, likely to be 4 percent, on the percentage of GDP received. The amount of money available to any recipient will, therefore, be fixed, so that projects will be in competition with one another. This has the important implication that even where the EU share of financing is as high as 85 percent (the current Cohesion Fund ceiling for most purposes), the opportunity cost of any project will always be the full cost of the project, not just the cofinancing proportion. This means that careful and transparent project appraisal will be needed.

Elements of a Methodology

The underlying purpose of this study is to assess the suitability of CEEC systems for public investment to deal with transfers from the Structural Funds, while ensuring at the same time that the recipient countries have well-conceived public investment programmes. The assessment also has to consider how these systems need to evolve to assure compatibility with the regulations and procedures, and to identify the trade-offs and choices confronting countries. A particularly important issue is identifying the means by which the opportunity cost of both programmes and individual investment projects are assessed. Given that the scale of EU transfers is fixed de facto by bargains struck between Member States, the authorities in recipient countries will have to take account of this in making choices.

Some prospective changes in public investment procedures will be desirable, irrespective of the advent of the Structural Funds and should, therefore, feature in the research. Examples are developments that engender “win-win” improvements, such as better auditing, monitoring and evaluation mechanisms. Other changes will involve choices between alternatives with differing payoffs. It will, therefore, be important both to identify the tradeoffs involved and to relate these to the opportunity costs of different proposals.

To shed light on these matters, a range of information will have to be generated. Because the CEECs differ in a variety of respects, it is recognised at the outset that it may not be possible to obtain satisfactory information on all the items for every country studied. Equally, if the information is to fulfil its role in guiding policy choices, many of the items will be needed.
The Nature and Characteristics of Intergovernmental Transfers Currently in Place

The starting point is to investigate the structure and nature of the relevant institutions in the country. This would be expected to comprise:

- A description of the bodies implicated in public investment; their legal status, mission, control, and any formal assignment of responsibilities.
- Knowledge of where the locus of decision-making lies and the degree of power exercised by the various tiers of government.
- An assessment of the strengths and weaknesses of the system as it stands and in anticipation of reforms substantially agreed to (as is the case for Polish local government).
- The proportions of the financial resources available to the authorities at different levels of government derived from own and other revenues, and the sources of the latter.
- The form in which transfer(s) between tiers occur: block grant, hypothecated grants, and so forth.
- The extent of conditionality or cofinancing obligations.
- The degree of interaction between authorities in decision-making, in monitoring and evaluation, and in political accountability.

Effectiveness of Public Investment and Impacts

How well public investment systems function is central to an assessment of how they need to change. A key issue here is whether the system provides the right sorts of incentives to economic agents and whether market disciplines are respected. In this regard, the concept of opportunity costs is crucial. Equally, if rules governing public investment are such as to induce local or regional authorities to take advantage of projects that either fit the rules or are most easily cofinanced, the outcome may be economically inefficient. The study will need to ascertain the extent to which decision-makers are obliged to take account of alternative uses of scarce resources and whether objective criteria are used in project selection. Issues to be explored include the following:

- Principles used to identify projects and to prioritise them, including the extent to which environmental considerations or other constraints are incorporated.
- Quality of project management and methods used to ensure that investment projects are brought to fruition in a timely manner.
- Procedures for (and experience of) monitoring of public investment projects and evaluation of their outcomes.
- Whether ex-post impact assessments are carried out and related to project appraisals.

The Flexibility of the System

Many facets of systems for public investment will bear on how readily they are able to adapt to new circumstances. These include the following:

- How adaptable the system is to new sources of revenue.
• Rigidity of procedures or degree of discretion in budget lines and how these are allocated.
• Experience in making use of PHARE, EIB, World Bank or EBRD money.
• The balance between local autonomy and coherence of the overall public investment system.
• Involvement of, or capacity to involve, NGOs and other stakeholders.
• Principles underlying choices about charging end users for using capital projects.
• Are subnational authorities' subjection to hierarchical control of finances or constitutional independence.
• The entitlement of subnational levels to borrow.

Need for Change to be Suited to the Structural Funds

The advent of the Structural Funds will mean that recipients have to conform to the appropriate rules and procedures. While some change in these can be anticipated, it must be regarded as probable that the programming approach, the principle of partnership, categories of eligible expenditure and expectations of cofinancing will remain. For the Structural Funds, it will be necessary to demonstrate that additionality has been respected, although this is not, at present, essential for Cohesion Fund projects. Information will be required, first, on the capacity of recipients to conform to EU procedures in the following respects:

• Having a regional (or national) development programme that can be translated into a CSF, SPD or similar planning framework.
• Possibility of ascertaining additionality.
• If a regional approach is adopted, whether plans exist or could be drawn-up at regional level.
• Administrative capability and experience in dealing with inward transfers and loans.
• An assessment of incentive structures and whether these identify the kinds of projects that should be put forward in programmes.

Taking advantage of the Structural Funds also has financial ramifications that have to be clarified. These include the following:

• The sufficiency of own revenues at the subnational level to enable cofinancing of projects under the Structural Funds, even if the rate is kept low.
• Possible changes in the local tax base to assist cofinancing.
• The availability of matching funds at national level and how these are controlled.
• Potential for attracting complementary funds from nonpublic sources and how this will affect the choice of projects.
• Other sources of external funding—World Bank, EBRD, and so on—and how these can be integrated with resources channelled through the Structural Funds.
• The compatibility of public accounting methodologies.
• The robustness of financial control procedures and the integrity of their operation. Compliance (or compatibility) with auditing requirements is part of this.
Feasibility of Securing the Required Change

Various changes will be needed to make CEEC public investment systems compatible with the Structural Funds. Some will involve high political stakes; others may demand little more than technical adjustments. Ascertaining the extent of ex-ante regional disparities and their political significance will be part of compatibility testing. If ethnic, religious, or other boundaries matter, information on these will be vital. Other issues include the following:

- Identification of current and prospective differences in public investment between likely rival areas.
- Scope for identifying needs on both the revenue and expenditure sides.
- Ease of enhancing statistical information.
- Extent of entrenchment of current administrative structures and the degree of resistance to change there will be.
- The political economy of change; dealing with winners and losers from a recasting of public investment, especially if new regional structures are created.

Checklist

This list can be regarded as a broad template for the categories of information that would, ideally, be collected. Some elements will either not be applicable or not available for certain countries; others will have to be regarded as common to all countries. Essential (E) and desirable (D) material is, therefore, distinguished in this checklist. For information that may only be relevant for selected countries a third category (S) is flagged.

Country Background

Qualitative

- Description of the structure of government and the links between tiers. This should cover the main powers and responsibilities of each tier and explain the channels by which they are able to influence or control each other. It should also explain revenue and expenditure assignments. (E)
- Description of the system for financing subnational capital investment. This should specify the types of grants made, any conditions attached to them, and the procedures for accounting for the expenditure. What formal rules guide public investment and how are these complemented by discretionary powers? (E)
- How well the system of intergovernmental transfers works and what problems in its functioning can be identified. (E)
- Arrangements in place for auditing and evaluation, and do these work in a way that facilitates policy learning. (D)
- Inventory of availability of regional statistics. (S)

Quantitative

- Breakdown of budgets of regional and local government, showing own revenues and intergovernmental transfers, and the types of expenditure flows between levels of government. (E)
- Extent of disparities in fiscal capacity between and across tiers of government. (E)
- Extent of regional disparities, especially in public infrastructure. (D)
- Flows of loan finance and FDI to country and, if possible, regions within the country. (S)
- Extent to which intergovernmental transfers mitigate differences in fiscal capacity. (S)

**Key Issues Relating to Adaptation to European Union Transfers**

**Qualitative**

- How compatible is the system with the information, procedural, and reporting requirements of the Structural Funds and the Cohesion Fund? (E)
- Are there constitutional or other rules about intergovernmental transfers that determine who will be the counter-parties for the administration of EU transfers. (E)
- What is the capability in the country for developing programmes to make use of EU transfers and how well-trained are indigenous economic development practitioners. (D)
- Assessment of the political dimension of adaptation to the Structural Fund procedures. Is there a need for major reform of subnational government and how great is the political challenge of achieving this? (S)
- To what extent are nongovernmental actors involved in economic development at the subnational level and who are the main interests? How does this augur for the building of partnerships in the form promoted by the Structural Funds? (S)
- Is regional (as opposed to national) economic development a priority? (S)

**Quantitative**

- Project financing the country receives from PHARE and how it has been allocated. (E)
- Sources and value of financial resources available (or potentially available) to co-fund projects supported by EU transfers. (D)
- Number of economic development practitioners and their distribution across the country. (D)

**Notes**

1. Commission briefing note on the Structural Funds.
2. For details of the derivation of optimal matching rates see Boadway and Hobson 1993, pp.101-3.
3. The growth enhancing effects of public infrastructure investment are well documented in the literature. See Easterly 1993, or Bougheas and Demetriades 1996.
4. The positive effects of infrastructure on trade are demonstrated by Bougheas, Demetriades and Morgenroth 1998.
References


Council of Europe. 1990. Types of Financial Control Exercised by Central or Regional Government over Local Government. Local and Regional Authorities in Europe Study Series. Strasbourg.


Recent World Bank Technical Papers (continued)

No. 405 Onorato, Fox, and Strongman, World Bank Group Assistance for Minerals Sector Development and Reform in Member Countries

No. 406 Milazzo, Subsidies in World Fisheries: A Reexamination

No. 407 Wiens and Guadagni, Designing Rules for Demand-Driven Rural Investment Funds: The Latin American Experience

No. 408 Donovan and Frank, Soil Fertility Management in Sub-Saharan Africa

No. 409 Heggie and Vickers, Commercial Management and Financing of Roads

No. 410 Sayeg, Successful Conversion to Unleaded Gasoline in Thailand

No. 411 Calvo, Options for Managing and Financing Rural Transport Infrastructure


No. 414 Salman and Boisson de Chazournes, International Watercourses: Enhancing Cooperation and Managing Conflict, Proceedings of a World Bank Seminar

No. 415 Feitelson and Haddad, Identification of Joint Management Structures for Shared Aquifers: A Cooperative Palestinian-Israeli Effort

No. 416 Miller and Reidinger, eds., Comprehensive River Basin Development: The Tennessee Valley Authority


No. 418 Okidegbe and Associates, Agriculture Sector Programs: Sourcebook

No. 420 Francis and others, Hard Lessons: Primary Schools, Community, and Social Capital in Nigeria

No. 421 Gert Jan Bom, Robert Foster, Ebel Dijkstra, and Marja Tummers, Evaporative Air-Conditioning: Applications for Environmentally Friendly Cooling

No. 422 Peter Quaak, harrie Knoef, and Huber Stassen, Energy from Biomass: A Review of Combustion and Gasification Technologies

No. 423 Energy Sector Unit, Europe and Central Asia Region, World Bank, Non-Payment in the Electricity Sector in Eastern Europe and the Former Soviet Union

No. 424 Jaffee, ed., Southern African Agribusiness: Gaining through Regional Collaboration


No. 426 Rushbrook and Pugh, Solid Waste Landfills in Middle- and Lower-Income Countries: A Technical Guide to Planning, Design, and Operation

No. 427 Mariño and Kemper, Institutional Frameworks in Successful Water Markets: Brazil, Spain, and Colorado, USA


No. 429 Gary McMahon, José Luis Evia, Alberto Pasco-Font, and José Miguel Sánchez, An Environmental Study of Artisanal, Small, and Medium Mining in Bolivia, Chile, and Peru

No. 430 Maria Dakolias, Court Performance around the World: A Comparative Perspective

No. 431 Severin Kodderitzsch, Reforms in Albanian Agriculture: Assessing a Sector in Transition

No. 432 Luiz Gabriel Azevedo, Musa Asad, and Larry D. Simpson, Management of Water Resources: Bulk Water Pricing in Brazil

No. 433 Malcolm Rowat and José Astigarraga, Latin American Insolvency Systems: A Comparative Assessment


No. 436 Roy Prosterman and Time Harstad, ed., Legal Impediments to Effective Rural Land Relations in Eastern Europe and Central Asia: A Comparative Perspective

No. 437 Csaba Csaki, Michel Dabatisse, and Oskar Honisch, Food and Agriculture in the Czech Republic: From a "Velvet" Transition to the Challenges of EU Accession

No. 443 Luc Occuit, John Elder, Charistian Hurtado, François Rantrua, Kamal Siblini, and Maurizia Tovo, DeMISTifying MIS: Guidelines for Management Information Systems in Social Funds

No. 444 Robert F. Townsend, Agricultural Incentives in Sub-Saharan Africa: Policy Challenges

No. 445 Ian Hill, Forest Management in Nepal: Economics of Ecology

No. 447 R. Maria Saleth and Ariel Dinar, Evaluating Water Institutions and Water Sector Performance