

**International Seminar on
Strengthening Public Investment and Managing Fiscal Risks from
Public-Private Partnerships**

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Session 1: Public Investment and Fiscal Policy

Comments by Christoph Rosenberg, Senior Regional Representative for Central Europe and the Baltics

There has been much focus on the new member states (NMS) in this session. So let me give you a perspective from where I live, i.e., Warsaw, Poland. Anyone who has spent a frightful 10 hours driving from Warsaw to Berlin will agree with Filip Keerman and Ana Corbacho that upgrading infrastructure in the NMS is a primary task, and that this will enhance the catch-up process of these countries.

Specifically, I would like to say a few words about EU funds, which several speakers rightly portrayed as a vehicle to increase and channel public investment. The amount of gross transfers to the NMS is indeed large—up to 4 percent of GDP, two-thirds in the form of structural funds—and expectations about their beneficial effects are correspondingly high. In the region, these monies are widely seen as manna from heaven. Much of the discussion is focused on how to absorb these funds as quickly as possible, while little time is spent on thinking through the broader macroeconomic consequences and possible policy tradeoffs..

Let me mention three macroeconomic considerations. First, as Ana Corbacho mentioned, absorbing EU funds has a direct impact on the fiscal balance due to the associated cofinancing needs. The size of this effect depends on the degree to which EU funds substitute spending that would have been undertaken anyway. Using ESA95 methodology, this fiscal drag can be about ½-1 percent of GDP—not negligible for countries trying to meet the 3 percent of GDP deficit limits imposed by the stability and growth pact.

Secondly, EU funds obscure the size and direction of the fiscal stimulus. With both budgetary revenues and expenditures containing substantial transactions with a non-domestic entity (the European Commission), the change in the headline fiscal deficit from one year to the other is no longer a good approximation of the demand impact of fiscal policy. Taking this into account, we find that fiscal policy in the NMS is a lot more pro-cyclical than meets the eye. This is an issue primarily in the Baltics, where economies are already showing signs of overheating. Here, EU funds are adding oil to the fire.

Finally, there are questions about the long-term growth impact of EU funds. Most studies that I have seen find the effect to be surprisingly small. For the NMS, the GDP level is estimated to be 2-4 percent higher in 2020, compared to baseline without EU funds. These models do not even take full account of the feedback mechanisms such as the real exchange rate appreciation associated with such transfers.

This leads me to two sets of questions: First, how can we make sure that the considerable efforts associated with the administration of EU funds translates into more than a short-term

boost to domestic demand, i.e., truly promotes real convergence? Building on Eivind Tandberg's presentation, how should a country go about determining whether EU funds should be allocated to, say, building roads or training people? Is the EU funds' presumed bias towards new projects and obstacle to productive investment, as suggested by Prof. Sturm?

Secondly, how can policy makers square the circle of exploiting the opportunities offered by the access to "free money" from Brussels while at the same time guarding against any destabilizing macroeconomic side-effects? Specifically, how can they avoid unwarranted fiscal expansion? As Filip Keerman made clear, the NMS cannot expect a relaxation of the EU's fiscal rules to accommodate the fiscal drag associated with EU funds. In my view, the only way out of this dilemma is to find savings elsewhere in national budget, especially in current spending. This boils down to a relative increase of capital spending in the budget—after all, the purpose of structural funds.