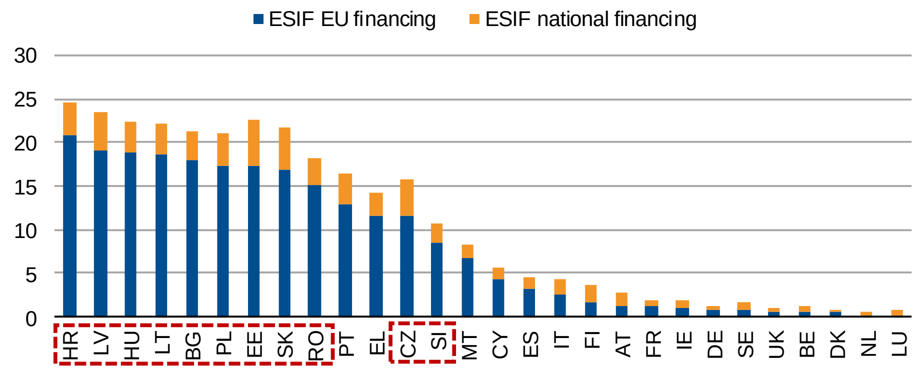
EU funds for Central and Eastern Europe: 2021-27 budget matters for sovereign outlooks

Central and Eastern European[1] (CEE) countries, the largest beneficiaries of EU funds as a percentage of GDP, are facing a possible reduction in EU investment for 2021-27, with EU priorities set to change and Brexit potentially creating a significant budgetary gap. Alongside the effective and timely implementation of existing – and future – EU-funded programmes, the outcome of budgetary negotiations will be key for the region's steady convergence with the rest of the EU. Progress has varied across the region, with lower potential growth seen among countries whose absorption of funds remains limited.

Scope's ratings on EU CEE countries are underpinned by the economic governance and macro prudential framework provided by the EU to support credible macroeconomic policies. A key pillar consists of the European Structural and Investment Funds (ESIF), aimed at fostering economic sustainability, job creation and innovation in the EU. More than half of the EU's budget for 2014-20, worth EUR 461bn, is channelled through ESIF[2] while CEE countries jointly account for nearly half of this amount.

Figure 1: ESIF 2014-20 allocation, % of 2018 GDP



Source: European Commission, calculations Scope Ratings

The main takeaways of this report are as follows:

i. EU funds are key for the outlook on CEE countries with regards to investment and growth, but so is the national strategy on spending and efficiency. As a share of 2018 GDP, the financial allocation for 2014-20 ranges from up to 8.6% for Slovenia (A/Stable) to up to 20.8% for Croatia (BBB-/Stable).

ii. Brexit, if it happens, and proposed EU funding changes for the 2021-27 period suggested by European Commission (EC), if implemented, are set to significantly reduce EU fund allocations to CEE. Bulgaria and Romania would be the only two CEE countries that would likely see their fund allocations increase.

iii. Scope views EU fund absorption to be an important rating driver for CEE countries, as it not only accounts for a crucial share of public investments for infrastructure and innovation, but also stimulates governments' long-term planning, governance and administrative capacity to use public funds effectively. Scope's assessment of these developments is captured, for instance, in the rating actions on Hungary (BBB/Positive), Romania (BBB-/Negative) and Croatia.

[1] Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, the Slovak Republic, Slovenia

[2] The ESI funds include the European Regional Development Fund, European Social Fund, Cohesion Fund (together forming the Cohesion Policy), European Agricultural Fund for Rural Development, European Maritime and Fisheries Fund, and Youth Employment Initiative https://ec.europa.eu/info/funding-tenders/funding-opportunities/funding-programmes/overview-funding-programmes/european-structural-and-investment-funds_en

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EU funds for the CEE region are likely to fall depending on the new funding priorities; focusing on how efficiently governments deploy them is therefore key to meeting the region's development needs

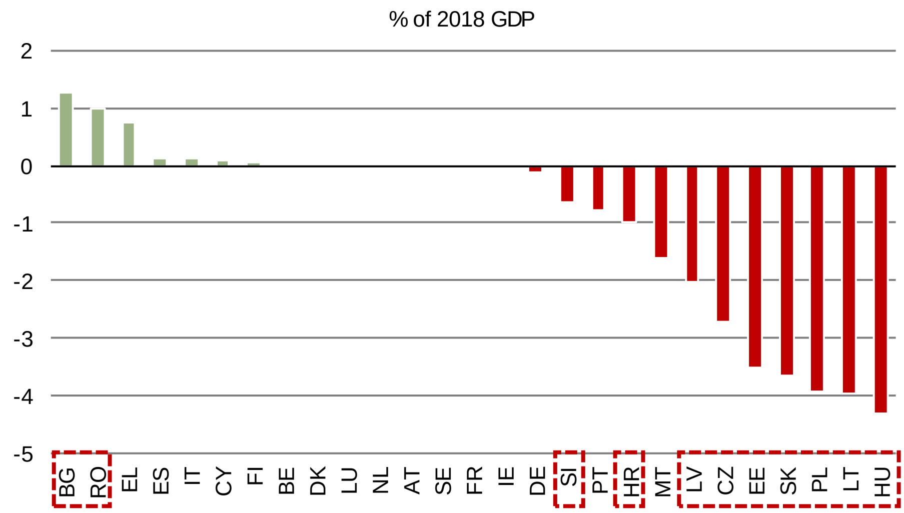
Before each programming period, the EU budget is negotiated between the European Council and the European Parliament, based on the EC's draft proposal. After the budget is adopted, each member state prepares an agreement with the EC that states how it plans to use the funding.

EU funding priorities set to change

The EC has proposed the inclusion of new criteria in rules governing investment under the Cohesion policy, which comprises around one-third of the EU budget aimed at reducing economic disparities between regions. These new criteria relate to four areas: youth unemployment, reception and integration of migrants, climate change, and education. The EC's proposal also factors in the planned EU exit of the UK, whose contribution to the 2014-20 budget is projected to be around 12% of the total, according to the official estimates[3]. These changes imply a reduction of around EUR 35.5bn in funding for the CEE region, but an increase for the southern periphery – Greece, Italy, Spain and Cyprus – by EUR 5.3bn altogether[4].

According to the EC, considerable progress has already been made towards an agreement on the EU's long-term budget for 2021-27. However, negotiations over the Common Agricultural Policy, which accounts for 37.8%[5] of total commitment appropriations in the 2014-20 multi-annual financial framework (MFF), are still too slow. Moreover, strong political leadership from the European Council is needed to finalise the next EU budget before an end-2019[6] deadline[7].

Figure 2: Cohesion policy funding change, 2021-27 vs 2014-20 under EC's proposal



Source: European Court of Auditors, calculations Scope Ratings

EC's new proposal to have a substantial impact on EU funds allocation

Under the EC's proposal[8], most CEE countries would see their funds reduced under the 2021-27 Cohesion Policy. The proposal assumes that the UK leaves the EU – which Scope views as the most likely outcome of Brexit talks even though the UK ultimately remaining in the EU remains a second most probable outcome. While the allocation

[3] https://obr.uk/efo/economic-fiscal-outlook-march-2019/
[4] https://www.eca.europa.eu/lists/ecadocuments/rcr_cohesion/rcr_cohesion_en.pdf
[5] http://www.europarl.europa.eu/factsheets/en/sheet/104/the-common-agricultural-policy-in-figures
[6] https://www.consilium.europa.eu/en/meetings/european-council/2019/06/20-21/
[7] European Commission June 2019, Roadmap to an agreement on the Union's long-term budget for 2021-2027
[8] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=COM:2018:375:FIN

method of Cohesion Policy funding is still largely based on GDP per capita, according to the EC proposal, countries would receive additional fund allocation premiums for socio-economic and environmental reasons. As a result, Hungary, Lithuania, Poland, Slovakia and Estonia would receive around 4% less Cohesion Policy funding (as a share of 2018 GDP) compared to under the current MFF. The allocations to Czech Republic, Latvia, Croatia and Slovenia would also decrease, by 2.7%, 2%, 1%, and 0.7% of 2018 GDP, respectively. Bulgaria and Romania would be the only CEE economies whose funding increases, by 1.3% and 1% of 2018 GDP, respectively. On other hand, the EU's southern periphery will benefit the most from the EC's proposal, with Greece, Italy, Spain and Cyprus seeing moderate allocation increases, as shown in **Figure 2**.

We expect the EC proposals to be adjusted by the European Council as well as the European Parliament in coming negotiations, resulting in meaningful deviations in both the size and allocation of the budget.

Table 1: Correlation between potential growth rates % and net EU payments % GDP, 2010-18

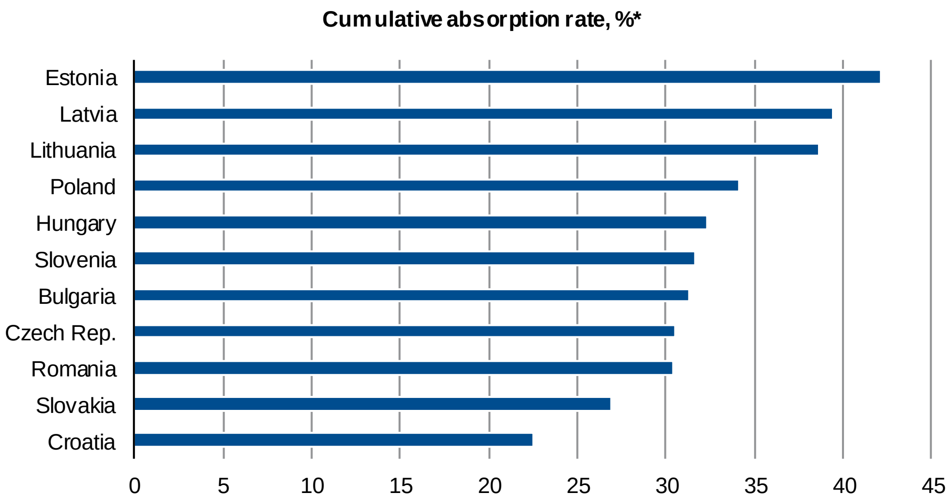
Croatia	0.95
Romania	0.58
Bulgaria	0.55
Poland	0.11
Czech Rep.	0.05
Hungary	0.02
Slovakia	-0.01
Lithuania	-0.45
Latvia	-0.50
Estonia	-0.52
Slovenia	-0.64

Source: EC, Scope Ratings

EU funds relatively important for the potential growth of less-developed regions

Still, improving the absorption of EU funds will be important for growth in the CEE region in view of the proposed redistribution of funding, which is the baseline for the negotiations. **Table 1** shows the correlation between potential CEE growth rates and net EU payments received relative to GDP over the 2010-18 period. While conclusive causal statements cannot be made based on a correlation analysis, these results do suggest the relative importance of EU funds for the least developed countries in the region cannot be understated, in that they increase potential growth through higher capital accumulation and productivity growth. Poland and Hungary, which have the highest absorption rates after the Baltic states (**Figure 3**), have high and increasing potential growth, at an estimated 3.9% and 3.7% in 2019, up from 3.8% and 3.4% in 2018, according to the EC. On the other hand, the same figure for Croatia, which has the region's lowest absorption rate, is estimated at only 1.8% for 2019. Likewise, Romania's growth potential – whose absorption rate is the third lowest among CEE countries – is set to decline to 3.6% in 2019 from 4.2% in 2017.

Figure 3: ESIF 2014-20 implementation progress, as of July 2019



Source: European Commission, Haver, 'cumulative absorption rate' is equal to cumulative net EU payments as a percentage of cumulative planned EU payments.

Institutional framework essential for the capacity to use EU funds

According to research[9], institutional factors alongside co-financing capabilities are key to determining the capacity of less developed EU regions[10] in deploying EU funds. Such

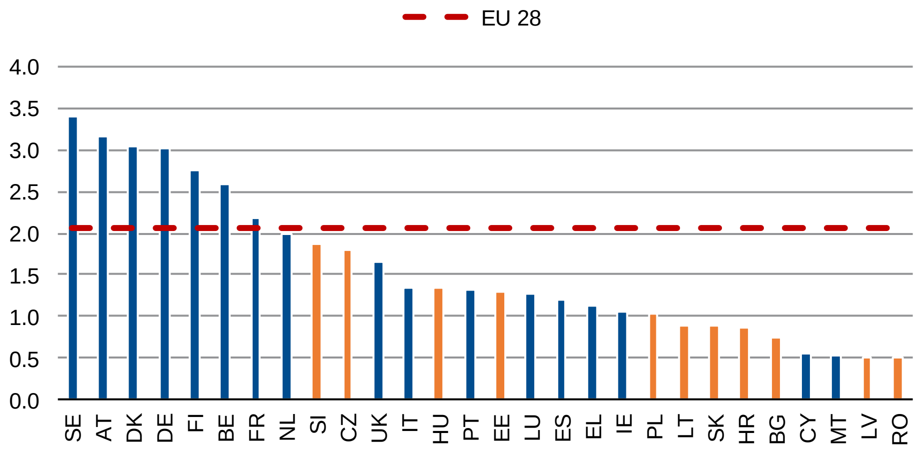
[9] Kersan-Škabić, Tijanić 2017, Georgescu, Zaman 2009.
[10] GDP per capita less than 75% of the EU average

institutional factors include the quality of governance, long-term planning, control of corruption and decentralisation. Also, the importance of these factors differs across regions. Even so, absorption capacity can improve through the strengthening of institutions, by simplifying public procurement procedures, enhancing administrative capacity, reducing fragmentation of public administration, and ensuring the rule of law.

Spending strategy and focus on performance are key in view of lower EU funding for 2021-27

According to the European Court of Auditors, the implicit focus on absorption rates could undermine the quality of outcomes. Furthermore, identifying high-quality projects to be funded could be challenging for CEE countries that have relatively low fund absorption rates and rely on EU funding for public investments[11]. R&D investment is significant for long-term growth; in CEE countries, however, it remains low and lags materially behind that of western European countries (**Figure 4**). Against this backdrop, boosting investment in R&D and education, including through a higher take-up of EU funds, will be a crucial step towards increasing long-term returns from future EU-backed projects in the CEE region.

Figure 4: R&D expenditure in 2017, % GDP



Source: Eurostat

UK's withdrawal from the EU to possibly leave a gap in EU budget

Brexit and the EU budget: The UK will contribute to the EU budget until it formally leaves the EU[12]. In July 2019, the European Council adopted contingency measures for the 2019 EU budget in the event of a no-deal Brexit. These ensure UK beneficiaries will continue to receive payments until an EU withdrawal, so long as the UK still contributes to the EU budget[13].

Brexit, if it happens, will leave a gap in the EU budget. The UK's financing share of the EU's 2014-20 budget is projected at around 12% of the total, or EUR 117.9bn, according the UK's Office for Budget Responsibility. The UK[14] has indicated it might pay to participate in several EU programmes even after Brexit, such as Horizon 2020, a research and innovation programme with nearly EUR 80bn of funding for 2014-20. The UK's participation in such programmes after Brexit would be subject to conditions defined by the EU for third countries.

[11] European Court of Auditors 2018, "Commission's and Member States' actions in the last years of the 2007-2013 programmes tackled low absorption but had insufficient focus on results"
[12] The UK's contribution to the EU Budget, Briefing paper CBP 7886, 24 June 2019
[13] https://www.consilium.europa.eu/en/press/press-releases/2019/07/09/2019-eu-budget-council-adopts-contingency-measures-for-a-no-deal-brexit/
[14] The UK's contribution to the EU Budget, Briefing paper CBP 7886, 24 June 2019

Factoring in EU funds absorption in Scope's rating decisions

EU funds absorption rates vary markedly among CEE countries

The capacity to absorb EU funds relates to three main features*:* i) macroeconomic absorption capacity determined by the EU rules fixing the amount of EU funds that a member state can receive; ii) financial absorption capacity, or the government's ability to co-finance projects; and iii) administrative capacity, which captures the ability to prepare, coordinate and implement projects.

Beyond absorption rates of EU funds, investment prioritisation and performance are important in addressing structural challenges. R&D expenditure relative to GDP in most CEE countries is driven by EU funding and remains well below the EU average. Also, in the rush to invest the significant funds still to be absorbed before the programme period ends, decision-makers may give insufficient consideration to value for money[15]. This is not a new problem: Countries were still spending 2007-13 funds until 2016, after the current MFF had started.

- As of July 2019, only the Baltic states had net EU payments amounting to around 40% of the planned amounts.
- The lowest funds absorption rates were by Croatia (BBB-/Stable), Slovakia (A+/Stable) and Romania (BBB-/Negative) at 22.5%, 27% and 30.4%, respectively.

EU fund absorption data do not necessarily reflect a government's ability to design and execute polices, though a poor record in putting EU funds to work may signal broader difficulties in the ability to invest public funds efficiently. Furthermore, for CEE countries to maintain their steady convergence while keeping external liability levels under control, it is essential to strengthen the capacity to absorb EU funds and focus more on performance and long-term growth-enhancing spending.

EU funds absorption and high-quality spending support Scope's rating decisions

We consider EU funds absorption to be a key sovereign rating driver for CEE countries. This is owing to two reasons: i) it accounts for a large share of public investments and is therefore important for improving infrastructure and productivity; and ii) it stimulates the governments' long-term planning, governance and administrative capacity to use resources effectively. Below are three case studies presenting the importance of EU funds absorption for EU CEE sovereign ratings.

Public investment in **Romania (BBB-/Negative)** fell to its post-EU accession low in 2017, at 2.6% of GDP, with a low take-up of EU funds[16], accounting for only quarter of the country's public investment since 2014. According to Scope, the country's potential for even stronger growth is limited, given its large labour-skills mismatch and low funds absorption rate. This reflects the country's high political turnover, absence of a strategic management framework and lengthy tender procedures[17]. These factors have contributed to Scope's assignment of a Negative Outlook after downgrading the credit rating one notch to BBB- in October 2018.

The absorption rate also remains low in **Croatia (BBB-/Stable)**, with only 22.5% of the planned EU budget spent as of July 2019. Croatia has relied on EU funds for public investment since its EU accession in 2013. Public investment averaged a moderate 3.2% of GDP during 2015-18 and has been well under the pre-crisis level of 6% of GDP during 2007-08. High fragmentation of the public administration, the state's strong presence in the economy and restrictive regulations in key infrastructure sectors hinder the implementation of public policies and weaken the efficient use of resources. These factors constrain Croatia's BBB-/Stable ratings.

[15] European Court of Auditors 2018
[16] IMF Article IV Consultation – Romania June 2018
[17] EC country report Romania 2019

On the other hand, the greater use of EU funds in **Hungary (BBB/Positive)** – with EU funds potentially accounting for 54% of annual public investment on average over 2014-20 – has underpinned our decision to change the Outlook on the sovereign's BBB rating to Positive in February 2018. The EC projects public investment in Hungary to increase further to 6.7% of GDP in 2019, from 5.8% in 2018 and 3.1% in 2016, supported by the higher absorption of EU structural funds.

Table 2: Net ESIF payments*, % GDP

	2014	2015	2016	2017	2018
Hungary (BBB/Pos)	4.0	3.2	2.4	2.0	2.7
Lithuania (A-/Sta)	2.9	0.6	1.8	1.8	2.4
Estonia (A+/Sta)	2.0	0.9	1.8	1.7	2.3
Poland (A+/Sta)	2.9	1.9	1.3	1.2	2.2
Latvia (A-/Sta)	3.2	3.0	1.7	1.4	1.9
Slovakia (A+/Sta)	1.3	4.0	2.5	1.0	1.7
Bulgaria (BBB+/Sta)	2.5	3.2	2.6	1.4	1.6
Romania (BBB-/Neg)	2.4	2.2	2.9	1.5	1.5
Czech Republic (AA/Sta)	1.9	3.6	2.0	1.0	1.2
Croatia (BBB-/Sta)	0.7	0.7	1.3	1.0	1.2
Slovenia (A/Sta)	2.1	1.7	0.5	0.5	0.9

Source: European Commission, Haver, calculations Scope Ratings.
*2014-16 includes payments under the previous MFF.

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