The Economic and Social Research Institute

Working Paper No. 94

Published in : *European Planning Studies*, Vol. 6, No. 6, 1998, pp. 677-694

An Irish perspective on the Structural Funds

by

John Fitz Gerald

May 1998

The Economic & Social Research Institute
4 Burlington Road
Dublin 4
IRELAND
Tel: 353-1-6671525
Fax: 353-1-6686231

An Irish perspective on the Structural Funds

by

John D Fitz Gerald*,

The Economic and Social Research institute, Dublin 4, Ireland

The EU structural funds played a minor, though important, role in the rapid convergence of Irish living standards to the EU level in the 1990s. As well as their direct impact, the funds had a beneficial effect on public administration, particularly in encouraging evaluation of results. Part of the reason for the Irish success story was the priority given to investment in human capital and physical infrastructure. For the future the principle of additionality of national expenditure should be reconsidered and some changes in the administration of the transfers could be beneficial.

* Correspondence to: John D Fitz Gerald, The Economic & Social Research Institute, 4 Burlington Road, Dublin 4, IRELAND. Tel: 353-1-6671525, Fax: 353-1-6686231

1. Introduction

A vital feature of recent Irish history has been the opening up of the economy and society as whole to the wider European experience. In the first years of independence after 1922 there was a learning process when new patterns of behaviour and new ways of thinking had to be developed. In the world of the 1920s and 1930s Ireland took the road of protection and self-sufficiency tending to close off the influence of the outside world. The economic manifestation of this political stance was the erection of very high tariff barriers to the outside world.

This period of isolation left a serious economic and political legacy after the war. Ireland of the 1950s was not only a very closed economy but it was also a very inward looking, even claustrophobic, society. The advent of free trade from the beginning of the 1960s was only one aspect of the opening up of the country to outside influences and ideas. Probably the most significant force for change in the economy and domestic politics was entry into the then EEC, along with the UK, in 1973.

Until Ireland's membership of the European Union, its external economic relations were characterised by a dependent relationship with the UK. As a result, for Ireland membership of the European Union was, in a way, the culmination of a long path to independence. The fact that certain powers and rights may be limited as a result of EU membership is more than offset by the benefit that Ireland is legally equal to its much more powerful neighbours and that the legal framework exists to enforce its right to protect its national interests.

This changed environment not only strengthened Ireland's economic independence but it also provided new ideas, a stimulus to look at a wider world and a knowledge that there were many different ways of achieving its social and economic objectives. The cultural impact of EU membership has spread throughout society affecting public administration, the trade union movement and employers alike.

More important than any other economic feature of EU membership is the access to the single market and the single market reforms were expected to bring significantly greater benefits to Ireland than was the related increase in Structural Funds (Bradley et al., 1992). However, the adjustment to the changing circumstances had costs as well as benefits. The costs were seen in the closure of many businesses as the economy adjusted. This process of adjustment continued into the 1980s but it is now largely complete for the manufacturing sector and what problems remain affect the services sector. A corollary of this process of adjustment by existing industry was the introduction of new foreign owned businesses across a wide range of sectors, but especially in certain key areas of manufacturing industry. The new multinational industry came to Ireland because it offered access to the EU market and because of a particularly favourable tax regime which had been introduced as early as 1957.

Membership of the EU was particularly important in the access it gave to the wider EU market for agricultural produce under the Common Agricultural policy (CAP). While the CAP and the agricultural sector were crucial to the economy at the time of membership, their significance has steadily fallen. Nonetheless the EU receipts as part of the CAP remain larger than all the receipts under the Structural Funds and the direction CAP reform will take in the next decade will still be a key issue for future Irish governments.

For Ireland an important feature of EU membership was the establishment of the Regional Fund. While initial expectations with respect to the fund may not have been realised, since 1973 Ireland has received significant support from it for structural adjustment (and also from the Social Fund). In recent years the EU Structural Fund process has caught the public imagination as a manifestation of the effects of EU membership. While Ireland benefited from receipts from such transfers from the mid 1970s, the reforms introduced as part of the Single Market process resulted in a significant increase at the beginning of the 1990s making a direct contribution to growth at an important time of economic change. However, it also had indirect effects through its influence on the public administration and even on the political process.

This article discusses the impact, direct and indirect, of the structural fund process on Ireland, what lessons are to be learnt from the experience of the last 10 years, and it considers how Ireland's relationship with the EU structural funds may change over the next decade. Section 2 of this paper sets out the economic background to the Structural Fund process in Ireland. Section 3 describes the role played by the Structural Funds in Ireland in recent years and Section 4 describes the economic impact they have had. Finally Section 5 draws some lessons from the Irish experience and Section 6 concludes by considering how Ireland's relationship with the EU may change over the coming decade.

2. The Economic Background

In the 1980s the Irish economy underwent a prolonged period of fiscal retrenchment which was associated with falling employment and little or no growth in output. By contrast it is to-day experiencing the benefits of a number of years of exceptional growth; over the 4 years 1994 to 1997 GNP has grown by around 7% a year and the numbers employed have increased by around 4% a year. The rate of unemployment fell from nearly 15% of the labour force at the beginning of 1994, to 10% to-day. Government borrowing, which reached 15% of GNP in the early 1980s, was reduced to less than 3% of GNP by the end of that decade and it has remained below that level ever since.

While the rate of growth currently being experienced is exceptional by the standards of the last 30 years (and by the standards of the rest of the EU), the factors underlying this success are not temporary (Bradley, Fitz Gerald, Honohan and Kearney, 1997). No single factor, taken in isolation, can explain the economic turnaround but much of what has happened can be captured by a relatively simple story. The major long-term factors include demographic change and the gradual accumulation of human capital – education and training – and the success of industrial policy in attracting foreign investment. The re-establishment of fiscal control over the 1980s was also crucial and the shake-up of attitudes and institutions which it brought about had a positive effect. The favourable trends in wage competitiveness have played a major role and have been sustained by a movement towards a social partnership approach to wage bargaining. These domestic causal factors have interacted favourably with several external forces, including wider developments in the EU and, in particular, transfers from the EU Structural Funds.

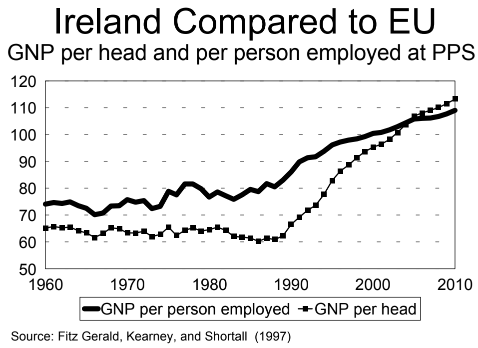
Ireland's post-war demographic experience is rather different from that of the rest of the EU and this holds a key to understanding the unusual performance of the Irish economy. The birth rate in Ireland did not begin to fall till 1980, long after the post-war baby boom had ended elsewhere in Europe, so that in the 1990s there is a continuing rapid increase in the potential labour force (which will last until the early years of the next decade). Labour force participation by women in 1980 was also very low by the standards of the EU but this situation is changing rapidly. The combined effect of the natural increase in the population and the increase in female labour force participation is to raise the potential growth in the labour force by 2 percentage points a year over the 1990s (Fitz Gerald, Kearney and Shortall, 1997).

One of Ireland's great mistakes over its first half century as an independent nation was its failure to invest in education. While the rest of north-west Europe invested heavily in human capital in the post-war years, Ireland ignored the issue; it was not until 1967 that second level education was provided free to all citizens. However, since 1970 the educational system has been greatly expanded at second and third level to bring it into line with the EU norm.

While two thirds of the generation who are retiring from the labour force to-day left school at 13 or 14, and less than 10% of them had the benefit of third level education, as a result of the recent investment in education 80% of the school leaving cohort last year completed second level education and over 50% continued on to third level education (Fahey and Fitz Gerald, 1997). The rising level of educational attainment, through raising productivity, is contributing between ½ and ¾ percentage points a year to the growth rate in the 1990s. The economic benefit of investment in education had its biggest impact in countries such as Germany and Austria in the 1960s and 1970s (Koman and Marin, 1997); Ireland is 20 years late.

The Irish economy in the past has experienced a high rate of increase in the potential labour force but this was offset by emigration rather than resulting in increased employment. In recent years there has seen a marked increase in the demand for skilled labour. The opening of the economy, in combination with a pro-active industrial strategy, made Ireland an attractive location for foreign investment, especially US investment, with easy access to the large European market. This investment is largely concentrated in sectors which require a skilled labour input. Due to the investment in education and training, the rapid increase in supply of skilled labour has meant that the increase in demand has not resulted in serious wage inflation. To-day the availability of the skills that firms need at competitive wage rates is proving at least as important an attraction to inward investment as the low corporate tax rate did in earlier decades.

Figure 1



In the early 1990s the substantial increase in EU structural fund payments, to over 3% of GNP, gave both a real and a psychological boost at an important moment when the period of fiscal retrenchment was coming to an end. Since then they have played a less important, though still significant, role in sustaining investment. They now amount to around 2% of GNP.

The apparent turnaround in the Irish economy is not as extreme as it may appear. Even in the face of adversity in the 1980s output per person employed continued a steady convergence towards the EU average. However, the effect of demographic factors was to reduce the proportion of the population in employment to an EU low in the mid 1980s. Since then the dependency ratio has fallen rapidly so that rising output per person employed is translating into a rapid rise in output per head (Figure 1). The result of these changes is that, having had a standard of living well below the EU average from 1960 to 1990, it is to-day rapidly approaching the EU average. While the infrastructural needs of the economy remain greater than those of its EU neighbours, in terms of income per head it should exceed the EU average in the early years of the next decade.

The key to the problem of the continuing high level of long-term unemployment lies in the poor educational attainment of those who were failed by the educational system in earlier decades. Remedying this structural problem has been a focus of attention for investment funded under both the previous and the current Community Support Frameworks (CSF).

3. The Community Support Framework in Ireland

The Structural Fund payments are designed to promote convergence in living standards within the EU by helping to finance more rapid growth in the regions which enjoy the lowest standard of living (Begg, 1997). They are not merely an expression of good will by the countries within the EU which are net contributors to the budget; they also reflect a view that it is in everyone's interest that disparities in living standards should be reduced and they are a mechanism for building a sense of solidarity between members of the Union. From the point of view of the richer regions there is a fear that too great a disparity in income could lead to disruptive and costly migration of labour. The interest of the less developed regions in this process needs no explanation.

While the initial transfer of funds from richer regions undoubtedly raises the income of the poorer regions, the long term impact is less certain. If the funds were cut off would the poorer regions be any better off than they were before the transfers began? If this is not the case then the poorer regions become “hooked” on the transfers as their enhanced standard of living depends on them. An example of this process is the Mezzogiorno in Italy where, in spite of continuing large transfers, the gap in productivity between Northern and Southern Italy remains large (Pench, 1993). The situation of Northern Ireland within the UK is rather similar (Bradley, O'Donnell, Sheridan and Whelan, 1995).

The principal policy instruments used to-day to address regional inequalities and promote greater growth in the periphery of the Community are the Structural Funds: the European Regional Development Fund; the European Social Fund; and the Guidance Section of the European Agricultural Guidance and Guarantee Fund. As part of the agreement on the Single Act it was decided that the Structural Funds (designated the Community Support Framework - CSF) should be reorganised and that their funding should be progressively doubled between 1987 and 1993. A further major increase was agreed as part of the Maastricht agreement. Part of this increase was contained in the new Cohesion Fund which is only available to the "cohesion countries" Ireland, Greece, Portugal and Spain. This expansion in funding was a recognition by the Community that the benefits and costs of the single market and of the Maastricht Treaty could be unevenly shared, adversely affecting the position of some of the peripheral regions of the EU.

This increase in funding was associated with the introduction of a more structured process where the governments responsible for the disadvantaged regions agree a programme of expenditure to be financed by the Structural Funds (see Begg, 1997). The evolution of the administrative process since the early 1970s reflects a concern by the donor countries that the funds will not be wasted. Since 1989 governments have had to prepare a detailed plan as to how the funds are to be spent.[1] These plans form the basis for negotiations with the EU Commission and, as modified in negotiations with the Commission, they then form the basis for the programme of EU funded investment. Once the framework is agreed detailed programmes of expenditure are prepared in conjunction with the EU Commission, covering each of the major areas of investment. The CSF process also involves a major commitment to monitoring how the funds are spent and to the evaluation of the effectiveness of the investment.

Figure 2

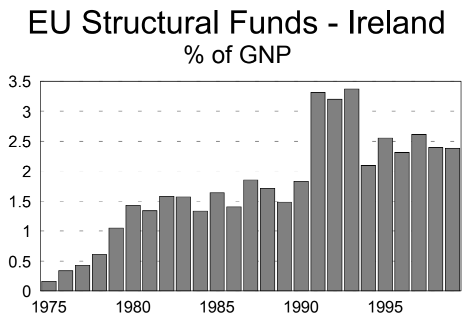


Figure 3

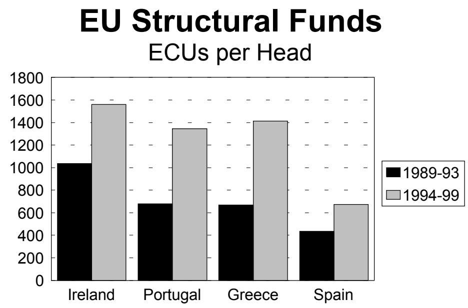


Figure 4

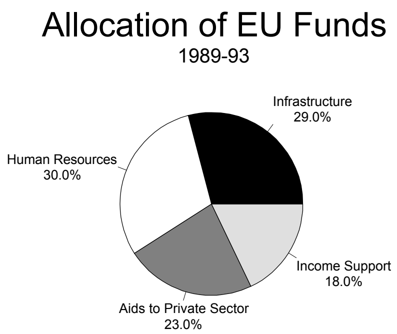
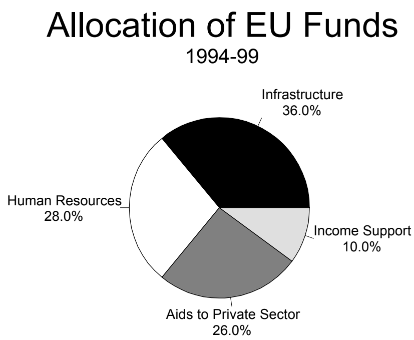


Figure 5



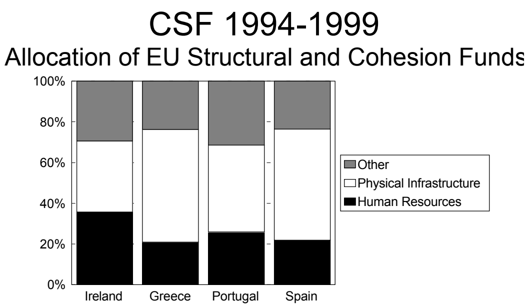
The changes in the EU Structural Funds process brought about by the Single European Act resulted in a very substantial increase in transfers to Ireland in the period 1989-93. As shown in Figure 2, having remained around 1.5% of GNP for many years, the volume of transfers increased in the period 1991-93 to over 3% of GNP (Honohan, 1997). Under the first CSF Ireland was more successful in attracting structural funds than were the other 3 cohesion countries (Figure 3). In spite of a further increase in the overall expenditure by

1 The two Irish plans were: *The National Development Plan 1989-1993*, Government of Ireland (1989) and *The National Development Plan 1994-1999* Government of Ireland (1993).

the EU on this form of aid in the current period (1994-99), the Irish receipts, measured as a share of GNP, have fallen back to around 2.5% of GNP. This fall is due to the very rapid rise in GNP over the period as the transfers measured in ECUs actually rose in the period (Figure 3). While Ireland is still receiving a somewhat larger share of the transfers than the other 3 countries, the gap has significantly narrowed in recent years.

In preparing the plans for how Ireland would spend the structural funds successive governments stressed the importance of allocating the money to investment to ensure that the EU funds make a lasting difference to the productive capacity of the economy. With some limited exceptions this precept has been followed in practice.[2] In Ireland the resources for investment under the CSF were allocated over four broad categories as shown in Figures 3 and 4. In both the first CSF (1989-93) and the current one the two biggest categories were investment in human resources and physical infrastructure. In particular, the Irish government attached a high priority in its plans to investment in education and training and, with the agreement of the EU Commission, it has allocated very substantial resources to these areas. Successive independent reviews of the Irish CSF have reinforced that strategy. A mid-term review of the first CSF, published in 1992, recommended, in particular, that the problem of early school leavers be tackled by enhanced investment in the educational system (Bradley, Fitz Gerald and Kearney, 1992). It went on to say that “while EC policy has emphasised training, more emphasis should in future be given to education in building up the long-term human capital of the work-force”. This view was further reinforced by another study which made recommendations on priorities for the current CSF (Fitz Gerald and Keegan, 1993) and the result can be seen in the overall allocation of funds within the current programme period.

Figure 6



Source: European Commission: First Report on Ecconomic and Social Cohesion, 1996

This contrasts with the choices made in the other cohesion countries where investment in physical infrastructure has received a higher priority. In Ireland over a third of total funds under both the last and the current CSFs went on investment in human resources whereas

2 A notable exception was the significant allocation to fund agricultural headage payments, though that was criticised by successive external evaluations (Fitz Gerald and Keegan, 1993 and Honohan, 1997).

under a quarter was allocated to this role in the other cohesion countries (Figure 6). This decision on priorities by the Irish authorities reflects the national strategy set out in successive *National Development Plans*.

4. The Impact of the Structural Funds

The EU structural fund process has both a direct and an indirect effect on the economy. The expenditure of the EU funds obviously increases demand in the years in which it occurs and, where it is invested, it increases the output potential of the economy in the long term. However, the structural fund process has also had an important impact through encouraging changes in the administrative and political system.

Administrative Change

The increase in funding under the first CSF encouraged the government to raise public investment from its extremely low level in the late 1980s. Without such a stimulus Ireland could have found itself suffering from underinvestment in the face of rapid growth in recent years. As such it had a positive influence on the overall stance of public policy.

The CSF process has also encouraged the introduction of effective long-term planning of public investment. In the past, investment projects stopped and started in line with short-term economic pressures on governments, resulting in significant waste of resources. Now the formulation of a national development plan and its subsequent implementation without major interruption leads to a more rational allocation of resources. In addition, the need to satisfy the donor countries, through the EU Commission, that their money is well spent has resulted in the introduction of a set of evaluation procedures which has helped change the way the administration approaches public expenditure. In the past the only question, once money had been voted by parliament, was whether it had been spent in accordance with regulations. Now there is increasing interest in assessing how effective the expenditure has been. In many cases these evaluations have been published and, while not always listened to, they have had a significant influence on policy.

The programme approach to public investment has also tended to focus attention on particular policy problems, making public servants involved in the planning process consider the wider implications of individual measures. For example, each of the so-called operational programmes under the CSF has its own monitoring committee consisting of relevant public servants, representatives of the EU Commission, some representatives of outside interests and, in the case of the major programmes, an independent evaluator reporting to the committee rather than to the government. While ultimate responsibility for spending decisions really rests with the Irish government, the involvement of the EU Commission officials has helped nudge domestic decision makers towards measures which are desirable on economic criteria. The long-term involvement of key EU officials in the process also helps provide continuity in decision making.

Economic Impact

The CSF funded expenditure affects the economy both through its impact on domestic demand for goods and services and also through the permanent impact on the production capacity of the economy.[3] The initial impact of the CSF on the Irish economy occurs as the funds are spent on buying goods and services. The very substantial volume of expenditure financed by the CSF means that there is a considerable domestic impact. The investment in infrastructure, in particular, is a major determinant of the output of the building sector.

The resulting “demand side” impact persists so long as the expenditure under the CSF itself continues. This initial demand side impact is generally substantially greater than the supply side effect. However, as it only lasts as long as the expenditure continues, the long-term impact on the economy will depend on the increase in productive potential which the CSF funded investment achieves.

There are four main channels through which the CSF impacts on the economy. Three of these channels involve a significant effect on the Irish economy's long-run supply potential: the fourth, income support, is unlikely to have any such lasting impact. Here the economic mechanisms are discussed in turn.

Human Capital. The supply side impact of the human resource investment funded by the EU affects the economy in a number of different ways. Firstly, it increases the productivity of the labour force. Secondly, it improves the labour market participation of certain groups - e.g., women, the long-term unemployed and the disabled. Thirdly, it affects the labour market prospects of new labour force entrants and it has an effect, through migration, on labour supply.

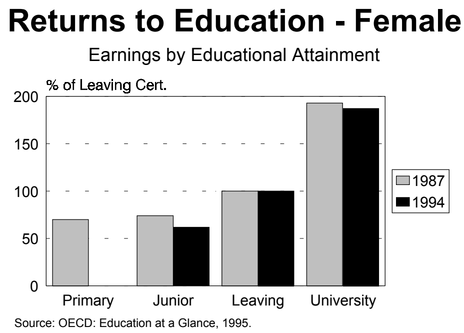
The increase in the average educational attainment of the labour force directly raises productivity. Firms which would have located elsewhere choose Ireland to undertake their business, increasing the employment of skilled labour. Assuming that labour is paid close to its marginal product, the rising share of skilled employment in the economy will result in higher productivity, on average, and higher incomes. In the absence of any change in the demand curve for skilled labour the increase in supply will tend to put downward pressure on skilled wage rates, further enhancing the attractiveness of Ireland as a location for business. If Ireland were faced with a fixed downward sloping demand for skilled labour

---

3 The ESRI Medium Term (MT) Model provides the essential framework within which the subsequent analysis of the impact of the current CSF on the Irish economy is conducted. Successive versions of the model are described in Bradley, Fitz Gerald, Hurley, O’Sullivan and Storey (1993), Bradley and Fitz Gerald, 1990, and Bradley and Fitz Gerald (1991).

the increase in supply would not be fully matched by an increase in skilled employment and this would be reflected in a fall in the average incomes of skilled workers.

Figure 7



In practice, as shown in Figure 7, the returns to education for individuals[4] have not greatly changed over the period of the first CSF in spite of a very big increase in the supply of skilled labour. In fact, recent work by Callan and Harmon (1997), indicates that, when all other factors are controlled for, returns may have actually increased. This indicates that as in much of the developed world since the 1980s, the demand for skilled labour also increased substantially. As a result, the return to the investment in education and training over the period of the first and second CSFs is very high.

The increase in human capital has also affected participation rates of women. Women with better education[5] have a much higher participation rate than those who leave school with minimal or no qualifications. Thus the rise in human capital has resulted in a further increase in the supply of skilled labour. One estimate (Fahey and Fitz Gerald, 1997) suggests that up to a third of the rise in female participation can be attributed to the rising educational attainment of the young female population.

Finally, the unemployment rate for the unqualified is very high. By raising the educational attainment of those who would otherwise have dropped out, the increase in human capital shifts individuals from the ranks of the unemployed into employment. Over the next few years this effect alone is expected to result in a reduction in the unemployment rate of 0.3 percentage points a year (Fitz Gerald, Kearney and Shortall, 1997). The reduction in the burden on the public finances of this fall in unemployment is substantial (Breen and Shortall, 1992) and the gain is enhanced by the increase in output generated by the increase in employment.

---

4 The data in this figure show the ratio of average earnings for women with a third level education, a leaving certificate (completion of high school) a junior certificate, or no qualifications compared to those of women with a leaving certificate. The data for men show a similar pattern.

5 On average, over the last half century, women in Ireland have been slightly better educated than men.

Finally, experience has shown that in recent years those with human capital do not remain unemployed in Ireland; they either get employment or they emigrate. For those who lack a good education the employment prospects outside Ireland are as bleak as they are in Ireland and they remain in Ireland unemployed. By helping shift part of the labour force from the ranks of the unskilled to the ranks of the skilled, the CSF investment is contributing to a reduction in the numbers unemployed in Ireland.

Infrastructural investment takes a number of different forms: increased expenditure on roads and ports; increased investment in sanitary services, increased investment in commercial sectors, such as energy and telecommunications[6]. These investments will first impact on the economy through an increased demand for building services.

It is on the supply side that this infrastructural investment can be expected to have the biggest long-term impact and it is here that the greatest uncertainty arises. Infrastructural investment may have a highly non-linear effect on the economy (there may be increasing returns to scale). For example, the provision of improved roads may have little effect if they merely serve to shift traffic jams from one town to another. However, the completion of the final link on a major artery could have a very big effect on travel times and, thus, on industrial costs.

Within the model the effects of infrastructural investment on the economy is implemented through a change in the cost of production of the industrial sector, a reduction in the cost of production in Ireland increases competitiveness leading to increased output and employment on a long-term basis. The reduction in transport costs will also reduce the costs of imports. However, given the very high level of import penetration in Ireland already, this is unlikely to have a major effect on the volume of imports.

Aids To The Private Sector take on a wide range of forms. Generally assistance is given in the form of a grant or subsidy designed to encourage the private sector to undertake certain investments which are believed to be highly desirable or of strategic importance. These aids take the form of incentives to expand or develop new industries. These measures first impact on the economy when the firms benefiting from the grants or subsidies undertake the desired investment expenditures. The effects of a change in the provision of grants to fund industrial investment and output in the long-term can be quantified within the model through their effects on the cost of capital (see Bradley, Fitz Gerald and Kearney, 1993).

---

6 In line with the recommendations of successive independent evaluations it has been considered appropriate that investment in the energy and telecommunications sectors be financed by consumers paying the appropriate price for their services. There seems no justification (in terms of externalities) for subsidising these sectors through providing cheap capital through EU funding. In the other areas, where it is not possible to charge for the use of the infrastructure or where there are other externalities, the provision of EU funds has been important in ensuring that such “public good” projects are undertaken.

Having quantified the impact on investment behaviour, the MT model provides a good tool for examining the long-term supply side impact of the resulting increase in the productive potential of the economy. The increase in potential supply results in higher exports and employment in the longer-term.

Aggregate Effects. The improvement in the balance of payments and government borrowing requirement, which will arise as by-products of the CSF, must also be taken into account. The increase in growth and employment financed by the CSF will reduce certain aspects of government spending and increase tax revenue through buoyancy effects. The results of these indirect changes are likely, in time, to more than offset the cost to the government of financing part of the CSF expenditure. Depending on how these benefits to the balance of payments and the public sector balances are used, they may add to the growth rate in the medium-term. For example, as assumed in the analysis below, if these indirect benefits are used to repay foreign debt then future debt interest payments will be reduced. The benefits of this investment in debt reduction appears as an increase in GNP (though not in GDP).

Figure 8

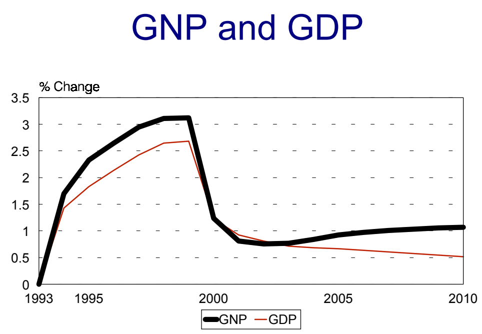


Figure 9

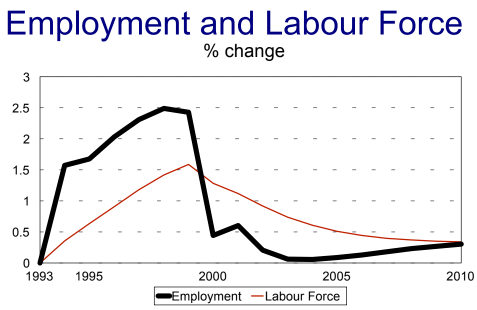


Figure 10

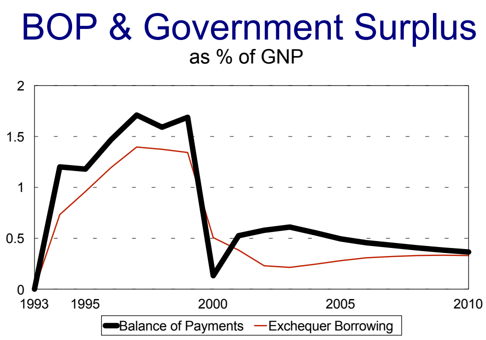
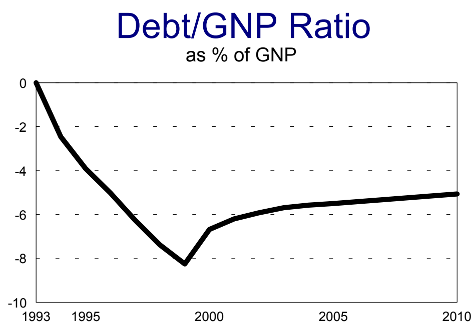


Figure 11



Impact of CSF 1994-1999. This methodology was applied to analysing the impact of the current CSF on the Irish economy in Honohan, 1997. A similar approach was taken in earlier analysis of the first CSF in Bradley *et al.*, 1992, and in Fitz Gerald and Keegan, 1993. Using a similar model, this approach has also been used to examine the impact of the structural funds in Spain and Portugal (Bradley, Herce and Modesto, 1995). In this analysis the impact of the EU expenditure alone is considered.[7] The associated public and private expenditure is assumed to be unchanged by the advent of the CSF. While this is an unduly simplistic assumption it is useful in facilitating exposition. In the publications cited above alternative assumptions were explored.

The best estimate of the impact of the current CSF (1994-1999), using the MT model, is summarised in Figures 8 to 11. (In order to highlight the impact of the current CSF the purely technical assumption is made that there are no further transfers after 1999.) The single most important measure of the achievement of the CSF must be its effects on the level of GNP. As shown in Figure 8, the initial impact of the CSF in the period 1994-99 is much greater than the more permanent effects shown for the period after 1999 (when transfers are assumed to be zero). This reflects the fact that the demand side impact is purely transitory and it fades away rapidly after the CSF is complete in 1999. The supply side impact takes some time to build up but it persists long after the CSF funds are spent.

The cumulative effect of the CSF is to raise GNP by between 2.5 and 3 per cent by 1998-99. When the demand side effects have disappeared (from 2000 onwards) and the supply side effects have built up, the permanent effect of the 1994-99 CSF is to raise the level of GNP by around 1 per cent compared with the level it would have been without the CSF.

The effects on GNP are somewhat greater than on GDP. This reflects the fact that the improvement in the balance of payments and the public finances, accruing from the injection of funds under the CSF, is a substantial benefit to the nation. This results in a reduction in foreign indebtedness. This, in turn, narrows the wedge between GDP and GNP, resulting in the more rapid rise in GNP.

The impact on GNP per head is somewhat lower than the impact on total GNP because of an increase in the population over the period to the year 2010 as a direct result of the CSF; the CSF improves the domestic labour market (Figure 9) reducing emigration or inducing immigration. The net effect of all these factors will leave GNP per head 0.7 per cent higher in the year 2010 than it was in the benchmark. The difference between the effects of the CSF on GNP and GNP per head reflects the problems in using any one measure of national welfare. If one uses GNP per head as the measure of progress this ignores any welfare increase to Ireland accruing to those who can find employment in Ireland rather than abroad.

Because of the exclusion from this set of simulations of the cofunded investment under the CSF the impact on the balance of payments (Figure 10) is particularly striking. For the

7 The MT model is run with and without the expenditure directly funded by the EU. The results of the two simulations are then compared to arrive at the impact of the CSF on the economy.

period of the current CSF it seems likely that the balance of payments surplus is between 1.2 and 1.7 percentage points of GNP above the level it would have been without the CSF. This reflects the fact that, while a substantial part of the initial investment goes on imported capital goods and material inputs, the bulk of the expenditure goes on purchases of domestic goods and services. The EU transfers then exceed the volume of imports generated by the increased investment. After the demand side effects peter out from 1999 onwards, the balance of payments will remain in surplus partly as a result of the increased output capacity and general competitiveness of the productive sector. The capital outflow balancing this surplus builds up foreign assets (or runs down foreign liabilities) and the return on this net foreign investment makes a further contribution to GNP.

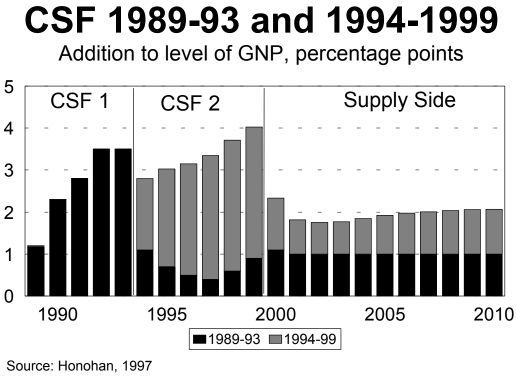
In the years covered by the current CSF, 1994-99, the EU financed expenditure provides a stimulus to the economy and a resulting very substantial improvement in the government borrowing requirement as a percentage of GNP (here shown as an improvement in the government surplus). Between 1997 and 1999 the government surplus (negative borrowing) will be almost 1.5 percentage points of GNP above what it would have been without the CSF. Thereafter, as the demand side effects of the stimulus disappear, the improvement in the government's finances is reduced. However, in the year 2005, due to the permanent supply side benefits of the current CSF investment, it will still amount to around 0.4 per cent of GNP.

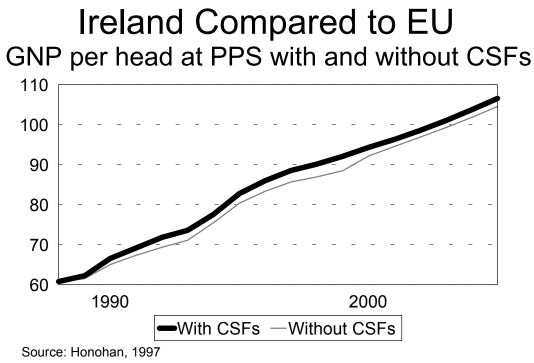
The cumulative impact of the increased growth and lower government borrowing will reduce the debt / GNP ratio by 5 percentage points by the end of the next decade (Figure 11). This will represent a significant contribution towards the achievement of the Maastricht guidelines on the public finances.

The employment effects of the CSF built up to a peak of over 30,000 jobs by 1997 (Figure 9). Much of this increase in employment is due to the demand stimulus financed by the CSF. After 1999, when the demand stimulus falls off, so too will the positive impact on employment. However, by the year 2010 there will still be 5,000 additional jobs as a result of the CSF investment.

Figure 12

Figure 13





Economic Impact of the CSF Process. Figure 12 shows the cumulative impact of the first two CSFs over the period 1989 to 2010. Their combined effect in the period 1995 to 1999 is to raise the level of GNP by between 3% and 4% above the level it would have been without the CSF. The fall in the 1994-95 period reflects a decline in receipts (expressed as a percentage of GNP) in the initial years of the current CSF. The long-run impact of the two CSFs will be to raise the level of GNP by about 2 percentage points above the level it would have been without them.

Figure 13 shows the impact of the two CSFs in promoting convergence in living standards between Ireland and the rest of the EU. The impact is particularly marked in the 1990s when the demand side effects are likely to be at their peak. While the effects will taper off once the demand side impact fades out, it will be, nonetheless, significant at over 2 percentage points of GNP. This does not take full account of the beneficial effects of the CSF on government debt and net foreign indebtedness in the long run. In addition, as discussed in Honohan, 1997, there is some reason to believe that the methodology may understate the full impact of the investment in areas of increasing returns to scale.

4. Lessons from the Irish Experience

There are two sets of lessons from the Irish experience of the structural funds which are of wider interest:

- Lessons concerning the priorities for investment;
- Lessons concerning the structural fund process itself.

The Irish experience of the structural funds has involved a substantial number of studies which evaluated the effectiveness of expenditure funded under the CSF and which considered the appropriate priorities for future expenditure. These studies have generally recommended that investment in human capital should remain a high priority. The investment undertaken in the past in education and training, which was part-funded by the EU, has made an important contribution to Ireland's current economic success. Within this broad area of investment, successive studies have recommended that priority be given to investment affecting those who leave the educational system with limited qualifications. As a result there has already been a refocusing of priorities which is currently having an impact on unemployment.

When looking to the next stage in the structural fund process, as mapped out in *Agenda 2000*, the range of recipient regions will shift to include new entrants in Central Europe. As part of the transition to market systems the public sectors in these economies are undergoing radical change and their educational systems have come under severe pressure. The Irish experience suggests that investment in human capital is vital to promote long-term convergence and that for the new entrants investment in human capital should be an important priority use for their future allocations of structural funds.

In Ireland the second high priority area for future investment is physical infrastructure, especially in transport. As the success of the investment in education is manifest in very high growth rates, the need for increased investment in transport infrastructure becomes more acute. This is reflected in the increased allocation to this area of activity in the current CSF. Whatever happens in the period after 1999 it seems likely that this area will remain a key priority for further public investment well into the next decade.

A lower priority was accorded to investment in aids to the industrial sector. Generally, the advice was that, unless there was clear evidence of market failure, the case for EU assistance to private investment was weak.

Finally, study of the Irish experience suggested that EU funds should not be allocated to fund commercial infrastructural projects where the cost of the investment could be recouped from users. In addition, because of the nature of the CAP regime (restricting output) there was little justification for major EU funded investment in the agricultural and fisheries sectors.

The principle of additionality - that all the EU funds should result in new investment - is central to the structural fund process; the funds should make a difference. However, this approach may be rather simplistic. With the benefit of hind-sight the timing of the major increase in the EU structural fund payments (around 1990) turns out to have been particularly appropriate for Ireland. If the increase had occurred earlier in the 1980s the transfers might have been side-tracked into funding current spending. Instead, by the end of the 1980s, the level of public investment was at an historically low level and, as a result, the increase in structural fund payments helped to lever an increase in infrastructural investment so that in the 1989-93 period there was genuinely an increase in investment.

In the future for Ireland (and this is probably true of the other cohesion countries) the range of projects being undertaken which are eligible for EU funding is now much greater than the volume of funding available. This means that the Irish government and the EU

Commission can effectively negotiate about which projects will have EU funds attributed to them and which will be subject to purely domestic funding. Under these circumstances the issue of additionality is rendered meaningless.

A corollary of the fact that the structural funds need not generate additional physical investment is that they can effectively be used to pay off domestic government debt (by reducing government expenditure on infrastructural investment). This means that the opportunity cost of the funds to the domestic government is identical to that of public funds raised from the domestic tax payer. As a result, if the domestic government is already allocating funds to investment on a rational basis the advent of structural fund receipts should not result in any change in behaviour. In addition if national authorities were optimising in their allocation of their own funds, by insisting on additionality, the EU Commission would be insisting that projects with a rate of return considered unacceptably low by the standards of the national authorities were implemented.

There are three sets of circumstances where the principle of additionality may still be sensible:

- If the objectives of the EU differ from those of the recipient government;
- If the EU has better information on the likely rate of return on investment than the national authorities;
- If investment decisions of the recipient government are sub-optimal in terms of their own objectives;

If none of these conditions are met then the structural funds would achieve the same impact if they were transferred directly to the recipient government and they, in turn, used them to reduce domestic borrowing. However, as argued above the current process may "add value" through helping improve domestic decision making. Given the current structure of decision making it could be desirable in the next CSF, assuming an overall reduction in funding, to spread it thinly over many projects. This would ensure that some of the desirable properties of the current decision making process are maintained. However, this might be achieved more effectively if the explicit condition for the transfer was the development of a suitable administrative process for arriving at domestic investment priorities rather than making it an accidental outcome, as at present.

A possible justification for the current procedure, where individual programmes or projects are explicitly funded by the EU, is that it gives the EU a high public profile. This may be desirable not just to create a good "image" but also to make clear to the electorate in recipient regions the conditional and essentially temporary nature of these transfers.

A distinct issue is the requirement of co-financing from national resources to the extent of 25 per cent or more of each project. By linking EU funding directly with projects, this co-financing requirement is a significant factor in creating confusion among project promoters (including Government Departments) regarding the marginal cost of EU assisted projects. Since the total amount of CSF funding is more or less fixed, the fact that a project is eligible for EU assistance does not reduce the opportunity cost of the funds involved, as there will always be enough projects to exhaust the available funds. There is no doubt that this important point is not understood by many participants in the decision-making process, who see EU funds as free resources.[8] If, as suggested above, the Commission moved over to a straightforward cash transfer then it would be clear that the money was a national resource to be spent as carefully as tax-financed resources.

The proliferation of Community Initiatives[9] in the past has posed problems. In the future (together with the cohesion fund) they should be integrated into the overall planning framework of the CSF. What should be avoided is the emergence of multiple windows of grant assistance leading to the situation where specific promoters of projects either receive multiple grants for essentially the same work, or alternatively get involved in a succession of unsuccessful applications to the different windows.

One aspect of the EU Commission approach to the CSF in Ireland which has posed some problems in the past is the insistence on dealing directly with local development groups. Local democracy in Ireland is weak and the EU insistence on local involvement in decision making has resulted in the establishment of *ad hoc* groups who have power to determine priorities for a small proportion of the transfers. This process has effectively by-passed the existing regional government structure. In the future it is desirable that this approach be modified for the following reasons::

- Accountability. There is a serious danger that the introduction of new untried structures involving *ad hoc* community groups could give rise to problems in this area. Fitz Gerald and Keegan (1993) recommended that the existing local government structure should be used as it is subject ultimately to democratic control and it has safeguards against corruption.

- Appropriate Rate of Return. All schemes which have been approved locally must demonstrate that they are likely to meet the benchmark (national) rate of return.

8 Where the promoter of the funds is a private agent then this incentive argument clearly has some force. Indeed, one might ask if a - say - 50 per cent grant-rate is not often too high to ensure a careful approach to project selection for private recipients.

9 i.e. special EU programmes of grant assistance with criteria of their own.

- Avoidance of Dead-weight. All schemes which have been approved locally must show that they involve minimal dead-weight.[10]
- No Displacement. All schemes approved locally must show that they involve a minimal risk of displacement.[11]

Conclusions

Looking to the future there is general acceptance in Ireland that the current rapid rate of convergence has implications for future CSF funding. However, there is an expectation domestically, fuelled by statements from the EU Commission, that the withdrawal of funding will take place over a transition period. The rapid economic progress currently under way in Ireland means that over the next 10 years Ireland will gradually move from the category of a "poor" region of the EU to being just one of the club. This transformation will occur whether or not the EU expands to include its Central European neighbours .

The seeds of Ireland's success were sown in earlier decades with the freeing of trade, increased investment in human capital, and changes in the demographic structure. The Structural Funds have made a marginal, though important, contribution to this progress. They have helped speed up a process which was already under way but Ireland is not dependent on them to guarantee its future standard of living. If they were to disappear suddenly it would be painful but not fatal. This contrasts with a number of regional economies elsewhere which have become "hooked" on transfers.

How should Ireland approach the likely gradual reduction in EU transfers beginning in 2000? While economic progress is real, Ireland has not fully converged on the EU standard of living and some continuation of the EU transfers will be important in completing the process after 1999. However, all players within Ireland expect that the process of reducing the structural fund transfers to Ireland will begin in 2000.

The bulk of the EU transfers to Ireland under the CSF are going to fund investment in physical and human capital. If this investment is worth undertaking to-day it will be worth undertaking in 2000; the opportunity cost of EU funds is the same as that of taxpayers funds. To obviate the need for disruptive fiscal retrenchment in 2000 it is important that the government move into surplus over the next two years. This would allow the state to replace a gradual reduction of EU funds post-2000 with funding from domestic sources.

The changing circumstances of the Irish economy has wider implications for Irish policy on the EU. The prospect of EU membership for Poland and other Central European countries highlights the problems with the existing CAP and this will force a reform of EU

---

10 The proposed schemes would not be undertaken without the funding from the CSF.

11 They will not result in another enterprise being put out of business elsewhere in the country.

agricultural policy. This could pose more serious problems for Ireland than an orderly winding down of the Structural Funds transfers, given that transfers to Ireland under the CAP are substantially greater than under the CSF.

References

Begg, I. (1997) Reform of the Structural Funds after 1999, forthcoming in *European Planning Studies.*

Bradley, J. (ed.) (1995), *The Two Economies of Ireland: Public Policy, Growth and Employment*, Dublin: Oaktree Press.

Bradley, J., and Fitz Gerald, J. (1990) Production Structures in a Small Open Economy with Mobile and Indigenous Investment, *European Economic Review*, 34, pp. 364-374.

Bradley, J., and Fitz Gerald, J. (1991) The ESRI Medium-Term Economic Model in Bradley, J., Fitz Gerald, J. and McCoy, D. (eds.) *Medium Term Review: 1991-96*, Dublin: The Economic and Social Research Institute.

Bradley, J., Fitz Gerald, J. Honohan, P. and Kearney, I. (1997) Interpreting the Recent Irish Growth Experience in Fitz Gerald, J. Kearney, I. and Shortall, F. (1997) *Medium-Term Review: 1997-2003*, Dublin: The Economic and Social Research Institute, Dublin.

Bradley, J., Fitz Gerald, J., Hurley, D., O'Sullivan, L, and Storey, A. (1993), HERMES: A Macrosectoral Model for the Irish Economy, in Commission of the European Communities (eds.) *HERMES: Harmonised Econometric Research for Modelling Economic Systems,* Amsterdam: North-Holland.

Bradley, J., Fitz Gerald, J., and Kearney, I. (1992) *The Role of the Structural Funds: Analysis of Consequences for Ireland in the Context of 1992*, Policy Research Series No. 13. Dublin: The Economic and Social Research Institute.

Bradley, J., Fitz Gerald, J., and Kearney, I. (1993), Modelling Supply in an Open Economy, *Economic Modelling*, Volume 10, No. 1, January, pp. 11-21.

Bradley, J., O'Donnell, N., Sheridan, N., and Whelan, K. (1995) *Regional Aid and Convergence: Evaluating the Impact of the Structural Funds on the European Periphery*, Aldershot: Avebury.

Bradley, J., Herce, J-A., and Modesto, L. (1995), The Macroeconomics Effects of the CSF 1994-1999 in the EU Periphery. An Analysis Based on the HERMIN Model, *Economic Modelling*, Vol. 12, No. 3, July, pp. 323-334.

Breen, R., and Shortall, S. (1992) The Exchequer Costs of Unemployment Among Unqualified Labour Market Participants, in Bradley, J., Fitz Gerald, J., and Kearney, I.

(1992) (eds.) *The Role of the Structural Funds: Analysis of Consequences for Ireland in the Context of 1992*, Policy Research Series No. 13. Dublin: The Economic and Social Research Institute.

Callan, T., and Harmon, C. (1997) The Economic Returns to Schooling in Ireland, Dublin: University College Dublin, Working Paper WP97/23.

Commission of the European Communities (1996) *First Report on economic and Social Cohesion: 1996.* Luxembourg: Office for Official Publications of the European Communities.

Fahey, T., and Fitz Gerald, J.(1997) The Educational revolution and Demographic Change in Fitz Gerald, J. Kearney, I. and Shortall, F. (eds.) *Medium-Term Review: 1997-2003*, Dublin: The Economic and Social Research Institute, Dublin.

Fitz Gerald, J. Kearney, I. and Shortall, F. (1997) *Medium-Term Review: 1997-2003*, Dublin: The Economic and Social Research Institute, Dublin.

Fitz Gerald J., and Keegan O. (eds.) (1993) *The Community Support Framework 1989-1993: Evaluation and Recommendations for the 1994-1997 Framework*. Report to the Department of Finance by The Economic and Social Research Institute. Dublin: The Stationery Office

Government of Ireland (1989) *National Development Plan, 1989-1993*. Dublin: The Stationery Office

Government of Ireland (1993) *National Development Plan, 1994-1999*. Dublin: The Stationery Office

Honohan, P. (ed.) (1997) *EU Structural Funds in Ireland: A Mid-Term Evaluation of the CSF 1994-99*, Policy Research Series No. 31. Dublin: The Economic and Social Research Institute.

Koman, R. and D. Marin (1997), Human capital and macroeconomic growth: Austria and Germany, 1960-92, London: Centre for Economic Policy Research Discussion Paper No. 1551.

OECD (1995) *Education at a Glance*, Paris: OECD.

Pench, L. (1993) Regional Disparities: the Southern Issue, *European Economy*, Reports and Studies, 1993, No. 1 The Economic and Financial Situation in Italy.