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COMMISSION STAFF WORKING DOCUMENT
Accompanying the document

COMMUNICATION FROM THE COMMISSION

Sixth report on economic, social and territorial cohesion: Investing in Europe's Future

{COM(2014) 473 final}

Chapter 4: Public investment, growth and the crisis

1. INTRODUCTION

The financial and economic crisis which started in 2008 had a dramatic impact on public finance all over Europe. Contraction of economic activity reduced the tax base and hence public revenue at a moment where expenditure was rising as a result of the counter-cyclical measures put in place in the Member States, the rise in unemployment and the support given to the banking system.

This has led to a significant increase in public deficit and public debt in most Member States which triggered a counterbalancing move of the fiscal stance towards consolidation, starting in early 2010. This translated into a reduction in public expenditure in a number of European countries. Growth enhancing public expenditure in areas such as education, R&D, ICT and transport infrastructure has been particularly affected compared to other items of public expenditure.

This has substantial implications for Cohesion Policy, which provides support for national, regional and local authority investment in growth enhancing area. Policy measures financed by Cohesion Policy have to be complementary with those initiated by Member States. Their effectiveness is put at risk if the resources allocated by the Member States to this type of expenditure are not sufficient.

Secondly, in a context where Member States reduce growth-enhancing expenditure, the role of Cohesion Policy becomes critical for financing public investment, which is important for maintaining growth potential and so for creating the conditions for successful and sustainable fiscal consolidation and reduction in debt in the future. The stance of fiscal policy and public finance developments at various levels of government in the Member States are therefore major elements of the context in which Cohesion Policy is operating that determine its capacity to deliver results.

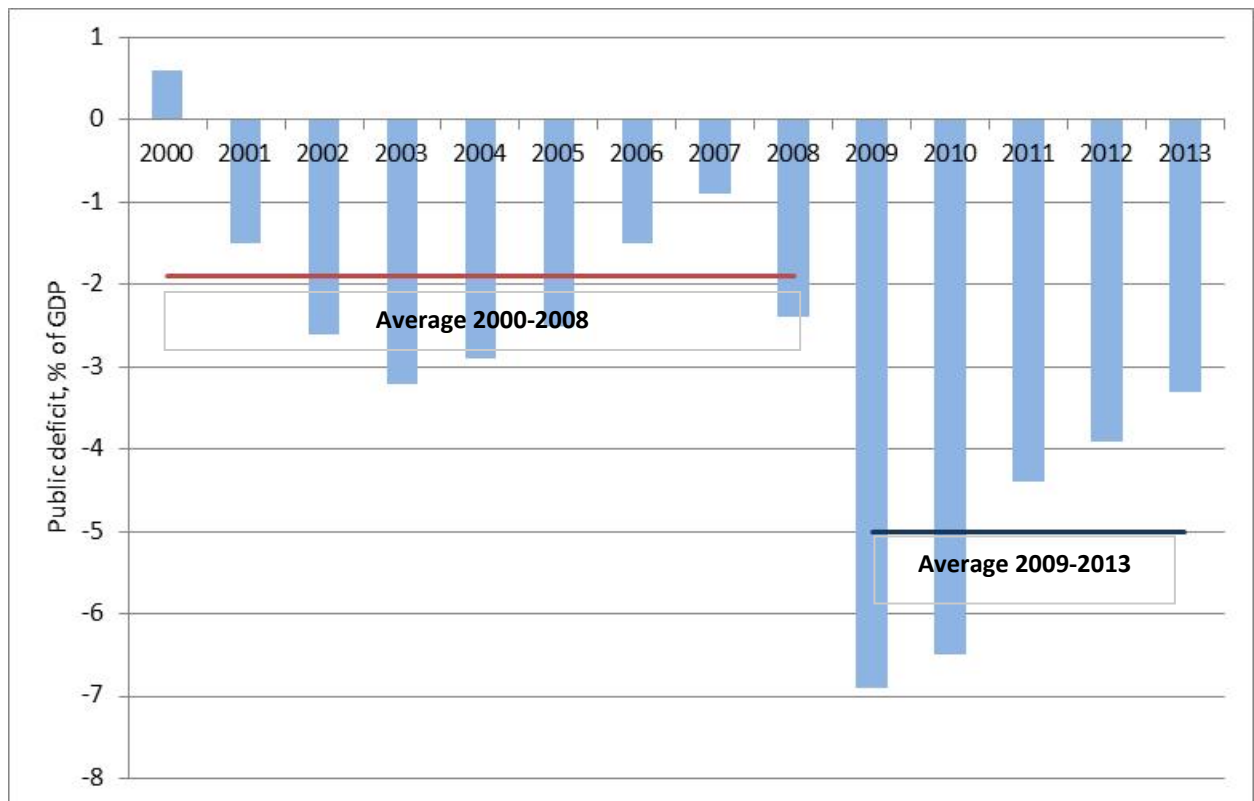
2. THE SHARE OF GROWTH ENHANCING SPENDING IN PUBLIC EXPENDITURE HAS DECREASED

2.1. The crisis pushed up government deficits

Public finances in the EU significantly worsened after the onset of the financial and economic crisis that started in September 2008 (Figure 1). From 2000 to 2008, the public sector balance in the EU-27¹ fluctuated around an average deficit of 1.9% of GDP, with a surplus of 0.6% of GDP in 2000 and a maximum deficit of 3.2% in 2003. Starting in 2008, the average deficit began to increase sharply, reaching 6.9% of GDP in 2009. In 2010, the deficit stabilised at 6.5% of GDP and was then progressively reduced to 4.4% of GDP in 2011, 3.9% in 2012 and 3.3% in 2013, largely because of the fiscal consolidation measures implemented from 2010 on.

¹ Data for Croatia are only available up to 2002.

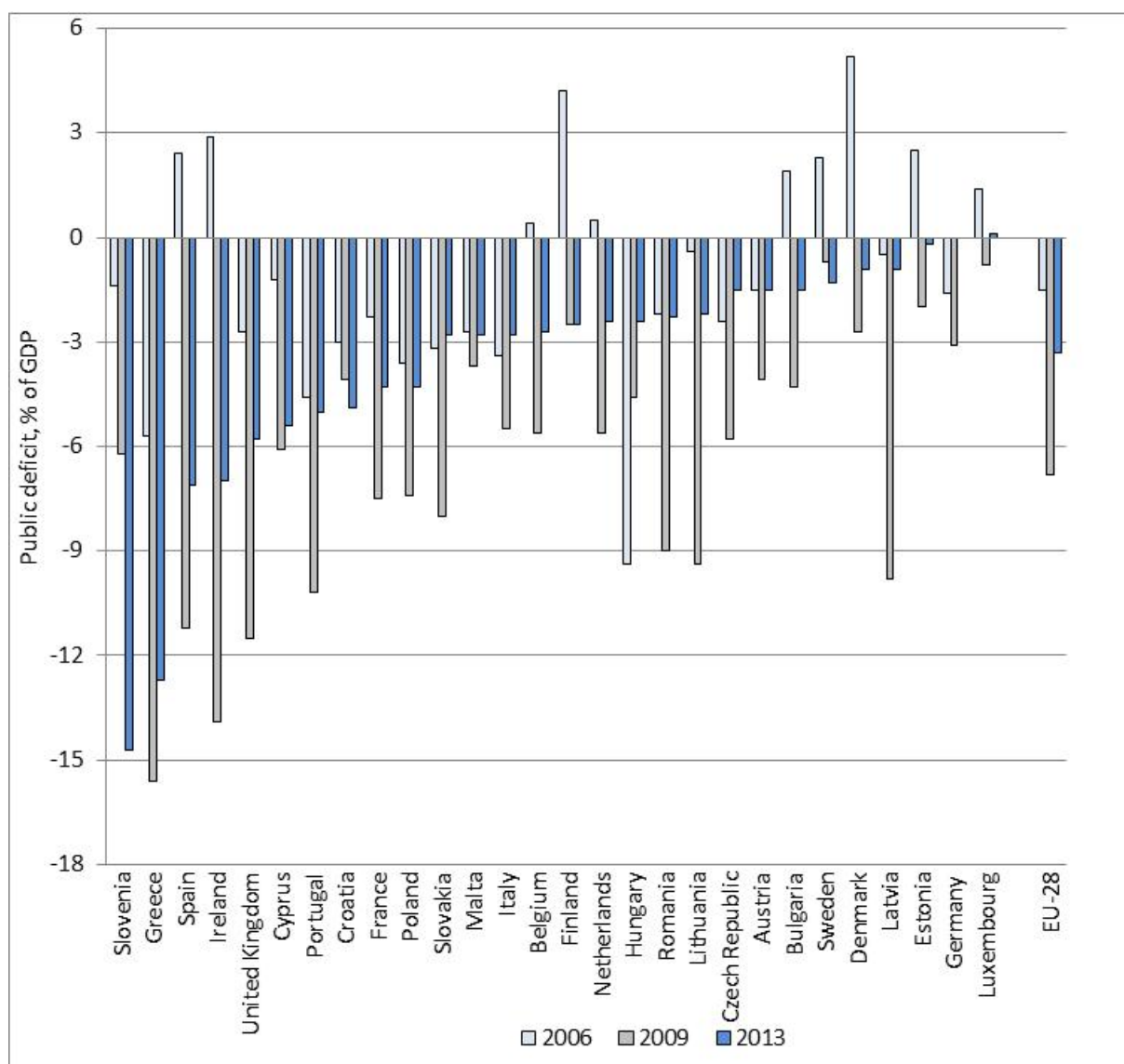
Figure 1 – General government balance, EU-27 average, 2000-2013 (% of GDP)



Source: Eurostat

The same broad pattern is evident in most Member States, though there are considerable variations between them in the scale of the changes. The deterioration in public finance was much more severe in some Member States than in others (Figure 48). In Spain and Ireland, a surplus of 2-3% of GDP in 2006 was transformed into a deficit in 2009 of around 11% in Spain and 14% in Ireland. There was also a dramatic increase in the deficit in Greece, from 5.7% of GDP in 2006 to 15.6% in 2009, as well as in Latvia, from 0.5% of GDP to 9.8% over the same period. In Luxemburg and Sweden, there was only a small change in the balance and in Hungary, where there were serious budgetary problems before the crisis struck, the deficit was reduced by fiscal consolidation measures from 9.4% of GDP in 2006 to 4.6% in 2009.

Figure 2 – General government balance, Member States
(ordered by deficit in 2012), 2006, 2009 and 2013 (as % of GDP)



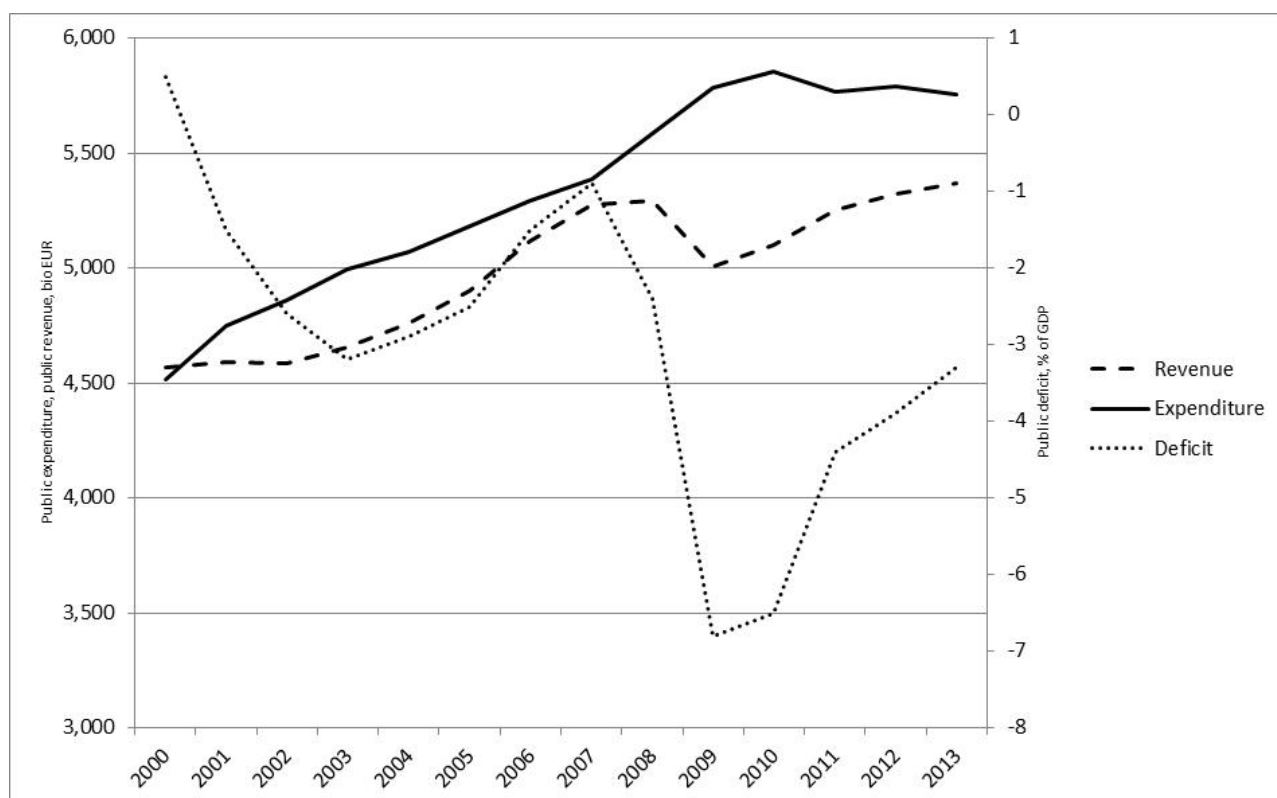
Source: Eurostat

In 2013, the deficit was largest in Slovenia (14.7% of GDP) and Greece (12.7%), followed by Spain (-7.1%) and Ireland (7%), while Luxembourg was in surplus (0.1%) and Germany on balance (0%). The deficit was lower than 1% in Denmark, Latvia and Estonia. The dramatic increase of the public deficit in 2009 was due to a large extent to the sharp decline in Government revenue that followed the reduction in economic activity resulting from the financial crisis and global recession (**Figure 3**). Government revenue in the EU-27 in real terms fell on average by 5.3% in 2009. It then increased in the three subsequent years (by 1.9% in 2010, 2.9% in 2011 and 1.4% in 2012), mostly because of the slight improvement in the economy (which expanded the tax base) together with increases in tax rates as well as measures to improve the collection of taxes in a number of Member States.

Government expenditure in the EU increased steadily in real terms during the years preceding the crisis, rising on average by 2.4% per year between 2000 and 2008. It then increased by 3.6% in 2009 and 1.2% in 2010 before declining by 1.5% in 2011

and then overall stabilising in 2012 and 2013 with nevertheless a slight downward trend. The expansion in 2009 reflects the combined effect of the automatic stabilisers which led to an increase in social transfers resulting from rising unemployment and the policy decisions providing substantial support to banks in difficulties as well as the fiscal stimulus packages put in place at the end of 2008. The subsequent movements reflect the fiscal consolidation programmes, which started to be implemented in 2010.

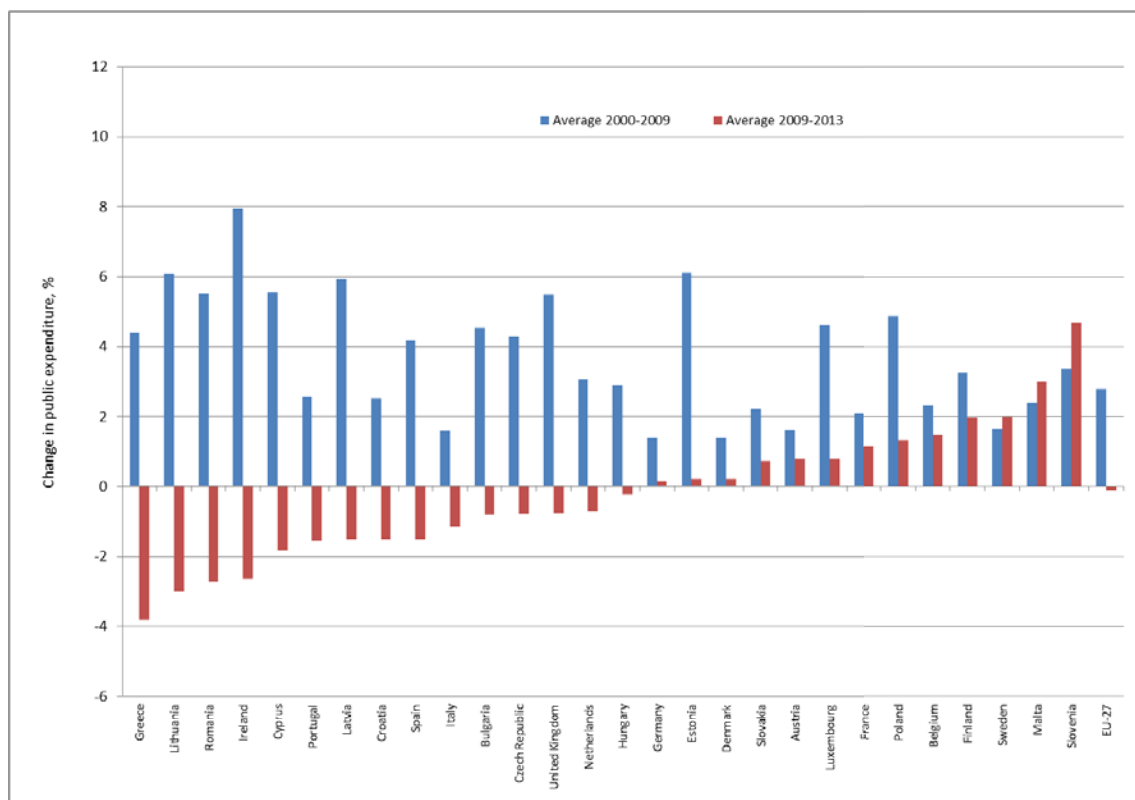
Figure 3 – General government expenditure, revenue (EUR bn, 2005 prices) and general government balance, EU-27, 2000-2013 (% of EU GDP)



Source: Eurostat

The same broad pattern of change applies to the majority of Member States, although there were significant variations between countries in the scale of movements (as highlighted in **Figure 4**). After growing at a moderate rate up to the onset of the crisis in most countries, government expenditure declined in real terms in 15 countries between 2009 and 2013. The decline was particularly pronounced in Greece, Lithuania, Romania and Ireland (where expenditures respectively fell on average by 3.8%, 3.0%, 2.7% and 2.6% a year between 2009 and 2013). In other Member States, public expenditure also declined though at a slower pace, below 2%, reflecting the EU-wide policy of fiscal consolidation. Public expenditure was on an upward trend since 2009 in 13 Member States, in general those where the impact of the crisis was less dramatic.

Figure 4 – Average annual change in general government expenditure, volume, 2000-2009, 2009-2013 (%)



Source: Eurostat. Average 2002-2009 for Croatia.

2.2. Public investment supports economic growth

It is commonly accepted in the economic literature that government expenditure may have an impact on economic activity in the short run and growth in the longer run, though there is no precise relationship between the former and the latter because it depends on a large number of factors. There is an overall consensus, however, that efficient regulation, an effective and a well-functioning public administration, and well-targeted and tailored public expenditure all are essential to the smooth functioning of modern economies by providing essential infrastructure and public services, ensuring the rule of law and enforcing property rights.

Such services include education and support for R&D both of which are important for long-term growth. Both, however, are likely to experience under-expenditure without government intervention since individuals when making their spending decisions will not tend to take account of the wider benefits to society and the economy which such expenditure gives rise to.

Recent research suggests that government expenditure can act as an important stimulus to the economy during a period of recession when the private sector is reluctant to invest and when its impact on economic activity is, accordingly, likely to be greater. It also suggests that it can have significant cross-border effects at such a time, leading to growth being spread through trade linkages across the EU economy, just as the depressing effects of fiscal consolidation can equally be spread from one Member State to others (see Box for a summary of the economic literature on these various effects of government effects).

Box: The economic literature on the effect of government expenditure on growth

There is wide agreement on the essential role of governments in investing in infrastructure and on the positive effect of this on economic growth (see e.g. Gramlich (1994)²). There is equally broad agreement that government intervention is needed to correct the tendency for the private sector to under-invest in education and R&D, because of a failure to take account of the social as well as the private returns. While there is a vast literature linking public support to education with growth, the fact that the links tend to be very long-term makes it difficult to identify them in the data. Nevertheless, the evidence points to a positive impact that expenditure on education has for growth (see Blankenau et al. (2007)³).

Whereas the positive effect of R&D on productivity growth is beyond doubt (see Griliches (1994)⁴), it is more difficult to assess the effect of public support for R&D. This is, first, because of a need to allow for possible ‘deadweight’ effects arising from the fact that the expenditure on R&D might have taken place even without government support (see, for example, Bronzini and Lachini, 2011⁵, who find that subsidies do not alter the behaviour of large firms). Secondly, even if a positive effect is observed, it is difficult to determine whether the resulting increase is compensating for underinvestment as predicted by theory or for other market failures such as difficulties of SMEs accessing finance for R&D. This is still an open question on which there is intensive research.

The impact of public expenditure on economic activity in the short term involves estimating the ‘fiscal multiplier’, as first formalised by Richard Kahn (a student of J.M. Keynes) in 1931, which is defined as the change in output resulting from a given change in government expenditure, taxes or a combination of both. The recent global recession has sparked renewed interest in estimating the size of this multiplier.

Estimates of the multiplier vary over time and between economies and depend on the type of model applied and the assumptions made. In broad terms, the size of the multiplier seems to be affected by factors such as the presence of financial friction, the credibility of the policy action concerned and its permanent or temporary nature, its composition, the presence or absence of market rigidities, the size of automatic stabilisers, the type of monetary policy in force, the degree of openness of the economy and the exchange rate regime (European Commission (2012)⁶).

The many estimates of the fiscal multiplier vary markedly in terms of size. Some estimates put it at less than one (see e.g. Barro (1981), Perotti (2005) and Barro and Redlick (2011))⁷,

² Gramlich E., 1994, *Infrastructure investment: a review essay*, Journal of Economic Literature, 32(3): 1176-96.

³ Blankenau, W.F., Simpson, N.B., and Tomljanovich, M., 2007, *Public Education Expenditures, Taxation, and Growth: Linking Data to Theory*, American Economic Review, 97(2): 393-397.

⁴ Griliches, Z., 1994, *Productivity, R&D, and the data constraint*, American Economic Review, 84(1): 1-23.

⁵ Bronzini, Raffaello and Eleonora Lachini, 2011, *Are incentives for R&D effective? Evidence from a regression discontinuity approach*, Banca d’Italia Working Paper 791.

⁶ European Commission 2012, *Report on Public Finances in the EU*.

⁷ Barro, R.J. , 1981, *Output Effects of Government Purchases*, The Journal of Political Economy: 1086-1121

Barro, R.J. and Ch. J. Redlick, 2011, *Macroeconomic effects from government purchases and taxes*, The Quarterly Journal of Economics 126 (1):51-102

Perotti, R., 2005, *Estimating the effects of fiscal policy in OECD countries*, CEPR Discussion Paper 4842, Centre for Economic Policy Research

others at greater than one (Blanchard and Perotti (2002), Beetsma and Giuliadori (2011) and Ramey (2011)) and even as high as 1.6% (Beetsma, Giuliadori and Klaassen (2008)⁸). Some analysis even point to negative multipliers (see e.g. Giavazzi, Jappelli and Pagano (2000)⁹, Giudice, Turrini and in't Veld (2007)¹⁰ or Di Comite et al. (2012)¹¹)

On the theoretical front, until recently most models were unable to produce multipliers significantly larger than one (see e.g. Aiyagari, Christiano and Eichenbaum (1992), Baxter and King (1993), Ramey and Shapiro (1998) and Cogan et al. (2010¹²)) due to the neo-classical features incorporated in them. Specifically, an expansionary fiscal policy is offset by consumers being assumed to take account of the future taxes they will need to pay to service increased public borrowing and so limiting any increase in their spending. Equally, increased borrowing to finance additional government expenditure is assumed to push up interest rates, so reducing – or ‘crowding out’ – private investment. The multiplier is, therefore, reduced as a consequence.

More recent models, however, suggest that the multiplier in periods of economic downturn may be higher than during periods of growth (as high as 2.5 as against 0.6, according to Auerbach and Gorodnichenko, 2013¹³). This asymmetry arises from certain features of recessions which are embedded in the new models – in particular, households being unable

⁸ Beetsma, R. and M. Giuliadori, 2011, *The effects of government purchases shocks: Review and estimates for the EU*, The Economic Journal 121 (550): F4-F32.

Beetsma, R., M. Giuliadori and F. Klaassen, 2008, *The effects of public spending shocks on trade balances and budget deficits in the European Union*, Journal of the European Economic Association 6(2-3): 414-423.

Blanchard, O. and R. Perotti, 2002, *An empirical characterization of the dynamic effects of changes in government spending and taxes on output*, The Quarterly journal of Economics 117 (4): 1329-1368.

Blanchard, O. and D. Leigh, 2013, *Growth Forecast Errors and Fiscal Multipliers*, IMF Working Paper 13/1, Research Department, International Monetary Fund.

⁹ Giavazzi, F., Jappelli, T. and M. Pagano (2000), "Searching for non-linear effects of fiscal policy: Evidence from industrial and developing countries", European Economic Review, vol. 44(7).

¹⁰ Giudice, G., Turrini, A. and J. in't Veld (2007), "Non-Keynesian Fiscal Adjustments? A Close Look at Expansionary Fiscal Consolidations in the EU", Open Economies Review, vol. 18(5).

¹¹ Di Comite F., Giudice G., Lendvai J. and I. Toming (2012), "Fiscal consolidation in the midst of the crisis", in *EU Balance-of-Payments assistance for Latvia: foundations of success*, European Economy, Occasional Papers 120.

¹² Aiyagari, S. R., L.J. Christiano and M. Eichenbaum, 1992, The output, Employment and interest rate effects of government consumption, Journal of Monetary Economics 30 (1): 73-86.

Baxter, M. and R. G. King, 1993, *Fiscal policy in general equilibrium*, The American Economic Review: 315-334.

Ramey, V. A. and M.D. Shapiro, 1998, Costly capital reallocation and the effects of government spending, in Carnegie-Rochester Conference Series on Public Policy, vol. 48, 145-194.

Cogan, John F, Tobias Cwik, John B Taylor and Volker Wieland, 2010, *New Keynesian versus old Keynesian government spending multipliers*, Journal of Economic Dynamics and Control 34 (3): 281-295.

¹³ Auerbach, A. and Y. Gorodnichenko, 2012a, *Measuring the output responses to fiscal policy*, American Economic Journal, 4(2): 1-27.

Auerbach, A. and Y. Gorodnichenko, 2012b, *Fiscal multipliers in recessions and expansions: Fiscal Policy after the Financial Crisis*, NBER Chapters, National Bureau of Economic Research.

Auerbach, A. and Y. Gorodnichenko, 2013, *Output spillovers from fiscal policy* forthcoming in American Economic Review Papers and Proceedings 103:141-146.

to borrow (Krugman and Eggertsson, 2012¹⁴), downward rigidity of nominal wages and financial friction (or the costs involved in making a transaction) – which tend to increase the multiplier in downturns as compared with periods of expansion.

In addition, particular focus has been put by some authors on the difficulty of reducing interest rates below zero so making monetary policy ineffective. Recent estimates of new-Keynesian models incorporating this feature are that the multiplier in such periods is between 3 and 5 because private investment and consumption are not crowded out by public spending (Christiano, Eichenbaum and Rebelo, 2011, Eggertsson, 2009, Woodford, 2011¹⁵). Accordingly, an increase in government expenditure can have a major effect on economic activity when monetary policy can do little.

Recent research in the European Commission (In 't Veld (2013¹⁶)), moreover, highlights the importance of cross-border spill-over effects through trade linkages from fiscal consolidation which reinforce the negative impact on output.

The greater than expected impact of public expenditure on output during recessions has been corroborated by recent empirical studies (e.g. Corsetti, Meier and Müller (2012), Auerbach and Gorodnichenko (2012a), Baum, Poplaski-Ribeiro and Weber (2012)¹⁷). These conclude that earlier research may well have underestimated the effects of fiscal policy on output in recessions and overestimated it in expansions (Auerbach and Gorodnichenko, 2012b And Blanchard and Leigh, 2013).

This would imply not only that an expansionary fiscal policy was more effective in stimulating growth during a recession than previously thought, but also that fiscal consolidation during such times entails bigger downward pressure on economic activity. At the same time, the effects of consolidation on growth need to be weighed against the importance of restoring sound public finances. As demonstrated by experience, Member States which have accumulated large amounts of debt can be subject to sudden reversals of market sentiment which could turn into outright financial crises if sizeable corrective measures are not taken.

2.3. Public expenditure increased, but now come down

As highlighted above, some categories of public expenditures are considered to be growth-friendly, in the sense that they can increase the rate of growth in the future.

¹⁴ Krugman, P. and G.B. Eggertson, 2012, *Debt, Deleveraging, and the Liquidity Trap: A Fisher-Minsky-Koo Approach*, The Quarterly Journal of Economics (2012) 127 (3): 1469-1513.

¹⁵ Christiano, Lawrence, Martin Eichenbaum and Gersio Rebelo, 2011, *When is the government spending multiplier large?*, Journal of Political Economy 119(1): 78-121

Eggertsson, G. B., 2009, *What fiscal policy is effective at zero interest rates?* Staff Report no. 402 Federal Reserve Bank of New York"

Woodford, M., 2011, *Simple analytics of the government expenditure multiplier*, American Economic Journal: Macroeconomics, 3(1): 1-35

¹⁶ In 't Veld, J. , 2013, *Fiscal consolidations and spillovers in the Euro area periphery and core*, European Economy, Economic Paper no. 506.

¹⁷ Corsetti, G., A. Meier and G. Müller, 2012, *What determines government spending multipliers?*, Economic Policy 27(72): 521–565.

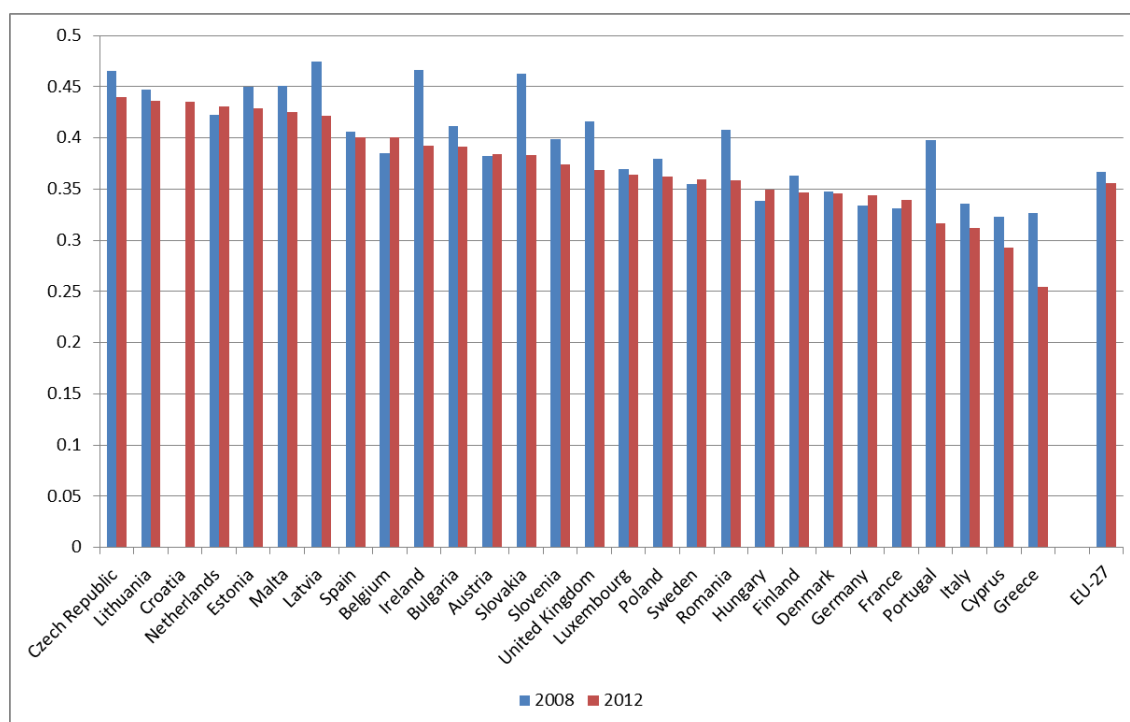
Baum, A., M. Poplaski-Ribeiro and A. Weber, 2012, *Fiscal Multipliers and the State of the Economy*, IMF Working Papers 12/286, International Monetary Fund.

This is the case as regards expenditure on, for example, education, health care, environmental protection, transport, R&D and energy.¹⁸

The deterioration in public finances and the fiscal consolidation measures which began to be implemented at the end of 2010 have resulted in significant changes in the composition of public expenditure in a number of Member States. In particular, growth-friendly expenditure has been cut back disproportionately as part of fiscal consolidation measures¹⁹.

Growth-friendly expenditure as a share of the total decreased in the EU-27²⁰ as a whole between 2008 and 2012, from 36.7% to 35.6% (Figure 5). The drop was particularly severe in Portugal (-8.1 percentage points), Slovakia (-7.9), Ireland (-7.4) and Greece (-7.2). The share increased in only 7 Member States, generally those which were less affected by the crisis and where fiscal consolidation was limited.

Figure 5 – General government expenditure on growth friendly categories (% of total general government expenditure), 2012.



Source: Eurostat.

2.4. Public investment increased and then dropped

The crisis has had a major effect in reducing private sector investment (Figure 6). Public investment (here defined as gross fixed capital formation of General

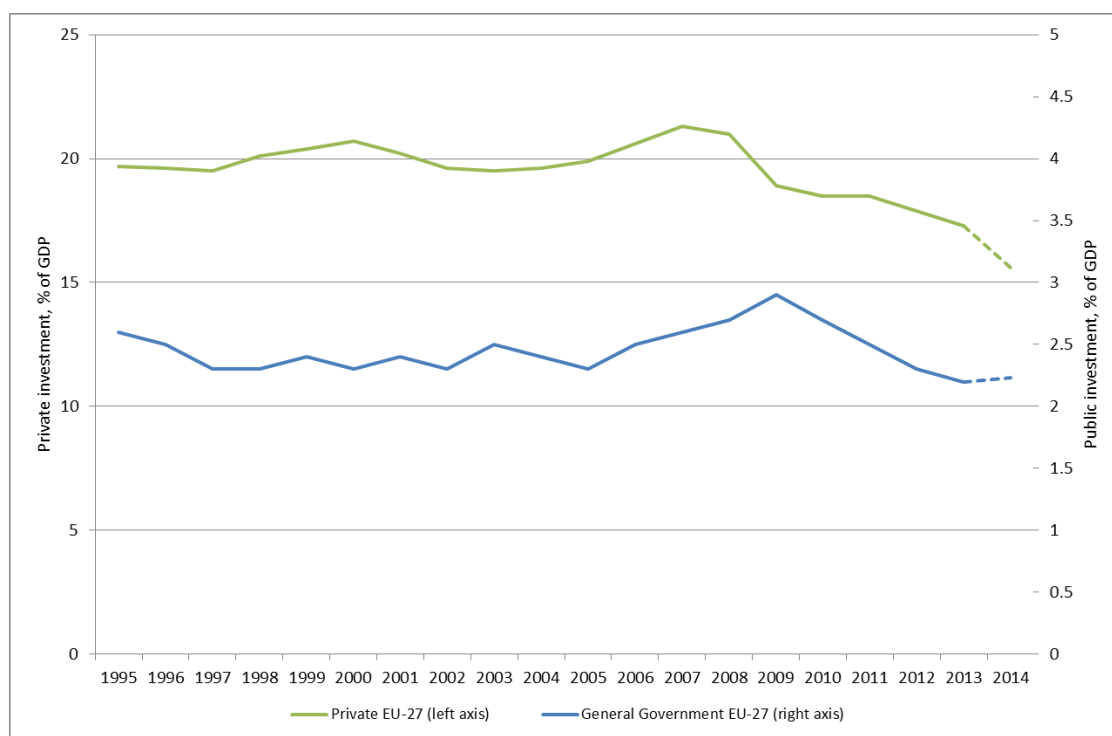
¹⁸ See European Commission, 2012, *The Quality of Public Expenditures in the EU*, Occasional Papers 125, where spending is analysed on the basis of Eurostat data on the Classification Of the Functions Of Government (COFOG), Directorate-General for Economic and Financial Affairs.

¹⁹ For the sake of this analysis, growth friendly expenditure correspond to the following COFOG categories: Economic affairs (which mostly consist of transport and energy), environmental protection, health and education. Note that R&D in those sectors are included.

²⁰ Data is not available for Croatia in 2008.

Government), which had remained fairly stable for a decade, increased significantly between 2007 and 2009, performing a counter-cyclical role by compensating, at least in part, for the decline in private investment. Since 2010, however, public investment has fallen while private investment has continued to decline due to sluggish growth prospects. According to the latest Commission forecasts for 2013 and 2014, investment in the EU-27 will reach historically low levels for General Government (in 2014) having done so in respect of the private sector in 2013.

Figure 6 - Public and private fixed investment, EU-27, 1995-2014
(Gross Fixed Capital Formation as % of GDP)



Source: Eurostat

3. REGIONAL AND LOCAL AUTHORITIES PLAY A KEY ROLE IN PUBLIC EXPENDITURE AND INVESTMENT

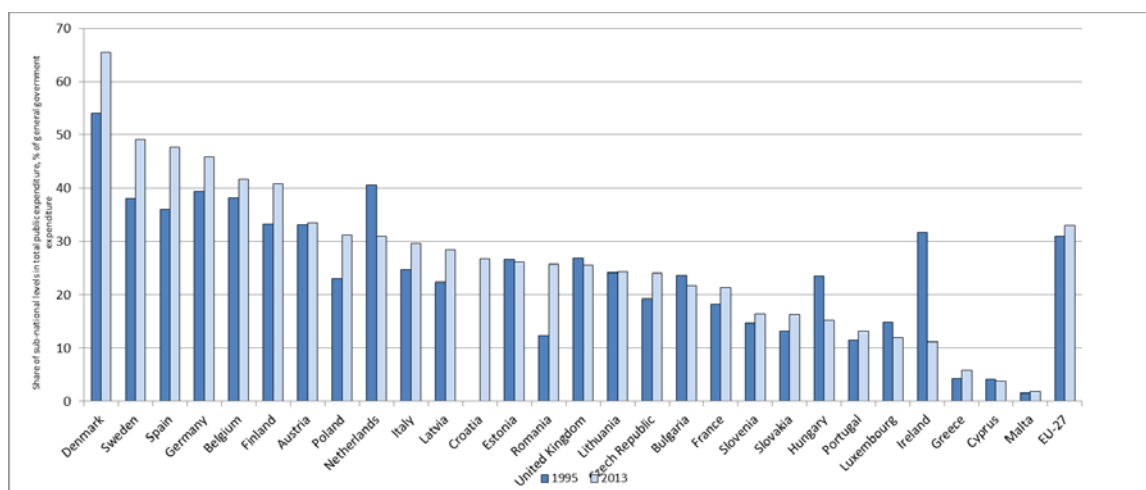
3.1. Regional and local authorities are responsible for a large share of public expenditure

The share of sub-national expenditure in total general government spending has increased in most EU countries over the past few decades as the role of regional and local authorities in delivering public policies has increased. Nevertheless, the share varies considerably between countries, largely reflecting differences in the institutional setting and the degree of decentralisation. Sub-national levels of government tend to be most important in Federal States, like Austria, Belgium and Germany or in countries like Spain and Sweden where there is high degree of decentralisation. It is important to note, however, that responsibility for undertaking

expenditure is not necessarily synonymous with decision-making powers (European Commission, 2012; Governatori and Yim, 2012²¹).

Regions and local authorities are responsible for around 66% of total public expenditure in Denmark and for almost 50% in Sweden and in Spain. In Greece, Cyprus and Malta, they are responsible for less than 6% (Figure 52). Overall in the EU-27²², the share of sub-national authorities increased by 2 percentage points between 1995 and 2013, with much bigger increases in Spain, Romania, Denmark and Sweden, and significant reductions in Ireland and the Netherlands.

Figure 7 - Sub-national governments expenditure in general government expenditure, EU-27, 1995 and 2013 (% of general government expenditure)



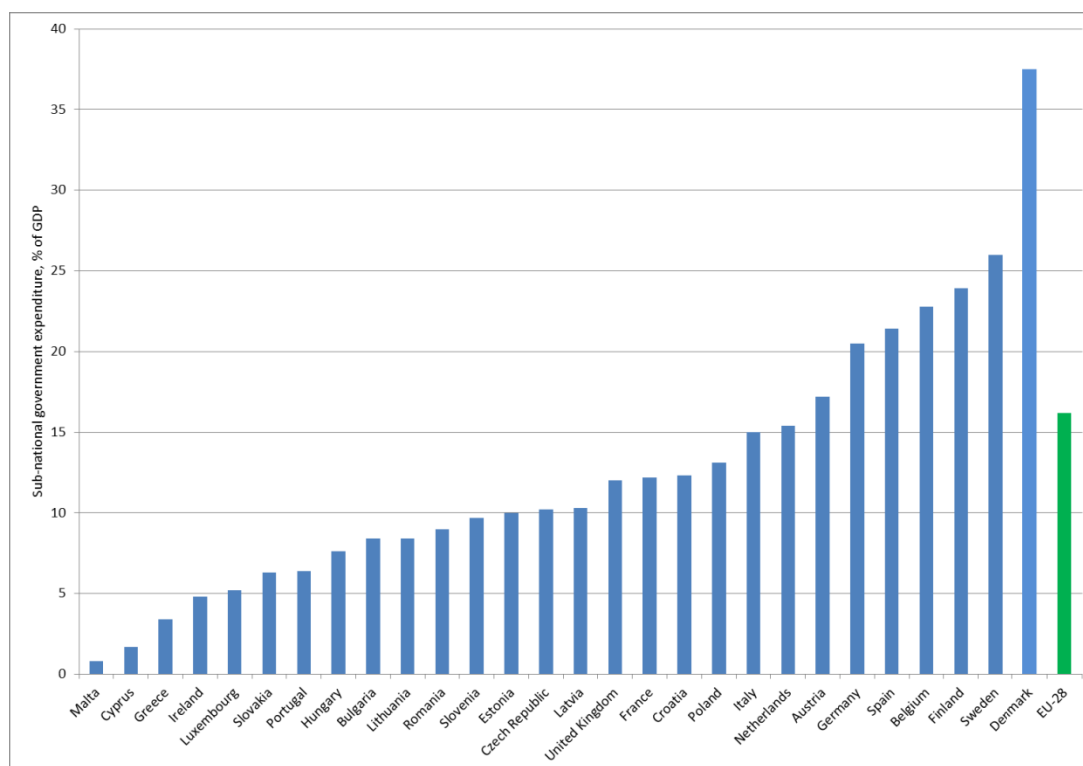
Source: Eurostat.

In relation to GDP, sub-national government spending averaged 16% in the EU-28 in 2013, ranging from less than 1% in Malta to almost 38% in Denmark (Figure 8).

²¹ European Commission, 2012, *Report on Public Finances in EMU 2012 – Part IV: Fiscal decentralisation in the EU – main characteristics and implications for fiscal outcomes*, European Economy 4/2012, Brussels. See http://ec.europa.eu/economy_finance/publications/european_economy/2012/pdf/ee-2012-4.pdf. Governatori, M. and D. Yim, (2012), Fiscal Decentralisation and Fiscal Outcomes, *European Economy, Economic Papers 468 / November 2012*, Brussels. See http://ec.europa.eu/economy_finance/publications/economic_paper/2012/pdf/ecp468_en.pdf.

²² Data for Croatia in 1995 is not available.

Figure 8 - Sub-national government expenditure, 2013 (% of GDP)



Source: Eurostat

Types of expenditure carried out by sub-national levels.

The expenditure of sub-national authorities is concentrated in particular areas, most especially in education, social services and housing, but also in healthcare, transport and communications²³ (Table 1). There are, however, large variations between Member States, reflecting the degree of decentralisation, the peculiarities of federal systems and the particular responsibilities entrusted to sub-national authorities.

In some countries, Denmark in particular, a large share of sub-national expenditure goes on social services, while in others, this is much less the case, such as in Italy, where the share is only 5% and where instead much more goes on healthcare.

²³ Transport and communications are included as part of ‘Economic affairs’ in the COFOG classification of expenditure, which also includes support to enterprises.

Table 1 - Sub-national governments expenditure by function, 2013
(% of total Sub-national governments expenditure)

	Social protection	Education	General public services	Health	Economic affairs (including transport)	Housing and community amenities	Recreation, culture and religion	Public order and safety	Environment protection
Belgium	20%	32%	17%	1%	15%	2%	6%	4%	3%
Bulgaria	8%	32%	10%	9%	12%	14%	5%	1%	9%
Czech Repub	6%	32%	13%	3%	22%	4%	8%	2%	10%
Denmark	55%	10%	4%	22%	4%	1%	2%	0%	1%
Germany (un	25%	22%	23%	2%	12%	2%	4%	7%	2%
Estonia	8%	35%	8%	18%	13%	7%	8%	0%	3%
Ireland	19%	23%	6%	0%	20%	13%	5%	3%	11%
Greece	19%	2%	35%	0%	17%	4%	7%	1%	16%
Spain	7%	18%	28%	24%	10%	2%	4%	4%	3%
France	18%	15%	16%	1%	13%	15%	10%	3%	8%
Croatia	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Italy	5%	7%	14%	48%	13%	4%	2%	2%	5%
Cyprus	0%	0%	43%	0%	0%	27%	16%	0%	14%
Latvia	11%	37%	9%	9%	12%	11%	7%	2%	2%
Lithuania	14%	34%	7%	18%	9%	3%	4%	4%	8%
Luxembourg	7%	15%	24%	0%	15%	9%	13%	2%	15%
Hungary	13%	29%	21%	8%	12%	6%	6%	0%	5%
Malta	0%	0%	59%	0%	10%	0%	4%	4%	23%
Netherlands	15%	29%	8%	2%	17%	3%	9%	7%	10%
Austria	20%	19%	15%	22%	13%	3%	4%	1%	2%
Poland	13%	29%	11%	14%	16%	5%	7%	2%	3%
Portugal	7%	12%	32%	6%	17%	8%	10%	1%	7%
Romania	15%	20%	10%	13%	18%	10%	7%	1%	6%
Slovenia	11%	37%	10%	11%	11%	5%	9%	1%	5%
Slovakia	8%	40%	14%	0%	15%	8%	6%	1%	8%
Finland	25%	17%	14%	30%	7%	1%	4%	1%	0%
Sweden	27%	21%	12%	27%	6%	3%	3%	1%	1%
United Kingd	30%	27%	9%	0%	7%	11%	3%	9%	4%
EU-27	20%	20%	17%	13%	11%	5%	5%	5%	4%

Source: Eurostat. Expenditure of local and state levels are not consolidated.

The overall expenditure of sub-national authorities is higher than that of central governments on many public services, such as education, cultural activities, water supply, public lighting and other community amenities and environmental protection (Table 2). In some Member States, public expenditure in these areas is almost entirely carried out by sub-national levels of government, though in many cases financed nationally through transfers from central government, which are often earmarked for these services²⁴. This, for example, is the case for housing in Belgium, Estonia, Latvia, Lithuania and Spain and environmental protection in Spain, Greece and Cyprus. Expenditure at the subnational level on education is particularly high in Spain and Germany, on healthcare in Denmark, Spain, Sweden, Italy and Finland, and on economic affairs in Spain, Germany, Belgium and Italy. Apart from Denmark, social protection, however, remains largely centralised in Member States.

²⁴ For example, healthcare in Denmark or Sweden. Note that earmarked transfers are not the general norm and often co-exist with general transfers.

Table 2 - Sub-national governments expenditure by economic sector, 2013
(% of total general government expenditure)

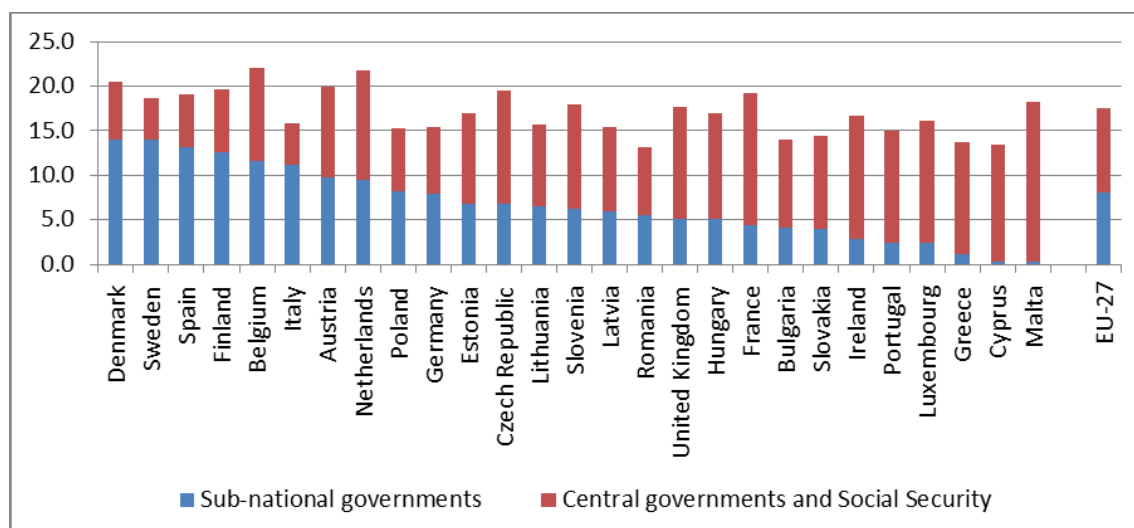
	Social protection	Education	General public services	Health	Economic affairs (including transport)	Housing and community amenities	Public order and safety	Recreation, culture and religion	Environment protection
Belgium	22%	83%	15%	3%	47%	100%	46%	94%	87%
Bulgaria	4%	62%	4%	10%	15%	91%	4%	42%	84%
Czech Republic	4%	48%	25%	3%	40%	59%	11%	30%	69%
Denmark	54%	46%	7%	98%	42%	60%	9%	49%	56%
Germany (un)	21%	95%	55%	7%	59%	82%	90%	93%	76%
Estonia	6%	53%	15%	23%	27%	97%	1%	44%	33%
Ireland	5%	19%	5%	0%	25%	67%	10%	33%	62%
Greece	3%	1%	4%	0%	17%	57%	1%	37%	90%
Spain	9%	96%	36%	94%	30%	97%	45%	82%	95%
France	8%	28%	24%	1%	39%	88%	20%	77%	87%
Croatia	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Italy	3%	24%	17%	78%	45%	64%	12%	49%	86%
Cyprus	0%	0%	7%	0%	0%	16%	0%	28%	91%
Latvia	9%	52%	19%	21%	21%	92%	9%	50%	17%
Lithuania	11%	58%	7%	20%	27%	97%	19%	44%	80%
Luxembourg	1%	15%	18%	0%	19%	43%	10%	37%	63%
Hungary	7%	45%	17%	8%	16%	58%	2%	30%	56%
Malta	0%	0%	7%	0%	1%	0%	2%	4%	13%
Netherlands	12%	49%	13%	3%	43%	84%	37%	80%	91%
Austria	13%	48%	36%	37%	37%	74%	14%	69%	71%
Poland	8%	48%	21%	28%	42%	77%	15%	78%	78%
Portugal	2%	12%	11%	6%	36%	86%	3%	63%	87%
Romania	10%	64%	13%	26%	16%	78%	5%	70%	64%
Slovenia	5%	41%	16%	10%	27%	60%	7%	44%	63%
Slovakia	3%	48%	14%	0%	23%	69%	3%	38%	55%
Finland	19%	50%	37%	61%	32%	53%	18%	65%	29%
Sweden	27%	74%	28%	84%	35%	89%	15%	70%	57%
United Kingdom	20%	42%	17%	0%	26%	39%	40%	44%	57%

Source: Eurostat. Expenditure of local and state levels are not consolidated.

Sub-national levels of government are responsible for a large share of growth-enhancing expenditure, as defined above (on education, healthcare, environmental protection, transport, R&D and energy). Overall, in 2011, they carried out over 46% of such expenditure in the EU-27, this accounting for 38% of their total spending.

The sub-national responsibility for the expenditure concerned, however, varies markedly between countries (Figure 9). On average, sub-national government spending amounted to around 8% of GDP in the EU-27 in 2012 but as much as 14% of GDP in Sweden and Denmark and as little as 0.3% in Cyprus and Malta. In eight Member States, sub-national governments were responsible for more than 50% of the growth-enhancing expenditure of General Government, the figures being highest in Sweden, Italy, Spain, Denmark and Finland.

Figure 9 - Growth Enhancing Expenditure, 2012 (% of national GDP)



Source: Eurostat

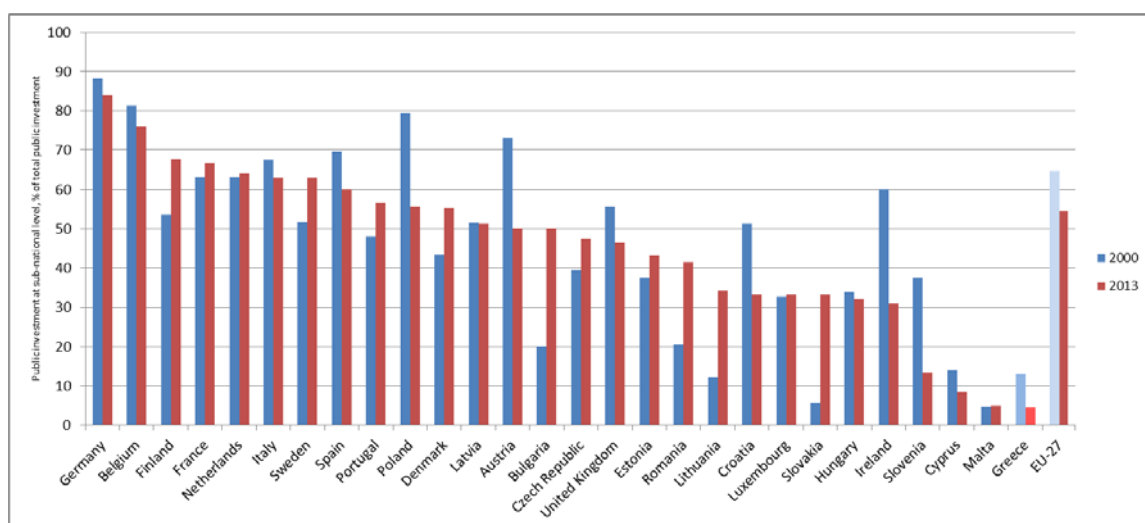
3.2. Regional and local authorities manage the majority of public investments

Sub-national governments contribute significantly to public investment²⁵. In 2013, around 55% of total public investment in the EU-28 was carried out by sub-national authorities (Figure 10). The share was particularly large in Germany, Belgium, Finland and France (over 65%). There are only a few Member States – Greece, Cyprus and Malta, especially – where sub-national governments account for only a minor share of public investment. These are generally countries where sub-national authorities are responsible for a very small share of total public expenditure.

Nevertheless, the share of sub-national authorities in public investment has declined since 2000 in 14 Member States, most especially in Ireland where it fell from 60% to 21% in 2013. As shown in the next section, this is to a large extent a consequence of fiscal consolidation measures implemented in response to the financial and economic crisis.

²⁵ Defined as the sum of Gross Fixed Capital Formation of the General Government and capital transfers paid by the public sector.

Figure 10 - Sub-national governments investment, 2000 and 2013
(% of total public investment)



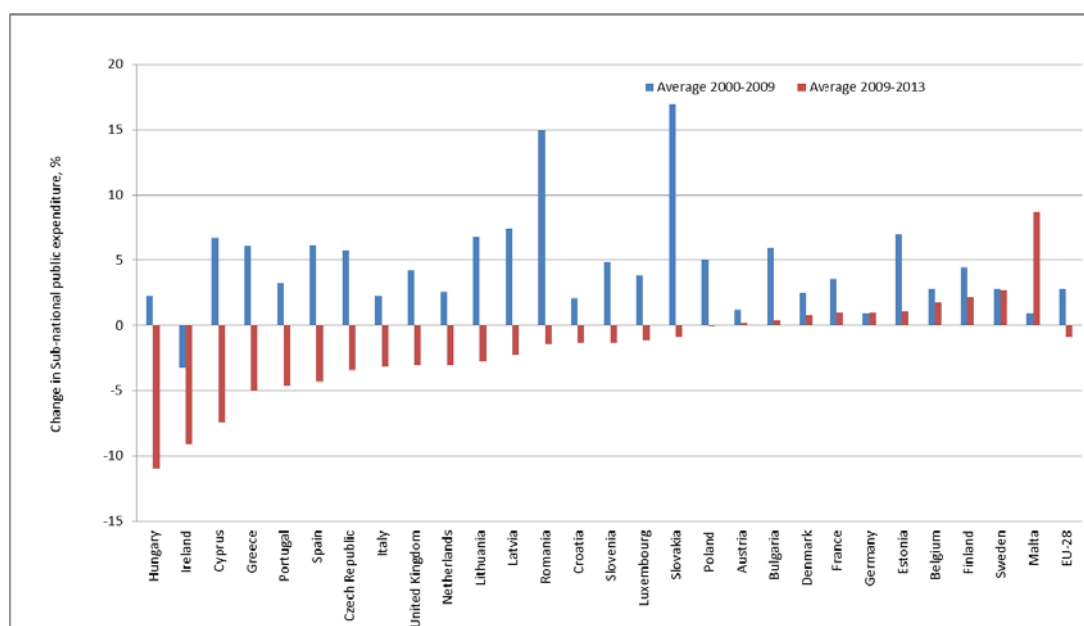
Source: Eurostat

3.3. The crisis ended a period of sustained growth of public expenditure by regional and local authorities

From 2000 up until 2009, public expenditure at the subnational level in the EU fluctuated around an average of just under 16% of GDP. In real terms, it grew at an average rate of 2.8% a year. In 2009, it increased by 3.4%, partly as a result of the fiscal stimulus package as well as the additional demands on social services. Fiscal consolidation measures implemented from 2010 on brought growth to an end, expenditure remaining unchanged in 2010 and then declining by 0.5% in 2011, 0.8% in 2012 and 2.2% in 2013.

A similar pattern of change is evident in most Member States. Except in Malta and Germany, growth in public expenditure at sub-national levels has been cut back in all countries (Figure 11), in a number of them – such as Hungary and Ireland, where it declined by 11% a year and 9% a year between 2010 and 2013 – substantially so.

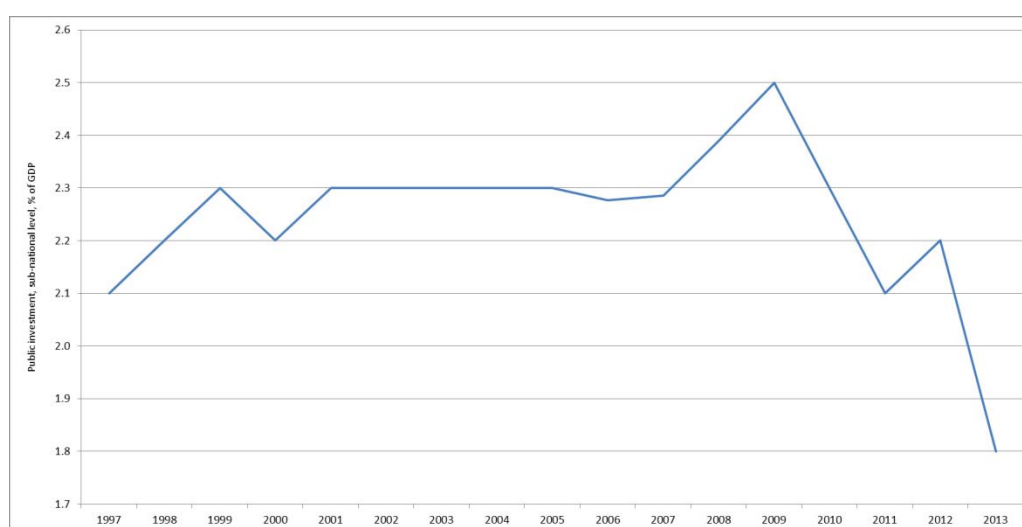
Figure 11 - Average annual change in sub-national government expenditure, volume, 2000-2009, 2010-2013 (%)



Source: Eurostat, Average 2002-2009 for Croatia.

The capacity of sub-national authorities to contribute to public investment in particular has been significantly affected by the fiscal consolidation packages implemented across the EU. Public investment at sub-national levels in the EU-27²⁶ increased steadily from the mid-1990s on to stabilise at around 2.3% of GDP between 2002 and 2007 (Figure 12). It then rose to 2.5% in 2009, partly as a result of stimulus measures. From 2010, when fiscal consolidation measures began to be introduced, to 2013, it declined sharply to 1.8% of GDP, much lower than the level observed in 1997. In real terms, sub-national public investment in the EU fell by 7.2% in 2010, 5.9% in 2011, 3.3% in 2012 and 8.6% in 2013.

Figure 12 - Sub-national government investment, EU-27, 1997-2013 (% of GDP)

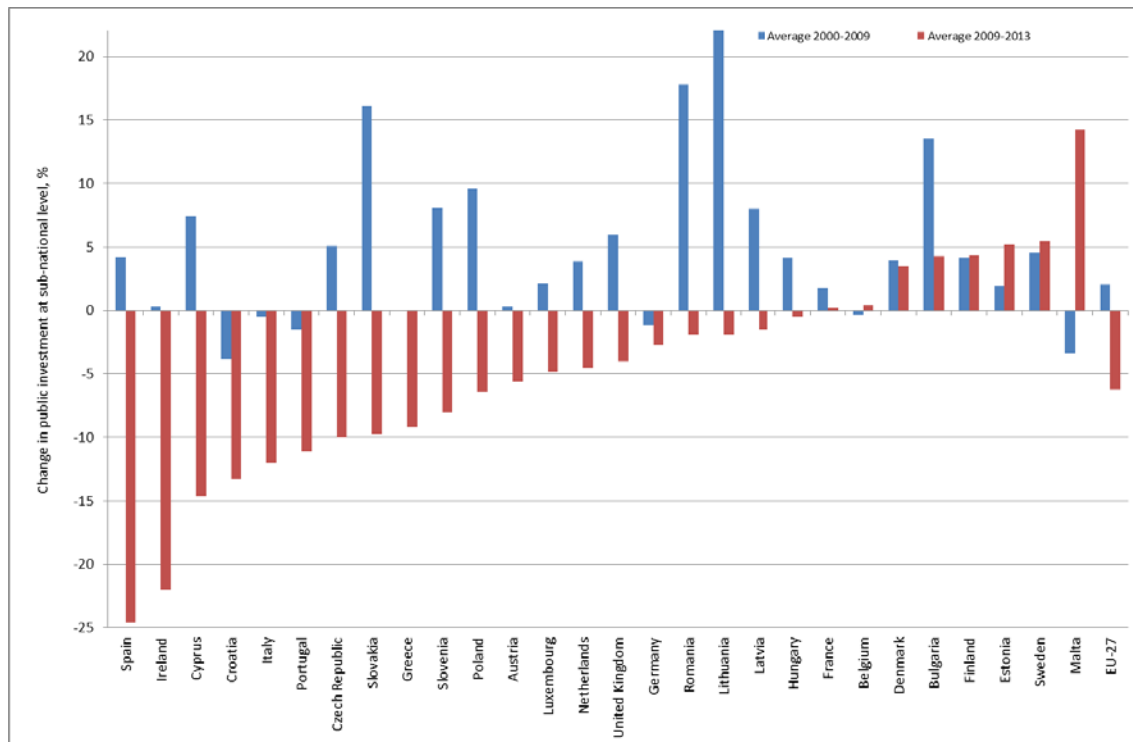


Source: Eurostat.

²⁶ Data for Croatia is only available from 2002.

Between 2009 and 2013, public investment at the sub-national level declined in real terms in 20 Member States. In most of the others, it continued to grow though at a slower pace. Growth was higher than before the crisis only in Belgium, Finland, Estonia, Sweden and Malta (Figure 13). The turnaround was most striking in Spain, where sub-national public investment increased by more than 4% a year in real terms between 2000 and 2009 and then declined by more than 22% a year between 2009 and 2013. It also fell significantly in Ireland (by 18% a year), Cyprus, (16%), Slovakia (13%) and Portugal (12%).

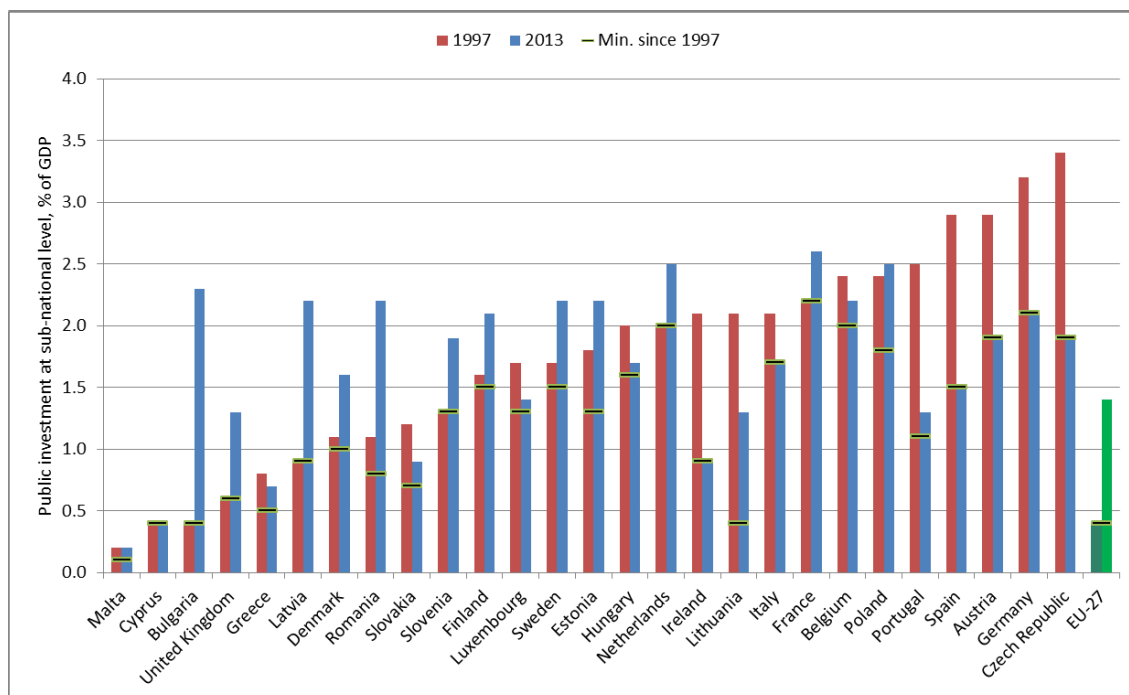
Figure 13 – Average annual change in sub-national government investment, volume, 2000-2009, 2010-2013 (%)



Source: Eurostat. Average 2002-2009 for Croatia.

These reductions imply that in 2013 public investment was lower relative to GDP than at any time since 1997 in seven countries of the EU-27, most notably in Spain (where it fell from 4.3% of GDP in 2009 to 1.5% in 2013) and Ireland (where it declined from 3.5% of GDP in 2008 to 0.9% in 2013).

Figure 14 - Sub-national governments' investment, 1997, 2013 and historical lows (% of national GDP)

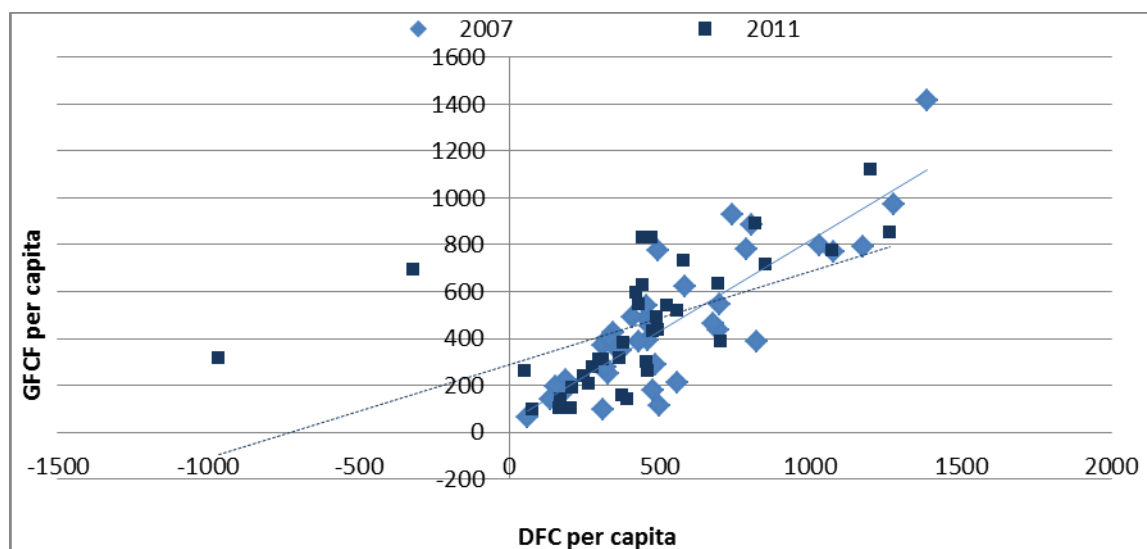


Source: Eurostat. Data not available for Croatia in 1997.

3.4. Investing during times of crisis: direct financing and regional and local investment

As indicated above, sub-national public investment has been severely affected by the crisis and the fiscal consolidation measures implemented in response to it. A study carried out by OECD (with a contribution from the European Commission) found that the OECD countries that faced the most serious economic difficulties over the period 2007-2011 saw the largest reductions in sub-national investment. A new indicator of direct-financing capacity, designed to measure the funds available to sub-national governments to finance investment without going into debt, shows that their capacity declined significantly over this period. As shown by Figure 61, capacity is closely correlated with spending on investment, which indicates that sub-national governments that generate the fiscal capacity to spend on investment tend to do so.

Figure 15: Sub-national direct financing capacity and public investment



Source: OECD.

Analysis of recent trends in sub-national finances shows that these were reduced significantly by the crisis. Expenditure on social services and transfers to companies, however, were maintained and even increased in some cases, so reducing the ‘fiscal space’ left for public investment.

Sub-national authorities were also faced by a worsening of borrowing conditions. The introduction of rules governing their borrowing or a tightening of those already in place which occurred in many OECD countries as part of fiscal consolidation measures further reduced their capacity to invest.

The OECD has highlighted the likelihood that this capacity will continue to be restricted over the medium-to-long term. In such a context, the institutional setting is likely to play an important role as regards both revenue (the income likely to be generated by local taxes) and expenditure (their spending responsibilities). In most OECD countries, demographic trends are likely to generate fiscal pressure on sub-national governments responsible for spending on healthcare and social services.

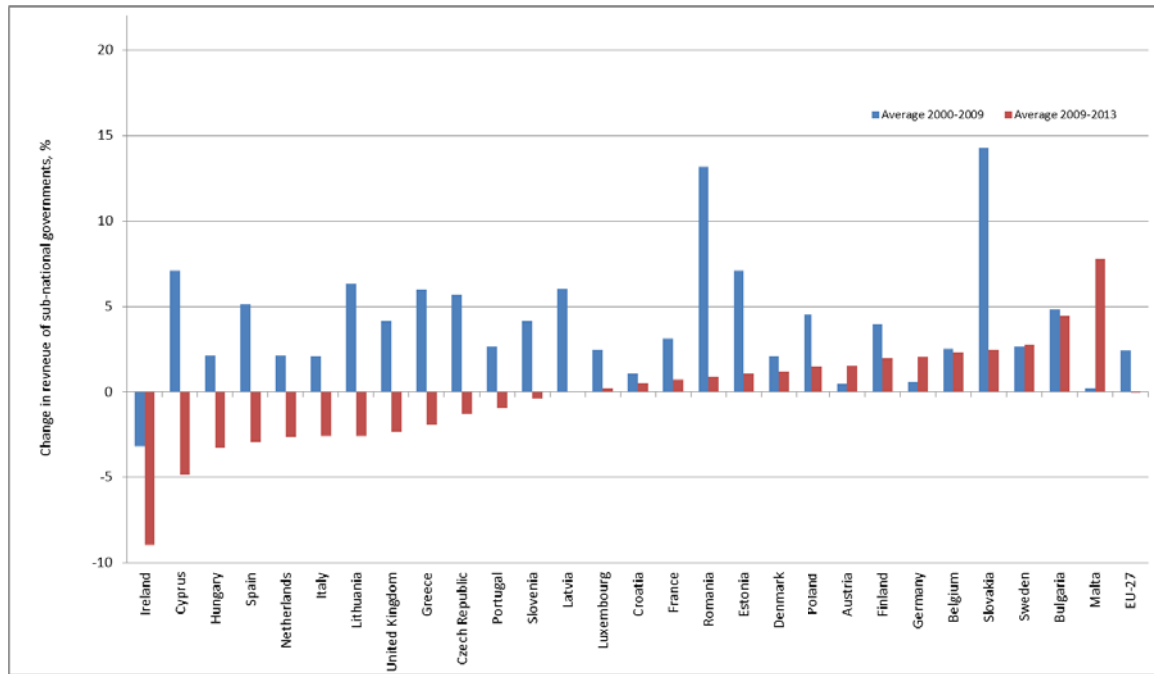
Central governments are well aware of future challenges likely to be faced by sub-national authorities and have introduced measures to control their revenue and debt levels in a number of countries. In several countries too, governments are seeking to gain economies of scale in public service provision by merging local authorities or establishing more co-operation between them. However, in countries where sub-national governments have major responsibility for expenditures in areas where pressure is likely to increase, further efforts will be needed to maintain their ability to provide high-quality services in the medium-to-long term.

3.5. Revenue at sub-national level relies primarily on transfers

Revenue of sub-national governments in the EU has been significantly affected by the crisis. While their revenue increased relatively consistently at a rate of around 2.5% a year in real terms on average between 2000 and 2009, it decreased by 0.1% a year between 2009 and 2013.

Over these four years, sub-national government revenue declined in 12 Member States (Figure 16). The fall was particularly large in Ireland, Cyprus, Hungary and Spain. In the other countries, revenue continued to grow but at a much slower pace than before the crisis. The only exceptions are Austria, Germany, Sweden and Malta where the growth of revenue was higher after 2009 than before.

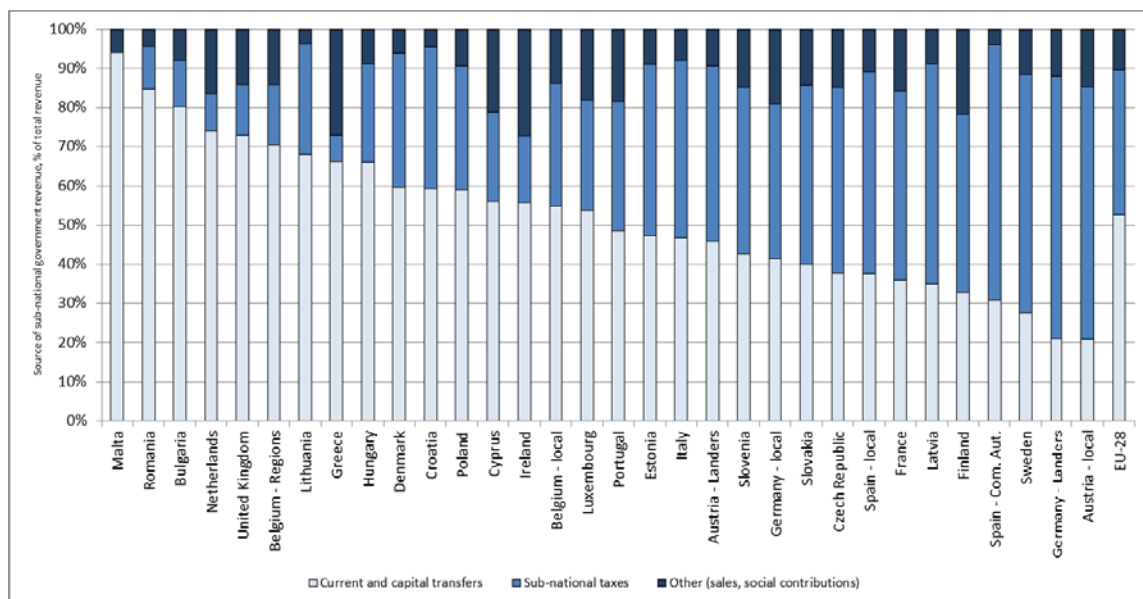
Figure 16 – Annual average change in sub-national government revenue in real terms, 2000-2009, 2009-2013 (%)



Source: Eurostat. Average 2002-2009 for Croatia.

The causes of these changes in sub-national government revenue differ between countries, depending on the sources of revenue. The main sources across the EU are current and capital transfers from central government. This is especially the case in Malta, Romania, Bulgaria and the Netherlands. In Germany, Austria, Spain and Sweden, in contrast, it is local taxes, reflecting the much greater degree of autonomy of sub-national authorities in the latter than the former. Transfers also provide a means of maintaining central government control over local expenditure.

Figure 17 - Sources of sub-national government revenue, 2013 (% of total revenue)

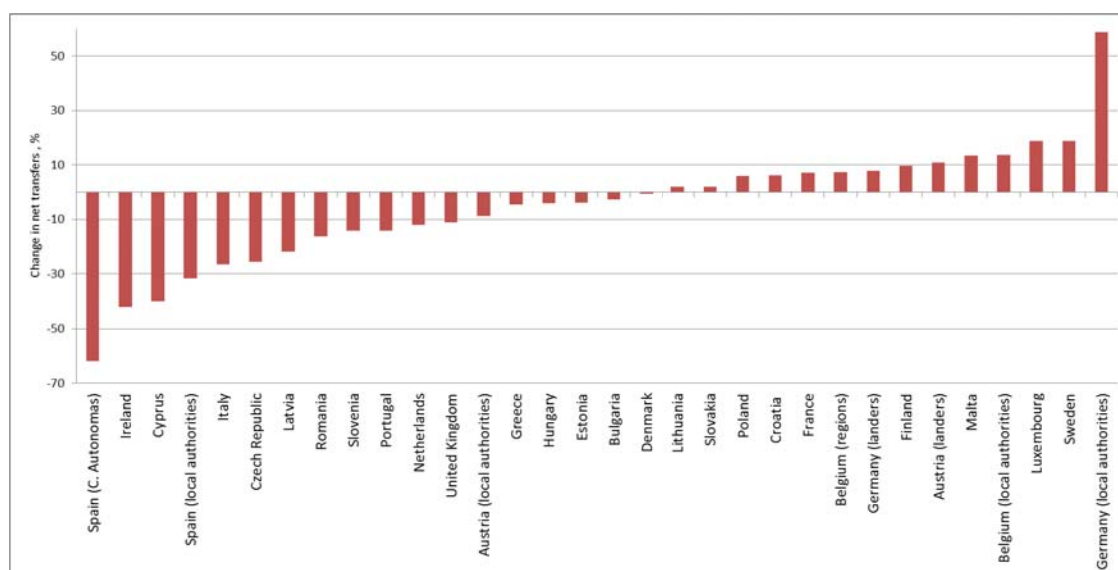


Source: Eurostat

In some cases, the decline in revenue after 2008 mostly stems from a reduction in income from local taxes, as for instance in the UK.²⁷ But in many Member States, it is due to a cut in transfers from central government. However, transfers go in both directions, since revenue from local taxes or sales by local authorities (such as of housing) can be transferred to central government. In some Member States, these transfers are significant and need to be taken into account when assessing changes in sub-national government income. In most of the Member States which were hit hard by the global recession, net transfers from the central government to local authorities were reduced significantly between 2009 and 2012. This was particularly the case in Spain in respect of net transfers to regional authorities which were reduced by 96% in real terms, as a result of both transfers from central government being reduced markedly (by 42%) and transfers from the regions to the centre being increased substantially (from only just around EUR 1.4 billion to EUR 32.2 billion at 2005 prices). A similar trend, but with less of a reduction, was also registered by Spanish local authorities. There was equally a significant reduction in Ireland, Czech Republic, Latvia and Italy. By contrast, central governments provided increased support to local and regional authorities in 14 countries, especially in Germany (both for Länder and local authorities), Lithuania, Sweden and Luxembourg. It is no coincidence that in most of the countries in which net transfers to sub-national authorities increased, the recession was of limited duration and there was less need for fiscal consolidation.

²⁷ In many instances, revenue from local taxes is largely controlled by central government which sets limits on the tax rates that can be imposed.

Figure 18 – Change in net transfers between central and State-local Governments, 2009-2013 in real terms,



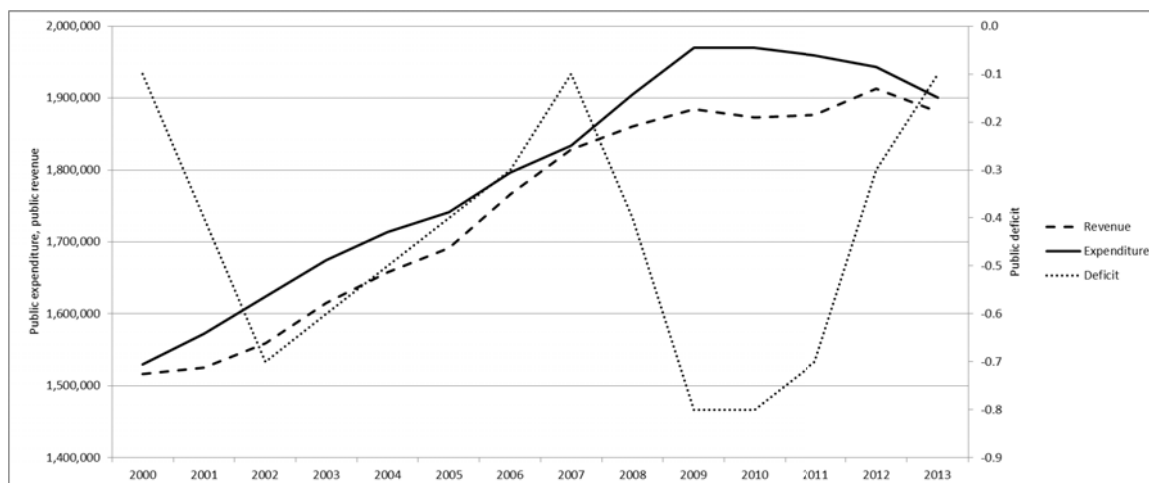
Source: DG REGIO calculations based on Eurostat data. Note: in line with the Eurostat public accounts dataset financial transfers for Germany, Austria, Spain and Belgium are calculated for two different levels of sub-national governments (S1312 state government, corresponding to federal/regional authorities and S1313 local government, corresponding to local authorities).

3.6. Public deficit and public debt of sub-national governments

As for all parts of the public sector in the EU, public finance at the sub-national level deteriorated significantly following the onset of the financial and economic crisis²⁸. While a small deficit of 0.1% of GDP was observed in 2007, public finance at sub-national level was in deficit to the tune of 0.8% of GDP in 2009 and 2010. This deterioration was mainly due to a fall in revenue in 2008 and 2009 (Figure 18), stemming mainly from the reduction of transfers from the central government. Fiscal consolidation measures then began to have an effect and the deficit was progressively reduced to 0.1% of GDP by 2013 returning to its 2007 level.

²⁸ Note that, because of transfers between various levels of government, the extent of public deficit at the sub-national level should not be interpreted as their contribution to the general government deficit.

Figure 19 – Sub-national government expenditure, revenue (EUR bn, 2005 prices) and sub-national governments deficit (% of EU GDP), EU-27, 2000-2013

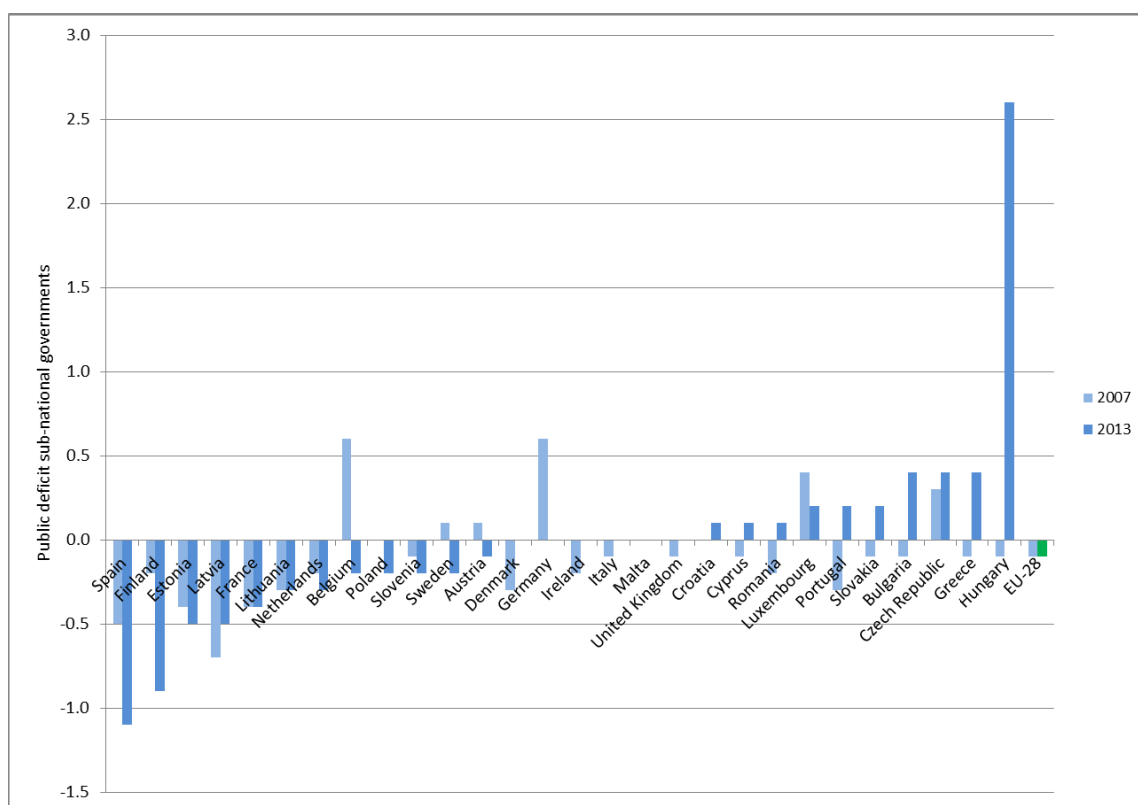


Source: Eurostat

The deterioration of sub-national public finance is more significant in some Member States, particularly in Belgium, Spain, Finland and Germany where the deficit increased by more than 0.5 percentage points between 2007 and 2013. In a few others, on the other hand, public finance at sub-national level improved, as in Hungary, Bulgaria, Portugal and Greece.

In 2013, the deficit at subnational level was largest in Spain and Finland (1% of GDP), while at the other extreme there was a surplus in Hungary (2.6% of GDP) and Greece, Czech Republic and Bulgaria (0.4% of GDP).

Figure 20 - Sub-national governments deficit, Member States, 2007 and 2013 (% of national GDP)

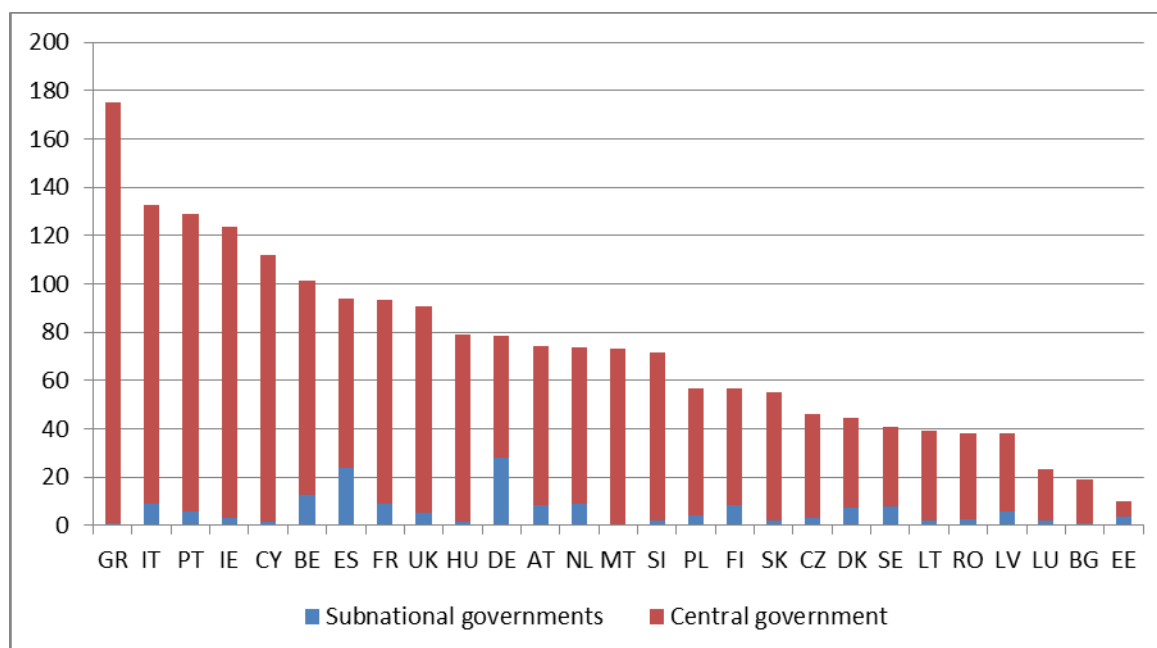


Source: Eurostat

The result of the increase in government deficits over the crisis period, at national as well as sub-national level, has been to raise accumulated public debt levels dramatically, which in overall terms rose by as much as 30 percentage points of GDP (from around 58% of GDP to over 87%) over the period 2007-2013. The increase occurred mainly during the recession years of 2008-2010, and the fiscal consolidation measures implemented since then in most Member States have reduced the pace of increase. The rise has been most pronounced in the Member States suffering the biggest contraction in economic activity, most of which have been subject to a macroeconomic adjustment programme – by close to 100 percentage points of GDP between 2007 and 2013 in Ireland, over 60 percentage points in Portugal and Greece and over 50 percentage points in Spain and Cyprus.

Despite regional and local authorities being responsible for around 30% of total General Government expenditure and about 60% of General Government investment, the increase in public debt, as in the deficit, principally stems from central government activities. The overall indebtedness of local authorities and regions without major legislative powers in the EU is below 10% of GDP in all Member States. While debt at sub-national level has increased significantly in some countries, such as Poland, Slovenia, Bulgaria and Latvia, it has been from a very low level in relation to GDP, so limiting the rise in absolute terms. In some countries (such as Hungary as indicated above), local authorities have even been able to reduce their indebtedness over the crisis period.

Figure 21 - Consolidated General Government gross debt, 2013 (% GDP)



Source: Eurostat

The deterioration in public finances has, however, hit some regional governments hard. In particular, the debt of Spanish regions in 2013 was over 20% of GDP and almost four times larger in 2013 than before the crisis. This is of concern because of the critical importance of regions in Spain for growth-enhancing expenditure and the provision of health and education. In addition, in Belgium, the debt of the three regions has almost doubled over the crisis period though it remains relatively low. On the other hand, the debt of regional governments in the two other federally-organised Member States, Germany and Austria, which have been less affected by the crisis, has declined since 2010.

Nevertheless, in Germany, sub-national public debt amounts to around 30% of GDP and accounts for over a third of the total debt of the public sector, the only country apart from Spain, where debt at this level represents more than 20% of the total. In both cases, sub-national debt is held predominantly by regional authorities (the Landër in Germany and Comunidades Autónomas in Spain), the debt of local government remaining relatively small. The latter is equally the case in other Member States, especially in the more centralised ones.

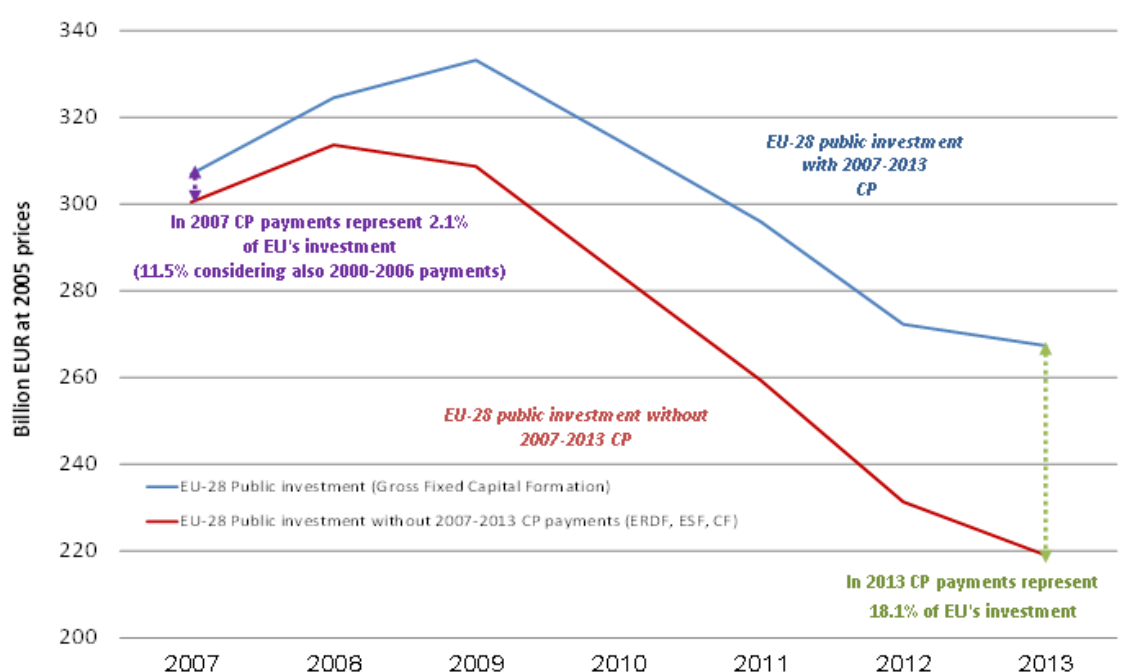
4. CONTRIBUTION OF COHESION POLICY TO PUBLIC INVESTMENT IN THE MEMBER STATES

As shown above, public investment has declined significantly since 2009. As a consequence, the importance of Cohesion Policy for the financing of public investment programmes has increased further in the crisis years. For many Member States, especially those facing a reduction in revenue and increase of social spending, Cohesion Policy has become the main source of financing for public investment.

During the 2007-2013 period, the allocation of Structural Funds and Cohesion Fund and the related national co-financing amounted on average to around 0.55% of the EU-27 GDP each year. Despite the amount being relatively small in relation to national public

accounts indicators, the macroeconomic implications of the ERDF, the ESF and the Cohesion Fund are significant, especially when compared to public investment. From 2010 to 2013, these funds represented the equivalent of around 14% of expenditure on public capital investment in the EU and to around 21.5% of total fixed public investment²⁹.

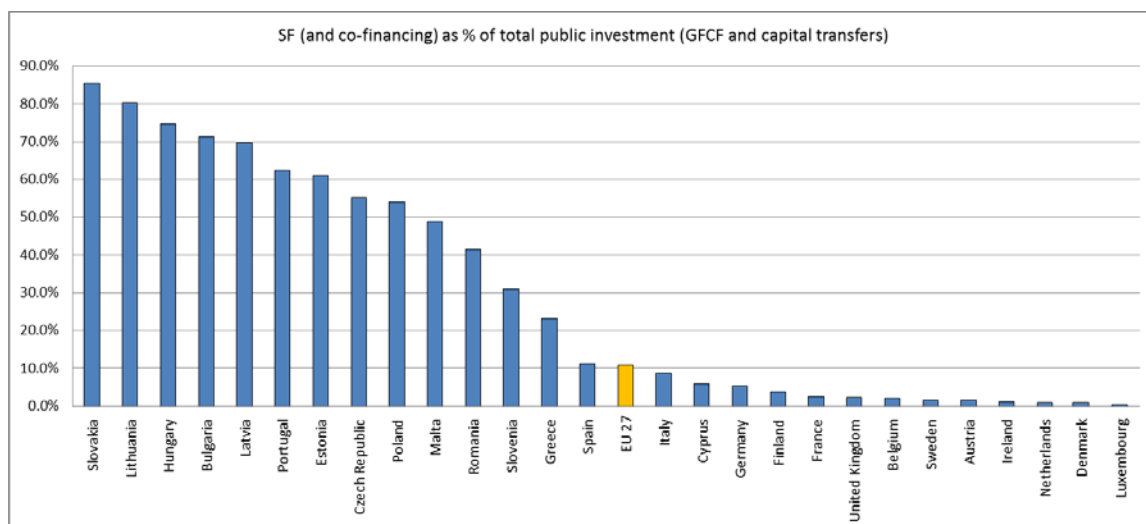
Figure 22- Contribution of Cohesion Policy (CP) to public investment in the EU-28 (2007-2013)



Source: Eurostat and DG REGIO

The ratio of funding to total public investment varies substantially across Member States, which mostly reflects the differences in aid intensity between regions and the scale of public investment in each Member State. The highest ratios are in Member States which are recipients of the Cohesion Fund and the ERDF under the Convergence Objective. In Slovakia, Hungary, Bulgaria and Lithuania, funding amounted to more than 75% of public investment. The lowest ratios are in Luxembourg, Denmark and the Netherlands, countries with no Convergence regions. Figure 64- Ratio of ERDF, ESF and Cohesion Fund allocations plus national co-financing to total public investment (average %, 2011-2013)

²⁹ Total public capital investment is equal to the sum of public fixed investment (Gross Fixed capital formation of the General Government) and capital transfers paid by the general government. Please note that the percentages reported have to be considered as ratios, as the expenditure co-financed by SF is not entirely captured by the two public investment indicators proposed in this section. Capital transfers include capital support to financial institutions.



Source: Eurostat and DG REGIO

The role of Cohesion Policy in supporting the capacity of Member States to carry out growth-enhancing investment implies that it has a direct link to macroeconomic policy issues. Cohesion Policy, accordingly, affects budgetary issues in the Member States not only because it provides additional resources to finance public expenditure but also because Member States have to co-finance EU programmes and respect the principle of additionality³⁰. The current financial and economic crisis has highlighted the need to reinforce coherence between Cohesion policy and the renewed EU economic governance system. This has led to the adoption of a series of reforms (described in Chapter 6 below) intended to reinforce the linkages between the two.

5. INVESTMENT, STATE AIDS, AND EIB LOANS

5.1. Competition policy

Competition policy is intended to ensure that firms have an equal opportunity to compete wherever they are located and from whichever Member State they originate. As government intervention is necessary in some cases, however, the Treaty provides for situations where State aid is considered compatible with competition in the internal market. A number of exemptions to the general prohibition on aid are, therefore, specified. Accordingly, State aid can be used, for example, to provide risk capital and funding to contribute to the pursuit of the Europe 2020 objectives by encouraging the adoption of more innovative and greener technology.

In 2011, State aid amounted to EUR 64.3 billion, or EUR 128 per head of population. In the three years 2009-2011, it averaged 0.6% of EU GDP per year, as the measures to combat the crisis pushed it up from 0.4% in the period 2006-2008.

State aid differs between Member States, varying in the 2009-2011 period from 2.2% of GDP per head in Malta to just 0.1% of GDP per head in Bulgaria.

Regional aid

³⁰ Under the principle of additionality, Member States commit to avoid replacing national funding with EU funds and to maintain a certain level of spending on public investment.

The Commission Guidelines on national regional aid for 2007-2013 set out the principles for determining whether or not aid for the economic development of disadvantaged areas, and specifically support of investment in new enterprise creation which it entails, is compatible with the internal market rules. This, therefore, allows higher intensity of aid in regions with lower GDP per head and in the outermost regions. For the 2014-2020 period, the Commission has adopted new Guidelines on national regional aid, which are part of a broader strategy to modernise methods of state aid control. These are aimed at fostering growth in the Single Market by encouraging more effective aid measures and at focusing Commission enforcement on cases with the biggest impact on competition.

The new Guidelines 2014-2020 are to:

- increase the overall share of regions where regional aid can be granted from the current level of 46.1% to 47.2 % of the EU population, mainly as a response to the crisis;
- reduce the aid measures subject to Commission scrutiny as more aid categories will be exempted from the obligation to notify the Commission beforehand, allowing Member States to spend small aid amounts with limited administrative burden;
- subject large aid measures to in-depth assessment of their incentive effect, proportionality, contribution to regional development and effects on competition;
- adopt a stricter approach to aid for investment by large enterprises in the more developed assisted areas;
- in outermost regions and sparsely populated areas, maintain and simplify the possibility for Member States to grant operating aid to companies;
- leave unchanged the maximum 'aid intensities' for the least developed regions. For other assisted regions, intensities are reduced slightly, by 5 percentage points, given the reduction in EU regional economic disparities and the need to avoid subsidy races between Member States in times of tight budgetary constraints;
- strengthen the anti-relocation provisions by not allowing regional aid to the same or a similar activity to be relocated within the European Economic Area (EEA).

Aid in disadvantaged regions

The Treaty on the Functioning of the EU (in Article 107(3)(a)) allows aid that promotes the economic development of areas where the standard of living is abnormally low or where there is serious underemployment ('category a' regions). In practice, the areas concerned are defined as NUTS 2 regions with a GDP per head of less than 75% of the EU-25 average, which broadly correspond to Convergence regions (including Phasing-out regions). In 2011, aid in these regions amounted to almost EUR 15.2 billion.

Aid in 'category a' regions increased by a quarter between 2009 and 2011 (from EUR 14 billion), though the longer-term trend is downwards (from an average of EUR 17 billion in 2003-2005 to EUR 13 billion in 2006-2008). The level of aid in such regions differs between Member States, reflecting differences in regional

policy, the extent to which aid is used to support development and the size of the eligible population.

Differentiated state aid possibilities for islands, sparsely populated areas and other regions categorised by geographical isolation

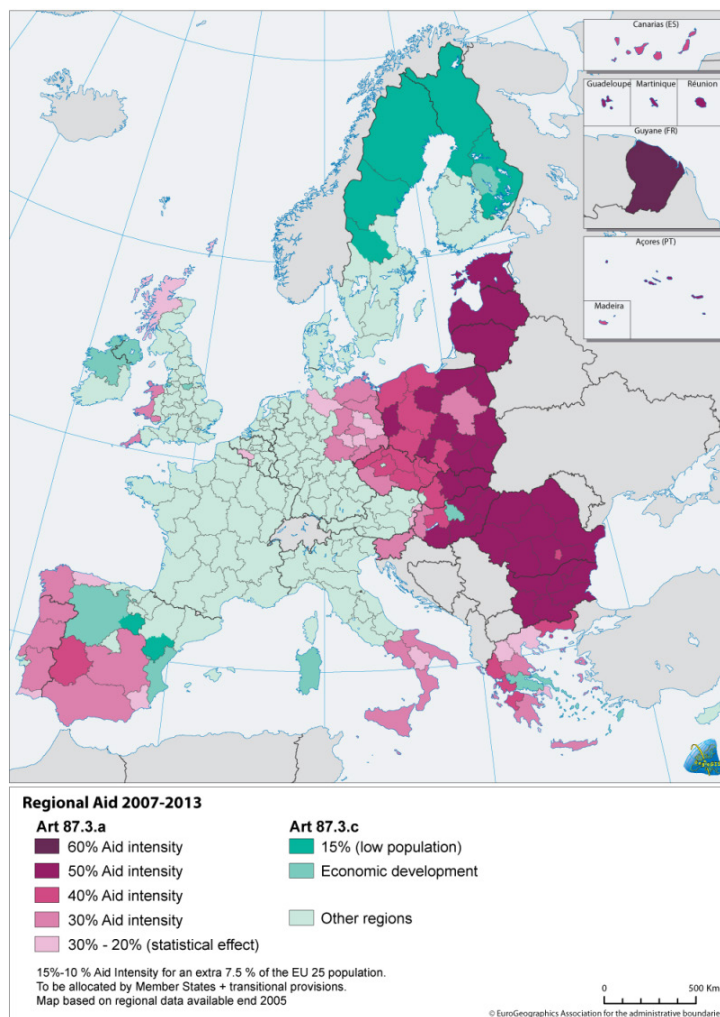
The Treaty on the Functioning of the EU (in Article 107(3)(c)) allows aid to be used to facilitate the development of certain other areas, where it does not significantly affect competition ('category c' regions). The areas concerned include those regions with a GDP per head below the EU-25 average, those with unemployment over 15% higher than the national average or those undergoing major structural change or in serious relative decline, as well as regions with low population density, islands with a population of 5,000 or less, regions similarly isolated geographically and regions neighbouring 'category a' regions. Aid in category 'c' regions totalled around EUR 2.9 billion in 2011 (i.e. just over a quarter of that in 'category a' regions) and was down by 39% from 2008.

State aid and the Lisbon objectives

The General Block Exemption Regulation (GBER) was introduced in 2008, giving automatic approval for a range of aid measures without the need for prior notification. Such a block exemption does not have a spatial dimension since it applies to all regions. The current GBER will be extended until the end of 2014 when the Commission will adopt a new GBER, introducing new categories of aid measure without the need for prior notification. The GBER covers aid to SMEs, research, innovation, regional development, training, employment and risk capital, as well as for environmental protection, entrepreneurship, business start-ups in assisted regions and issues such as the difficulties of women entrepreneurs to access finance.

The reform introduced by the GBER was aimed at redirecting aid towards the Lisbon objectives by encouraging Member States to focus on assistance that will be of real benefit to competitiveness, job creation and social and economic cohesion. At the same time, it reduced the administrative burden for public authorities, aid recipients and the Commission alike. The GBER unified and simplified previous rules, and enlarged the categories of state aid covered by the exemption. Almost 41% (EUR 17.2 billion) of aid to industry and services was already block exempted in 2011 under the previous regulations as compared with 19% (EUR 11 billion) in 2008 and 6% (EUR 3 billion) in 2006.

Map 1 Regional aid, 2007-2013



5.2. European Investment Bank

European Investment Bank loan operations are directed towards the political priorities established by the EU. The 2013-2015 operational strategy of the EIB combines lending, blending lending with EU funding, and advisory work to respond to the objectives of EU Cohesion Policy and Europe 2020.

The strategy has been updated in response to the crisis and is focused on (though not limited to) smart growth. The contribution of EIB is multi-faceted, encompassing support for infrastructure projects for growth and cohesion including the completion of the TENs and the deployment of broadband technologies. Supporting SMEs (especially in knowledge-based activities) is also a central objective, as they are considered to be crucial for growth, employment and innovation in the EU. The EIB provides support for sustainable and resource efficient transport, energy efficiency and renewable energy production as well.

In response to the crisis the EIB is providing EUR 60 billion additional lending over the period 2013-2015, increasing the target for loans given from a EUR 42 billion to EUR 62 billion in 2013, and EUR 60 billion in both 2014 and 2015. This will enable the Bank to increase its activity in four priority areas: innovation and skills, SME access

to finance, strategic infrastructure and increased investment to meet the EU's resource efficiency objectives.

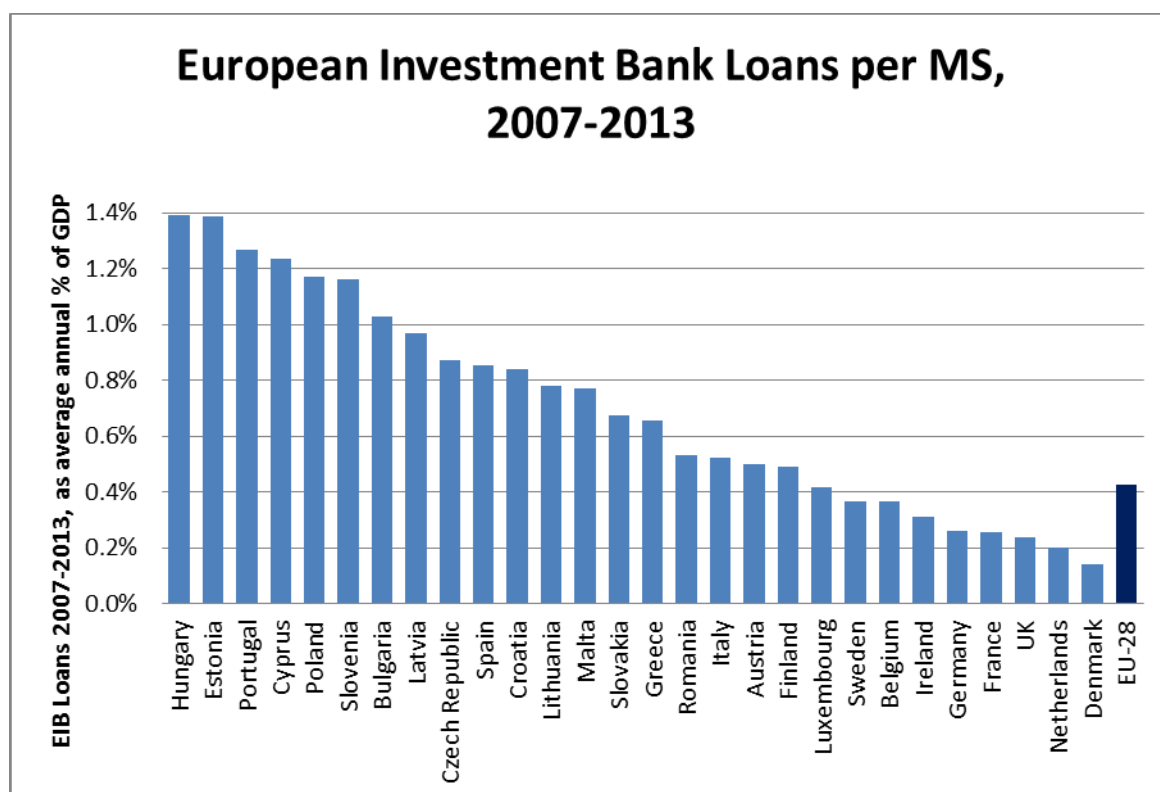
The European Commission and the EIB have also developed a number of joint financial instruments where the lending provided is blended with EU funding to support the pursuit of Europe 2020 targets. These have a leverage effect on funding and help to increase the impact for final recipients.

In the 2007-13 programming period, around EUR 20bn has been invested in the Structural Programme Loans instrument, which combines loans with grants.

The Bank's activities also include managing the JASPERS technical assistance facility which provides support to EU Member States to improve the quality of the major projects submitted for grant financing by the Structural and Cohesion Funds. From its inception in 2006 up until the end of 2012, a total of 226 JASPERS-supported projects in 12 countries were approved, involving investment totalling EUR 39bn (EUR 10bn in 2012).

In addition, the Bank, together with the European Commission and the Council of Europe Development Bank, set up the JESSICA initiative (Joint European Support for Sustainable Investment in City Areas) which is intended to provide reimbursable finance for financing revenue-generating urban projects through the Urban Development Funds. By the end of 2012, a total of 75 JESSICA evaluation studies had been commissioned and 18 holding funds had been set up with finance totalling EUR 1.7 billion covering 54 regions and . 37 Urban Development Funds had been established with finance amounting to around EUR 1.4bn.

Figure 23 European Investment Bank loans per Member State, 2007-2013



Source: EIB, Eurostat and DG REGIO calculations

6. CONCLUSION

The financial and economic crisis has led to a severe deterioration of public finance in most EU Member States. Public deficits increased sharply in 2009 resulting in the adoption of fiscal consolidation measures across the EU starting in 2010. As a consequence, public expenditure was reduced in a number of Member States while the rate of growth was limited in the others.

The various categories of public expenditure were not all affected, however, in the same way. Growth-friendly public expenditure and public investment were particularly targeted by fiscal consolidation measures, public investment in the EU-27 being expected to fall to historically low levels in 2014.

This is particularly true for subnational levels of government which are responsible for a large share of growth-friendly public expenditure and public investment. Since 2010, public investment at sub-national level has fallen significantly in the EU-27, declining back to 1997 levels. The biggest reduction is in Spain where sub-national public investment fell by 24% a year on average between 2009 and 2012.

In such a context, the role of Cohesion Policy in supporting growth-enhancing public expenditure in a number of Member States has become of major importance and by far the main source of financing for public investment. Given this, the role of Cohesion Policy in helping the Member States to pursue a dynamic way out of the economic crisis and achieve the Europe 2020 objective is becoming ever more crucial. The tendency for public investment in Member States to be reduced is equally a concern because it calls into question their ability to respect the principle of additionality and to co-finance Cohesion Policy programmes in the future.