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Improving Government Quality in the Regions of the EU and its System-Wide Benefits for Cohesion Policy

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Abstract

We quantify the general equilibrium effects on economic growth of improving the quality of institutions at the regional level in the context of the implementation of the European Cohesion Policy for the European Union and the UK. The direct impact of changes in the quality of government is integrated in a general equilibrium model to analyse the system-wide economic effects resulting from additional endogenous mechanisms and feedback effects. The results reveal a significant direct effect as well as considerable system-wide benefits from improved government quality on economic growth. A small 5 per cent increase in government quality across European Union regions increases the impact of Cohesion investment by up to 7 per cent in the short run and 3 per cent in the long run. The exact magnitude of the gains depends on various local factors, including the initial endowments of public capital, the level of government quality, and the degree of persistence over time.

Keywords: government quality; cohesion; economic growth; public investment; regions; EU

Introduction

The role of government quality as a driver of economic development at subnational level has come under considerable scrutiny in recent years. The majority of the research on the topic has focused on the European Union (EU), where it has been found that regional differences in government quality impinge on a wide range of socio-economic and political outcomes, including the delivery and efficiency of public investment. Variations in regional government quality across the EU significantly affect both economic growth and powerfully mediate the returns to investment under virtually all public policies, including major funding programmes such as the European Structural and Investment Funds (ESIF). 'The quality of government becomes – for the large majority of regions – the basic factor determining why a region grows. In many of the regions receiving the bulk of Structural Funds, greater levels of cohesion expenditure would, in the best-case scenario, only lead to a marginal improvement in economic growth, unless the quality of the government is significantly improved' (Rodríguez-Pose and Garcilazo, 2015, p. 1288).

In this paper, we revisit in far greater detail than hitherto – by means of newly developed datasets and a variety of advanced econometric methods – the issue of the impact of regional quality of government on the returns to European Cohesion investments. We

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