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Structural Funds And Economic Crises: Romania’s Absorption Paradox

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Abstract

EU officials and government authorities are considering that structural funds may represent the instrument by which EU Member States can recover from the present crisis. However, theoretical evidence suggests that the absorption capacity of any country is also affected by economic downturns. Using Romania as a case study, we will attempt to solve this peculiar dilemma by analyzing three factors which are paramount for the absorption of structural funds, respectively: the macroeconomic and financial capacity, the administrative efficiency and people’s uncertainty regarding the European funding system. Preliminary results seem to confirm that a country’s capacity to spend the allocated money is also crippled by economic depressions.

Keywords: economic crises; structural funds; absorption capacity; co-financing.

1. Introduction

The current economic crisis has determined policymakers to search for methods to create jobs and boost economic growth. For many politicians, especially those in comparatively poorer countries, structural funds offered by the EU appear as the long searched for panacea. However, trying to exit an economic crisis by using structural funds implies somewhat of a logical paradox. The absorption capacity of any country is also influenced by these macroeconomic phenomena. The national factors which influence the ability to spend the allocated EU money (also known as absorption determinants) are correspondingly affected by general economic fluctuations.

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We will group Romania’s determinants of absorption under three main categories: macroeconomic and financial capacity, administrative efficiency and individual’s uncertainty regarding the European funding system. Economic theory and empirical evidence suggest that all of these magnitudes were considerably crippled by the current economic downturn. It is no coincidence that between 2007 and 2013 Romania had the worst absorption rate in the European Union (European Commission, 2013). Again, it is no coincidence that most of the European Member States incurred similar low percentages of paid expenditures during the same time period (European Commission, 2013).

Both practitioners and researchers (Zaman & Georgescu, 2009; Berica, 2011; Boldea, 2012) talk about a seemingly paradox of absorption. They claim that this paradox refers to the fact that it is the most disadvantaged nations that experience the greatest difficulties in absorbing structural funds (Katsarova, 2013). However, we argue that the real paradox consists in the attempt to use structural funds as the means of exiting an economic crisis. This type of popular rational contains in it the seeds of circularity. Even if the European funds would be efficiently used and would actually generate healthy economic growth – and there are numerous voices that argued that this is not the case (Boldrin & Canova, 2001; ECORYS, 2006) – the factors which determine the absorption rate are themselves hit by the economic crises.

The methodology used for the elaboration of the present study consisted mainly in verbal logic and the interpretation of statistical data. Because this field of study has a somewhat qualitative character, we consider that economic analysis based on a priori reasoning is the best fit approach for such a task. In order to illustrate our findings, we have also made use of different statistical data collected both from national and international sources.

2. Literature review

It is a well-known fact that EU’s Cohesion policy aims at reducing economic and social disparities between the different regions involved. The means by which this goal can be supposedly reached are the Structural Funds. Given their impressive amount (being second in rank only to the Common Agricultural Policy) their impact has been analyzed from several different perspectives. Whether it was their ability to stimulate economic growth and regional development (Martin, 1997; Cappellen et al., 2003; Sapir, 2003; Ederveen et al., 2006), their added value (Bachtler & Taylor, 2003) or the effects they have on the business environment (Midelfart-Knarvik & Overman, 2002), structural funds have always been in the spotlight of all European debates.

In the past few years, due to the economic crisis, more and more voices have considered structural funds to be the “cure” for the economic downturn. The European Commission emphasized on several occasions the important role that these funds could play in the economic recovery of Member States, since their main objective is to eliminate economic disparities between regions (European Commission, 2009). Other economists have also supported this idea (Jiletcovici, 2010; Smail, 2010).

In these conditions, spending the money allocated through structural funds was placed at the top of the list of most national governments. In order to boost the absorption rate, European institutions implemented a set of measures (Healy & Bristow, 2013; Katsarova, 2013). Among them, we can mention the adoption of regulations providing temporary increases of the EU co-financing rates for those Member States that were severely affected by the economic crisis and the modification of the n+2 rule for Romania and Slovakia (Katsarova, 2013).

However, even if we assume that structural funds could actually generate growth, one question still arises: can a country increase its absorption rate in difficult economic periods or is this absorption capacity itself influenced by economic crisis? There are several studies focused on the factors which determine Romania’s capacity to spend EU funds, both at European (Katsarova, 2013; Healy & Bristow, 2013) and national level (Zaman & Georgescu, 2009; Berica, 2011; Zaman & Cristea, 2011; Boldea, 2012). Most of these studies aim at making policy recommendations in order to increase the absorption coefficient. The determinants identified and analyzed vary from study to study, some of the most commonly cited being: bureaucracy and corruption, the national capacity to co-finance projects, macroeconomic indicators (GDP, inflation, exchange rates, etc.) and uncertainty felt by the business environment which deters companies from applying for European financing. Although experts disagree on policy recommendation, there seems to be a consensus related to the fact that bad economic periods do have an impact on a country’s absorption capacity.
Given the wide range of determinants, we chose to focus on three of them: the macroeconomic and financial capacity, the administrative efficiency and people’s uncertainty regarding the European funding system. Our choice was also motivated by the fact that the same categories were tackled by the European institutions (Katsarova, 2013).

3. The factors determining Romania’s capacity to spend structural funds

The absorption capacity can be defined as a country’s ability to spend in an efficient and effective manner the structural funds that were allocated to it (Katsarova, 2013). The absorption rate, on the other hand, is being calculated according formula:

Equation (1): Absorption rate = total money spent and reimbursed / total money allocated x 100

The academic environment linked this phenomenon to three types of capacities that should exist at national level: macroeconomic capacity, financial capacity and administrative capacity (Zaman & Georgescu, 2009; Berica, 2011). However, we consider that it is more useful to analyze the first two under the same category because the capacity of any one country to co-finance its projects depends on macroeconomic variables like GDP, government revenues, inflation, exchange rates and government deficits. Also, we consider that a third determinant must be included – i.e. private individuals faith in the European funding system. People can become skeptical as to whether the payments they made in the course of their projects are going to be reimbursed. Once uncertainty steps in, small and medium size companies can start considering structural funds less attractive based on fear of bankruptcy.

Although our study concentrates on Romania’s example, we consider that the results can be practically applied to any European Member State. We will show that all three of the previously mentioned determinants are affected by economic crises, crippling a country’s capacity to absorb structural funds.

3.1 Macroeconomic and financial capacity

A country’s ability to attract structural funds depends on its macroeconomic variables, each of them influencing the absorption rate in a different way. Among these variables, the most important one is probably government revenue, because a country requires resources to co-finance its European investment projects. We will discuss below a few macroeconomic indicators which have a direct influence on Romania’s absorption rate and show that in the 2007-2013 period, all of these indicators were affected by the economic crisis.

The first and most obvious indicator is the country’s GDP. It is a well-known fact that EU administrative rules limited the transfer of funds to a maximum of 3.8 per cent of the countries’ GDP in the period 2007-2013 (Katsarova, 2013). This means that the amount of allocated funds varies in direct proportion with this macroeconomic variable. However, in times of economic crises, a countries’ GDP growth usually decreases or can even become negative.

This implies that the country’s maximum amount of funds allocated also diminishes in times of crises. But this is not all. Government revenue will also decrease relatively to GDP, which translates into the fact that there will be comparatively fewer resources to finance European projects. This phenomenon will be usually reinforced given that when economic downturns occur, governments tend to have increased problems collecting taxes. Bad economic periods push numerous individuals which can no longer operate efficiently towards “black markets” (Dicoi, 2012). On top of this, there is still one more macroeconomic tendency which will hinder the absorption rate, and that is the fact that whenever economic depressions appear, government expenses, especially those connected to welfare spending, increase.

Table 1: Macroeconomic indicators for Romania

<table>
<thead>
<tr>
<th>Subject Descriptor</th>
<th>Units</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross domestic product, constant prices</td>
<td>Percent change</td>
<td>6.317</td>
<td>7.349</td>
<td>-6.576</td>
<td>-1.149</td>
<td>2.158</td>
<td>0.689</td>
<td>1.997</td>
</tr>
<tr>
<td>Unemployment rate</td>
<td>Percent of total labor</td>
<td>6.413</td>
<td>5.788</td>
<td>6.859</td>
<td>7.277</td>
<td>7.400</td>
<td>7.038</td>
<td>7.130</td>
</tr>
</tbody>
</table>
Romania’s situation in the 2007-2013 period is a text-book case study. As we pointed out earlier, Romania had the worst absorption rate in the EU in that specific period. Can this be attributed to chance? We argue that if one looks at the statistics, this scenario would have been predictable. As Table 1 indicates, between 2007 and 2013 Romania was heavily affected by the economic crisis. After the inflationary boom in 2007 and 2008, economic growth dropped to -6.6 per cent of GDP in 2009 and -1.1 per cent in 2010. It is clear that this decrease in the national GDP affected Romania’s capacity to co-finance European projects. But there is an even more interesting phenomenon at work. We can see from Table 1 that government revenues over the period in question increased slower than government expenses did. In 2009 there was actually an absolute drop in government revenue from approximately 165 to 156 billion Lei. All these data suggest that the co-financing process was hindered by the economic crisis, which in turn affected the absorption capacity at a national and regional level.

Other important macroeconomic variables which can have an impact on a country’s capacity to absorb European funds are unemployment and inflation. If unemployment is high, it means that fewer people are willing and able to implement investment projects, on the one hand, and that the state will spend more money on welfare, on the other. Furthermore, a high unemployment rate could underline the inefficiency of structural funding programs aimed at reducing unemployment, especially through life-long learning and through professional reconversion courses. As we can see, Romania had an unusually high unemployment rate reaching over 7 per cent since 2010 onwards.

Inflation can also play its part in the absorption equation. All the loan contracts are signed in the national currency while some of the goods intended for purchase have prices expressed in Euros (Berica, 2011). A depreciation in the national currency as compared to the Euro could create problems regarding the implementation of the projects. Romania’s inflation rate was rather high in the analyzed period, reaching 7.8 per cent in 2008 and then being maintained at around 6 per cent in the following years.

The last indicator which we will analyze in this section is a rather unusual one. Although it has an indirect effect on the country’s capacity to absorb European funds, we argue that its effects are considerable indeed. This indicator is the commercial bank’s lending interest rate. Figure 1 shows the evolution of the lending interest rate in Romania, which is calculated as a national average of the interest rates charged by private banks when offering short and medium term credits. It is a well-known fact that numerous small and medium size companies (but also some public institutions) do not have sufficient resources in order to provide the necessary cash flow for the projects (Zaman & Cristea, 2011). Therefore they go to the banks hoping that they may obtain the resources necessary until the payments are finally reimbursed.

| General government revenue | National currency (billions) | 134.173 | 165.549 | 156.373 | 168.635 | 181.567 | 193.148 | 209.406 |
| General government total expenditure | National currency (billions) | 147.141 | 190.407 | 192.782 | 202.256 | 205.277 | 207.921 | 224.106 |

Source: (IMF, 2013)
However, economic theory informs us that business fluctuations are caused by bank credit expansion (Strigl, 1934; Mises, 1953; Hayek, 2008). The same theory explains that the beginning of the crisis is marked by an increase in the interest rate, which signals the fact that the available resources which were previously saved are insufficient in order to fund all the investment projects which were undertaken. We can see the same scenario in Romania. The highest interest rate was registered in 2009, when the GDP decreased by a rate of 6.6 percent. But if banks are increasingly reluctant to offer credit to untrustworthy companies, this will also affect the absorption of EU funds. The beneficiaries will find it increasingly complicated to obtain the cash needed to implement the projects.

3.2 Administrative efficiency

The second determinant of absorption which we will analyze is the administrative efficiency. There are two key aspects worth mentioning regarding this determinant, those being the degree of bureaucracy and the level of corruption. The absorption of structural funds depends on the capacity of national agencies to be efficient in their tasks. However, during any economic crisis, bureaucracy usually tends to get thicker (by adding red tape) while corruption frequently increases.

Before going further on this issue, we would like to shortly describe the European funding system. When speaking about structural funds, one must never forget their purpose and their corresponding methodology. They are the instruments through which the objectives of the Cohesion Policy are achieved. In other words, they represent redistributive tools, aimed at financing projects that wouldn’t have otherwise appeared on the market. This was clearly stated in a report drawn up for the European Commission (Sapir, 2003): “Additionality criteria are meant to avoid the risk of crowding out local investments and to ensure that cohesion policy finances investments that otherwise would not have been undertaken”. Thus, from an economic point of view, they finance projects that wouldn’t have been profitable to entrepreneurs on the market, by redistributing financial resources from the EU budget. The objectives of the Structural Funds are established in an administrative manner at EU level, while at national level, the development objectives and the operational programs, through which the structural funds are spent, are also elaborated by bureaucrats.

Now, it is clear that the whole machinery of EU funding rests on the efficiency and good faith of public servants, both at national and at European level. But both of these attributes seem to be affected in bad economic times. In Romania’s case, corruption seems to have increased during the crisis period, as the following quote from the National Integrity System Assessment states (Transparency International Romania, 2011):

“[…] the financial and economic crisis generated even more vulnerabilities to a country constantly situated among the last two or three European countries in the Corruption Perception Index, with less than 4 points until 2010 on a scale from 1 to 10, where 1 is a captive state and 10 is an entirely free of corruption state”.

Figure 1: The evolution of the lending interest rate in Romania
Source: (World Bank Group, 2013)
According to the cited study, Romania had a score of 53.8 with regard to the control of corruption, while the government efficiency aggregated by the Worldwide Governance Indicators had the lowest score in the European Union, of only 51%. Furthermore, as Table 2 shows, the wastefulness of government spending, as well as the favoritism in decisions of government officials, occupy ranks that should be a cause for concern.

Table 2: Indicators related to the effects of corruption in Romania

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Value</th>
<th>Rank / 142</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intellectual property protection</td>
<td>3.0</td>
<td>98</td>
</tr>
<tr>
<td>Public trust of politicians</td>
<td>1.9</td>
<td>119</td>
</tr>
<tr>
<td>Favoritism in decisions of government officials</td>
<td>2.5</td>
<td>115</td>
</tr>
<tr>
<td>Wastefulness of government spending</td>
<td>2.7</td>
<td>107</td>
</tr>
<tr>
<td>Ethical behavior of firms</td>
<td>3.4</td>
<td>103</td>
</tr>
<tr>
<td>Transparency of government policy making</td>
<td>2.9</td>
<td>140</td>
</tr>
</tbody>
</table>

Source: (Transparency International Romania, 2011)

Of course, there is a possibility that these figures are overstated and it is also useful to keep in mind that variables like corruption and bureaucracy are rather hard to quantify. We do consider however that it is highly probable that a worsening of the economic climate can lead to a surge in red tape and unethical practices at government level. The empirical data cited above seems to reinforce our argument.

3.3 People’s uncertainty regarding the European funding system

In the previous subsections we have discussed the effects that economic crises generally have on macroeconomic indicators, bureaucracy and corruption. The last determinant that we shall analyze is the uncertainty felt by businessmen to apply for EU funding. Few experts have taken this factor into consideration when analyzing the determinants of absorption. However, it seems clear that the private sector’s reluctance to apply for funding does have an impact on the absorption rate. This is the main reason why we chose to study this last factor.

Entrepreneurship is based on taking risks and being rewarded for this, so businessmen are used to operate in uncertain conditions. However, they normally base their actions on profit and loss accounting. This is the typical mental tool of the market economy which is used by entrepreneurs to forecast events in an uncertain environment (Mises, 1949). Nevertheless, decisions relating to structural funds are different from this point of view, because they have to take into consideration politico-administrative actions and not market prices.

We are fully aware of the scientific difference between risk and uncertainty (Nelson & Katzenstein, 2011). However, we consider that it is somewhat immaterial for the present study. When we use the term uncertainty we refer to the lack of trust (uneasiness) that entrepreneurs feel when they consider applying for EU funding. We do not believe that this subjective feeling can be quantified or that a numerical probability can be associated to these actions.

There are three main types of factors that influence this general level of uncertainty felt by the private sector involved in European funded projects: the climate of legislative inconsistency (Transparency International, 2011), delays in the reimbursement of incurred expenses and the projects’ approval process. Each of them is like an alarm which signals businessmen to stay away from structural funds and consider productive market oriented projects.

Empirical data collected regarding the Romanian economy seem to confirm these arguments. For example, Transparency International Romania (2011, p. 20) stated that “the climate of legislative inconsistency discourages investment and seriously affects substantial business and European projects”. Even though this climate is generated mostly by the questionable adoption of laws, rules and regulations, it is clear that the economic crisis affected this process, since between 2007 and 2013 most of the important legislative acts have been passed without the vote of the Parliament.

Although the legislative climate indicator can be criticized as being too general, there is another phenomenon which targets beneficiaries of Structural Funds specifically. In the case of projects which were already accepted, uncertainty appears first of all due to the slowness of the bureaucratic process of reimbursing the incurred expenses. In some cases, firms contracted credits in order to be able to cover the required co-financing and at some point were forced to declare bankruptcy because the reimbursements were not paid in time. For example, the representatives of the
Businessmen Association of Romania are claiming that companies which have been operating for several years are now on the verge of bankruptcy because the payments were delayed (Belcean, 2012; Ollescu, 2012) and that the member companies will never use Structural funds again (Ollescu, 2012). Thus, the business environment is now quite reticent in applying for European funded projects, since they cannot rely on the sums from the reimbursements in their economic calculations.

Another source of uncertainty for the private sector lies in the project preparation, submission and approval phase. Most companies will incur costs with the elaboration of projects (e.g. hiring consultant companies; using existing human and material resources for the elaboration of projects etc.), but the approval of the projects is not guaranteed (Zaman & Cristea, 2011). For example, in the Sectorial Operation Program - Human Resources Development (POSDRU), the rate of success for the approval of projects in Romania was around 29% in 2012. This means that out of the total number of submitted projects, less than a third was approved and have already entered the implementation phase (AM POSDRU, 2012). In these conditions, it is normal for people to become more skeptical and question these rather cumbersome selection processes which lack the much needed transparency.

All these facts add up and increase the uneasiness felt by the private sector related to the implementation of projects financed from structural funds, which in turn leads to a reduction of the number of possible beneficiaries (and implicitly of the sums that could be absorbed at national level).

4 The absorption paradox reconsidered

When experts and practitioners talk about the absorption paradox they usually have in mind that the countries that have the most urgent need of structural funds also manifest an inability to attract and spend them (Zaman & Georgescu, 2009; Boldea, 2012; Katsarova, 2013). However, what we have attempted to point out in the present article is that the real paradox consists in the attempt to use structural funds for exiting an economic depression.

Business cycles also affect the capacity of a Member State to absorb EU funds. As we have seen, the three main absorption determinants, respectively the macroeconomic and financial capacity, the administrative efficiency and the general public’s uncertainty regarding the European funding system, are severely crippled in bad economic periods. Shortly put, whenever a depression hits a certain country it is highly probable that the GDP will decrease, corruption and bureaucracy will surge while people’s confidence in the EU funding system will generally deteriorate.

As economists, it is extremely hard to argue that structural funds generate economic growth and that EU redistributive schemes will bring about an optimal allocation of resources (and we have no intention of doing that). On the contrary, from an economic point of view, the market is the most efficient mechanism of allocating resources (Mises, 1949). What we do want to underline is that structural funds cannot be used by Member States to recover from the present crisis because economic downturns cripple a country’s capacity to absorb those resources. Such an argument is rather inconsistent from a logical point of view.

5 Conclusions

After briefly describing structural funds and their effects on the national economy, we have shown that these financial instruments cannot be used in order to exit the present crisis, because the absorption capacity of a country is also crippled by economic downturns.

The factors which determine the rate of absorption can be grouped under three main categories, respectively: macroeconomic and financial capacity, administrative efficiency and individuals’ uncertainty regarding the European funding system. First of all, an economic crisis will have a tendency to decrease government revenue while increasing expenditures, leaving fewer resources available to co-finance European projects. Unemployment, monetary instability and scarcity of credit will reinforce this tendency.

Regarding the efficiency of public officials, which is paramount for the good execution of European funding schemes, it is extremely probable that additional red tape and corruption practices will result as a consequence of the economic crisis. At the same time, private entrepreneurs who use structural funds will become more skeptical regarding the system. They will start questioning the selection process and will become weary about future delays in reimbursements.
Romania’s situation can be used as a text-book example. The deteriorating macroeconomic environment, the increasing corruption practices and the lack of trust of the private sector in using structural funds can explain why Romania had the worst absorption rate in the European Union between 2007 and 2013. However, we consider that the study has a rather general character and that the results can be applied to all Member States. If the European funding schemes maintain their current form, bad economic periods will have a negative effect on a country’s absorption capacity.

References


