THE ROLE OF FISCAL CAPACITY IN ABSORPTION OF EUROPEAN FUNDS[1]

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This paper examines the role of fiscal capacity in absorption of European funds in the country with the lowest absorption rate from EU. A special focus is placed on the key intervention area from Priority Axis on improving quality of life in rural areas (Measure 322 of Romania's Rural National Development Plan). The units of analysis are rural municipalities of Romania, for the period of 2007–2012. Key data sources are represented by local budgets execution, official data with beneficiaries of European funds, a national census of municipalities' access to European funds as well as a qualitative research. The study shows that the funds are concentrated on communities with low fiscal capacity. It also shows that the fiscal capacity depends on size of the organization and that of the population, but also on mayor's political affiliation. Its importance varies between financing lines. The study sheds light on the under-researched topic of capacity of absorption of European funds focused on demand side.

Keywords: *fiscal capacity, European funds, rural communities, structural funds.*

INTRODUCTION

At national level, Romania has the lowest level of absorption capacity of European funds, among EU-27 (Fiscal Council, 2013: 82). The causes for this situation have been placed both on offer (Management Authorities, intermediary bodies, etc.) as well as on demand side (applicants and beneficiaries of European funds). Administrative capacity has been identified as one key explanatory factor by intermediary evaluation reports of the operational programs. Additional factors related to the general environment of accessing European funds have been considered (legal provisions related to public procurement procedures, excessive control procedures, programming documents, etc.). For Romania's case, few studies focus on demand side (Stănculescu *et al*., 2009; Toth *et al*., 2010) and even fewer on fiscal capacity of applicants or beneficiaries of European funds (Toth *et al*., 2010;

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Ionescu-Heroiu *et al*., 2014). In this way, the study fills the gap on an under-researched topic and focuses the analysis on rural municipalities of Romania. The paper considers beneficiaries of all sources of European funding (rural municipalities with European-funded projects in implementation). A special focus is placed on applicants and beneficiaries of Measure 322, from Priority Axis 3, on improving quality of life in rural areas (Rural National Development Plan).

This paper examines the role of fiscal capacity in absorption of European funds for rural municipalities of Romania. Taking into consideration the costs for feasibility studies, consultancy firms for elaborating the documentation or ensuring the co-financing part of the applicant, we expect to find a positive relationship between the level of fiscal and absorption capacities. Previous studies on Romania have shown that the fiscal capacity influences the muncipality's capacity to submit project applications (Toth *et al*., 2010). Definitions of key terms are presented in the second section. The study is based on a mix of quantitative and qualitative methods described in the third section. Results and discussion of data analysis are included in Section 4 while the last part presents the concluding remarks as well as agenda for future research.

KEY TERMS AND DEFINITIONS

There are two key terms of the paper, both concerning different types of organizational capacities: fiscal and absorption capacity. Therefore, our view on capacity is as both resource as well as a process. The fiscal capacity is viewed as a key resource of the municipality, while the absorption capacity is a process variable. We are therefore in line with previous conceptualization of capacity in the public sector – as input, throughput or process variable (Christensen and Gazley, 2008: 266). As input variable, capacity represents a measure of organizational potential or a stock of resources (Honadle, 1981). The conceptualization of fiscal capacity for this paper is however different from that of the organizational capacity as a type of capability (Addison, 2009: 1). It is in accordance with the idea that the conceptualization of capacity depends on the context (Gargan, 1981) and therefore it uses the definitions of fiscal capacity in relation to the absorption capacity of European Funds.

The first systematic study on absorption capacity (in relation to the structural funds) is considered that of Boot *et al*. (2001). Same definitions and analysis models are used in an ex-ante evaluation report for DG Regio/ DG Enlargement (Boeckhout *et al*., 2002). The study uses a systemic perspective and is centered on the programming phase. The factors influencing the absorption capacity at state level are represented by external environmental factors (such as EU legislation) or the macroeconomic, fiscal and administrative capacities (Boeckhout *et al*., 2002). The macroeconomic capacity has been identified as the absorption capacity in the early development of the studies in this field. In operational terms, absorption capacity represents the share of structural funds in the GDP (Boeckhout *et al*., 2002). We are using the term of structural/European funds to designate both the

Structural and Cohesion funds as well as that from the Common Agricultural Policy.

The three factors of macroeconomic, financial and administrative capacities represent the offer side, while the demand side lies within the applicant's capacity to submit projects (Sumpikova, 2006: 3). The fiscal capacity at state level refers to the co-financing capacity. A similar meaning is also used for the applicant's level in the ex-ante evaluations conducted for Romania's case (Oprescu *et al*., 2006). In the studies on local government, fiscal capacity has also been considered part of the municipality's administrative capacity (Tatar, 2010; Lorvi, 2012). While we acknowledge that there are multiple influences at organizational and environmental level on the municipality's absorption capacity, they exceed the scope of this paper. Our view on absorption capacity is related to the concept of organizational effectiveness and more specifically to the system-resource model (Marin, 2014). However, given the space limitations of this paper, we are only examining the process aspect of the concept. The focus of this paper is on the influence played by the municipality's fiscal capacity in absorption of European funds.

The reference unit of analysis is a certain type of public organization – Romanian rural municipality. Therefore, these organizations share common characteristics of public organizations: i) they have publicly elected leaders; ii) they are multifunctional (problems of control, representativity and participation, transparency, equal treatment, service quality, etc.) and iii) they do not function in a free and competitive market (Christensen *et al*., 2008). In addition to these characteristics, Romanian rural muncipalities are also characterized by: i) territorial fragmentation which results in higher unit cost of the services – more than half of communes are under 3,000 inhabitants (National Institute of Statistics, 2011); ii) significant social disparities (Sandu, 2011); iii) significant influence of the fiscal crisis on budgetary revenues (Stănculescu *et al*., 2009) and iv) poor road, water and sewage infrastructure (Eurostat database, Romanian Rural National Development Plan)[2].

As second tier of the local government, Romania includes the level of county council. While there are no formal subordination relations between the municipalities and the county councils, there is however a certain degree of dependency regarding co-financing part for European funded projects. The section on data analysis will further elaborate on this. For this part of the paper, we intend to introduce a set of concepts and ideas derived from resource dependency theory, as developed by Pfeffer, Salancik (1978). According to them, the interorganizational dependency has to be analyzed in relation with the following four problems: i) magnitude of resource dependency (the degree in which a specific resource is used); ii) importance or 'power' of a specific resource; iii) the degree to which a specific group holds discretionary power over a certain group; and iv) the degree to which the control of the resource is concentrated. There are various types of interdependency (Marion, 1999) based on the relations of power, outcomes and organizational behaviour.

[2] For other characteristics of the Romanian public administration reform, including stage of decentralization process, see Vet *et al*., 2011 (monograph country: Romania).

These are: i) symmetric interdependency (balanced power relations) and asymmetric, such as: ii) result dependency (product of two or more systems) and behaviour (activities of a system are related to another system). Furthermore, result dependency can be competive or symbiotic ones. In this latter case, the result of a system is a result for the other, or two systems are both dependent on each other's result. Correspondingly, there are specific types of possible strategies (Hoffman, 2004: 183): i) changing or adapting the constraints; ii) changing the interdependency by fusion, diversification or extension; iii) associations, joint-ventures, development of collective directorates; iv) changing the legislation of legitimacy of external environment through political actions (new taxes and fees, subventions, licences, etc.). Those organizations which are in asymmetric relations can simply 'buy' the environment through fusion (merging) or extension. These terms will be used in Section 4, on data analysis.

DATA AND METHOD

Data for this analysis come mainly from administrative data sources – local budgets execution for the period of 2007–2012, as published by the Ministry of Administration and Internal Affairs as well as lists with results of project's selection (for the Measure 322 from the Romanian National Rural Development Plan). For each of these sources, an individual database, at commune level, has been compiled by the author. In addition to these sources, the paper uses results from a census of municipalities conducted in 2009 on Local Authorities' Access to European Funds. This source allows for differentiation between lines of financing as well as number of approved projects. It is used for analyzing absorption capacity at commune level for the period of 2007–2009. The process of data collecting, cleaning and drafting of the research report has been carried out by a consortium made up of the Romanian Centre for Economic Modeling, Research Institute for the Quality of Life and National Centre for Training in Statistics (National Institute of Statistics). The project has been funded by the Soros Foundation Romania (2009). The high response rate of the census (94%) alongside with a high degree of data accuracy (responses of the municipalities have been checked against official data from management authorities) allows for in-depth analyses on absorption of European funds. The quantitative data sources are supplemented by a survey conducted in 2012 on a probabilistic sample of rural municipalities from all development regions of Romania (N = 140, rate of response of 96%). However, for the purpose of this paper there is a limited usage of this survey's findings.

In addition to these sources, a qualitative research has been carried out by the author in the year of 2012. The interviews include two main groups of representatives: i) representatives of the municipalities from six communes located in the counties of Giurgiu, Vrancea and Bacău and ii) experts from management authorities, associations of local public authorities, consultancy firms, research institutes or financial institutions. In total, a group of 12 experts have been interviewed.

The main data limitation of this analysis rests with the operationalization of absorption capacity for the period of 2009–2012. Based on availability of data, we have used as proxy for capacity of absorption of European funds the public expenditures with projects funded by external sources as declared in the local budgets execution. This implies several limitations. There can be cases of municipalities with projects approved in the year of 2012 but have not yet disbursed expenditures. At the same time, the data does not allow a differentiation between lines of financing or an analysis of total volume of funds contracted through European-funded projects. However, it allows analysis at national level that can be further complemented by future studies.

For this analysis the fiscal capacity reflects the degree of local fiscal autonomy. We have operationalized the concept as the share of own revenues in total revenues of local communities. Own autonomous revenues exclude the sums allocated from shares of personal income tax for equalization purposes. They are the type of revenues upon which the local authority holds a greater degree of control. Data analysis differentiates between two main periods from the current programming period of European funds: i) 2007–2009, characterized as a "beginning" or "preparation" phase and ii) 2009–2012, a period of "full implementation" of European funds. For each of this period there is an annual average value for the indicator. In this way, the indicator reflects evolution of own revenues for the whole period and reduces the influence of oscillating revenues (as has been the case in the years of fiscal crisis).

DATA ANALYSIS

Most of the European funded projects, for the period of 2007–2009, for Romanian rural municipalities are the ones from the programs with the highest rates of absorption – Regional Operational Programme and Measure 322 from the National Rural Development Plan (Marin, 2014). The projects funded from all other five operational programs represent approximately 15% of the total number of approved projects.

At regional level, the municipalities with projects approved from European funding are mostly located in the regions of North East, North West and South West of Romania. The results are similar for Measure 322. The findings are confirmed by the intermediary evaluations for the National Rural Development Plan (MADR, 2010: 65–66). The above mentioned development regions rank first, for the period of 2007–2009, on both number of approved projects as well as total eligibile contracted funds.

The situation from 2009 is rather a 'preparation' phase for structural funds, at least for the operational programs. On demand side, the rural municipality's capacity for project application is very high (Stănculescu *et al*., 2009). Nevertheless, on offer side, the analysis of the environment shows obstacles which are difficult to surpass, as is the case of financig lines still closed. Consequently, absorption at national, programme[3] and commune level remain quite low.

For the period of 2009–2012, at national level, the number of rural local authorities with European funded projects in implementation tends to be higher. Sizes of the organization and of the commune play a significant part. The 'winners' from this period are more likely to be average and large communes (above 3,000 inhabitants) and average or socially developed (social development index, data from 2008). By large communes we include the category of above 5,000 inhabitants. Large municipalities (last quartile on the number of employees, data from 2009) have significantly higher chances to have European funded projects in implementation for the period of 2009–2012. The available data do not allow a separate analysis on each financing line. However, previous intermediary evaluation reports for the operational programs indicate that, most likely, the financing from the National Rural Development Plan remains the most important funding source for Romanian rural municipalities (Romanian Association of Communes, 2012).

The share of requested funds from total allocations for the Measure 322 is very high. Almost half of Romanian communes had in 2009 project proposals submitted for this financing priority. The explanations lie within the areas of the intervention (mainly investments in road, water and sewage infrastructure), high volume of funds for a project, credit guarantees through the Romanian Rural Credit Guarantee Fund and higher predictability of funds disbursement (as compared to State Budget Funds, results from qualitative research of 2012).

The share of 'winner' communes (from the total number of communes submitting project proposals) is quite low at national level for Measure 322. If we compare the submitted projects (data from the census of 2009) with the approved projects (official data with lists of beneficiaries from the period of 2009–2011), the result is that only a small share of communes (22%) have also financed projects. This category of 'winners' is rather from average socially developed communes and has no previous experience with European funding in the period of 2007–2009. The regional profile of winners is similar to the one registered at national level, with most projects located in North East and North West development regions of Romania. Data is confirmed by previous intermediary evaluations of the National Rural Development Plan (MADR, 2013: 123). Commune's development index, as published by the Ministry of Agriculture and Rural Development, also differentiates among the applicants for this line. The funds from this priority are rather targeting poor communes (above 55% of the population is poor).

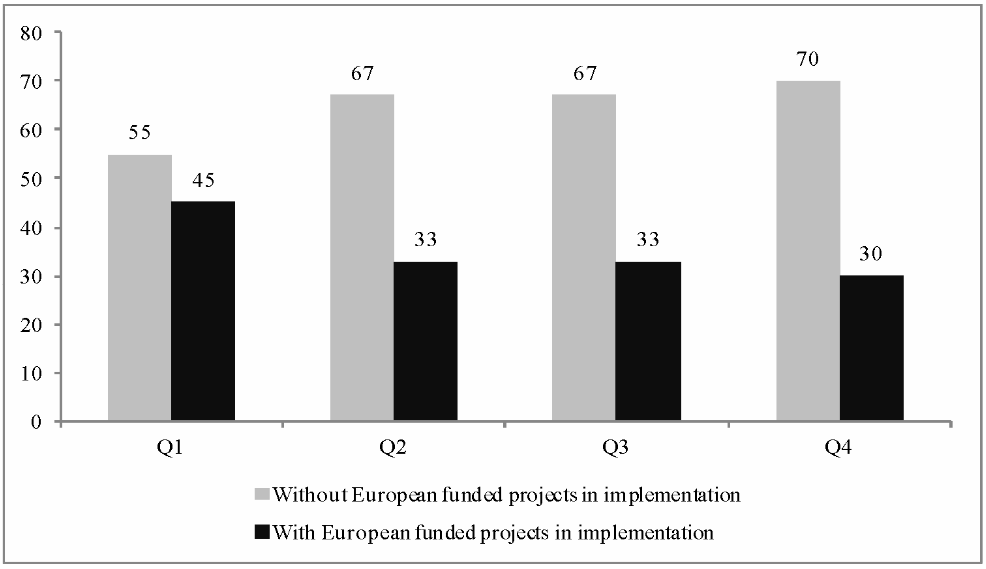
Fiscal capacity depends on size of population and of the organization, in line with similar previous studies (Šumpiková *et al.*, 2004; Tatar, 2010; Lorvi, 2012)[4]. Municipalities with high fiscal capacity have significant greater chances to be from big commnunes and municipalities (above 5.000 inhabitants or more than 40 employees).

[3] Except for Measure 322.
[4] These references consider size of the population.

Fiscal capacity is a significant predictor for absorption of European funds, but the sign of the relationship is contrary to the hypothesized relationship. Communes with low fiscal resources – own revenues below average (2009–2012) have significant greater chances to have European funded projects in implementation in the reference period. Explanatory factors are represented by criteria, type of eligible expenditures and type of project accessed from structural funds.

Figure 1

Distribution of rural municipalities according to fiscal capacity and implementation of European funded projects (2009–2012)



N = 2860. Data: Annex 24, Local Budgets Execution, as published by the Ministry of Administration and Internal Affairs, for the years of 2009, 2010, 2011 and 2012. We have used as proxy variable for implementation of European funded projects whether the municipality has reported or not expenditures with externally funded projects (structural and others). Fiscal capacity is measured as share of own revenues in total revenues (annual average for 2009–2012). Communes with low fiscal capacity are placed in the first quartile of fiscal capacity (Q1).

The criteria for evaluation of structural funded projects do not consider fiscal capacity of the applicant, neither for investment projects, nor for 'soft' ones as would be the projects related to development of administrative capacity or human resource development[5]. Moreover, specific financing priorities award supplementary points in the evaluation of projects submitted by poor communes. This is the case of the key intervention area of Measure 322. More than half of communes with projects in implementation have projects approved on Measure 322. At the same time, the integrated projects from Environment Sectoral Operational Programme on

[5] Explanation provided by Victor Giosan, independent consultant on local public finance.

management of waste, water, environment and sewage are accessed usually by partnerships between County Councils and a grouping based on geographic, and not on financial resources criteria of rural and urban municipalities from the corresponding area or region. The relationship holds true also for the case of Measure 322. Communes with low fiscal resources (share of own revenues in total revenues under the national average) have significant greater chances to have projects approved on Measure 322 in the period of 2007–2011.

Another fiscal resource in the management of structural funded projects is represented by the sums allocated from State Budget Funds for local budgets equalization or direct allocations from Government Reserve Funds. A share of twenty percent from equalization funds are assigned by County Council Decision. This represents the most important financial resource for co-financing mentioned in the survey from 2012. The other co-financing sources are, in order of frequency of responses the following: Romanian Rural Credit Guarantee Fund, local budget, bank loan or direct allocations from Government Reserve Funds.

At county level, a large number of communes are in a situation of resource dependency towards the County Council. It is an assymetric result relation (Marion, 1999). The resources managed by the County Council are for paying the arrears and for 'supporting the local development programs and infrastructure projects that need local co-financing' (Art. No. 33 from Law no. 273/2006 on local public finance). Consequently, the type of relation between the commune and the County Council could be referred to as a symbiotic relationship (approval of projects depends on ensuring the co-financing part).

Do you receive funds from the County Council?

Yes, they have helped us, I am actually very satisfied with this situation. They are still helping us, at least this is what I hope, because the situation has changed a little bit this time. I am telling you frankly that everything I have succeeded I did it with the support of the funds from the local budget, co-financing part from the local budget and County Council. (Mayor, North East Development Region)

Transparency of funds allocation depends on each County Council as well as on mayor's political affiliation. (Toth *et al.*, 2010: 129). The resource dependency relationship had its peak in the year of 2008. For this year, the whole equalization sum (instead of 20% of the funds) has been left for County Council decision (Art. 6, State Budget Law for 2008).

Have you received the funds from the County Council?

Yes, they have a formula.

Usually for this sum there is no formula, I mean for the part of 20%.

They used to make up some formula so that they can have a justification, but they are giving the money on other criteria, we hope for better days after these elections. (Accountant, North East Development Region)

In this case, an individual strategy (municipality's mayor changing his/her political affiliation) can result in a growing organizational legitimacy. Consequently, there is also a change regarding the constraints that the organization has to face.

In this case, the fiscal capacity depends on the mayor's political affiliation. This variable can also prove to be an explanatory one in the relationship between the municipality and the management of the intermediary bodies/management authorities. Previous studies have shown that the management of intermediary bodies depends on the political affiliation of the ruling party/ parties (Marin, 2011).

Another organizational strategy as identified by the resource dependence theory is the development of partnerships, either with other public organizations (municipalities or County Council), or with other private organizations. Considering the partnership as an organizational capacity for collaboration, a separate analysis has shown that the projects developed in partnership have better chances for approval from European funds (Marin, 2014).

The costs for drafting the project proposal are likely to become problematic only in the case of non-funded project applications. If the project is approved, these type of costs are eligible for funding. However, if the application does not receive the requested funding, there can be specific causes, partly out of municipality's control: i) there are insufficient funds for a specific session – the case of projects on the 'reserve list' (eligible project) or for a specific measure/key intervention area (the total volume of funds requested by eligible project applications is greater than the allocated volume of funds for the corresponding financing priority) or ii) rejected project (the project does not fulfill eligibility criteria/registers a minimum score). Moreover, there is also the situation in which the feasibility studies are no longer valid while the evaluation session unfolds. In this case, there is a long term between the application and projects selection results. Consequently, the feasibility studies along with the whole series of official approval notices have to be completed once more. This is more likely to happen at the beginning of the programming period, as the interviews with experts have shown. Therefore, the importance of fiscal capacity is likely to be higher in the case of communes with non-funded project applications. Nevertheless, a separate analysis has to be conducted at commune level (for each financing line) in relation with the average value of own revenues. The value of this indicator has been negatively influenced by the financial crisis from 2009–2010.

The problem of feasibility costs is quite important because the validity term of these studies is short and, afterwards, if you are not among the winners, you have to start all over again or even worse, there has been the case of communes with expired term of feasibility studies due to a long period of evaluation.

There are a lot of programming documents, each line has its own guide but there is no harmonization between them. This means that a feasibility study for application on Measure 322 is not valid for applying for the Regional Operational Programme and, therefore you need a lot of money and this is the case for the rural municipalities, where there are no funds or human resources […] we have applicant's guide, corrigendum to the applicant's guide and corrigendum to the corrigendum of applicant's guide. (Expert on structural funds, non-governmental organization)

The large amount of funds requested with project applications submitted for financing from the National Rural Development Plan (especially for Measure 322) is partly due to the financial conditions offered to its beneficiaries. The communes with approved project applications benefit from guarantees from the Romanian Rural Credit Guarantee Fund (a non-bank financial institution), with fiscal conditions more advantageous than the ones offered by bank institutions. The share of the guarantee offered by this fund is up to 100% of total volume of pre-financing requested fom the Payment Agency for Rural Development and Fisheries.

The beneficiaries of funds from the National Rural Development Plan have much more advantages as regards financing compared to other structural funds beneficiaries. They do not pay bank interest, they only pay a monthly bank commission of 0.05%. We also have a very clear and simple methodology and they receive an answer from us within three days. (Representative of the Romanian Rural Credit Guarantee Fund)

In case the project fails in implementation, the Fund assumes responsibility for beneficiary's errors, even though these surpass its control area. In case the documentation submitted by the beneficiary to the Payment Agency is not considered eligible, the Payment Agency for Rural Development and Fisheries executes the Romanian Rural Credit Guarantee Fund.

Another problem related to fiscal capacity lies in ensuring the necessary cash-flow for project implementation. This holds true mostly for operational programmes, not for the National Rural Development Plan: 'co-financing is not a problem for local authorities, but the cash-flow is' (Representative of the Management Authority for Regional Operational Programme). An analysis of multi-annual budgetary planning for each potential beneficiary can partly resolve this problem. However, some representatives of the municipality feel that they do not hold control over provisioning their own revenues. The causes for this situation lie either within the effects of the fiscal crisis, or within the area of penalties that cannot be collected.

We are not able to have bank loans because we have no necessary revenues. The share of collection of own revenues is of 70%, but is of 40% if you consider penalties. These are road or market place penalties ... And they are here from one budget year to another. I have no legal possibility of collecting them, or executing them, now I can no longer even sew them or transform it into community work, I have nothing to do with them. (Accountant, South Development Region)

The municipality's fiscal capacity is analyzed only if the commune applies for a bank loan. In this case, the financial institution decides whether the project submitted is 'bankable' or not. 'The criteria for a bankable project are different than the eligibility criteria for approval of the project' (Bank representative[6]) and they are analyzed by the bank from the phase of project submission, so that to ensure better chances for success in the implementation of the project.

[6] Conference on absorption of European Funds, National Bank of Romania, 10th of May 2012.

CONCLUSIONS

This paper examines the role of fiscal capacity in absorption of European funds for rural municipalities of Romania. The study covers a large part of the current programming period (2007–2012). Its main conclusions are based on analyses conducted at national level. Contrary to the hypothesized sign of the relationship, the analysis shows that communes with low fiscal capacity (own revenues under average) have higher chances to have projects approved from European funding. By examining which are the influences on fiscal capacity, the study also shows several other conclusions.

The importance of fiscal capacity depends on the financing line or key intervention area. A large part of Romanian communes have contracted European funded projects through the National Rural Development Plan. From this funding, Measure 322 regarding improvement the quality of life in rural areas has registered a high level of requested volume of funding. The financial conditions offered to the beneficiaries of this funding through the Romanian Rural Credit Guarantee Fund are far more advantageous than the ones offered through the operational programs. Additionally, the evaluation of the project proposals awards supplementary evaluation points for the communes in which there is a high share of poor population. Therefore, future studies on local government's absorption capacity should consider separate analyses between financing lines.

Fiscal capacity depends on the size of population and that of the organization. Municipalities with high fiscal capacity have significant greater chances to be from large communes and organizations.

The financial resources for co-financing European projects are highly dependent on County Council decision. As a result, there is an asymmetric result resource dependency relation between the rural municipality and the County Council. The highest level of discretion in allocation of these funds has been registered in the electoral year of 2008. Under these circumstances, municipality's fiscal capacity depends on mayor's political affiliation. Further in-depth analyses are needed on this topic.

The paper assumes absorption capacity as a dependent variable. However, it is also interesting to examine which is the effect of the absorption capacity on the municipality's fiscal capacity. Previous studies have shown that a large number of European funded projects can result in significant budget pressures (Giosan and Glenday index in Ionescu-Heroiu *et al*., 2014).

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Articolul analizează rolul capacităţii financiare în absorbţia fondurilor structurale pentru ţara cu cel mai scăzut nivel al ratei de absorbţie. O atenţie specială este acordată Măsurii 322, Axa Prioritară 3 privind îmbunătăţirea calităţii vieţii în mediul rural (Planul Naţional de Dezvoltare Rurală al României). Unităţile de analiză sunt primăriile de comune din România, pentru perioada 2007–2012. Principalele surse de date sunt reprezentate de execuţiile bugetelor locale, un recensământ al primăriilor privind Accesul Autorităţilor Locale la Fondurile Europene, alături de o cercetare calitativă. Studiul arată că fondurile europene se concentrează în comunele cu un nivel scăzut al capacităţii financiare. În acelaşi timp, capacitatea financiară este dependentă şi de mărimea organizaţiei şi a comunei, dar şi de afilierea politică a primarului. Importanţa capacităţii financiare depinde de liniile de finanţare. Studiul acoperă o arie mai puţin investigată, cea a capacităţii de absorbţie a fondurilor europene la nivelul cererii.

Cuvinte-cheie: *capacitate fiscală, fonduri europene, comunităţi rurale, fonduri structurale.*

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