Theoretical and Applied Economics
Volume XXI (2014), No. 3(592), pp. 45-56

Sustainability of public co-financing of investment projects with EU financial assistance in Romania

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Abstract. *The public sector capacity of the EU Member States to access the European funds depends highly on the sustainability of their government budgets. According to the European Commission assessment, Romania is not facing a risk of fiscal stress in the short run. However the effects of the economic crisis and the vision with a predominantly social character regarding the public expenditures have contributed to the limitation of resources allocated for economic development. The low level of absorption of the European funds in Romania means implicit losses for the national economy, but a higher level could have been a cause for excessive budget deficit. In order to reduce the pressure on the state budget the government aims at being committed mainly in investment projects with EU financial assistance. This reflects the substitution of the state own financial resources with foreign funds, therefore the additionality effect initially wanted by the EU decreases. The paper evaluates the public investment effort in Romania under the Fiscal Pact limit on deficit and the conditionalities negotiated with IMF, as well as its effects on the economy and budget deficit.*

Keywords: additionality, public investment, co-financing of European funds, budget deficit.

JEL Classification: H54, H62, E65.
REL Classification: 20J, 18F, 13F.

1. Introduction

Additionality of funds within European Union means that the transfers from the central European authority to the national or regional authorities aim to supplement funds raised by EU countries to generate new projects in order to stimulate economic development. The financial implications of the transfer of additional funds in EU countries have been discussed in recent papers (Del Bo et al., 2011), in which are identified the effects of substitution of the public funds with the one transferred, effects of modifying the sectoral financial allocation from their own funds, plus tax effects.

Kalaitzidakis and Kalivitis (2008) pointed out that a high volume of financial assistance can be an impediment to growth in the economy due to the excessive taxation imposed by the need to co-finance the investment projects. Arpaia and Turrini (2008) examined the fiscal reaction functions and tested the hypothesis that governments will reduce public investment for fiscal consolidation and public debt reduction. Likewise, Missale et al. (2009) have argued that the new EU member states may substitute expenditures from their own resources and reduce the total investments. The authors show that in the case of an increase in the budget deficit and public debt, public expenditures on education and investment are reduced and the additionality effect is neutralized. The evidences show that EU countries were restricted from taking investment decisions because of the need to ensure debt sustainability rather than limiting within the values of the public deficit, according to the rules of the Stability Pact.

All EU countries are in a real competition to attract financing available in the market and pay an increased attention to investments that do not generate major imbalances on the budget deficit and public debt. Some vulnerabilities and difficulties in absorbing EU funds in Romania have been highlighted by Socol et al. (2011), among which there is the reduced fiscal space and the difficulties of increasing VAT to the companies that need to co-finance projects. Also, the lack of prioritization of public investment and multi-year budgeting identified until 2012 are considered challenges to the sustainability of public finances (Altăr et.al, 2012).

Sustainability of the public finances is closely related with the impact of the economic, financial and fiscal crisis, and with the indicator of population ageing. Fiscal sustainability refers to the ability of the government to assume all debts and financial expenses in the future. Fiscal policy is not sustainable if it involves high levels of public debt and government deficit. The overall assessment of the sustainability of public finances reveals that Romania does not face a fiscal risk on short-term. Sustainability gap of Romania reflects almost completely the long-term costs of population ageing (European Commission, 2012).

The paper highlights the investment effort financed from budgetary sources in Romania under the limits imposed by the budgetary constraints within the EU. One component of this budgetary effort is the co-financing of the EU financial assistance for investment projects. On the one hand, the low absorption rate of the Structural Funds calls into question the default losses of the national economy by not using the allocated funds. On the other hand, the co-financing effort allocation at the level of the programs may generate excessive budget deficits. This paper aims to analyze the increasing of the co-financing of the investment projects during the period 2013-2015 and the effects on the budget deficit, given the significant increase in the absorption of structural and cohesion funds.

2. Metodology and data source

The research is based on empirical analysis of the expenditures' structure of the consolidated state budget, which highlights the dynamic investment budget support, including co-financing of the European projects.

To determine the impact of investments on the economy the investment multiplier is calculated:

Investment multiplier (k) = ΔGDP due to investments / ΔI,

where:
ΔGDP = annual variation of GDP
ΔI = annual increase of investments *(*gross fixed capital formation*)*

The annual change in GDP due to investment is based on the annual contribution of investments to economic growth.

The data sources used are based on Eurostat database, data from the National Institute of Statistics regarding the national accounts published by the Ministry of Public Finance and Ministry of European Funds.

3. Investment ratio of budget expenditures and budget deficit

Empirical data show that the new EU countries have changed to some extent the structure of public expenditures. Budgetary constraints, imposed by the Stability and Growth Pact and more recently by the Fiscal Pact entered into force in 2013, create pressure so that the Structural Funds may produce substitution effect rather than additionality.

Before the year of 2008, countries with high levels of debt, most of them being the old EU countries with higher levels of development were characterized by a low share of public investment in order to meet the deficit limit, especially if the debt exceeded 60% of GDP. This includes countries such as Belgium, Germany and Austria (European Commission, 2010, p.21).

In the latest period, analysis of the data on capital budget expenditure (Table 1) does not follow a clear relationship between the share of these expenditures in GDP and the budget deficit to GDP. The limit of 3% imposed by the Stability and Growth Pact does not seem to affect countries like the Czech Republic and Poland, which during the crisis have maintained a high share of budget expenditures for investments, above the EU27 average level, even if exceeding the 3% limit. This shows that a high deficit does not prevent countries to finance investments. For the support of the financial investment decision it is more important the level public debt. In Romania the share in GDP of the investments financed from the budget was high in the period of 2010-2012, comparable with Poland and Czech Republic and significantly above the EU27 average (Table 1).

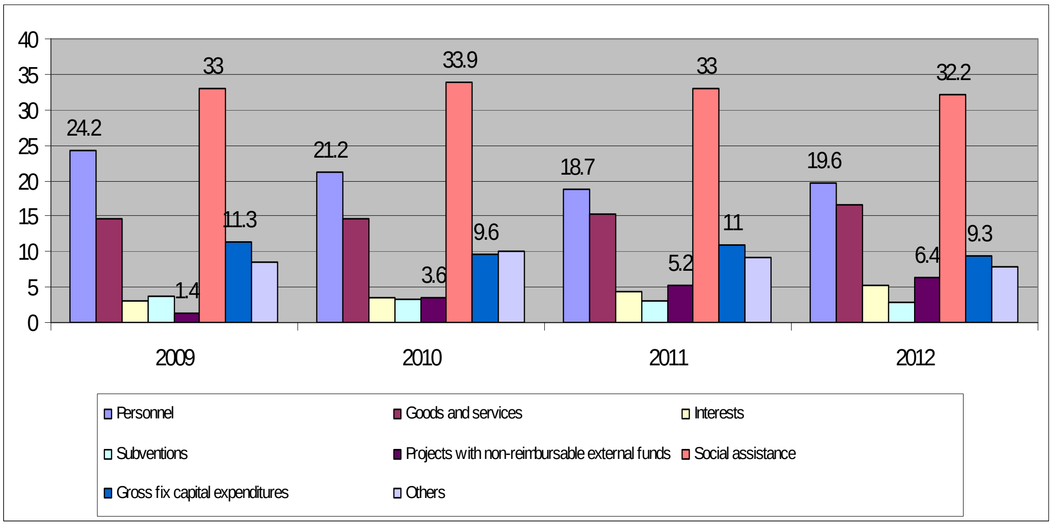
Table 1. *Government expenditures for investments versus budget deficit*

	Capital expenditure* from the consolidated general budget to GDP (%)			Deficit under the excessive deficit procedure (%)		
	2010	2011	2012	2010	2011	2012
UE27	4.3	3.5	3.7	<0.1	<0.1	-4.0
Bulgaria	5.0	3.7	3.9	<0.1	<0.1	<0.1
Czech Republic	5.7	5.1	6.2	-4.8	-3.3	-4.4
Cyprus	5.3	4.5	4	-5.3	-6.3	-6.3
Estonia	3.4	3.6	6.5	0.2	1.2	-0.3
Hungary	4.7	5.8	4.7	-4.3	4.3	-1.9
Latvia	7.5	6.8	4.7	-8.1	-3.6	-1.2
Lithuania	5.1	4.9	3.9	-7.5	-5.5	-3.2
Malta	3.5	3.1	3.8	-3.6	-2.8	-3.3
Poland	6.4	6.2	5.1	-7.9	-5.0	-3.9
Romania	6.5	7.9	5.6	-6.8	-5.6	-2.9
Slovenia	5.6	5.8	4.1	-5.9	-6.4	-4.0
Slovakia	3.7	3.4	2.7	-7.7	-5.1	-4.3

* Gross fixed capita formation,, including capital transfers

Source: Eurostat, Government Finance Statistics, Summary tables - 1/2013, 1997-2012 data and author calculations.

The structure of the budgetary expenditures in Romania in the period of 2009-2012 indicates a predominance of social spending (about 32-34%) and personnel costs (about 18-24%). During this period there is a gradual increase on budgetary expenditures on projects funded by external grants from 1.4% in 2009 to 6.4% in 2012, however, associated with a reduction in the share of capital expenditure incurred by the state budget from 11.3% to 9.3% during the same period (Figure 1).

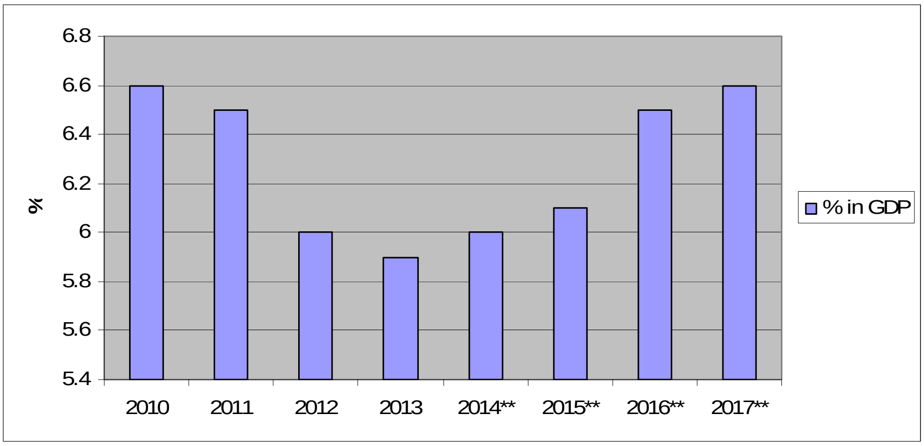


Source: Summaries of the general consolidated budget execution, Ministry of Public Finance.

Figure 1. *Structure of budgetary expenditures, 2009-2012*

The announced investment expenditure of the government for 2013 represents 16.3 % of total expenditures, being budgeted according to the efficiency criteria, following that in 2015 to reach 17.3% (Romanian Government, 2013). These levels appear to be significantly higher than in the past, but in fact include both capital expenditures and expenditures for projects funded by non-reimbursable external funds. Within the structure of these expenditures, the component "capital expenditure" falls starting with 2014 even in nominal terms compared to 2013 and increases the component of project co-financing. Expenditures for co-financing are fully assimilated to investments, although only some are for gross fixed capital formation.

A relevant picture of the evolution of the budgetary effort for investments is determined by economic classification (Figure 2). In fact only since 2015 it is noticed a revival of projected investment, broadly defined.



*Expenditures for investments include capital investments and expenditures for projects with non-reimbursable external funds

** Estimations

Source: Ministry of Public Finance, *Preliminary Report on the implementation of the budget for the years 2010, 2011 and 2012* and *Report on the macroeconomic situation in 2014 and its outlook for the years 2015-2017*

Figure 2. *Budgetary expenditures for investment* (% in GDP) during the period 2010-2013 and estimations for the period 2014-2017*

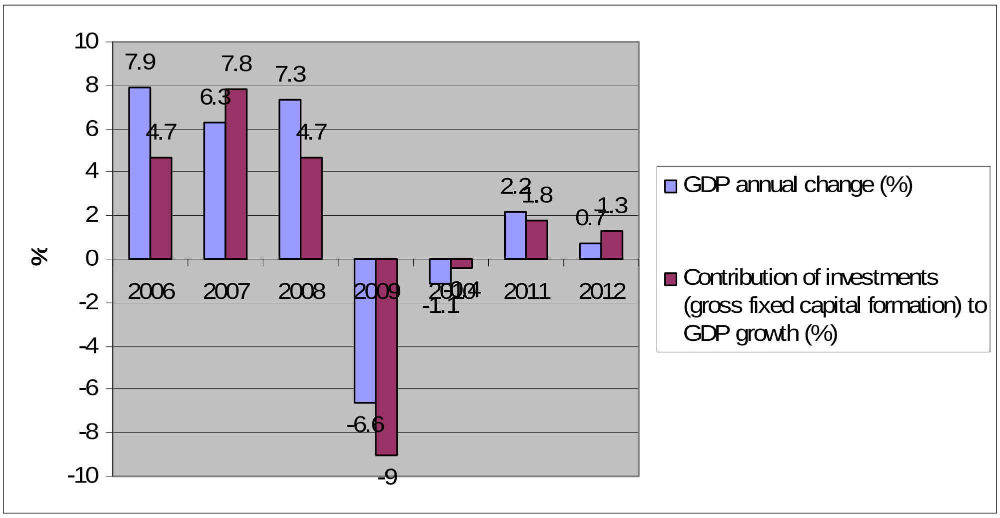
The public sector capacity and coherence in co-financing the EU projects depend primarily on the overall sustainability of public finances in Romania. Estimates for the period after 2013 provide a certain level of co-financing from the state budget, based on the projected growth in the optimistic scenario and adequate institutional capacity for ongoing projects.

4. The effect of public investment on economic growth

The potential of economic growth is higher in the new Member States than in the more developed EU as an expression of the difference regarding the reporting base and of the catching-up process. According to Eurostat, in 2007-2013 it is showed that most countries have a GDP/capita (in PPS) between 70% and 130% of the EU28 in 2012. Poland has recorded an increase of GDP/capita from 55% of the European average EU28 in 2007 to 67% in 2012 and GDP /capita in Romania during the same period increased from 42% to 50% of the EU28 average. The different evolution of new Member States is due to differences in the speed and results of reforms in the pre-accession to European Union and also to the specific orientation of the resources to investments and to the capacity to absorb European funds.

Public investments can play an important role, which stimulates economic growth. In a recent analysis regarding Romania (Altăr et al., 2012, p.86) it is stated that, if their funding would increase government debt, the effect on economic growth is negative. An increase in public debt leads to an increase in future interest costs, increase that has to be financed by raising taxes and dues.

From the analysis of macroeconomic data on the contribution of gross fixed capital formation (GFCF) to economic growth (Figure 3), it is pointed out that the variation in investments and GDP growth have been produced in the same direction.



Source: Data from National Institute of Statistics

Figure 3. *Contribution of investments (GFCF) to economic growth in Romania, 2006-2012*

Calculating the investment multiplier according to the methodology set out before, it appears that it was subunit in the post-accession (Table 2), indicating that the effect of driving investment in the Romanian economy was low.

Table 2. *Estimated investment multiplier in the Romanian economy*

	2006	2007	2008	2009	2010	2011	2012
GDP indices (to the previous year)	1.079	1.063	1.073	0.934	0.984	1.022	1.007
GFCF indices (to the previous year)	1.199	1.303	1.156	0.719	0.979	1.073	1.049
Annual variation of GDP (billion RON in 2005 prices)	22827.41	19642.27	24193.97	-23470.8	-5314.36	7190.328	2338.164
Annual variation of GFCF (billion RON in 2005 prices)	13636.79	24895.51	16701.19	-34776.6	-1868.65	6359.384	4580.238
GFCF contribution to economic growth (%)	4.7	7.8	4.7	-9	-0.4	1.8	1.3
GDP variation due to GFCF (billion RON in 2005 prices)	13580.87	6408.745	15576.94	-32005.6	-1328.59	5882.996	4342.304
Investment multiplier	1	0.26	0.93	0.92	0.71	0.93	0.95

Source: Author calculation.

Separating the impact of public investment on growth is methodologically difficult. It can be appreciated, however, that the low level of multipliers is primarily due to low efficiency of investments financed from public sources, many of which are unfinished or having less effect on output growth. Thus, with high probability, the public investments have a lower multiplier effect in comparison to that determined for total investment.

5. Implications of increased EU co-financing financial assistance for investment projects in Romania

According to the Strategic Report on the Implementation of EU cohesion policy (European Commission, 2013), Romania is ranked last in the European Union in terms of absorption of structural funds in the period 2007-2013 with a contracting rate in 2007-2011 by about 70% and a repayment rate of 20%. These rates have increased in the meantime, reached the end of 2013 to 91.78% and 20.12%.

Thus, an important issue that reflects poor absorption of European funds lies in the large differences between the contracting rate (scriptic money stipulated in the contracts signed with the beneficiaries) and actual payments reimbursed by the European Commission in each Operational Programme. In this respect, it is illustrative the Sectoral Operational Programme-Transport, where they made the fewest payments to beneficiaries, being obvious the weak implementation capacity, with very large delays to the beneficiaries.

Among the major causes of the low level of absorption of the European funds it can be mentioned:

- Poor budget strategic planning at the national level, one of the components being the ability to co-finance from the national budget. The effects of

incomplete integration of structural funds in the national systems of public finance, particularly in terms of financing the public investments and public procurement, are reflected in the lack of flexibility in funding the initial objectives which didn't take into account the impact of the economic crisis.
- The distortion effect generated by delaying the introduction of some provisions or financing mechanisms to fund projects from the state budget, and then to adjust the repayments with the European Commission, after verifying how the money was spent. This led to the insolvency/default of many beneficiaries because reimbursements from the European Commission were low.
- Unclear legislation on public procurement, which generated the initial approval of acquisitions that proved to be subject to breaches of Community principles transposed into Romanian legislation much later and thus of the financial corrections.
- Parallel implementation of funding from structural funds and agreement with the International Monetary Fund and the non-correlation between the two in terms of objectives and targets set (i.e. the deficit target would not have allowed the involvement of the state budget in financing the projects in advance and /or tensuring the co-financing).

Data analysis on providing domestic public resources scheduled to ensure co-funding received from the EU starting with the accession of Romania in 2007 reveals that the amounts budgeted were oscillating and the economic and financial crisis effects have passed on these co-financing also. In the first two years of the programming period 2007-2013, the absorption level was insignificant. After another four difficult years 2009-2012, when the budgetary expenditure for co-financing began to increase, the absorption level of structural funds only reached 11.4% in 2012. By September 30, 2013 the cumulative absorption rate reached 25% (Table 3).

Table 3. *Evolution of budgetary expenditure and absorption of European funds in Romania*

	2009	2010	2011	2012	1.01-30.09 2013
Budgetary expenditures for projects with funding from non-reimbursable funds post-accession * (million euro)	631.53	1737.17	2545.48	2966.32	1947.82
% of Total expenditure of GCB	1.4	3.6	5.2	6.4	5.5
% of GDP	0.5	1.4	1.9	2.3	1.4
Cumulative absorption level** of the Structural Funds (%)	2.0	8.62	9.4	11.47	25.0
EC reimbursement, cumulative (billion euro) for the period 2007-2013	0.58	0.87	1.06	2.2	4.8

* Author calculations based on annual average exchange rate.

** Calculated as rate of funds reimbursed by the European Commission to the total financial allocation for the period 2007-2013.

Source: Consolidated general budget (CGB), annual summaries, Ministry of Public Finance and data of the Ministry of European Funds.

An objective of the fiscal policy for the period 2013-2015 is the reform of public investments by substantially increasing of funds allocated to co-financing the European projects. Government aims to reach an absorption rate of 50-80% of the non-reimbursable structural and cohesion funds by the end of 2015, with reference to the used and returned European money by the European Commission (Government of Romania, 2013).

The state budget analysis for 2013 reveals that investment amounts are higher than the one budgeted for the year 2012, under the concept that the co-financing of the projects financed from European funds is assimilated to the investment notion. This means that the Romanian state will support investments primarily from the European funds. In 2013, the budgetary funding is directed primarily towards the investments that have high performance and that can be completed by 2014.

The negative factors that put pressure on the budget:

- The taking over by state budget of the corrections by the European Commission for failure to comply with the rules of using European funds. Romania will have to pay for the deficiencies in the system from 2009-2011 over one billion euro and the amount represents 5% of the current financial allocation. It is possible that the increased accelerated absorption level of the last year to generate unexpected new corrections within the budget under conditions of incomplete improvement of institutional capacity to support the process.
- Low multiplication of investments. If the investment multiplier remains subunit, the budget investment effort for co-financing European projects is not effective and does not generate the expected GDP growth. Thus, using European funds as a solution to boost the economy fail to meet its object and purpose.
- The overlap of the extension approved for the funds in the period 2007-2013 with the first two years of the next programming period 2014-2020 can generate major deficits or make it impossible to co-finance new projects. For the next financial year, Romania will have 39.5 billion European funds, 18% more than before. Annual allocation for 2014-2020 is not yet finalized, but insufficient capacity of the state to financially support an additional amount may compromise the delay in the absorption of the funds allocated for the next seven years.

Favourable factors which reduce the pressure on the budget deficit:

- Postponement of the deadline by three years of spending and repayment of amounts allocated during the programming period 2007-2013.

- Approval granted already by the EU institutions for the 2007-2013 programming period for the temporary reduction of co-financing from EU countries up to 5% in order to reduce their budget effort in times of economic crisis.
- Temporary enforcement by the European Commission of the investment clause for 2014 to the Member States which are not in the procedure of excessive deficit and which have a negative economic growth or below potential. In the case of Romania, which can benefit from this clause, the measure can contribute to reducing the co-financing and achieving sustainable economic growth.

The most-favoured factors indicate an opening of the European Union to increase the absorption capacity of the Member States through the provision of additional facilities. This reflects a deviation from the principles stated above. Creating favorable conditions for the budgetary construction does not solve automatically the problem of maintaining within the limits of the allowed budget deficit, as it depends largely on the quality of the absorption process.

Conclusions

The analysis performed in this paper leads to the following conclusions:

- To ensure the sustainability of the budget, the deficit may be accepted, but on condition of achieving expenditures which ensure healthy economic growth;
- It confirms the trend of substitution of the national budget effort for investments with European Funds;
- If the investment multiplier is continuously subunit, the investment effort from the budget for co-financing EU projects is not effective;
- Reaching an absorption rate of 50%-80% is not achievable unless obtaining the reimbursements for the years 2011 to 2013 and only after this process the new projects should be reimbursed, otherwise cash-flow problems may appear and can tend to block the implementation process;
- The overlap of the extension with the first two years of the programming period 2014-2020 can generate deficits or can make it impossible to co-finance major or new projects in the first years, with all the disadvantages of such delays already experienced;
- Implementation by the European Commission of the investment clause, as an exception measure to productive investment is an opportunity to be situated within the accepted deficit limit and at the same time to continue funding the projects from the state budget.

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