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Research Article

**Spotlight on Factors Influencing the Absorption
Rate of EU Funds in Romania**

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Abstract

This paper aims to analyze the factors influencing the absorption of EU funds under cohesion policy, in particular the administrative capacity related factors. Analysis of the absorption rate has a significant importance since it measures the capacity of a state or region to make effective and efficient use of the funding available under cohesion policy which is considered the most important EU investment policy, in particular in new member states. The authors used a genuine decomposition formula of absorption rate to identify the supply side and demand side administrative factors influencing absorption and applied it to the case of Romania's Operational Programs funded during 2007-2013 under Convergence Objective. The results obtained allowed the authors to reveal the main administrative weaknesses

explaining why Romania has very low absorption rate; the bottlenecks identified should be lessons learnt and should be properly addressed by Romanian policy makers for 2014-2020 programming period.

Keywords: absorption capacity, EU cohesion policy, structural funds, administrative absorption capacity

Introduction

Traditionally, the EU cohesion policy was considered to be a supranational solidarity policy with specific redistributive and compensatory aims. The EU cohesion policy had *compensation function and goals* (visible after UK accession) since it was *"primarily concerned with meeting compensatory demands articulated from real or prospective losers of the integration process and the most important integration moves in the history of the EU would not have been possible without side-payments to opponents or adversely affected groups"* (Eiselt,I, 2006). The compensation aim is specific to the EU enlargements (in particular the southern and eastern enlargements), but also to the processes of deeper integration since *"the economic and monetary union was expected to have failed from both political and*

economic perspectives without side payments and investments in economically lagging member states and regions” (Allen, D, 2000). From this perspective, it is likely to consider that the cohesion is aimed at allocating the economic benefits among member states and compensating the economic losses triggered by the processes of enlarging and deepening European integration. The cohesion policy is a redistributive policy, designed as “a set of specific funds and Community initiatives redistributing financial resources partly collected from the member states and partly gained from the Union’s so-called traditional own resources through the EU budget” (Eiselt, I, 2006), of which instruments basically consisted in financial transfers (through EU budget) from more affluent member states to economically weaker members states.

After 1988 -1993 reform, the cohesion policy transformed: from a solidarity policy towards an *investment policy for development objectives supporting balanced economic development, economic gains and competitiveness for regions of the member states*. The allocation mechanisms were no longer exclusively dependent on the level of development of the regions, but rather dependent on the results and impact of the investment activities/projects on economic and social development. Since then, the cohesion policy focused on efficiency indicators as main criteria for allocating funds, and it reoriented on *funding projects generating gains in economic efficiency and competitiveness* for recipient regions; achievement of the policy objective depends more on the capacity of the regions and regional stakeholders to develop efficiency generating projects in support for economic growth and the

simple positioning of a region among the less developed ones is no longer the guarantee for being granted more cohesion money.

Starting with the programming period 2007-2013, the EU cohesion policy turned into a **support and investment policy for regional economic competitiveness**: *"cohesion policy should provide opportunities for the future [...] rather than compensation for the problems of the past"* (Constantin & all, 2010); thus, *the syntagm "competitiveness – cohesion" does no longer represent an antinomy competitiveness versus cohesion, but a tandem of interdependent objectives* (Constantin D & all, 2010).

Consequently, this financial support is no longer perceived as an "aid", but rather as an "investment" for faster growth and competitiveness, addressing the faster development needs of the regions lagging behind development. The cohesion policy

becomes *the most important investment policy of the EU* to support economic efficiency, employment and competitiveness at regional level. To this end, the new EU cohesion policy allocation mechanism was redesigned in order to provide funding for projects and programs addressing competitiveness goals and priorities set up in the Lisbon strategy and latter Europe 2020 strategy. The earmarking of the Lisbon and Europe 2020 priorities into the cohesion policy is considered the key element for providing an effective solution to the cohesion policy dilemma of accommodating the two apparently divergent goals of: (1) reducing development disparities and (2) boosting competitiveness. Consequently, for both 2007-2013 and 2014-2020 programming periods, the *EU cohesion policy strongly connects the EU long term development and competitiveness strategies and objectives (Lisbon and Europe 2020 Strategies) with*

the traditional cohesion policy objective of reducing economic disparities and reducing regional development gaps. The "Lisbonisation" of the cohesion policy is a turning point in the reforming of this policy "shifting the focus of cohesion policy from traditional alleviation of regional disparities to enhancing human resources and the knowledge intensive economic activities in prospective competitive parts of the economy" (Kalman & Tiits, 2014). Still the redistributive function subsisted, since the new cohesion policy preserved the implicit policy objective that economically weaker member states should profit more from cohesion money than affluent ones: for 2007-2013 programming period, over 81.5% of the cohesion policy budget is allocated for convergence objective (addressing the needs of less developed regions of the EU) of which 70.5% is allocated to speed up convergence of least developed member states, most belonging to

new members states. The new "investment policy" and support for competitiveness approach, together with the preservation of the redistributive function intensified the debates over the effective use ("*absorption*") and impact of the funding under EU cohesion policy, in particular in new member states from Eastern and Central Europe. Allocations under EU Cohesion policy have been constantly growing since the '80s and became, at present, the most important item of expenditures; thus, the analysis of the effective and efficient use of these large amounts of financial resources became important for both EU and member states decision makers. This is the reason why the issue of **absorption of the funds** under cohesion policy has come to the forefront in European policy talks and academic debates.

Spotlight on the absorption capacity of EU funds

After the 2007 enlargement, due to the relative weight of the available funding under cohesion policy heading in the EU budget (347.7 bill EUR for 2007-2013 and 351.8 bill Euro for 2014-2020, representing almost 1/3 of the EU budget resources), the issue of **absorption capacity of the EU funds** under cohesion policy has come to the forefront of the European discourse, in particular in new member states from Eastern and Central Europe as main recipients of the funding available. Most of the definitions refer to the absorption EU funds for cohesion as *“the capability of a region or member state to allocate and to fully spend the financial resources under cohesion policy in an efficient and effective way”* (Dragan, 2008; Horvat A, 2005); it measures *the extent to which a state/region is able to fully spend the allocated financial resources*

from the EU funds in an effective and efficient way (Kopeva & all, 2011). Consequently, increased absorption capacity is widely considered a key condition for making a maximum contribution of the EU funding to economic and social cohesion; taken into account also that the EU funding under cohesion policies plays the key role that as the main investment instrument, in particular in new member states from Eastern and Central Europe, this could explain the recent interest for understanding and analyzing the absorption capacity and factors of influence with the a view of identifying measures to increase absorption.

Specific factors from both the supply side and the demand side have significant influence on the absorption capacity of EU funds. The absorption capacity on *demand side* means the actual ability of the project applicants to generate acceptable projects (Kopeva

& all, 2011) and is largely dependent on (a) administrative capacity - the ability of applicants and project beneficiaries to prepare and implement good eligible projects and to properly manage the projects in order to reduce the incidence of irregularities and (b) financial capacity - the co-financing capacity of the beneficiaries. The absorption capacity on *supply side* largely depends on the institutional system created in each member state to manage the EU funds (Dragan, 2008) and can be assessed by reference to three distinctive components (Oprescu & all 2005; Kopeva & all 2011; Dragan, 2008; Sumpikova, 2007): *macroeconomic capacity* - indicates the rate of the EU funding in terms of the GDP of the recipient member state (limited at 4%); *financial capacity* - the ability to co-finance EU supported programmes and projects, to plan and guarantee these national contributions in multi-annual budgets, and to collect these

contributions from several partners (state, regional and local authorities, private bodies) interested in a programme or project *administrative capacity* – the ability and skills of central, regional and local governments to prepare suitable plans, programmes and projects in due time, to decide on programmes and projects, to arrange the co-ordination among principal partners, to cope with the administrative and reporting requirements, and to finance and supervise implementation properly, avoiding irregularities as far as possible (Horvat, 2005; Kopeva & all, 2011). The administrative capacity is dependent on both the design of the implementation system and its functioning (operationalization of rules) and it comprises: (a) structures (clear assignment of responsibilities and task of legal body in the EU funds management for the entire program management cycle: programming, implementation, management, evaluation and

monitoring, financial management and control etc.); (b) human resources (adequate supply and availability of qualified personnel, clear job description, personnel performances etc.) and (c) systems and tools (availability and effective use of instruments, methods, guidelines, manuals, systems, procedures, forms) (Kopeva & all, 2011)

The absorption capacity of EU funds is usually measured by “**absorption rate**”, an indicator defined as the level of *verified payments disbursed* as percentage of the *planned allocations* (funding available) for a particular program, region or for a member state. Due to the importance of cohesion funding as an investment tool to foster development and competitiveness for many EU member states, the 100% absorption rate becomes a major concern for regional and central governments.

Consequently, governments deployed efforts to prevent and

manage the *deficiency of absorption capacity* (Horvat & Maier, 2004) and *absorption bottlenecks* (Kalman, 2002). Analysis conducted so far about the effects of EU funding identified the so-called “absorption problems” (Kalman, 2002; Kalman, 2011, Dragan, 2008) which have to be carefully taken into consideration, by policy and decision makers:

administrative absorption' problems – is resulting in a difference between transfers from EU budget under cohesion policy and the increase in the productive capital in the beneficiary region/member state;

rent-seeking problem – it refers to the people who interfere for the use of EU funds with the view of gaining personal advantages and it becomes manifest through external forms of corruption at various levels (between national governments and EC, between

governments and various organizations having interest in accessing EU funding etc.);

timing related problems – EU funding in infrastructure projects consists in long-term focused public investment and may have significant opportunity costs in the short-run, such as delays in private investment decisions or private investment even being crowded out by public sector (Dragan, 2008);

prioritization problems – the inability of the regional/central governments to define a limited number of investment priorities may lead to suboptimal use of EU funding.

The use of EU funding is governed by the additionality principle which means that the EU financial resources allocated to the member states are additional to the national available funding and do not substitute the member state investment efforts.

Consequently, it seems that the “*EU structural funds are intended to finance projects in addition to what would anyway be included in the budget*” (Paliova, 2014); if the obligation to co-finance EU programs/projects under cohesion policy is also taken into account, it seems that the EU funding may cause an additional fiscal burden (Paliova, 2014) to member states, in particular the less developed ones.

The exclusive focus on increased absorption rate of governments could generate negative adverse effects and hidden costs which may consist of (Herve & Holman, 1998 quoted in Paliova, 2014): (a) direct adverse impact due to suboptimal management of the funds, for instance because of undue political interference, mismanagement, or even corruption; and (b) indirect adverse effect due to distortion of relative prices in case of economies

with supply constraints, for instance, if there is structural unemployment due to rigid labor markets and/or by affecting private investments or creating temporary but unsustainable growth that blurs and delays overdue structural reforms.

Explaining the absorption rate: a methodological approach

Traditionally, when analyzing the absorption rate, it is useful to distinguish between: (a) *contracting ratio* (projects are approved and contracts signed); (b) *absorption ratio* (advance payments plus verified payments disbursed); (c) *certification ratio* (invoices have gone through the national verification and certification process and the certified expenditures sent to Brussels for approval and disbursement of funds); and (d) *final absorption*

rate, when projects have been certified by the European Commission (Paliova, 2014).

The authors of this paper combined the methodologies and tools used in specific literature and used a specific decomposition formula for the absorption rate in order to identify, analyze and explain the influencing factors of the absorption rate of EU funds, respectively: (a) *internal absorption rate* – verified payments reimbursed (including advance payments) by management authorities (MA) to beneficiaries/total allocations; (b) *final absorption rate* – verified payments disbursed by EC/total allocations. The authors consider both internal and final absorption rates to be dependent on the following variables: (a) *attractiveness rate for potential beneficiaries to access and make use of EU funding* – requested funding (value of projects

submitted) against available allocations; (b) the *contracting rate of projects submitted* or the “*success rate*” – value of projects approved and contracted against requested funding (value of projects submitted); (c) *the quality of expenditures incurred in projects contracted* – expenditures reimbursed by national authorities or by EC against value of projects approved and contracted and it measures the capacity of the beneficiaries to effectively spend money for the objectives and activities contracted. The authors assume that *the administrative factors*, from both the supply side and the demand side, have influence over all three variables. Based on these assumptions, the authors of this paper will use the following formulas:

$$\text{Internal absorption rate} = \frac{\text{Payments reimbursed by national authorities}}{\text{Planned allocations}} = \frac{\text{requested grants}}{\text{planned allocations}} \times$$

$$\frac{\text{contracted grants}}{\text{requested grants}} \times \frac{\text{payments reimbursed by national authorities}}{\text{contracted grants}}$$

$$\text{Final absorption rate} = \frac{\text{Payments reimbursed by EC}}{\text{Planned allocations}} =$$

$$\frac{\text{requested grants}}{\text{planned allocations}} \times \frac{\text{contracted grants}}{\text{requested grants}} \times \frac{\text{payments reimbursed by national authorities}}{\text{contracted grants}}$$

The authors consider that both the internal absorption rate and the final absorption rate are relevant for the analysis of the absorption capacity of EU funding. The empirical evidence (statistical data series for 1993-2015, available in various EC reports and national reports) indicates that the final absorption rate is often lower than the internal absorption rate: the difference indicates the performance gap of the payments

certification and disbursements (as part of the financial management and control phases of the EU funded programs cycles) existing between EC services and regional/member states institutions involved in the EU funds management and control. The higher this difference between internal and final absorption rates, the lower the administrative capacity of a member state to effectively perform the financial management of EU funds.

The ***attractiveness rate for the potential beneficiaries to access and make use of EU funding*** ($\frac{\text{requested grants}}{\text{planned allocations}}$) is

determined by:

supply side factors related to:

quality of the programming of the funds, in particular the capacity to set up the relevant investment priorities for

local/regional/sectoral needs; the observance of the *partnership principle* in the programming phase of EU funds becomes an essential prerequisite: the latter motivation to apply for funding is directly dependent on the engagement of relevant stakeholders, potential beneficiaries/ in defining priorities during the programming phase.

quality of the support provided by the MAs to potential beneficiaries, quality and availability of information about EU funding and funding conditions included.

procedures and conditions for accessing funding – basically bureaucratic burden, low transparency of evaluation and selection etc. may discourage applicants to apply for funding.

demand side factors related to:

capability of potential beneficiaries to understand funding priorities and conditions and to prepare eligible projects to be

submitted in due time; it is dependent on: access to information about EU funding opportunities; availability of internal capabilities or external resources (e.g. consultants, access to guarantees and credit facilities) to access EU funding.

The ***contracting rate***/***“success” rate*** ($\frac{\text{contracted grants}}{\text{requested grants}}$) is

influenced by:

supply side factors related to:

quality of the project evaluation and selection processes - it is dependent on the availability of adequate qualified human resources, tools and procedures for project evaluation and selection: low qualification of evaluators as well as inconsistent evaluation grids/selection procedures will contribute to approval of poor projects..

project pipeline – activities developed by MAs to assist the beneficiaries in preparing applications

demand side factors, in particular *administrative factors* related to the capacity of beneficiaries to prepare good projects.

The ***quality of the expenditures*** measured by reimbursement rate ($\frac{\text{payments reimbursed by national authorities}}{\text{contracted grants}}$ or $\frac{\text{payments reimbursed by EC}}{\text{contracted grants}}$) is

an indicator of the effective project/program budget execution by reference to the compliance with eligibility conditions and it is influenced by:

supply side factors related to:

quality of the implementation, financial management and control, in particular the capacity of the institutions to define and apply adequate procedures for the performing expenditure verification

and project monitoring, irregularities detection and management;

quality of the support (through help desk activities) provided to the beneficiaries to prevent occurrence of ineligible expenditures and irregularities.

demand side factors related to:

quality of the project management – the capacity of the beneficiaries to comply with specific expenditures eligibility rules and procedures, depending on access to information, availability of personnel or to consulting services for the project implementing/management/financial management etc.

operational capacity of beneficiaries to implement the project – availability of resources to develop project activities, capacity to achieve project objectives and targets;

financial capacity of the beneficiaries to implement the project - it includes both availability of internal financial resources as well as access to other sources of external funding (e.g. access to credit facilities) to implement projects and manage cash-flow difficulties

To increase the quality of the analysis of the absorption rate, the methodology presented above should be complemented by: surveys and in-depth activities of MA, analysis of the typologies and capabilities of the beneficiaries under each Operational Program.

Absorption rate 2007-2013: main findings for Romania

The focus of this section is to analyze the variables and factors influencing absorption rate in Romania, in particular to identify

administrative bottlenecks contributing to the lowest absorption rate in EU-27 (measured at end august 2015). During 2007-2013, in Romania, under Convergence objective, the EU funds were distributed, across 7 Operational Programs (OP): Human Resource Development (HRD) OP; Administrative Capacity Development (ACD) OP; Technical Assistance (TA) OP; Regional OP; Environment OP; Increase of Economic Competitiveness (IEC) OP; Transport OP. Based on the most recent official data (Ministry of European Funds, august 2015), the authors calculated the indicators described in the methodology section; the calculations are presented in table 1 below.

Please See Table 1 in the PDF Version

Notes:

All values presented in the table reflect exclusively the EU non-reimbursable assistance (not including Romania public or private co-financing of the projects or OPs) and are expressed in Euro; the exchange rate used is the Inforeuro Exchange rate of August 2015, 1 EUR = 4.4083 ROL

Internal payments include payments made by MAs (they included both advance payments and expenditures made by project beneficiaries and reimbursed by Managing Authorities);

Attractiveness rate = value of the submitted applications/EU value of planned allocations

Contracting rate/"success" rate = value of the contracted grants/value of the submitted applications

Internal reimbursement rate = Internal payments made by Managing Authorities/Value of contracts signed

EC reimbursement rate = EC payments / Value of contracts signed

Internal absorption rate = Payments made by Managing Authorities / Planned allocations

Final absorption rate = EC payments / planned allocations

Source: official data from Romanian Ministry of European Funds, http://www.fonduri-ue.ro/files/implementare-absorbtiie/Anexa.1-31.august._2015.pdf, and own calculations

As shown in table 1, at the end of August 2015, the final absorption rate was at 52.02%, the lowest rate in EU-27. The final absorption rate is 17.19 pp lower than internal absorption rate, due to: (a) incidence of the advance payments from EC; (b) low performance of MAs to certify and reimburse expenditures to the beneficiaries and to prepare and submit Declarations of expenditures to EC; (c) incidence of irregularities observed by EC for the expenditures declared by MA, leading to corrections and

payment suspension, in particular in case of Competitiveness, HRD, Regional OPs. Because of the non-reimbursed expenditures by EC (together with corrections and payments suspension), Romania redirected, at least temporarily, national funds from other investment priorities to continue funding projects contracted under the 7 OPs. The main adverse effects consisted of: (a) sub-optimal allocations of national funding; (b) low availability of EC reimbursements to be reintroduced in payments disbursement flows with adverse effects of beneficiaries cash-flow and project budget execution.

The most attractive OPs were the HRD OP, IEC OP, ACD OP (attractiveness rates of 495.92%, 407.12%, 351.72%). Information presented in table 1 allows the authors to conclude for these OPs:

there is a good quality of the programming, respectively the OPs priorities addressed relevant needs of the regions, sectors and applicants;

there is good capability of the applicants to prepare applications the attractiveness of the OPs depends on the typology of the eligible beneficiaries: the more diversified the typology, the more attractive the OPs from the point of view of applications submitted.

The average *contracting rate*/*"success" rate* is 38.95% reflecting that the capability of applicants to prepare **good** applications to be selected and contracted remains very low (only 1/3 of the applications submitted were approved and contracted). This low capability seems to be specific to local public administrations (very much dependent on internal

capabilities), to SMEs and NGOs (limited financial capability to use consultancy services); this conclusion is supported by empirical evidences: *the lowest success rate* is specific to the HRD OP, IEC OP, ACD OP which have as main beneficiaries SMEs, NGOs, local public administrations, research organization, trade unions. There is no information available about the quality of the evaluators and the quality of the evaluations performed, so the authors cannot analyze how and at which extent the evaluators' performances and evaluation procedures influenced the "success" rate across various OPs. The best performing OP is the Environment OPs of which high success rate is due, in particular, to the project pipeline preparation activities and support provided to applicants by MA, in particular for major projects.

According to the data presented in the table 1 above, during 2007 – 2013, in case of the ***quality of payments***, the following conclusions could be drawn:

internal rate of reimbursement: of 63.08% is very low taking into account the time of the analysis and the need for compliance with N+2 rule (4 months before expiration of N+2 rule which allows beneficiaries to make payments only until 31.12.2015 and to get reimbursed by mid-2016) which makes the 100% absorption target impossible to be reached. This low rate is the result of: (a) poor performance of the MAs to reimburse payments to the beneficiaries in due time; main causes reside in: insufficient qualified personnel, bureaucratic and ineffective procedures of expenditures checks and controls; (b) low execution of budgets at project level, significantly dependent on the: (i) financial and

operational capacity of beneficiaries (ii) cash flows difficulties induced by poor performance of MAs to reimburse beneficiaries in due time; (c) incidence of irregularities reflecting low financial management capability of the beneficiaries .

In this respect, the HRD OP is the worst performing (57.76%) because, in particular of: (i) excessive bureaucracy and administrative burden for expenditures checks; (ii) insufficient qualified personnel; (iii) incidence of irregularities; the main reason for this OP poor performance resides in its complexity and diversity (the most diverse typology of beneficiaries, with diverse financial regime and constraints) and administrative burden for financial management and control tasks (highest number of projects with hundreds of expenditure items of low

value) which made verification more difficult, time consuming and less effective.

EC rate of reimbursement: of 47.42% is very low indicating low administrative capacity, in particular from the supply side factors, respectively: (a) low capacity of MAs to prepare Declarations of expenditures and to claim the reimbursements to EC (19.94% of the internal payments disbursed by MAs were not declared yet to EC); (b) low certification capability at national level; (c) incidence of irregularities observed by the EC by reference to the nationally certified expenditures. The worst performing OP is still HRD OP for the same reasons presented above.

The time delay between EC disbursements and MA internal payments to beneficiaries is very little explaining the large difference (17.19 pp) between internal and EC reimbursement rates. From the demand side perspective, both internal and EC reimbursement rates are also dependent on the execution of the budgets for contracted projects. At present, there is no evidence about the actual payments made by the beneficiaries not included in the reimbursement claims presented to MAs; thus, any further analysis of the beneficiaries budget execution influence over reimbursement rate cannot be conducted.

Conclusions

Based on 2007-2013 experience, for Romania, the supply side factors, in particular related to administrative capacity, seem to

have the largest influence over the absorption rate. For increased and effective absorption during 2014-2020 period, Romania should focus on measures addressing the administrative weaknesses identified, in particular: (a) development of effective actions for project pipeline preparation and support for beneficiaries to increase the success rate of the projects; (b) increased performance for financial management and control (e.g. simplification and increased effectiveness of procedures for expenditures checks and certification to reduce ineffective administrative burden and incidence of irregularities). The poor administrative capacity of EU funds is reflected in low absorption rate; the ultimate costs of low absorption rate are reflected by increasing development and competitiveness gap.

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