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ACRONYMS AND ABBREVIATIONS

ADNS	Animal Disease Notification System
ALMP	Active Labor Market Policies
APAPS	State Privatization Agency
BCR	Banca Comerciala Romana
CEC	Savings Bank
CEECs	Central Eastern European Countries
CEFTA	Central European Free Trade Agreement
Cif	Cost Insurance Freight
CMO	Common Market Organizations
CNVM	National Securities Commission
COMTRADE	Commodity Trade Database
EAGGF	Guarantee and Guidance Fund
EFTA	European Free Trade Association
ESI	Export Specialization Index
EU	European Union
EXIMBANK	Export-Import Bank of Romania
FDI	Foreign Direct Investment
FTA	Free Trade Arrangement
GSP	Generalized System of Trade Preferences
GVA	Gross Value Added
IACS	Integrated Administration and Control System
IR	Information Revolution
ISC	Insurance Supervisory Commission
ITA	Information Technology Agreement
MEBO	Managed Employee Buyouts
MERCOSUR	Southern Common Market (Mercado Común del Sur)
MIG	Minimum Income Guarantee
MLSSF	Ministry of Labor, Social Solidarity and Family
MNC	Multinational Corporations
NAFTA	North American Free Trade Agreement
NIS	National Institute of Statistics
NPAA	National Program for the Adoption of the Acquis
OECD	Organization for Economic Cooperation and Development
PAYG	Pay-as-you-go
PEP	Pre-Accession Economic Plan
POF	Private Ownership Fund
PSE	Producer Support Estimate
ROL	Romanian Lei
SCF	Structural Cohesion Fund
SDA	State Domain Agency
SEE REM	South East Europe Regional Energy Market
SIF	Financial Investment Companies
SITC	Standard International Trade Classification
SME	Small and Medium Enterprises
SOE	State-owned Enterprise
SOF	State Ownership Fund
TWA	Temporary Employment Agency
ULC	Unit Labor Cost
USITC	US International Trade Classification
WDI	World Development Indicators
WIIW	Vienna Institute for International Economic Studies
WTO	World Trade Organization

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The report is presented in two volumes: Volume 1 comprises the summary report; and Volume 2 comprises the main report with annexes.

EXECUTIVE SUMMARY

1. **Romania is pursuing a broad reform program, including institutional, governance and economic restructuring reforms, which are anchored in its process for accession to the European Union (EU).** Indeed, recent progress indicates that reforms are beginning to reach a critical mass and that the economy may be turning a corner. In contrast to the 1990s, in the last four years Romania has made good progress in stabilization, growth, and poverty reduction. This progress is due, in large part, to its solid performance in trade integration with the EU and global markets. However, this performance is limited to a few activities, since large segments of the economy remain largely unrestructured and inefficient.

2. **The challenge is to expand integration with the EU more broadly throughout the economy by relying on market driven mechanisms in a predictable rules-based policy environment with the state sharply focused on the provision of essential public goods.** The reform agenda of EU accession-led restructuring remains large.

- **Implementing the institutional reform agenda.** This is the first priority in the EU accession-led reform agenda. These reforms are being defined in the context of the negotiations and implementation of the various chapters of the *acquis communautaire*. While Romania has taken important initial steps in judiciary, governance, and public administration reforms, particularly as regards regulatory changes, much of the reform agenda remains to be implemented and many significant challenges remain. Following the recent constitutional referendum, a new overarching legislative framework is being established for the judiciary and the court system and this needs to be expressed in the regulatory framework. Above all, steps need to be taken to ensure effective implementation. Similarly, recent regulatory changes intended to improve transparency and governance need to be implemented, and in some instances laws such as the Law on Declaration of Assets and the Law of Conflict of Interest need to be revised to improve their comprehensiveness and clarity. In the area of public administration, a more systematic approach to policy formulation needs to be established and embodied in institutional structures and processes, and the Civil Service Law needs to be refined and implemented. The government's reform program is being supported by the European Commission, EBRD, the World Bank, the IMF, and other development partners. Complementing these efforts, this study focuses on selected policies of the real sector as Romania integrates with the EU and the world markets.

- **Building on trade integration (Section 2 in the Summary Report).** Trade performance has been robust over the last decade and trade integration has accelerated in the last four years. During this period, Romania had the largest increase in its share of EU external imports among the Central Eastern European Countries (CEECs). Key drivers of this growth are unskilled labor-intensive products, clothing, and footwear in particular. However, other manufactures, particularly electrical and machinery products, also show a strong performance. This

trade diversification provides a robust foundation for trade expansion. Romania's foreign direct investment (FDI) flows, although among the lowest in the CEECs relative to GDP, are having a large pull effect on trade expansion since they are dispersed among a large number of small firms (predominantly Italian and German) in low technology, unskilled labor-intensive production.

To deepen trade integration, Romania would need to broaden its trade performance throughout the economy. Without further expansion of private sector activity in the economy, agricultural transformation, and enhanced labor market flexibility, Romania would appear to be losing its potential comparative advantage in high tech and skilled labor-intensive production as well as in natural resource-intensive production, as its resources are pulled toward low technology and unskilled labor-intensive activities or remain in large unrestructured segments of the economy. Without relying on market-driven mechanisms for reallocating resources, including labor, from low to high productivity activities and larger FDI flows to upgrade technology, Romania is unlikely to move to higher technology and potentially competitive activities. Similarly, without increasing labor market adjustment and without addressing the challenges of investment in education and the quality of education, and upgrading the skills of Romania's labor force, the competitiveness of Romanian firms will continue to depend on the availability of low-wage unskilled labor. As a result, competing with suppliers from other developing economies will become increasingly difficult as the EU ends quantitative restrictions on textiles and clothing under the World Trade Organization (WTO) agreement on January 1, 2005, and as large developing countries participate more fully in the global markets.

- **Restructuring the enterprise sector (Section 3).** In no other area has the legacy of the socialist years weighed on Romania so heavily as in enterprise reform. The slow and inefficient enterprise reform of the past has left Romania with a larger number of enterprises to be privatized or liquidated than in all of the other CEECs combined. Public enterprises are the core of the unrestructured part of the economy. While there are dynamic private businesses which are leading Romania's solid trade performance in the EU and world markets, the expansion of these internationally competitive private firms is hampered by the sizable number of unrestructured public enterprises and the soft budget constraints prevailing between the state and the enterprise sector that keep unviable enterprises from exiting the economy.

  This recent momentum in enterprise reform needs to be accelerated and hard budget constraint discipline needs to be extended to the transaction interface between the state and enterprises. Privatizing to outside strategic investors rather than employing the failed privatization methods of the past, eliminating the practice of nonpayment and arrears build-up in the transaction interface between the state and enterprises, and improving the business climate are all actions that are fundamental to the sustainability of growth and competitiveness.

- **Implementing agricultural transformation (Section 4).** The potential competitiveness of agriculture that is associated with Romania's moderate climate and the availability of land remains largely untapped. The legacy of Romania's agricultural subsidization strategy, the persistence of state holdings of large loss-making state farms and land, and the slow economic restructuring elsewhere in the economy have taken a heavy toll on the country's agriculture and food sector. As a result, agricultural productivity is low and it is stagnant, despite increases in farm inputs: the sector includes 40 percent of the labor force whose share in GDP is only 14 percent.

  Clearly, for Romania to realize its economic potential and to integrate with the EU, agricultural policies and transformation need to be driven by competitiveness. Measures to achieve this end include the following: completing the privatization of state farms and state-owned land; consolidating the small-scale farming sector, so that it can rely on market-driven mechanisms in determining investment and production in the sector; shifting to policies that target efficiency gains rather than relying on the failed price support and export subsidies; and separating instruments that target efficiency gains in agriculture from those aimed at poverty reduction in the rural areas.

- **Enhancing labor market adjustment (Section 5).** Businesses report that rigid employment laws are a significant obstacle to their efficient performance. In cross-country comparisons, Romania has some of the most rigid conditions of employment, with tight restrictions on hours worked and on night and holiday work, and with a relatively high minimum wage. Several details in the labor regulations create perverse incentives for workers: for example, in managing absenteeism, and in granting periodic automatic increases in wages based on years worked and not on productivity. Limited economic restructuring and limited labor mobility characterize labor market dynamics in Romania across sectors in the economy. In addition, labor market participation is low and the high and long-term unemployment rates among new graduates and low-level educated youth reflect a significant mismatch between the skills that the education system generates and the labor market demand. In many areas the new Labor Code is more restrictive than the original one and represents a step backwards.

  Increased labor market flexibility is needed to improve sectoral employment imbalances and competitiveness, and hence to reduce the risks to the sustainability of growth, as competing in the EU and global markets becomes increasingly more difficult. The reform agenda includes the following aims: increasing the flexibility in entry/exit from employment by relying on economic rationale and performance to justify and estimate the costs of dismissals; and eliminating disincentives for those who wish to work beyond retirement age or under more flexible arrangements, including temporary and part-time employment. The Labor Code needs to be changed along these lines if the benefits from solid growth are to be more broadly shared on the basis of performance and productivity. Furthermore, reforms are needed to address the skills mismatch gap reflected in the

high and long-term unemployment rates among new graduates and low-level educated youth.

3. **Notwithstanding recent progress, there are risks and vulnerabilities to the macroeconomic stabilization and reform achievements to date (Section 6).** First, there are quasi-fiscal risks due to nonpayment and arrears accumulation. And second, there are fiscal risks due to financial weaknesses in the social security system (particularly the pension system deficits) and to the costs of upgrading environmental standards consistent with the concept of a single market of the EU.

4. **There is the challenge of eliminating the persistently large quasi-fiscal deficits resulting from nonpayment and arrears in the transaction interface between the state and enterprises.** The energy sector in Romania has been a main source of persistently large quasi-fiscal deficits—more so than in many other transition economies. Hidden subsidies and losses in the energy sector were as high as 6.5 percent of GDP in 2001, and while these declined to 2.5 percent in 2002, they increased to above 3 percent in 2003. In addition, total tax arrears (net end of period stock) were estimated at 10.8 percent of GDP in 2001 and 12.6 percent in 2002. More than two-thirds of implicit subsidies are due to the energy sector. Hence, energy sector reform is an essential first step.

- **Completing energy sector reform (Section 7).** Energy subsidization has been used to support loss-making enterprises and to provide an implicit subsidy to consumers. Subsidization has been provided through tolerance, and therefore encouragement, of low bill collection rates and energy pricing below full cost recovery tariff rates. These losses have resulted in a significant deterioration in basic energy infrastructure and have reduced the primary production of oil, coal, and gas. Because energy is a critical component of production, energy subsidies have distorted relative prices and have reduced efficiency throughout the economy. Furthermore, since energy company losses are often financed with tax arrears and unpaid loans, they have added to a rising stock of public debt. In the last four years there has been important progress in tariff and collection rates. However, soft budget constraints prevail in the transaction interface between the state and energy enterprises.

  The challenge is to implement hard budget constraints between the state and energy enterprises and complete the restructuring of the energy sector of Romania's road map for EU accession. While good progress has been made in power and gas tariff reform, further price adjustment (larger increases in gas to reach import parity) and the further restructuring of companies will be required as investments are undertaken. These measures include moving to import parity in the medium term, improving collection to achieve sustainable financial viability and imposing hard budget constraints on the transaction interface between the state and enterprises. Regarding industry restructuring, the challenges include the need for the commercialization of generation subsidiaries and the introduction of the private sector in the unbundled gas structure. However, the dangers of vertical integration

should not be underestimated given the weight that global industry players have in the sector.

5. **Quasi-fiscal financing should be eliminated and replaced by efficient financial intermediation (Section 8).** Quasi-fiscal subsidization is crowding out financial intermediation. This explains, to a large extent, the low level of financial intermediation in Romania compared to other CEECs. Banking credit represents only 8 percent of the total financing of the corporate sector while arrears represent 36 percent. Neither loss-making nor profitable companies are excluded from relying on nonpayment and arrears to finance their operations. However, the degree of use of tax arrears is inversely related to profitability. Clearly, quasi-fiscal financing channels resources to non-viable firms. In contrast, an efficient financial intermediation mobilizes and directs resources to the most profitable investment opportunities. Hence, developing efficient financial intermediation is a high priority in the reform agenda.

- **Developing efficient financial intermediation. (Section 8).** Romania has made progress in consolidating the financial sector since 1999, when bank restructuring took hold. The regulatory and supervisory environment has improved and progress has been made in building a more solid foundation for financial sector development. However, the continuing strong presence of state-owned banks, which represent 40 percent of bank assets and 32 percent of loans, places Romania at a disadvantage compared to its peers. Similarly, the basic financial infrastructure needs to be strengthened in several areas. Without the proper valuation of capital, supervision on a consolidated basis, improvements in access and coverage of the credit registry, and a stronger capacity to assess and manage risk, the financial sector cannot intermediate resources efficiently.

  Reform priorities include the completion of bank restructuring and the strengthening of the regulatory and supervisory infrastructure. Measures that are needed to develop a further basic financial infrastructure include the following: (i) implementing fully supervision on a consolidated basis; (ii) strengthening risk assessment and management; (iii) completing the adoption and full implementation of international accounting and auditing standards and practices; and (iv) improving the coverage of and access to the credit risk information system. Abolishing the Emergency Ordinance 61, which came into force in 2003 and permitted the authorities to seize any collateral pledged to a bank in order to collect tax arrears, is an important step forward. There is a need, however, to abolish the legal framework that allows compensation without cash of the bilateral obligations stipulated in the Government Ordinance No. 77/1999. Romania should rely on revenue collection and administration reform as a more appropriate and effective approach to eliminating nonpayment of taxes.

6. **While Romania has made progress in fiscal adjustment and consolidation, fiscal risks remain.** The monetary financing of quasi-fiscal expenditures from the National Bank of Romania was halted in 2000. Fiscal deficits have been cut in half compared to 1997, and budgetary consolidation has remained broadly on track. This progress has contributed to reducing the rate of expansion of public indebtedness. Estimates of fiscal sustainability included

in this report indicate that, under generally favorable assumptions, a debt-stabilizing primary fiscal balance of 0.4 to 1 percent of GDP seems to be sustainable provided quasi-fiscal deficits are eliminated and the macroeconomic adjustment mechanism becomes monetary dominant so that monetary policy becomes functionally independent of fiscal needs. However, two key areas of reform are needed to address fiscal risks (i) deepening the reforms of the social security system to address its financial weaknesses; and (ii) containing the costs of upgrading environmental standards.

- **Deepening the reforms of the social security system.** The social security system is a key long-term source of fiscal risk. Despite recent reforms, including a two-year increase in the statutory retirement age and a widening of the contribution base to include the self-employed, farmers and the unemployed, the pension system remains unsustainable. Without further reform the system imbalances will continue to grow and to pose a serious threat to macroeconomic sustainability, particularly if the economy grows slowly. The urgency for reform is increasing owing to the demographic challenge of an aging population. Policy issues and reforms in the social security system are presented in the World Bank's recent Public Expenditure and Institutional Review of Romania, and thus are not covered in this study.

- **Containing the costs of upgrading environmental standards (Section 9).** In relation to countries which joined the EU this year, Romania is starting out with a lower level of environmental capital and a poorer state of the environment. The estimated cost of the environmental investments needed to reach EU standards is therefore comparatively large (around €29.7 billion during the period 2004-2015—the highest among CEECs). About 75 percent of this cost is to be financed by the central and local governments and the private sector. A two-pronged approach is needed to contain the costs of upgrading environmental standards. First, estimates of the total costs and benefits for each of the environmental directives should guide the sequencing of the investments and their implementation, and those investments that generate the greatest benefits should be selected first. The estimates show that Romania will derive the greatest benefits from air pollution reduction, followed by water and waste management. The second reform is needed to enhance the role of the private sector, which is critical if targets are to be met, and fiscal risks are to be reduced.

7. Ultimately, Romania's success in integrating with the EU depends on its implementing the policy reforms outlined in this report, and achieving its goal of EU accession is predicated on its implementing the institutional, administrative and governance reform agenda.

SUMMARY REPORT

RESTRUCTURING FOR EU INTEGRATION: THE POLICY AGENDA

1. STRENGTHENING STABILITY, GROWTH, AND INTEGRATION WITH THE EU

1. Romania is pursuing a broad reform program, including institutional, governance, and economic restructuring reforms which are anchored in its process toward EU accession. The institutional and governance reforms are being made in the context of negotiations and implementation of the various chapters of the *acquis communautaire* and are being supported by the World Bank's Programmatic Adjustment Loan, currently being developed, and by programs of other development partners. To complement these efforts, this study focuses on selected policies of the real sector as Romania integrates with the EU and the world markets. Indeed, recent progress indicates that reforms have turned the corner—the challenge is to make consistent and sustained progress in the institutional, governance, and economic restructuring reform agendas.

2. Policies that underpin stability, economic restructuring, and integration with the EU and the global markets anchor Romania's progress toward EU accession. Restructuring for EU integration requires that the reallocation of resources should rely on market driven mechanisms in a predictable rules-based policy environment with the state sharply focused on the provision of essential public goods.[1] While progress has been made in policy reforms in the last few years, the reform agenda of EU accession-led restructuring remains large.[2]

3. To extend this integration effort more broadly throughout the economy and to safeguard the sustainability of trade performance and growth (Section 2), three areas of reform are central: restructuring the enterprise sector (Section 3), transforming the agriculture and food sector (Section 4), and increasing labor market adjustment (Section 5). Quasi-fiscal and fiscal risks, however, need to be addressed decisively (Section 6). To address the quasi-fiscal challenge: (i) hard budget constraints need to be implemented to eliminate quasi-fiscal financing of enterprises and instead enterprises need to rely on efficient financial intermediation (Section 8); and (ii) energy sector reform needs to be completed (Section 7). Further fiscal consolidation is needed and will require addressing financial weaknesses in the social security system, and also containing the costs of upgrading environmental standards (Section 9).

4. Romania has been implementing reforms toward stabilization, economic restructuring, and integration with the EU and the world markets, and recently the country has taken initial

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[1] Essential public goods include governance and the rule of law, basic infrastructure, health and education, and a well-targeted fiscally sustainable social safety net.

[2] See Chapter 1 in Volume 2 of this report for a more detailed discussion of policy issues on stability, growth, and integration with the EU and world markets.

steps have been taken on the institutional and governance reform agenda. This section first provides an overview of recent economic developments. It then outlines the broader reform agenda, which includes judiciary, governance, and public administration reforms. This section ends with an assessment of Romania's performance in a regional perspective.

1.1. Economic Performance: An Overview

5. The legacy of the socialist years has weighed heavily on Romania during the transition years. Policies during the 1990s were dominated by entrenched interest groups, which were embedded in state-owned enterprises (SOEs), and exhibited a pervasive lack of discipline in relations with the financial sector and were characterized by poor public administration that resulted in unsustainable macroeconomic policies. As a result, structural reforms and institutional changes were delayed.

Table 1 Selected Economic Indicators, 1992-2003

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003p
GNI per capita (Atlas method, US$)	1,240	1,190	1,270	1,470	1,590	1,520	1,520	1,580	1,680	1,710	1,850	
						(Percent)						
Total Poverty rate (headcount)				25.4	20.1	30.3	30.8	33.2	35.9	30.6	28.9	
Extreme Poverty rate (headcount)	..	..		..9.4	6.3	11.2	11.3	12.5	13.8	11.4	10.9	
Unemployment rate						8.9	10.4	11.8	10.5	8.6	8.1	7.8
Real GDP growth	-8.8	1.5	3.9	7.1	3.9	-6.1	-4.8	-1.2	2.1	5.7	4.9	4.7
CPI inflation (p.a.)	210.4	256.1	136.7	32.3	38.8	154.8	59.1	45.8	45.7	34.5	22.5	15.1
						(Percent of GDP)						
Investment	31.4	28.9	24.8	24.3	25.9	20.6	17.7	16.1	19.5	22.6	23.1	
Foreign Direct Investment	0.3	0.3	1.1	1.2	0.7	3.5	4.8	2.9	2.8	3.0	2.5	2.7
Gross Domestic Savings	20.8	24.0	22.5	18.6	17.6	13.5	9.7	11.4	14.5	13.9	15.0	
Total revenues and grants	38.7	34.0	32.0	31.4	29.6	28.9	29.9	31.9	31.4	30.5	29.7	30.9
Total expenditure and net lending	43.7	34.4	34.7	34.8	33.9	34.2	35.3	35.5	35.4	33.7	32.4	33.6
Overall fiscal balance	-4.6	-0.4	-2.2	-3.4	-4.8	-5.3	-5.4	-3.6	-4.0	-3.3	-2.6	-2.4
Current account balance	-8.0	-4.5	-1.4	-5.3	-7.4	-6.1	-8.4	-4.0	-3.9	-6.0	-3.4	-6.2
External debt			18.5	18.2	23.5	27.2	23.8	25.9	27.8	29.6	33.7	30.2
Public and publicly-gtd. Debt 1/	..	..	11.8	12.9	19.4	22.9	21.1	24.2	23.6	24.6	25.5	
Interest payment						3.8	4.7	5.3	4.8	3.8	3.0	2.9
Official reserves (mo. of imports)	0.2	0.1	1.1	0.4	0.6	2.5	2.4	2.1	2.5	3.2	3.5	
Broad money/GDP (percent)	30.8	22.3	21.4	25.3	27.9	24.6	24.8	24.6	23.0	23.2	24.7	

Source: World Bank and IMF databases; Romania Public Expenditures Review (2002) and Poverty Assessment (2003) The World Bank..

6. In the 1990s, macroeconomic instability exacerbated the decline in the standard of living. During this period, Romania experienced two major economic crises one in 1991-93 and another in 1997-98 (see Table 1). In the 1991-93 crisis, the annual inflation rate reached 256 percent, the debt to Gross Domestic Product (GDP) ratio increased from 3 percent in 1990 to 16 percent in 1993, and the accumulated GDP contraction was about 30 percent. In the 1997-99 crisis, inflation reached above 150 percent per year from a level of about 35 percent per year in 1995-96, the debt to GDP ratio reached 40 percent, and the accumulated GDP contraction was about 15 percent. These events exacerbated the effects of the collapse of output on broad segments of

the population, and total poverty rate reached a peak of close to 36 percent and extreme poverty reached 14 percent in 2000.

7. In the last four years, however, there has been a turnaround in terms of both the magnitude and quality of macroeconomic adjustment and growth (see Table 1). Recent improvements in macroeconomic performance and growth have contributed to reductions in poverty levels, which by 2002 had declined to 28.9 percent in the case of total poverty and to under 11 percent in the case of extreme poverty. GDP growth has been reestablished at around 5 percent per year, led primarily by investment and exports rather than consumption. Occasionally, though, aggregate consumption surfaces as a key driver of growth, reflecting sporadic reflationary pressures related to high wage increases in SOEs. The inflation rate has declined more rapidly than projected in the macroeconomic stabilization program and was about 15 percent per year in 2003, the lowest level since the start of transition. The fiscal deficits of the consolidated general government have been cut to about half the 1997 levels, but the external current account gap, estimated at 5.8 percent of GDP in 2003, is high. However, official reserves have been increasing and reached a record level of over US$8 billion, or about 3.5 months of imports, in 2003—an impressive increase by US$4.5 billion since 2000. The banking sector is on firmer footing and direct lending by the central bank has been eliminated. International market sentiment towards Romania has continued to improve—Standard & Poor's upgraded Romania's sovereign currency risk from B+ to BB- in February 2003.

8. These results reflect initial progress made in a broad institutional agenda, including judiciary, governance, and public administration reforms. As discussed in the following section, while significant challenges remain and much of the agenda remains to be implemented, important initial steps have been taken.

1.2. The Broad Reform Agenda

9. Romania is pursuing a broad reform agenda that is motivated in large part by its desire for EU accession. The authorities have successfully concluded negotiations on 22 of the 30 chapters of the *acquis communautaire*. However, many significant challenges remain. Among these challenges are Romania's ability to meet the criteria for entry into the EU and to implement the *acquis* in the field of justice and home affairs, to improve governance and reduce corruption, to implement key reforms in public administration, and to ensure human rights and the rights of minorities. In terms of the economic criteria for accession, the authorities need to establish a functioning market economy by vigorously implementing the privatization program, improving the business environment, and introducing labor and capital market reforms.

10. **Judicial reform.** Significant initial steps have been taken, including the September 2003 adoption of a comprehensive Judicial Reform Strategy for 2003-2007. The objectives of this strategy were to enhance the rule of law in the country, to strengthen the institutional independence of the judiciary, to increase the efficiency of the courts and the professional level of both judges and court personnel, to improve the quality of judgments and of legal predictability in dispute resolution, and to achieve compliance with the EU standards and regulations. In October 2003, through a national referendum, constitutional amendments were adopted which would: (i) establish the principle of the independence of the judiciary and ensure the right to a fair trial within a reasonable time; (ii) transform the Supreme Court of Justice into a

High Court of Cassation and Justice, responsible for ensuring the consistent interpretation and implementation of laws throughout Romania; and (iii) revise the composition and mandate of the Superior Council of the Magistracy, which would strengthen its role as an institutional guarantor of judicial independence. This establishes an overarching legal framework for judicial reform that now needs to be fleshed out in legal detail and implemented.

11. **Governance reform.** Efforts have been made to curb corruption, including the adoption of the National Program for the Prevention of Corruption and the National Action Plan against Corruption in 2001. Freedom of information legislation has been adopted and a National Anticorruption Prosecutor's office has been established. In March 2003 further legislative advances were made with the establishment of basic regulations for public asset declarations by public officials, and with new legislation on conflicts of interest.

12. **Public administration reform.** Several actions have been directed at improving public administration. The Civil Service Law was recently overhauled as part of the government's package of anti-corruption measures. The proper direction for the reform of the policy formulation process, long subject to excessive reliance on emergency ordinances, has been taken with the passing of the Law on Decisional Transparency in early 2003, and with the constitutional changes later that year limiting the scope of emergency ordinances.

13. **Many challenges, however, remain in the institutional reform agenda.** In the areas of judiciary, governance, and public administration, the reforms going forward include: refining the newly introduced legislation, developing the necessary secondary legislation and norms, and building effective implementation and monitoring systems. This is being carried out with a strong program of support from the EU and the IFIs, including a Programmatic Adjustment Loan (PAL) program currently being developed with the World Bank and a program with the IMF currently under discussion. The main features of the PAL program supporting Romania's qualification for the political criteria for EU accession include: amending the Law on the Superior Council of the Magistracy; eliminating extraordinary appeals in criminal cases and further strengthening the institutional independence of the judiciary through the enhancement of the role of the Superior Council of the Magistracy; increasing the accountability of judges and the court system for the timeliness and quality of their work; providing a more efficient organization of the court system; and improving the system of court financing. The Law on Declaration of Assets and the Law on Conflict of Interest will be made more comprehensive, and better provisions will be made for the publication and indexation of results. The Civil Service Law will be amended and comprehensive Civil Service management monitoring indicators will be collected. A Civil Service law on salary setting will be adopted and new systems of pay grading and employment management put in place. A new public financial management reform system will be launched, and specific measures will be taken for the improvement of education finance, the reform of pension finances and the rationalization of the hospital system.

14. **The government program includes structural reforms that are going forward**. These reforms are being supported by the European Commission, the EBRD, the World Bank, the IMF, and several bilateral programs. Under these programs, the privatization program will be completed with the full disposition of the APAPS portfolio, and the privatization the BCR and CEC banks as well as major public enterprises in the energy sector. Gas prices will be advanced

towards economic levels. District heating systems will be overhauled, with the introduction of new tariff rates and heat metering and control systems, and programs for the restructuring of the mining industry and of Tarom will be completed. Improvements in the business environment will be sought through the following measures: the revision of the Companies and Securities Laws, the enhancement and extension of the Silent Approvals Law procedures, the refinement of the bankruptcy law and procedures, and the implementation of accounting and auditing practices. The Labor Code will be amended to improve market flexibility, and a set of reforms will be introduced to enhance the functioning of the capital markets: this will include the introduction of a consolidated law on the regulation of private equity funds, which will also apply to the Financial Investment Companies (SIFs).

15. The urgency of this agenda is greater than it may appear, if Romania is to catch up with the CEECs. As discussed in the following section, notwithstanding the progress made to date, Romania needs to build on the recent progress and extend integration more broadly throughout the economy if it is to succeed in catching up with the economic performance of other CEECs.[3] In some instances, countries in the region have accelerated the pace of reforms, as their timetable for EU accession is fast approaching. With one of the lowest per capita incomes in the region, Romania also needs to accelerate growth and strengthen stabilization efforts to set its economy on a sustainable convergence path.

1.3. Romania's Performance in a Regional Perspective

16. In the last four years Romania's economic performance has shown a remarkable improvement compared to the 1990s. Nevertheless, the country's economic performance relative to the CEECs is mixed (Table 2). Romania's growth of 4.3 percent per year in 2000-2002 reached the average growth in the CEECs (excluding Romania).[4] The relatively good growth performance of the last few years is, however, tempered by the fact that Romania has the lowest GDP per capita at PPP and improvement in its social indicators is slow (Box 1). Improvements in competitiveness are limited to a few activities, while large segments of the economy remain unrestructured (see Section 3). The slow and inefficient enterprise reform of the past has left Romania with a large number of enterprises (a total of 1,900 firms) fully or partially in state hands, (1,300 SOEs and 600 in state hands). The inefficiencies and losses in the enterprise sector are large—the total tax arrears of the enterprise sector (eop stock) are estimated at close to 13 percent of GDP in 2002 (see Section 3). Agriculture includes 40 percent of the labor force whose share in GDP is only 14 percent, and the rural areas include 45 percent of the population, and 67 percent of Romania's poor. The agriculture and food sector, however, remains unrestructured, and heavily subsidized, and productivity is low despite increases in inputs. As a result, Romania's potential competitiveness associated with its moderate climate and the availability of land remains largely untapped (see Section 4).

17. Solid performers in the region have leveraged economic restructuring, financing needs, and the resulting net job creation through FDI and expansion of the private sector in the economy. Initially, a large share of FDI was related to privatization, and as the policy framework

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[3] Central Eastern European Countries (CEEC) are defined here to include Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Lithuania, Latvia, Poland, Romania, the Slovak Republic and Slovenia.
[4] Calculations of CEEC averages exclude Romania.

improved green field FDI increased in importance. In turn, the private sector undertook the risks of investments needed for economic restructuring, improved technology and managerial skills, thereby increasing competitiveness, and deepened integration with the EU and the world markets. These changes also allowed most CEECs to put their fiscal house in order by eliminating implicit subsidization, and to set their economies on a sustainable convergence path by increasing their reliance on market mechanisms to allocate resources across sectors.

Table 2 Romania and the CEECs: Selected Economic Indicators, 2000-2002 a/

	GDP per capita in 2002, PPP (US$)	GDP Growth,. 2000-2002 (avg. %)	CPI Inflation, 2000-2002 (avg. %)	Interest Rates, 2000-2002 (avg. long term, (%) b/	Overall Fiscal Balance, 2000-2002 (avg, % of GDP	External CAB, 2000-2002 (% of GDP)	Broad Money (% of GDP	Private Sector Output, 2002 (% of GDP)	FDI, 1995-2002 (avg. % of GDP)
Bulgaria	6,909	4.8	7.8	11.2	-0.9	-5.4	43.3	75	4.3
Croatia	9,967	4.0	3.9	11.5	-6.2	-4.9	66.0	60	4.5
Czech Rep.	15,148	2.8	3.5	4.9	-3.7	-5.8	75.5	80	7.4
Estonia	11,712	6.6	4.4	8.8	0.0	-8.0	42.6	80	5.1
Hungary	13,129	4.2	8.2	8.0	-5.4	-4.6	47.2	80	4.2
Latvia	8,965	6.9	2.4	3.5	-2.6	-8.1	36.5	70	5.5
Lithuania	10,015	5.8	0.9	9.5	-2.0	-5.4	29.3	75	4.0
Poland	10,187	2.1	5.8	18.6	-4.7	-3.9	64.6	75	2.9
Romania	**6,326**	**4.3**	**34.2**	**27.7**	**-3.3**	**-4.2**	**23.6**	**65**	**2.7**
Slovak Rep.	12,426	3.3	7.6	8.1	-4.4	-1.2	65.3	80	5.4
Slovenia	17,748	2.9	8.3	9.7	-1.8	-0.0	55.5	65	1.9

Notes: a/ Data are an average of 2000-2002 unless otherwise specified. b/ Rates pertain to the following: Bulgaria, commercial bank lending (weighted average); Croatia, prime lending, Czech Republic, one-year interbank lending; Estonia, commercial lending; Hungary, 10-year government bond auction; Latvia, prime lending – refinancing; Lithuania, prime lending; Poland, refinancing; Romania, interbank lending; Slovakia, one-year interbank lending; and Slovenia, discount rate.
Sources: International Financial Statistics, IMF; World Bank database SIMA, and Datastream.

18. The risks and vulnerabilities involved in Romania's recent achievements cannot be underestimated. While the overall fiscal deficit compares favorably with other CEECs, the relatively modest fiscal deficit of the consolidated general government does not reflect the size of nonpayment and arrears. The inflation rate in Romania declined from 45.8 percent in 1999 to 22.5 and 15.1 percent in 2002 and 2003, respectively. However, current inflation rates greatly exceed those of other countries in the region, which have been in the single digit levels since the late 1990s. Further fiscal adjustment and a stricter incomes policy are needed to sustain a gradual but sustained reduction of inflation.

19. The economy is exposed to external risks. In 2000-2002, the average external current account deficit of around 4 percent of GDP was below the average of 5 percent observed in the CEECs. However, the deficit increased to nearly 6 percent of GDP in 2003 and it is increasingly financed by relatively mobile portfolio capital flows and less by FDI. This exposes the economy to the risk of sudden capital flow reversals, which could ultimately hurt growth.

20. This vulnerability is magnified by the inefficiency and small size of the financial sector. At 24 percent of GDP, the level of monetization of the Romanian economy is about half the

average level of other countries in the region (Table 2). The low level of financial intermediation reflects weaknesses in basic financial infrastructure, the still dominant role of state owned banks, and the heavy reliance on nonpayment and accumulation of arrears which is crowding out bank lending as the most important source of financing (Section 8).[5] The banking sector dominates the financial sector, holding about 90 percent of the total assets in the system. As a result of important reforms in the banking sector since the banking crisis, today the liquidity of banks is high and the sector seems to be well capitalized and profitable.[6] However, in contrast to other countries in the region, where the banking sector is mostly private—the median of state owned banking is 4.6 percent of total assets—state-owned banks in Romania hold nearly 40 percent of bank assets and a similar share in all deposits, and 31 percent of loans. While the state share is concentrated in only two state banks, both earmarked for privatization, the challenge now is to proceed with the actual transfer of ownership.

Box 1 Trends in Selected Social Indicators, CEECs

Based on GDP per capita at PPP, Romania is the poorest country with the second largest population among the CEECs. In addition to making progress in poverty reduction—poverty rates have declined from a peak level of 13.8 in 2000 to 10.9 in 2002—Romania's social indicators have also been improving. Adult illiteracy, infant mortality as well as the mortality of children under 5 years of age, school enrollment and life expectancy at birth have improved since the start of transition (Chapter 1).

These improvements are remarkable taking into account the fact that Romania, besides being one of the poorest countries in the region, started the transition in a more precarious condition in terms of social indicators. However, direct comparisons of social indicators, irrespective of differences in per capita incomes, show that Romania on the whole was and remains worse off than other CEECs. Improvements in social indicators over time have been slower in Romania than in other CEECs.

Selected Social Indicators, CEECs

	GDP per capita, PPP (US$) 2002	Adult Illiteracy (%)		School enrollment, secondary (% Net)		Mortality rate, infant (per 1,000)		Mortality rate, under-5 (per 1,000)		Life expectancy at birth, total (years)	
		1990	2002	1990	2000	1990	2001	1990	2001	1990	2002
Bulgaria	6909	2.8	1.4	63.3	87.6	14.8	14	18.7	16.0	71.4	71.8
Croatia	9967	3.1	1.5	63.2	79.0 /b	10.7	7.0	12.5	8.0	72.2	73.8
Czech Republic	15148	..	..	86.1 /a	87.1 /a1	10.8	4.0	12.4	5.0	71.7	75.0
Hungary	13129	0.9	0.6	74.8	87.2 /c	14.8	8.0	16.8	9.0	69.3	71.8
Latvia	8965	0.2	0.2	76.8 /d	74.4	13.7	17.0	18.1	21.0	69.3	70.4
Lithuania	10015	0.7	0.4	80.5 /e	88.6	10.3	8.0	13.5	9.0	71.3	72.7
Poland	10187	0.4	0.3	75.8	90.9	19.3	8.0	21.9	9.0	70.9	73.8
Romania	**6326**	**2.9**	**1.7**	**72.8 /f**	**79.6**	**26.9**	**19.0**	**35.7**	**21.0**	**69.7**	**70.0**
Slovak Republic	12426	..	..	..	74.9	11.96	8.0	14.1	9.0	70.9	73.3
Slovenia	17748	0.4	0.3	88.6 /g	..	8.4	4.0	10.2	5.0	73.3	75.9
Estonia	11712	0.2	0.2	82.3 /h	82.8	12.4	11	17.2	12	69.5	70.6

Source: World Bank database (SIMA). Notes /a data 1993 and /a1 1995; /b 1997; /c 1999; /d 1993; /e 1994; /f 1993; /g 1997; /h 1992.

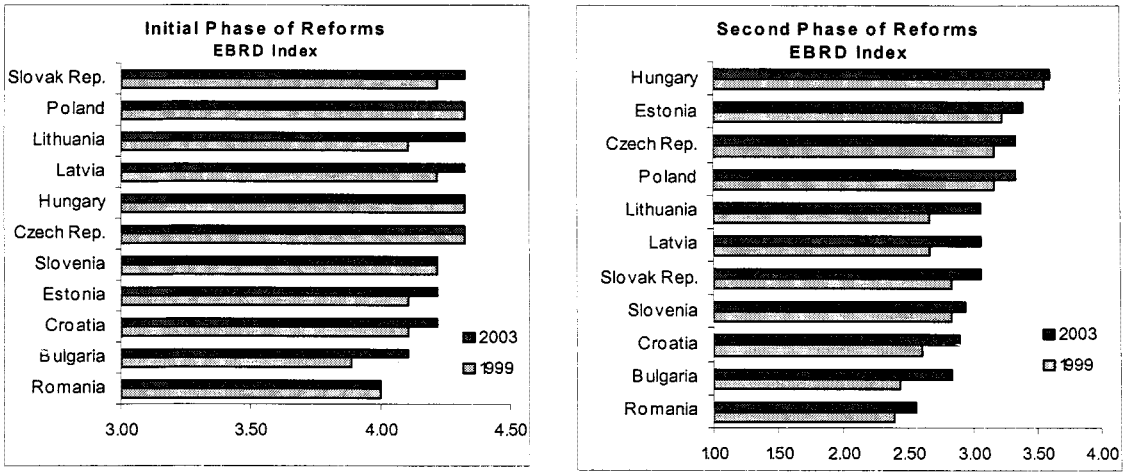
21. The pace of recent reform efforts needs to be accelerated if Romania is to catch up with CEECs. Selected indicators of the progress of structural reforms between 1999 and 2003 are

[5] See Chapter 6 of Volume 2 of this report.

[6] There are, however, issues on the assessment of the capital of the banks (see Chapter 6 in Volume 2 of this report).

shown in Figure 1. The figure distinguishes between two types of reforms. The first relates to the changes in basic economic liberalization typical of the early stages of transition, and the second to the deeper more complex reforms that involve the privatization of large scale enterprises, financial sector development, and changes in institutions and governance structures. There are two clear observations. One is that Romania's progress in the first stage of reforms has stalled compared to that of other countries in the region. The other is that, relative to its regional peers, Romania lags significantly in implementing the second phase of reforms.

Figure 1 Selected Indicators of Progress of Reforms: CEECs



Source: EBRD Transition Indicators; Indicators for the initial phase of reforms are calculated as unweighted averages of indicators for: small-scale privatization; price liberalization; trade and foreign exchange system. Indicators for the second phase of reforms are calculated as unweighted averages of indicators for: large-scale privatization; governance, and enterprise restructuring; competition policy; banking reform and interest rate liberalization; securities markets and nonbank financial institutions; infrastructure reform.

22. While stability and growth performance have improved, these achievements must be complemented by consistent progress in the structural and governance reform agendas. Romania's rating in the initial phase of reforms is good but it has remained unchanged in 2003 compared to 1999, while other CEECs have continued to advance. While Romania had a better rating in the initial phase of reforms than Bulgaria in 1999, by 2003 Bulgaria's rating surpassed that of Romania. Romania made some progress in the second phase of reforms between 1999 and 2003. However, it is in the second phase of reforms that Romania has shown the greatest lag behind other CEECs. Romania's rating in the second phase of reforms in 2003 is close to that of Bulgaria, Latvia, and Lithuania in 1999 in the second phase of reforms. If Romania is to catch up with the other CEECs in second phase reforms, then reforms in enterprise restructuring and large-scale privatization would need to be implemented decisively.

23. The political economy of reforms in Romania is beyond the scope of this study. Clearly, the slow pace of reforms in the 1990s has been costly to Romania. These costs could not have been maintained without the means to finance them. Nonpayment and arrears have been pervasive in maintaining otherwise unviable activities. The low levels of public debt in the early 1990s provided headroom to finance them—public and publicly guaranteed debt more than doubled between 1994 and 1999. A better understanding of the drivers of change of the political

economy of reforms in Romania (who wins, who loses, and how decisions are being made) could be useful in accelerating the pace of reforms.

24. Trade integration is progressing more rapidly than the other dimensions of economic integration discussed above (Table 3). The share of imports in total imports and the share of exports in total exports from/to the EU and sub-regional markets are at the higher end of those observed in the other CEECs. This indicates that trade integration with the EU plays an important role in economic restructuring and hence in productivity gains in the tradable sectors– mainly in unskilled labor-intensive activities such as clothing and footwear (see Section 2). Romania is establishing economic links to this highly competitive market. While FDI levels are low, there is evidence that these flows are having a strong pull effect on Romania's trade performance, given the strong links of these flows to small and medium enterprises (see Section 2). Limited domestic financing to small and medium enterprises (SMEs) does not seem to be holding back these companies from carrying out the needed investments and achieving the productivity and quality levels required to compete in EU markets. This shows that the policies that affect FDI flows, including financing, and incorporating local producers into global production networks are far more important and have more impact in terms of economic restructuring and productivity gains than do other policies, such as those aimed at addressing limited domestic financing to SMEs. However, the total trade relative to GDP is low compared to that of other CEECs, which reflects the fact that improvements in competitiveness have a limited scope in the economy.

Table 3 Romania and the CEECs: Selected Indicators of Trade Integration, 2002

	Imports plus Exports to GDP (%)	Imports from EU (% of Total imports)	Imports from CEEC-10 (% of total imports)	Exports to EU (% of total exports)	Exports to CEEC-10 (% of total exports)	FDI from EU (% of total FDI)
Bulgaria	83.4	54.3	5.2	55.5	10.5	69.1
Croatia	113.9	56.9		50.6		71.2
Czech Rep.	68.1	57.4	2.4	65.4	1.3	84.1
Estonia	125.2	65.5	2.3	69.4	6.4	
Hungary	108.9	56.2	9.8	72.6	10.0	80.2
Latvia	78.5	51.2	3.1	52.5	21.5	
Lithuania	96.9	42.6	0.3	43.9	0.7	
Romania	69.3	61.6	5.1	65.7	11.3	61.1
Slovenia	96.3	67.6	9.3	57.7	5.8	85.6

Note: FDI shares are for 2001; all other indicators are 2002 data.
Source: World Bank database SIMA; UN COMTRADE, and Datastream.

25. Romania's reform efforts to date have had their rewards in terms of stability, growth, and integration with the EU and global markets. This progress is being driven, in large part, by the country's remarkably rapid pace of trade integration with the EU and global markets. This is a promising trend as regards Romania's aspirations to join the EU. However, as is shown in the next section, the large segments of Romania's economy which remain unrestructured represent a considerable risk to the sustaining of solid trade performance and to growth. Romania needs to make consistent progress in its structural and governance reform agendas to move up technologically, to improve competitiveness more broadly across its economy, and to safeguard the sustainability of growth.

2. Building on Trade Integration

26. Romania has had a solid performance in trade integration with the EU and global markets. However, trade integration is limited to a few activities in the economy, working around large unrestructured segments of the economy dominated by public enterprises. Extending this performance more broadly across the economy, however, is central to the sustainability of this trade integration performance and growth. This section first provides an overview of Romania's trade policy framework. It then assesses its trade performance and indicates key features of its solid performance. The section ends with a reform agenda for addressing the risks and emerging challenges to trade integration. [7]

2.1. Trade Policy

27. The recent progress in Romania's economic performance is due, to a large extent, to its prospects for EU accession. Thanks to the European Association Agreement and the EU Eastern Enlargement project, Romanian foreign trade policy has facilitated its integration into the global economy. The benefits to Romania are broadly outlined in this section. The EU associate status has encouraged bilateral trade liberalization not only with the EU but also with other countries enjoying preferential status in their relations with the EU. Romania has become a member of the Central European Free Trade Agreement (CEFTA), and an associate member of the European Free Trade Association (EFTA), and it has a Free Trade Arrangement (FTA) with Israel and Turkey. Together with these countries (excluding Israel), Romania is a party to the Pan-European Cumulation Agreement, which led to the establishment of a free market for industrial products in 2003. This has created broad opportunities for moving segments of the production processes across borders without losing duty-free access. More recently, under commitments made in the Balkan Stability Act, Romania has concluded negotiations and signed bilateral FTAs with Albania, Bosnia and Herzegovina, the FYR of Macedonia, and Serbia/Montenegro. Romanian producers have duty-free access to most of these trading partners' markets but, in return, they also have to face competition from their imports being subject to mostly zero-tariff rates. However, Romania has not made similar progress in multilateral trade liberalization.

28. Romania has, on average, the highest MFN applied tariff rates, not only among CEEC-10[8] countries but also among Stabilization and Association countries, which results in a large scope for reverse discrimination.[9] Romania's simple average MFN applied tariff rate on industrial products is 16 percent and its weighted average tariff rate is 4.4 percent. However, nearly 86 percent of all 8-digit industrial custom lines face an applied tariff rate above 5 percent, and 42 percent of these custom lines face a tariff rate above 15 percent. The rationale for such

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[7] See Chapter 2 in Volume 2 of this report.

[8] The CEEC-10 includes: Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, the Slovak Republic and Slovenia.

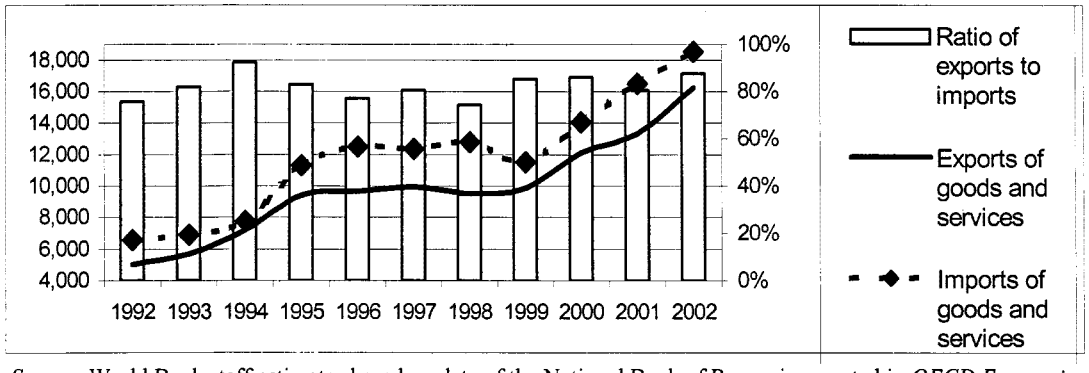
[9] Reverse discrimination occurs when differences between MFN tariff rates in the home country and in the trading partners' domestic market, ceteris paribus, result in placing producers in the home country at a disadvantage compared to producers in the preferential trading partners' domestic markets. The result is similar to providing an import subsidy on the final product imported by the home country since the MFN tariff rate on the imported input in the home country is substantially larger than the MFN tariff rate on the same imported input faced by producers in the preferential trading partners' domestic markets. Hence, these differences place producers of the final product in the home country at a disadvantage compared to their peers in the trading partners' domestic markets.

large MFN tariff rates, however, is questionable. For most products manufactured in Romania, producers face competition from firms from the EU and other FTA partners. Tariffs do not protect them from competition from imports. For some products, where there are only a few producers that are competitive worldwide, MFN tariff protection only leads to reverse discrimination and higher prices paid by Romanian users. For others, importers seek exemptions from duties—redundancy in tariff rates generating opportunities for corruption.

2.2. Trade Performance

29. Trade performance appears to be based on solid ground and may be sustainable provided the pace of structural and governance reforms is accelerated. Indeed, as discussed in the sections below, the sustainability of Romania's solid trade performance hinges on expanding integration more broadly throughout the economy and eliminating large inefficiencies in the enterprise sector and the agriculture and food sector, and increasing labor market adjustment. Romania's trade performance shows the following characteristics.

Figure 2 Foreign Trade in Goods and Services, 1992-2002 (millions of US dollars)



Source: World Bank staff estimates based on data of the National Bank of Romania reported in *OECD Economic Assessment: Romania,* June 2002.

30. *Trade expansion continued well beyond the initial reorientation of trade associated with the end of the CMEA* (Figure 2). While the expansion following the collapse of central planning could be attributable to the unavoidable realignment of trade patterns once the CMEA disappeared and economic considerations began to shape trade, the reorientation cannot have driven export growth for more than three or four years. However, in Romania the expansion continued, indicating progress in industrial restructuring that has led to the emergence of new exporters that are competitive in international markets—these appear to be linked to FDI and de novo companies, particularly SMEs.

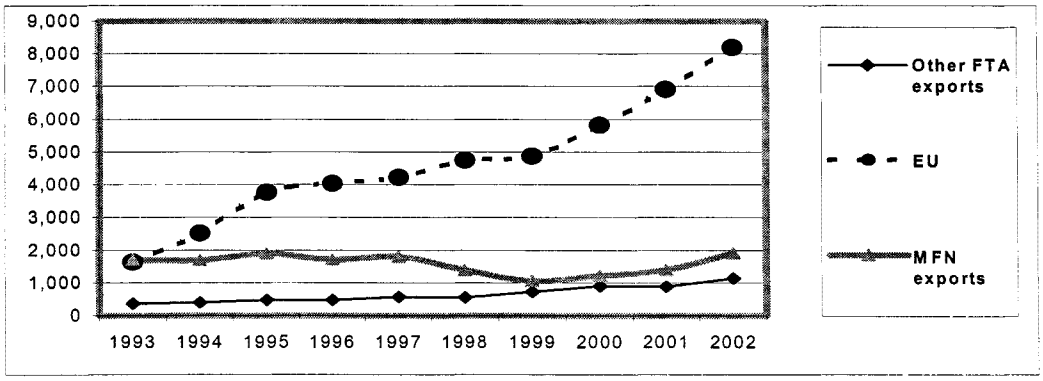
31. *Romania's share in EU external imports increased every year during 1993-2002, accompanied by a strong expansion of Romania's imports.* Among the CEEC-9,[10] Romania's export performance in EU markets matches that of the relatively large and industrially advanced economy of the Czech Republic. Only Estonia (30 percent) and the Slovak Republic (22 percent) had average export growth rates (measured in terms of change in the share of exports in EU

[10] The CEEC-9 includes: Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, the Slovak Republic and Slovenia.

external imports) over 1993-2002 that were higher than Romania's (20 percent), and these two countries had a quite small base level of exports. This performance was accompanied by an equally strong expansion of imports.

32. *Romania's most rapid trade expansion in EU markets occurred in 2000-2002 despite adverse external market conditions and slow growth in EU economies* (Figure 3). Romanian producers appear to be core rather than marginal suppliers and are therefore not excessively vulnerable to swings in import demand in highly developed markets. The dramatic increase in the Romanian presence in EU markets occurred in 2000-2002 against the background of the falling import demand in the EU. This suggests that Romanian exporters have firmly established a commercial presence in EU markets.

Figure 3 Exports to the EU and Other Preferential and MFN Markets, 1993-2002
(millions of US dollars)



Source: World Bank estimates based on the UN COMTRADE database as reported by Romania.

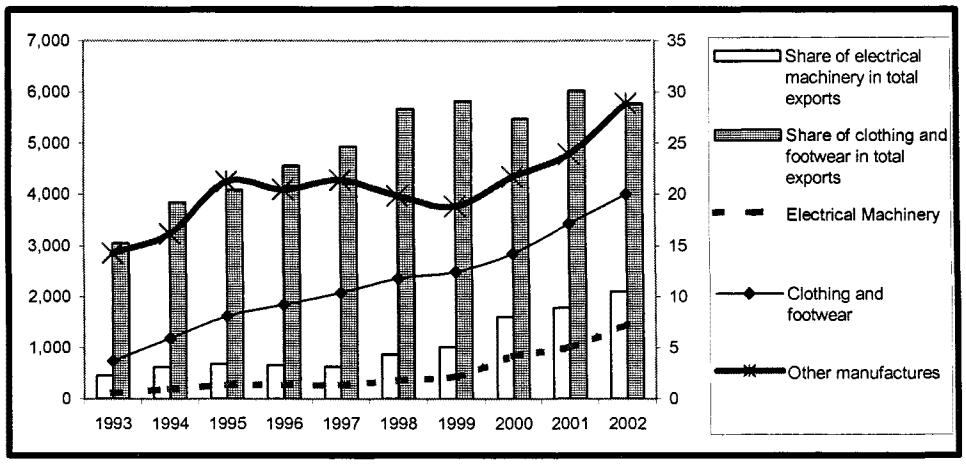
33. *In 2000-02, Romania also maintained a strong export growth in other markets during the marked acceleration in EU-oriented exports* (Figure 3). While the share of Romania in EU imports increased 64 percent, from 0.64 percent to 1.05 percent, between 1999 and 2002, the share of markets other than those of the EU in Romania's total exports fell only slightly, from 34 percent to 33 percent, indicating an equally strong export performance elsewhere. Considering the weak import demand in the EU and other highly developed countries, this has been a remarkable performance.

34. *Romania is not a single product exporter and its import base is also broad.* Although garments tower over other products in Romania's exports, their dominance is not as pervasive as in other countries (Figure 4). Although clothing remains the most important single sector determining overall export performance in EU markets, its relative weight has been on the decline without negatively affecting overall exports. In fact in the recent past it is capital equipment that has accounted for most of the export expansion, not only to the EU but also to other markets. The combination of product and the geographical diversification of exports and imports seems to augur well for the sustainability of exports.

35. *The drivers of Romania's trade expansion seem well anchored in strong production chains in the EU.* Over the broader period of transition to competitive markets, clothing and to a lesser extent footwear have been the engines of trade expansion for Romania. Empirical evidence

in this study shows the following: (i) both sectors appear to be firmly entrenched in EU clothing and footwear value chains; (ii) Romania is no longer solely an assembly shop for EU firms that are taking advantage of low cost, largely female, labor (many clothing producers have moved from simple cut-make-trim operations, where buyers supply fabrics, to FOB operations, with the clothing firm responsible for obtaining fabrics); and (iii) backward linkages have been developing with much input for both sectors' export activities being supplied locally. This suggests the increased sophistication of domestic producers of footwear parts and textiles.

Figure 4 Exports, 1993-2002 (millions of US dollars and percent)



Source: World Bank staff calculations based on UN COMTRADE statistics as reported by Romania.

Table 4 FDI Inflows in Comparative Perspective, 1991-96, 1997-2002 [a/]

	Average FDI (in millions of US dollars)			Average FDI per capita (in US dollars)			Cumulative FDI over 1990-02		
	1991-96	1997-02	2002	1991-96	1997-02	2002	Total (mln. ofUS$)	per capita in US$	2001 GNP (percent)
Bulgaria	85	782	647	10	79	48	4,927	587	27
Estonia	135	422	296	90	249	197	3,051	2,034	55
Czech Republic	1,089	6,242	9,886	106	520	1,059	39,227	3,808	54
Hungary	2,156	1,890	908	211	179	106	24,484	2,400	40
Latvia	159	323	349	64	142	140	2,926	1,170	38
Lithuania	56	596	744	15	149	201	3,587	969	30
Poland	2,119	6,127	4,371	55	148	113	46,483	1,204	28
Romania	**207**	**1,334**	**1,324**	**9**	**60**	**61**	**9,249**	**413**	**20**
Slovak Republic	175	1,834	4,260	32	325	1,078	10,322	1,911	42
Slovenia	111	612	1,950	55	282	989	4,017	2,009	22
Total/average	6,254	20,152	24,621	59	175	257	148,096	1,406	34

Note: a/ 2002 is a preliminary estimate.
Source: Various issues *of Economic Survey for Europe* (UN Economic Commission for Europe), World Development Indicators 2003 (World Bank, 2003) and IMF Balance of Payments database.

36. *Development in trade in parts and networks indicates the growing specialization and competitiveness of Romania in some of the most dynamic niches of world trade.* These are usually lucrative activities that provide stability to commercial relations and create opportunities

for supplying several different single producers of a final product. This adds the opportunity of diversification, beyond the simple benefit of the stability associated with being part of a well-established supply chain of single large firm.

37. *Although Romania has been the least successful among the CEEC-10 in attracting FDI inflows* (Table 4) *it appears that FDI flows have boosted trade performance more than is the case elsewhere. The* reasons for this include the large number of relatively small foreign-owned firms, mainly Italian and German, operating in low tech, unskilled labor-intensive sectors. Knowledge and technological spillovers from these firms appear to have been significantly stronger than in most transition economies. The associated influx of management skills and technology is providing a positive impact on the modernization of the country's industrial capacities.

2.3. Building on Trade Integration: A Reform Agenda

38. The present trends in trade performance, may not be sustained without the acceleration of the pace of the economic restructuring reforms, particularly the restructuring of the enterprise sector, the transforming of agriculture, the increasing of labor market flexibility, and the strengthening of the macroeconomic framework. These reforms are all the more urgent if the emerging challenges to Romania's trade performance are to be addressed. These challenges are the following:

39. *The continued domination of unskilled labor-intensive products in EU-oriented exports is troubling* (Table 5). Slow progress in structural reforms is keeping Romania from reallocating resources from sectors with low productivity to more productive and potentially competitive sectors. Without further expansion of private sector activity in the economy, increased labor market flexibility, and a predictable policy environment, Romania seems to be losing its potential comparative advantage in high tech and skilled labor-intensive production as large amounts of resources are mired in the unrestructured part of the economy. Without economic restructuring, and without market-driven mechanisms to reallocate resources, including labor, from low to higher productivity activities and FDI flows to upgrade technology, Romania's economic potential remains untapped. Similarly, without improvements to education and the upgrading of the skills of its the labor force, the competitiveness of Romanian firms will continue to depend on the availability of low-wage unskilled labor. As a result, competing with suppliers from developing economies will become increasingly more difficult.

40. *The end of EU quantitative restrictions on textiles and clothing imports under the WTO Agreement on Textiles and Clothing of January 1, 2005, presents a significant challenge to the sustainability of export performance.* While it is difficult to predict the potential impact of a new import regime, Romania has some advantages compared to other exporters from non-European developing countries. These advantages include geographical proximity and a large presence of foreign owned firms with, thus far, solid commercial links to EU producers and distributors. However, the operations of value chains are particularly vulnerable to potential delays and disruptions in various stages of the supply chain. Without a predictable and stable policy environment, and without sustained structural reforms, as well as improvement to the overall business climate and efforts to keep increases in wages in line with productivity growth at the

firm level, and without the application of trade and transport facilitating measures, Romanian firms are vulnerable to a rapid loss of their comparative advantage relative to Asian or African competitors in some production lines.

Table 5 Factor Intensity of Romania's Trade with the European Union, 1993-2002

Factor Intensity Product	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002 est.
Romania's Exports to EU: ($ million)										
Natural Resource Based	338	641	986	837	985	1,004	1,154	1,278	1,428	1,330
Unskilled Labor	1,295	1,670	2,194	2,476	2,824	3,352	**3,630**	3,887	4,762	6,497
Capital Intensive	200	366	578	644	650	767	842	1,307	1,429	**1,534**
Skilled Labor	214	406	**686**	680	685	763	611	653	807	981
All above products	2,045	3,082	4,443	4,637	5,143	5,885	6,238	7,125	8,425	10,343
Composition of Romania's Exports to EU: (percent)										
Natural Resource Based	17	21	22	18	19	17	19	18	17	13
Unskilled Labor	63	54	49	53	55	57	58	55	57	63
Capital Intensive	10	12	13	14	13	13	14	18	17	15
Skilled Labor	10	13	15	15	13	13	10	9	10	9
Romania's Export Specialization Index in EU										
Natural Resource Based	0.51	0.65	0.70	0.57	0.62	0.64	0.71	0.61	0.58	0.50
Unskilled Labor	**3.71**	**3.31**	**3.18**	**3.40**	**3.44**	**3.57**	**3.71**	**3.81**	**3.79**	**3.94**
Capital Intensive	0.29	0.34	0.36	0.38	0.34	0.33	0.33	0.46	0.43	0.37
Skilled Labor	0.63	0.79	0.93	0.90	0.81	0.73	0.55	0.57	0.57	0.53
Share in EU's External Imports: (percent)										
Natural Resource Based	0.16	0.28	0.37	0.31	0.36	0.41	0.47	0.42	0.48	0.55
Unskilled Labor	1.19	1.45	1.70	1.82	2.02	2.28	2.44	2.58	3.10	4.34
Capital Intensive	0.09	0.15	0.19	0.20	0.20	0.21	0.22	0.31	0.35	0.41
Skilled Labor	0.20	0.35	0.50	0.48	0.48	0.47	0.36	0.38	0.47	0.58
All above products	0.32	0.44	0.53	0.54	0.59	0.64	0.66	0.68	0.82	1.10
Romania's Net Exports to EU: ($ million)										
Natural Resource Based	-362	61	7	-311	-59	-103	96	71	-90	-457
Unskilled Labor	654	826	943	1,076	1,215	1,425	1,657	1,717	2,238	3,191
Capital Intensive	-745	-843	-1,118	-1,415	-1,376	-1,742	-1,587	-1,792	-1,777	-2,267
Skilled Labor	-283	-66	-77	-211	-147	-455	-423	-671	-1,037	-1,515
All above products	-735	-23	-245	-860	-367	-875	-257	-675	-665	-1,048

Source: World Bank staff estimates based on EU as reported from UN COMTRADE statistics.

41. *Substantial progress to be made in economic restructuring, particularly the privatization or liquidation of large SOEs and the institution of reforms to improve the business environment and labor market flexibility, remains as a core challenge.* The divergence between Romania's export basket and its relative endowments is an indication that government policies have prevented the emergence of competitive markets that would reallocate resources from sectors with low productivity to industrial sectors with a potential comparative advantage. While in other CEEC-10 economies FDI inflows have closed the gap between endowments in skilled labor and the dominance of unskilled labor-intensive products in their exports to EU markets, this has not happened in Romania as yet. The factor intensity of the EU-oriented export basket, after a significant change in 1994-95, reverted to its original composition in 1993, except that the share of capital-intensive products increased at the expense of natural resource-intensive products.

42. Even though the line between capital and skilled labor-intensive products is not sharply defined, the continued dominance of unskilled labor-intensive products is in sharp contrast to the experience of most other CEEC-9 countries. In most of them, the initial gap between an endowment featuring a relatively highly skilled labor force and a high volume of unskilled labor-intensive exports has been closed relatively quickly. This process was aided by FDI flows which were initially related to privatization sales to strategic investors and, as the policy framework improved, were associated with green field investments. While competitive production cost structures and the proximity to important markets are necessary conditions for attracting FDI, they are not sufficient to attract MNCs that establish outside production blocs. An unpredictable policy environment, burdensome tax administration and customs procedures, transportation delays, telecommunications problems and other logistics issues usually prevent the emergence of border-spanning production networks.

43. *In contrast to exports, where improved market access to regional partners has been significantly offset by much lower MFN rates than in Romania and competition from EU producers, the scope for reverse discrimination in Romanian markets has been several times higher.* As shown in the previous section, Romania has on average the highest MFN applied tariff rates not only among CEEC-10 countries but also among Stabilization and Association countries, and the economic rationale of these rates is questionable, since the scope of reverse discrimination is large. It is therefore recommended that Romania start moving its MFN tariffs toward the Common External Tariff of the EU.

44. *Structural reforms supportive of enterprise restructuring, agricultural transformation and labor market flexibility are needed to improve the prospects for Romania's trade performance.* Romania's moderate climate and the availability of land point to potential competitiveness in agriculture, provided that investment and production decisions in the sector are driven by market mechanisms. The availability of an inexpensive skilled labor force suggests a comparative advantage in skilled labor-intensive products. On both counts, export performance has not borne out these expectations, as agricultural net exports have remained stagnant and there has been no perceptible shift toward skilled labor-intensive exports. High protection and the subsidization of this sector have resulted in major allocative distortions and low productivity, despite preferential agreements, and constitute a major barrier to the development of competitive agro-food production lines.

45. In sum, Romania's potential in sectors other than unskilled labor-intensive tradables and in the agriculture and food sector remains largely untapped. If Romania improves its policy and governance frameworks so as to attract FDI flows at levels similar to other CEECs, the evidence suggests substantial benefits for the future competitiveness of Romanian products. The role of FDI and de novo industries in economic restructuring, competitiveness, and the generation of meaningful net job creation in transition economies is well documented. Furthermore, the alignment of applied MFN tariffs on industrial products to those of the EU CET would represent a significant improvement. It would expose both local producers and exporters from Romania's preferential partners to conditions similar to those that the latter face in EU markets. Without the restructuring of the enterprise sector, the expansion of the private sector in the economy, and a heavier reliance on market driven mechanisms to reallocate resources from low to high

productivity activities across the economy, including agriculture, the risks to Romania's trade performance and integration are large.

3. Restructuring the Enterprise Sector

46. In no other area has the legacy of the socialist years in Romania weighed as heavily as in enterprise reform. The slow and inefficient enterprise reform of the past has left Romania with a larger number of enterprises to be privatized or liquidated than that in all of the other CEECs combined. Public enterprises are the core of the unrestructured part of the economy. As discussed in the previous sections, there are dynamic private businesses that are leading Romania's solid trade performance in the EU and world markets. Their scope of action, however, is limited to a few activities operating around the unrestructured enterprise sector. Furthermore, the expansion of these internationally competitive private firms is hampered by the sizable unrestructured public enterprises and the soft budget constraints that keep unviable enterprises from exiting. In the last few years the share of new firms, weighted by employment, is high and compares well with other CEECs and thus many new firms have started operations. In contrast, the share of exits, weighted by employment, is very low compared to new entries. This unstable business environment reflects the dominant role of unrestructured public enterprises over a competitive fringe of private businesses and represents a significant risk to extending integration with the EU and the world markets more broadly across the economy.[11]

47. Recently, however, Romania has carried out privatization to strategic investors. The government has reduced the number of large loss-making enterprises by completing important privatizations, including Siderurgica Hunedoara, Tractorul and Roman Brasov and ARO Campulung. Indeed, the momentum for enterprise restructuring seems to be picking up. The challenge is to accelerate the pace of these reforms and to avoid the failed privatization modes used in the past. This section first takes stock of the remaining privatization agenda. It then examines the links between hard budgets, productivity, and stability, and discusses the role of domestic competition and productivity gains. This is followed by a discussion on policies affecting the business climate, including licensing regimes, contract enforcement, and labor regulations. The section ends with a reform agenda for accelerating private sector development.

3.1. Privatization and Economic Restructuring

48. Only recently has Romania carried out privatization to strategic investors. As discussed above, Romania has a legacy of a large number of enterprises that are still fully or partially in state hands. By end-2003, Romania had privatized only about 40 percent of its large enterprises and about two-thirds of its medium enterprises (Table 6). There are 1,300 SOEs and another 600 enterprises that are effectively under state control. No other country in the CEECs has such a large remaining privatization agenda (with more such enterprises than the rest of the CEECs combined).

[11] See Chapter 3 in Volume 2 of this report.

49. In 2002, the private sector generated about 65 percent of GDP, compared with a regional average of 76 percent. Furthermore, only 19 percent had strategic investors, since 33 percent of Romania's enterprise sector was still in state hands, 24 percent was insider-controlled, and 13 percent was controlled by shares of mass-privatization.[12] In contrast, in the Czech Republic by 1998 about 85 percent of the companies had a strategic owner following the privatization of 1992-94, and by end-2003, 33 percent of its enterprise sector had significant foreign ownership. Since 1999 the Slovak Republic has been a preferred destination for foreign investment in the region and about 40 percent of its GDP produced is by foreign-owned companies.

Table 6 Privatization in Romania, 1993-2002

	Companies for privatization	Companies privatized	
		Number	Share of total (%)
Large	708	288	40
Medium	2549	1582	62
Total	3257	1870	57

Source: Romanian Authority for Privatization and Management of State Ownership.

3.2. Modes of Privatization and Their effects on Outcomes

50. Romania's choice of privatization modes, in the past, caused delays and thwarted the necessary restructuring. Romania's isolation program, supported by Romanian "Structural Funds," was aimed at bringing companies back to a sound financial condition. But managers remained in place and, since they were either elected by the workers or approved by the union, they did not take the necessary steps to improve the financial viability of these companies. Instead, they focused their efforts on accessing the Structural Funds and finding ways to continue to accumulate arrears. Little restructuring took place, and the funds were used for employment preservation. At the close of the program in early 1997, only four firms graduated into profitability, two were privatized, and two were liquidated out of 147 companies that participated in the program. Had the Structural Funds been used to offer separation packages to workers, the resources used in the isolation program could have offered an average of 30 monthly wages to every employee.

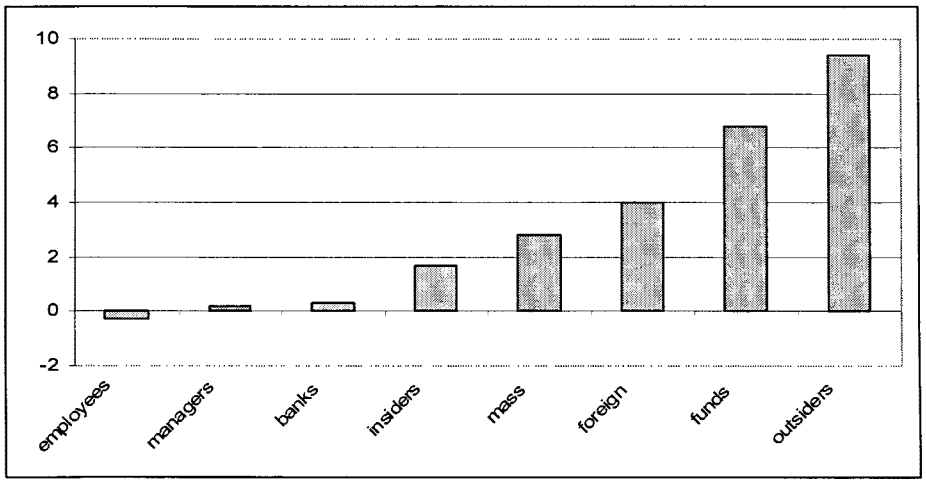
51. In contrast to the mass privatization in many CEECs, Romania's approach limited commitment to long-term restructuring and investment. Mass privatization in many CEECs, including Bulgaria, the Czech Republic, Poland, and the Slovak Republic, where the privatization funds were privately owned and operated, resulted in majority owners and hence a commitment to long-term restructuring and investment. In contrast, in Romania the funds were state-managed, with boards of directors appointed by the government and approved by the Parliament. The nominal owners, 18 million Romanian citizens, exercised no effective control. As a result, majority owners did not emerge in Romania, and without majority owners, a commitment to long term restructuring did not emerge. Restructuring under managed employee buyouts (MEBO) was equally disappointing.

52. Since 1998, privatization for cash has gained momentum in most CEECs, and recently Romania has started to privatize to strategic investors. This shift in policy strategy is crucial to Romania's economy, given the large size of the privation agenda that is going forward. And the

[12] The remainder was in the hands of privatization funds and dispersed owners.

potential productivity gains are large, provided that the privatization mode is to strategic investors and carried out in a transparent manner (Figure 5).

Figure 5 The Benefits of Outsider Ownership in Central and Eastern Europe
(average annual productivity growth, percent)



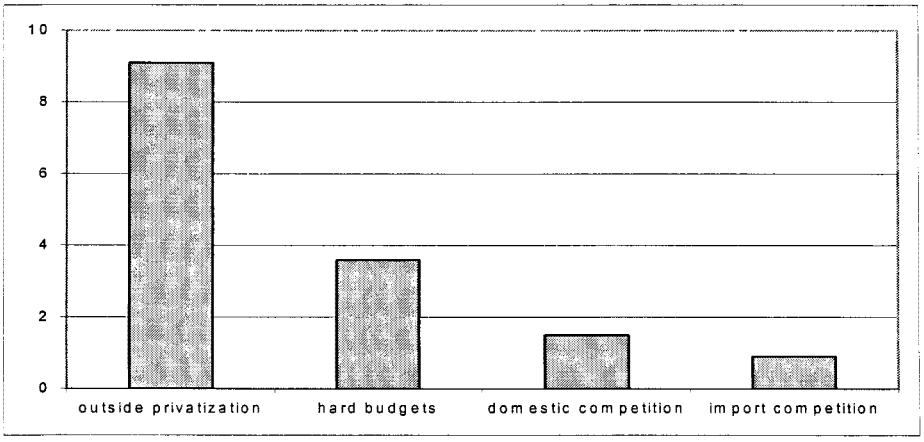
Note: Insiders does not simply add the analyses for employees and managers as some studies do not distinguish among the two groups. Similarly, Outsiders does not simply add the various groups of outsider investors. In some cases, these are reported and analyzed together. The two categories—Insiders and Outsiders—should only be compared to each other.
Source: Djankov, S. and Peter Murrell, 2002, "Enterprise Restructuring in Transition: A Quantitative Survey," Journal of Economic Literature.

3.3. Hard Budgets, Productivity, and Macroeconomic Stability

53. In contrast to most CEECs, applying hard budget constraints remains a major challenge in Romania. The evidence from other transition economies shows that hard budgets are the second most important determinant of enterprise restructuring and productivity gains (Figure 6). Most CEECs have had to deal with loss-making financially unviable enterprises. However, in most cases distressed assets were isolated under state fund management and sold off or liquidated. Unlike the situation in most other CEECs, nonpayment and arrears in the state/enterprise transactions is common in Romania. Both financially unviable and financially viable companies rely on nonpayment to finance their operations. In contrast, this practice is nearly absent in private-to-private transactions in Romania. The challenge is to extend this practice to the state-private transactions in the economy.

54. Strengthening the financial discipline of the enterprise sector in Romania is fundamental not only to growth and productivity but also to macroeconomic stability. To the extent that much of the public enterprise sector is unprofitable and unrestructured, however, companies depend on budgetary assistance and quasi-fiscal subsidies to continue operating. Furthermore, unrestructured public enterprises remain a source of inflationary pressure and low competitiveness: historically they have been a source of rapid wage increases unrelated to productivity gains. Rapid real wage growth was partly responsible for the strong real appreciation and consequent sharp exchange rate devaluation of 1998 and 1999 that was needed to restore current account sustainability.

Figure 6 Hardened Budgets Increase Productivity Growth in Transition Economies (average annual productivity growth, percent)



Source: Djankov, S and Peter Murrell, 2002, "Enterprise Restructuring Transition: A Quantitative Survey" Journal of Economic Literature.

55. Budgetary subsidization involves sizable implicit subsidies including nonpayment of taxes and accumulation of tax arrears, budgetary credits, transfers from off-budget funds and government payment of guaranteed loans. Table 7 presents estimates of the amount of budgetary subsidization of the enterprise sector. Direct subsidies declined from 2.6 percent of GDP in 2001 to 2.2 percent in 2002.[13] However, explicit budgetary subsidies are not the only public resources transferred to enterprises. In Romania, a variety of implicit subsidies is provided to both state-owned and private companies. The transfers include budgetary credits, nonpayment of taxes and accumulation of tax arrears, transfers from off-budget funds, and government payment of guaranteed loans. In total, these implicit non-energy subsidies increased from 4.1 percent of GDP in 2001 to 5.5 percent in 2002. In addition, there are significant implicit subsidies from the energy sector to non-energy producers and households, of which about two-thirds accrue to firms.[14] In 2002 these subsidies were 2.5 percent of GDP, and they increased to an estimated 3.2 percent in 2003.

[13] Until the late 1990s, state-owned enterprises in Romania depended heavily on directed bank credits to finance losses and inter-enterprise arrears, which often were driven by rapid wage increases. As the loans were seldom repaid, the financial imbalances were effectively monetized. As a result, monetary policy could not be reconciled with the strategy of using the exchange rate as a nominal anchor to control inflation. After 1997, soft-budget constraints were no longer financed by the central bank. Firms also began to impose hard-budget constraints on each other. Today, because the enterprises remain largely unrestructured, continuing losses have been financed with direct budgetsubsidies, tax arrears, unserviceable foreign loans that are ultimately repaid by the government, and subsidized sources of energy.

[14] Energy sector subsidies have been estimated by the IMF. See the September 2003 Staff Report for the Fourth Review Under the Stand-By Arrangement and Request for Waivers of Performance Criteria. These estimates exclude the district heating companies that were not spun away from Termoelectrica. The estimate of the allocation of subsidies between households and producers is based on the 2003 IMF Policy Discussion Paper (PDP/03/02) by Stephane Cosse.

Table 7 Subsidization of the Enterprise Sector, 2001-02

	2001	2002	2001	2002
	(billions of lei)		(% of GDP)	
Direct Subsidies 1/	30,923	32,772	2.6	2.2
Energy	9,633	12,372	0.8	0.8
O/w local government	3,841	4,564	0.3	0.3
Transportation	7,765	8,620	0.7	0.6
O/w local government	2,808	2,875	0.2	0.2
Agriculture 1/	6,280	2,581	0.5	0.2
Other	7,245	9,199	0.6	0.6
Implicit Subsidies	47,476	83,864	4.1	5.5
Budgetary credits, net	978	1,165	0.1	0.1
Tax debt	35,417	65,033	3.0	4.3
Change in end of year stocks	26,901	63,423	2.3	4.2
Cancelled interest and penalties	8,516	1,610	0.7	0.1
Energy fund	3,068	4,175	0.3	0.3
Loan guarantees paid	8,013	13,492	0.7	0.9
O/w energy sector	7,435	6,050	0.6	0.4
Quasi-Fiscal Energy Subsidies 2/	39,027	25,554	3.3	1.7
Low tariffs	31,763	22,304	2.7	1.5
Non-payments	7,264	3,250	0.6	0.2
Memorandum:				
Total tax arrears (eop stock)	126,587	190,010	10.8	12.6
O/w arrears of 76 large loss-makers	46,944	68,274	4.0	4.5
rescheduled arrears	6,259	5,019	0.5	0.3

Notes: 1/ Includes items classified in the state budget as transfers to mining and agriculture. 2/1 Based on IMF estimates of the allocation of subsidies between households and firms in 2001.
Source: Ministry of Finance; Ministry of Industry and Resources; World Bank staff estimates.

56. Indeed, in Romania subsidization through nonpayment, accumulation of arrears, and periodic barter settlement is widespread. Both public and private enterprises use tax arrears to finance themselves (Table 8). Neither loss-making nor profitable companies are excluded, although the degree of the use of tax arrears is inversely related to profitability -- thus it is far higher in SOEs. Majority and minority state-owned companies have had the largest tax debts as a percentage of total assets during the last two years, averaging 30 percent and 7 percent, respectively. Of these companies, which had losses in both 2001 and 2002, the arrears averaged, respectively, 37 and 11 percent of assets. For private companies, persistent loss-makers averaged more 30 percent of assets in tax debt, while profitable entities owed the equivalent of 2 percent of assets. Furthermore, the distribution by type of arrears tends to be about the same irrespective of the level of profitability, with debts to the state budget, social insurance funds, and local and special funds on average accounting for, respectively, 51 percent, 37 percent, and 12 percent of the total amount owed. In sum, nonpayment and arrears accumulation are pervasive in the public enterprise transaction interface. These practices undermine both economic restructuring and stability.[15]

[15] See Chapter 1 in Volume 2 of this report.

Table 8 Tax Arrears, 2001-02 (percent of total assets)

	Large Losses in both 2001 and 2002		Losses in at Least One Year		Profitable in both years		Total	
	2001	2002	2001	2002	2001	2002	2001	2002
Regie Autonomes	..	..	3.7	3.6	1.1	1.1	1.8	1.8
State-owned	69.4	74.6	30.7	6.1	1.1	1.3	6.4	4.3
Majority state	32.6	40.7	25.1	28.8	14.4	17.6	26.7	33.1
Minority state	11.7	10.5	10.3	11.4	1.6	1.0	7.3	7.1
Private	31.1	36.1	7.9	10.4	2.3	2.1	5.7	6.3
Cooperative	44.5	76.9	18.9	18.7	5.7	4.6	9.2	8.8
Total	27.9	32.4	9.5	10.7	2.4	2.2	7.1	7.4
o/w state budget	13.7	14.7	5.2	6.1	1.1	1.0	3.6	3.8
social security	11.2	14.2	3.0	2.7	1.0	0.9	2.6	2.6
local gov. & spec. funds	3.1	3.5	1.3	1.9	0.2	0.2	0.9	1.0

Source: Julian Fennema and Mark Schaffer, "Financial and Economic Performance of Romanian Firms 2001-2002" the World Bank.

57. In contrast, this practice is much less extensive in private-to-private enterprise transactions. Firms largely impose hard budget constraints on each other. Empirical evidence shows that the scale of overdue trade credit among enterprises in Romania is not outside the range found in developed Western market economies.[16] Late payment to suppliers is common, but persistent non-payment is not.[17] Extending this hard budget discipline to government transactions is key to Romania's improving productivity dynamics—hard budget discipline enhances competition among firms for markets, financing, and labor, resulting in higher productivity and hence competitiveness.

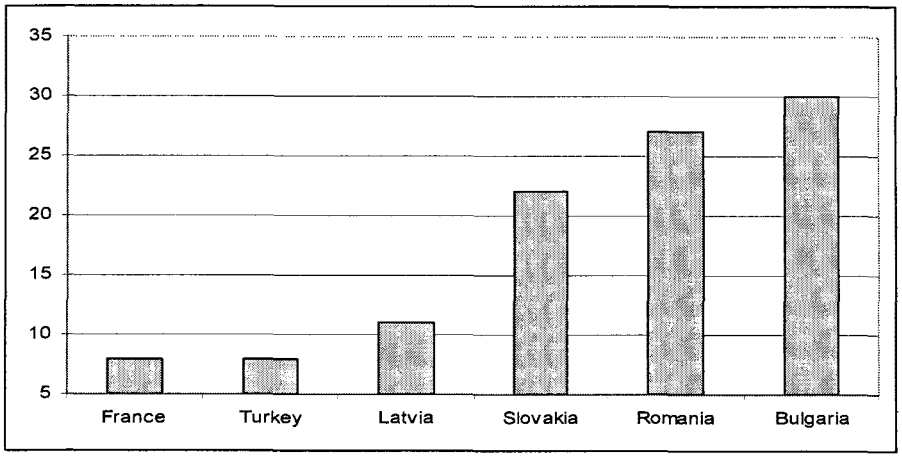
3.4. Domestic Competition

58. Figure 6 shows that improving domestic competition is the third most important determinant of enterprise restructuring. As is illustrated in Figure 7, below, the conditions for starting a new company in Romania have ample scope for improvement. In particular, the commercial registry is one of the least efficient in the region, taking on average three weeks to issue a company identification number. Furthermore, exit rarely takes place and by the time it does, assets are often obsolete. Romania's bankruptcy law has the weakest protection for creditors of any transition economy. Once a company is in distress, its management dictates the terms of the insolvency process. This together with the common use of nonpayment and arrears, results in a strong bias on the part of creditors to avoid using formal insolvency and contributes to the low level of financial intermediation observed in Romania. Assets remained unused for years, and this inflicts large costs on the economy and on employment.

[16] See Julian Fennema and Mark Schaffer, "Financial and Economic Performance of Romanian Firms 2001 – 2002," a 2003 background report prepared for the Romania Country Economic Memorandum on the basis of the financial reporting of approximately 49,000 companies.

[17] Of course, timeliness of payment tends to vary inversely with profitability, and the payment discipline of state-owned firms has been relatively weaker compared to other firms. Also, it is clear that energy companies have been more tolerant of late payment.

Figure 7 Room for Improvement in Entry Regulation, 2003 (number of days to legally start operations of a new business)

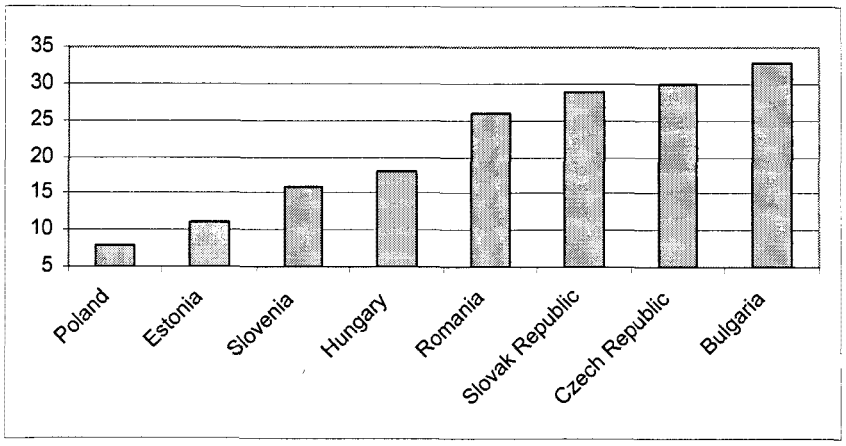


Source: Doing Business website, www.worldbank.org/Doingbusiness.

3.5. Licensing Regimes

59. Recently, Romania has made important progress in this area. In mid-2003, the government introduced the silent consent rule, which had an immediate impact on 480 licenses. The new rule allows companies to undertake activities if the relevant government authority has not responded within 30 days. In addition, new legislation is to be accompanied by a regulatory impact assessment, in line with OECD standards. Finally, statutory limits on the processing of licensing requests have been mandated. As illustrated in Figure 8, the pace of reform in this area needs to be sustained—25 percent of businesses in Romania report licensing as a moderate to major obstacle to doing business.

Figure 8. A Quarter of Businesses Identify Licenses as a Major Problem (percentage of businesses that say business licensing is a moderate to major obstacle)



Source: BEEPS 2002 survey.

3.6. Enforcement of Contracts

60. The enforcement of contracts in Romania faces more serious challenges than may at first appear. As described in Section 1, judiciary reform is high in the agenda in Romania's process toward EU accession. In late 2003, important initial steps were taken, including the adoption of the Judicial Reform Strategy 2003-2007, and of constitutional amendments overhauling the legal framework for judicial reform. Regulatory and organizational changes have to be further worked out and, more important, actions need to be taken to develop a functional, transparent, and independent judiciary system. These changes will improve the enforcement of contracts. There is evidence that deficiencies in the judiciary are significant. [18] A recent World Bank study reports that these deficiencies have for the most part discouraged businesses from resolving disputes through litigation. [19] Only very large enterprises seem to be more litigious than medium and small businesses. In addition, the large and dominant presence of public enterprises combined with the practice of barter settlement further reinforces these findings, since firms can resort to these alternative mechanisms to settle disputes. Therefore, the low 240 days needed to enforce a simple debt contract in Romania, compared with an average of 252 days in the CEEC, reflects deficiencies rather than strengths, since only large companies use the courts to settle disputes and the judiciary lacks transparency (Chapter 3). Furthermore, in 2003, Emergency Ordinance 58/2003 reintroduced two levels of appeals for all types of commercial disputes, and hence, represents a step backward in the efficiency of settling commercial cases. Data from January 2004 indicate that debt collection cases can now take, on average, one year to resolve. In addition, deficiencies in the enforcement of contracts protecting property rights to land in agriculture are a major stumbling block for agricultural transformation (discussed in Section 4).[20]

3.7. Labor Regulations

61. Businesses report that rigid employment laws are a significant obstacle to their performance. As illustrated in Figure 9, in cross-country comparisons Romania has some of the most rigid conditions of employment, with tight restrictions on hours worked, and on night and holiday work, and a relatively high minimum wage. Several details in the labor regulations create perverse incentives for workers: for example, in managing absenteeism, and in periodic automatic increases in wages based on years worked and not on productivity. Recently, Romania revised it's the Labor Code that it inherited from the socialist years. In some areas the new Labor Code is more restrictive than the original one (Section 5).[21]

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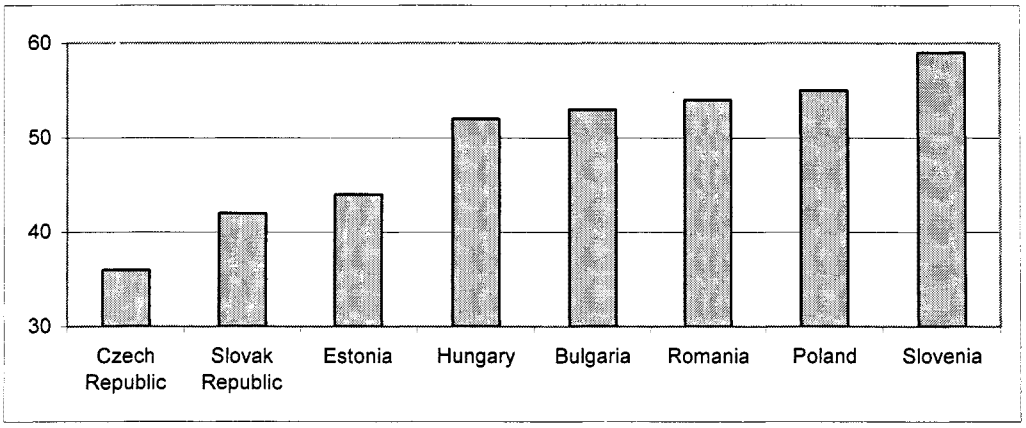
[18] *Romania: A Public Expenditure Review*, 2002, the World Bank and Regular Reports on Romania by the EC, 2002 and 2003.

[19] *Building Market Institutions in South Eastern Europe: Comparative Prospects for Investment and Private Sector Development*, the World Bank, forthcoming in 2004.

[20] See Chapter 4 in Volume 2 of this report.

[21] See Chapter 5 in Volume 2 of this report.

Figure 9 Employment Regulation Index (index varies between 0 and 100; higher values for more rigid regulation)



Source: Doing Business project, www.worldbank.org/Doingbusiness.

3.8. Restructuring the Enterprise Sector: A Reform Agenda

62. Reform priorities that are important to restructuring the enterprise sector include the following:

- *Implementing the large privatization agenda decisively and transparently to strategic investors is the highest reform priority.* It is only recently that Romania has carried out privatization to strategic investors. This recent momentum given to enterprise reform needs to be accelerated. Privatizing to outside strategic investors, rather than relying on the failed privatization modes of the past, together with eliminating the widespread practice of nonpayment and arrears, are fundamental to the success of the restructuring reforms in terms of growth, net job creation, and competitiveness.

- *Implementing hard budget constraints in the transaction interface between the state and enterprises is necessary.* Private companies largely impose hard budget constraints on each other. In contrast, soft budget constraints prevail in the transaction interface between the state and enterprises. If hard budget disciplines are not applied to government transactions, the unrestructured public enterprises will remain dominant, and unviable firms will remain active longer, which will hamperthe expansion of competitive firms that are able to integrate with the EU and the world markets.

- *Improving the business environment is necessary for growth and competitiveness.* Progress in this area has been mixed. A more systematic approach to these reforms is necessary if growth and competitiveness prospects are to improve. The actions needed should include enhancing domestic competition by adopting more flexible labor market principles and more efficient entry and exit rules for businesses (particularly regarding bankruptcy), simplifying the licensing regime, and improving the efficiency and predictability of commercial contracts.

63. As in the case of the enterprise sector, transforming the agricultural and food sector requires expanding the role of the private sector and improving the business environment in the sector and in the economy as a whole. The economic potential of a large amount of resources, human and physical assets, and land remains largely untapped.

4. Implementing Agricultural Transformation

64. The agricultural sector in Romania includes 45 percent of the population living in the rural area, and 67 percent of the poor. The 4.8 million people working in Romanian agriculture today constitute about 72 percent of agricultural labor in all the EU-15 countries combined. The legacy of the past agricultural policies of heavy reliance on subsidization, the slow restructuring elsewhere in the economy, and macroeconomic instability have taken a heavy toll on Romania's agricultural and food sector. As a result, agricultural productivity is low and is not improving: the sector includes 36 percent of the labor force, which contributes only 14 percent of GDP. However, as discussed in Section 2, Romania's moderate climate and the availability of land point to the country's potential competitiveness in agriculture. This potential competitiveness, however, can only be unleashed provided that investment and production decisions in the sector are driven by market mechanisms and agricultural policies target efficiency improvements. This section first provides an overview of Romania's agricultural policy framework, and then analyzes the results to date of these policies. The section ends with a reform agenda for implementing agricultural transformation. [22]

4.1. Policy Framework

65. Agricultural transformation in Romania has several dimensions: economic, rural, and social. Economically, while the agricultural sector is potentially competitive given Romania's moderate climate and land availability, policies have resulted in an agricultural sector with one of the lowest productivities among CEECs, occupying 36 percent of the labor force, and receiving large subsidies. The rural dimension is highlighted by noting that 45 percent of the population lives in the rural area. The social challenge is clear by noting that 67 percent of Romania's poor are in the rural areas. As Chapter 4 of Volume 2 and this section show, an important step towards agricultural transformation is to separate policy instruments aimed at increasing productivity in agriculture, from those aimed at supporting rural development, and those aimed at reducing poverty in the rural areas.

66. In the early 1990s, after the first democratic elections, Romania embarked on a process of general economic reform which included reforms in the agriculture and food sector. Progress, however, was rather modest until 1997. Since 1997 Romania has made uneven progress in implementing and maintaining the sectoral reform program. In 2000 the substance of reform began to shift toward measures aimed at EU accession. The overall process, however, has been slower and the results are less consistent than in other CEECs in the final phases of the EU accession process.

[22] See Chapter 4 in Volume 2 of this report.

67. The central component of Romania's current agricultural policy framework is the costly and largely ineffective distortive agricultural support program with its high level of subsidization (Table 9). The 2003 budget and subsidy program envisages a further significant increase in support to agriculture. Expressed in U.S. dollars, the 2003 program is close to $450 million, up from about $350 million in 2002. This support program represents about 4 percent of the total state budget (down from 10 percent in 1992-93) and less than 1 percent of GDP (down from 3 percent in 1992). Like other modes of intervention, the level of overall support to agriculture has fluctuated widely during the transition period. The level of support as expressed by the Producer Support Estimate (PSE)[23] was relatively modest during most of the 1990s, but it definitely seems to be higher since 1998. The liberal policies introduced in 1997, when the PSE dropped to a 10-year low of 3 percent, were short lived and support to agriculture has increased significantly since then. Thus, the average PSE during 1991-96 was 13 percent, whereas after 1998 it rose to 20-25 percent. The level of support varies significantly by commodity. The sugar, milk and poultry sectors receive the highest levels of support at 64, 46, and 34 percent, respectively. On the other hand, oilseeds receive hardly any support, while the pork sector is actually taxed.

Table 9 Structure of the Agricultural Support Program in 2003

	ROL (mil.)	Percent
Direct Support Measures	**13,675.50**	97
Price Support	5,101.00	36
Input Support	7,140.60	51
Other Direct Payments	685.00	5
Credit and Investment Support	749.90	5
Indirect Support Measures	**328.6**	3
General Ag. Service Support	103.60	1
Export Subsidies	225.00	2
Total	**14,005.10**	**100**

Source: Ministry of Agriculture.

68. Most policies directed to agriculture mix economic, with rural, and poverty reduction objectives into the same instrument. Judging by the results, these measures have proved to be ineffective and in some instances financially unsustainable. For example, the input voucher system, introduced in 1997, was designed to redirect subsidies away from state farms, and to increase farm output by providing better access to inputs. However, the voucher scheme was seen as social welfare program and blamed for failing to increase production output. Similarly, relying on direct and indirect payments to support income of agricultural producers mixes economic objectives with poverty reduction. Romania's agricultural support policy explicitly targets large-scale farms, most of them publicly owned. More recently, the government introduced pension benefits to farmers on a non-contribution basis. Clearly the mix of policies has been ineffective and costly in terms of resources allocated to the sector.

69. The sector has been subject to frequent and ad hoc changes in trade policies. Prior to 1997, there were frequent changes to temporary exceptions and reductions benefiting particular exporters and importers. More recently the volatility takes the form of frequent use of safeguards and temporary interventions on behalf of domestic producers. Other important features of the current sectoral policies include: there is low and inconsistent taxation in the agricultural sector; an incomplete transition in the farming sector; the agroprocessing industry is unprepared for EU entry; commodity and factor markets are not adapted to the needs of privatized agriculture; and the urban-rural gap reveals significant rural problems.

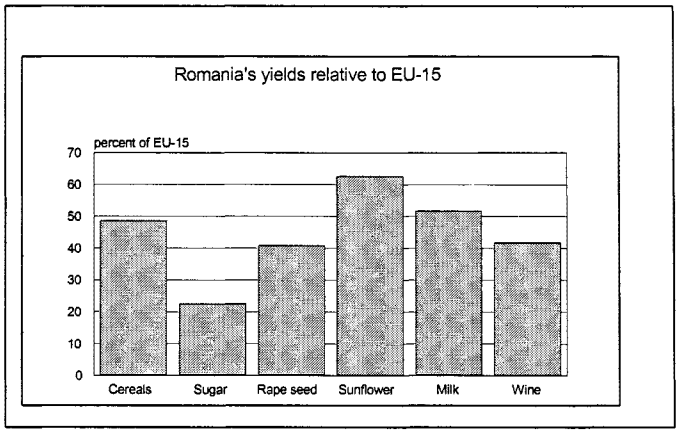
[23] PSE is estimated by the ratio of financial state support provided to producers relative to the value of producers' output.

70. The other two dimensions in agricultural transformation are the policies for rural development and poverty reduction. Romania's rural population of 10.1 million reside in 13,000 villages, clustered in about 2,700 communes. Rural income is 27 percent below urban income and about 67 percent of the poor are located in the rural areas. With few exceptions, such as the Guaranteed Minimum Income program which targets the poorer segments of the population, most other policies mix economic, rural, and poverty reduction targets.

4.2. Policy Outcomes

71. As a result of poor agricultural policies, agricultural productivity in Romania is low and is not improving. About 36 percent of Romania's labor force employed in agriculture contributes only about 14 percent of total GDP (2001 data). The low productivity of land is manifested in the generally low yields, which achieve at most 50 percent of the corresponding EU-15 yields (Figure 10). In livestock enterprises, milk yields hover around 3,000 liters per cow per year compared with 5,800 in EU-15. Based on the aggregate value of production, Romanian agriculture generates about €500-€600 per hectare, compared with €2,000 per hectare in EU-15, and about €1,500 per worker, compared with €21,000 per worker in EU-15 (1999 data). A weighted ranking of EU-15 and 9 countries, which joined the EU this year, by the yields of milk, cereals, and sugar puts Romania at the very bottom of the scale (together with Bulgaria).

Figure 10 Romania's Yields Relative to EU-15



Source: EU, OECD statistics

72. The lack of economic restructuring in other sectors of the economy, together with macroeconomic instability and high inflation has had an impact on the agriculture and food sector. The sector has become a refuge for those struggling to complement their low incomes with subsistence food production, particularly the older and poorer segments of the population and the unemployed. About one-fourth of the labor force in agriculture is 60 years or older and 67 percent of Romania's poor are in the rural areas. Indeed, this effort to complement low incomes with subsistence food production has been effective, since nutrition poverty is more prevalent among the urban poor (the incidence of this dimension of poverty is about 50 percent among the urban poor, whereas the rural poor have an incidence of 28 percent).[24] While this is

[24] See *Romania: Poverty Assessment, Volumes 1 and 2*, Report number 26169-RO, The World Bank, 2003.

difficult to ascertain, it is possible that the introduction of defined benefit pensions to farmers without appropriate links and incentives to years of contributions may have created the incentives for the urban unemployed to move to rural areas while still participating in informal activities as a way of making ends meet.

73. A shifting of agricultural policy strategy towards efficiency and competitiveness is central if Romania is to bridge the gap between the dire conditions and the potential competitiveness of its agriculture and food sector. Policy instruments need to be separated from those aiming at poverty reduction, those aimed at expanding business opportunities in the rural areas, and those aimed at improving productivity and competitiveness of the agricultural sector.

4.3. Agricultural Transformation: A Reform Agenda

74. For Romania to realize its potential as a successful competitor in agricultural markets, the first step is for agricultural policies and transformation to be driven by competitiveness. This means abandoning the failed policies of the past, with their emphasis on increasing production, intervention in favor of specific commodities, and the introduction of costly distortions. These policies have resulted in low yields in both crop and livestock production and in the lowest agricultural labor productivity in the region by far. Competitiveness requires higher efficiency and productivity in agriculture. This can only be achieved by policies that facilitate the structural reorganization of agriculture by reallocating resources from activities where productivity is low to activities where the potential productivity is higher. This implies allowing inefficient farms to close down and removing obstacles to the expansion of new and more efficient farming units.

Table 10 Status of State Farm Privatization (April 2003)

	Number of farms	Percent
Starting number of state farms in SDA portfolio, Jan. 2000	739	100
In liquidation/reorganization/bankruptcy (Law 64/1995)	382	51
Privatized	279	38
Remain to be privatized	78	11

Source: Ministry of Agriculture.

75. The recommended agricultural policy framework and support system would need to focus on facilitating the required structural changes and improving competitiveness by implementing the following reforms.

- *Quickly completing the privatization of state farms and ensuring that the bulk of state-owned land is privatized by auction or expeditiously entrusted to private operators (see Table 10);* allowing the creation of functioning land markets under clear and transparent rules; imposing hard budget constraints on bankrupt state farms and enforcing bankruptcy procedures on those which have continued to report losses during the last four to five years (nearly half of the state farms); and eliminating preferential treatment of large farms.

- *Facilitating of the consolidation of the small-scale farming sector through land market development.* To this end, Romania should adopt policies that simplify

registration and titling procedures, minimize transaction costs, and ensure property rights through effective contract enforcement.

- *Integrating the various instruments of government intervention in the sector into a more consistent and predictable framework.* This would include the provision of a reliable orientation for farmers until the CAP is introduced and a more effective use of budgetary support to agriculture through a policy strategy shift of support programs to target efficiency enhancement rather than price support and export subsidies.

- *Reforming the agroprocessing sector through the privatization of state-dominated subsectors such as sugar, fruits, and vegetables, preferably to outside strategic investors.* Foreign capital is needed for the modernization and upgrading of privatized agroprocessing. And Romania needs to complete its efforts to meet the food and safety quality and standards of the EU.

- *Clearly separating policy instruments aimed at improving productivity and competitiveness in the agriculture and food sector from those aimed at protecting the poor in the rural areas.*

5. Enhancing Labor Market Adjustment

76. As discussed in the previous three sections, productivity is low in most sectors in Romania, except in unskilled labor-intensive activities where trade performance shows that productivity has enabled producers to compete in the EU markets. However, the economic potential in skilled and natural resource intensive activities is largely untapped. Romania's development prospects and its efforts to catch up with other countries in the region in integrating with the EU are determined by its ability to reallocate resources from low to high productivity activities across the economy. Success depends to a large extent on the functioning of three factor markets: labor, capital, and land. This study addresses policy issues in the first two. This section discusses policies needed to enhance labor market adjustment. Without labor market flexibility, it is unlikely that the economy will be able to respond to the emerging challenges discussed in Section 2. Nor will the economy be able to improve prospects for higher labor productivity and hence better labor income earnings.

77. The section starts with an overview of Romania's employment, output, and wage dynamics in a regional perspective. It then presents an analysis of inter-sectoral labor market adjustment and sectoral employment imbalances, followed by a discussion of key findings in job destruction and creation in a regional perspective. A discussion of issues on the relation between education, employment and skills mismatch follows. The section ends with a reform agenda intended to enhance labor market adjustment.[25]

[25] See Chapter 5 in Volume 2 of this report.

5.1. Employment, Output, and Wage Dynamics: Romania in a Regional Perspective

78. Employment dynamics in Romania have closely followed the fluctuations in output and macroeconomic performance. However, in contrast to early reformers in the region, in Romania the employment dynamics and output fluctuations were driven by the effects of unsustainable macroeconomic policies on output rather than by economic restructuring. The sharper declines in Romania took place during the two macroeconomic crises of 1991-93 and 1997-98 (Chapter 1). This reflected not only Romania's protracted economic restructuring but also its policy strategy of employment preservation.

Table 11 Output, Employment and Wage Adjustment (percentage change relative to initial levels)

Country	ΔGDP		ΔEmployment		ΔWage	
	1994/1989	2001/1989	1994/1989	2001/1989	1994/1989	2001/1989
Bulgaria	-23	-17	-24	-31	-48	-57
Czech Republic*	-10	6	-10	-12	-24	1
Hungary	-16	12	-26	-23	7	14
Poland	-18	15	-14	-16	-18	32
Romania	**-21**	**-14**	**-9**	**-22**	**-37**	**-37**
Slovak Republic	-21	9	-16	-15	-34	-25

For the Czech Republic GDP changes are computed between 1994 and 1990, and, respectively, 2001 and 1990.
Source: World Bank staff estimates based on.

79. Romania's strategy in 1989-1994of preserving employment shifted in 1995-2001 to one of average wage preservation. These strategies have taken a heavy toll on the dynamics of output, employment, and wages. Table 11 shows the unsustainability of this strategy. The collapse of output at the start of transition was exacerbated by unsustainable macroeconomic policies, which resulted in the crisis of 1991-93. While Romania's economy contracted by 21 percent in 1994 relative to 1989, employment declined by only 9 percent—the smallest decline in employment among other countries in the region. The brunt of the adjustment fell on wages, which declined by 37 percent, and hours of work.[26] By 2001, the adjustment in employment was significantly larger than that of output: employment declined by 22 percent and output by 14 percent relative to 1989 levels. However, the decline in wages in 2001 relative to 1989, remain unchanged compared to the wage adjustment observed in 1994 relative to 1989 reflecting in part the benefits of recent stabilization efforts but also a policy strategy of average wage preservation.

80. Average wage preservation masks the wide variance of wage adjustment across the economy. The benefits of stabilization efforts are tilted towards providing proportionately greater benefits for lower income groups, which have greater reliance on labor earnings, compared to higher income groups. However, the benefits of average wage preservation have been far larger for those employed in SOEs, many of them loss making, than for those employed elsewhere in the economy. Furthermore, since the decline in employment is not matched by a corresponding

[26] The average annual number of hours effectively worked in industry was 1,588.2 in 1994, down from 1,759.2 in 1990 (NIS data).

rise in registered unemployment, the adjustments reflect a sharp reduction in labor participation associated with retirement and early retirement programs and with discouragement.

5.2. Inter-Sectoral Labor Market Adjustment and Sectoral Employment Imbalances

81. Inter-sectoral labor market adjustment and sectoral employment imbalances in Romania show worrisome trends (Table 12). In terms of initial conditions, in 1989 Romania had the largest share of employment in agriculture among CEECs comparable only to that of Poland. More important, in 1989 the departure index[27] of 31 and 33 percent, relative to EU-South and EU-North, respectively, shows that among CEECs, Romania inherited the most distorted employment structure compared to an average EU economy. In terms of overall trends in inter-sectoral labor market adjustment in 1989-2001, Romania diverges significantly from other CEECs by its large increase in the share of employment in agriculture and its limited labor reallocation opportunities elsewhere in the economy. Indeed, the lack of labor reallocation opportunities in the non-agricultural sectors has turned agriculture into the labor employer of last resort.

Table 12 Structure of Employment by Main Sector in Selected CEEC, 1989, 2001 (percent)

	Bulgaria		Czech Republic		Hungary		Poland		Romania		Slovak Republic	
Sector	**1989**	**2001**	**1989**	**2001**	**1989**	**2001**	**1989**	**2001**	**1989**	**2001**	**1989**	**2001**
Agriculture	19.0	26.3	11.7	4.7	16.6	6.2	26.8	19.1	27.9	42.3	13.8	6.1
Mining	2.6	1.2	3.6	1.4	2.0	0.3	3.4	1.9	2.3	1.4	1.0	1.0
Manufacturing	34.9	20.1	34.0	27.7	28.6	24.8	24.5	19.9	33.0	18.9	32.1	26.1
Electricity, gas, water	0.8	2.0	1.4	1.9	2.6	2.1	1.1	1.9	1.2	1.9	1.6	2.5
Construction	7.8	4.3	7.3	9.1	7.0	7.1	7.8	6.7	7.0	4.0	11.6	8.0
Trade	9.2	15.3	11.5	16.1	11.3	17.9	8.9	15.9	5.9	10.1	11.1	15.4
Transportation	6.8	7.3	6.5	7.7	7.7	8.1	7.2	6.0	6.9	4.9	6.4	7.6
Finance	0.6	5.6	0.5	7.6	0.8	7.7	1.0	6.8	0.3	1.9	0.4	6.7
Community services	18.4	17.8	23.5	23.9	23.4	25.9	19.3	21.7	15.3	14.6	22.0	26.5
DI-South	24.2	22.9	17.2	11.6	16.5	8.7	23.0	15.0	31.3	37.3	18.4	11.2
DI-North	27.3	27.7	19.6	15.8	19.6	12.4	27.7	19.9	33.4	42.3	21.6	14.6

Note: The Departure Index (DI) is a coefficient of departure, defined as the overall excess employment in the sectors where employment in the Eastern European country exceeds mean employment in the comparator countries.
Source: OECD-Labor Force Statistics (1998), ILO, country statistics, and World Bank staff calculations.

82. The departure indexes show that the distortions in the employment structure deteriorated in 2001 compared to the distortions observed in 1989 (Table 11). Policies which have delayed economic restructuring and limited labor mobility across non-agricultural sectors are reflected in Romania's departure indexes. The departure indexes show an alarming trend of rising distortions in the country's employment structure by 2001 relative to those prevailing in 1989. Romania's

[27] The departure index measures the proportion of the workforce in a given country that would need to change sector to attain the same structure of employment as that of a comparable Western European economy in 1989. The departure index is a stylized indicator of employment structure that would prevail given the same factor endowments, technologies, and prices in a given country as those observed in the comparator economy. Under a neoclassical general equilibrium framework, prices, and technologies are the same across countries with trade, production, and employment patterns varying across countries owing to differences in the countries' factor endowments. Hence, the departure index is a solid approximation of extent of distortions at the start of transition, allowing for differences in factor endowments.

departure indexes increased from 31.3 to 37.3 percent by 2001 compared to 1989 with EU-South as comparator, and from 33.4 to 42.3 percent for the same period with EU-North as comparator. In contrast, all other CEECs in Table 11 showed an improvement in their departure indexes with EU-South and EU-North comparators, including Bulgaria—with the exception of a negligible increase in its EU-North index from 27.3 to 27.7 percent by 2001 compared to 1989. These trends show that EU-South and EU-North continue to adjust to changing economic conditions, and other CEECs continue to reform, and hence their departure indexes have declined. In contrast, protracted reforms in Romania resulted in a deterioration in its departure indexes rather than an improvement. Indeed, Romania's slow progress in economic restructuring and reforms, particularly in labor market flexibility, are taking a double toll on its economy—the economic and social costs of inefficiencies and limited labor reallocation opportunities, and the costs of dangerously lagging behind other CEECs.

Table 13 Change in Employment, 2001/1989 (millions)

	Bulgaria	Czech Republic	Hungary	Poland	Romania	Slovak Republic	South Europe
Agriculture	-0.040	-0.406	-0.581	-1.837	1.471	-0.214	-1.082
Mining	-0.079	-0.129	-0.087	-0.304	-0.109	-0.003	-0.021
Manufacturing	-0.904	-0.524	-0.452	-1.343	-1.588	-0.247	0.085
Electricity, gas, water	0.023	0.010	-0.051	0.087	0.066	0.012	0.010
Construction	-0.206	0.038	-0.072	-0.363	-0.337	-0.120	0.959
Trade	0.055	0.147	0.136	0.745	0.434	0.049	1.716
Transportation	-0.076	0.013	-0.069	-0.370	-0.238	0.001	0.277
Finance	0.140	0.335	0.261	0.795	0.165	0.134	1.300
Community	-0.265	-0.110	-0.154	-0.205	-0.113	0.014	1.313
Total Change	-1.35	-0.63	-1.07	-2.80	-0.25	-0.37	4.56
Job Creation:	0.22	0.54	0.40	1.6	2.1	0.2	5.7
% change	5.1	10.1	8.1	9.6	19.5	8.4	27.9
% of labor force	4.0	7.5	5.7	6.0	13.6	5.3	
Job Destruction:	-1.57	-1.17	-1.47	-4.4	-2.4	-0.6	-1.1
% change	-36.6	-21.7	-29.7	-26.0	-21.8	-23.4	-5.4
% of labor force	-28.5	-16.3	-21.0	-16.4	-15.6	-15.8	
Memo items:							
Labor force (2001)	5.5	7.2	7.0	26.8	15.4	3.8	
Population (2001)	8.0	10.2	10.1	38.6	22.3	5.4	

Note: South Europe: Spain, Greece, Portugal.
Source: Staff computations based on ILO, OECD, and NIS statistics.

5.3. Quantifying Labor Market Adjustment: Job Destruction and Creation in Romania in a Regional Perspective

83. The prolonged rigidity of Romania's employment composition reflects the mechanics currently at work in terms of job creation and destruction (Table 13). Job destruction in Romania between 1989 and 2001 as a share of its labor force in 2001 is 15.6 percent, which together with that of the Slovak Republic is the lowest job destruction to labor force ratio among the CEECs included in Table 12, the percent change of job destruction in the Slovak Republic is higher than that of Romania—23.4 percent compared to 21.8 percent. The percent change of job destruction in Romania during the same period is 21.8 percent, which, together with that of the Czech Republic, is the lowest, compared to other CEECs. The largest job destruction to labor force ratio

and percentage change by 2001 relative to 1989 are those of Bulgaria with 28.5 and 36.6 percent, respectively.

84. Romania's large job creation to labor force ratio and percent change during the same period, 13.6 and 19.5 percent, respectively, are largely due to the large expansion of employment in agriculture—the only country among other CEECs where this is observed. Excluding the expansion of employment in agriculture, Romania's job creation to labor force ratio together with that of Bulgaria is the lowest among other CEECs—around 4 percent. While Romania and Bulgaria show different reform trends and have different pending reform agendas, the low job creation in both countries indicates that both countries need to implement reforms to increase labor market flexibility and to reincorporate a large percentage of their working-age population back into the labor market.

5.4. Education, Skills, and Employment

85. Upgrading skills is essential to sustaining trade performance, supporting integration with the EU, and improving the standard of living. The fact that Romania's strong trade performance is concentrated mainly in unskilled labor-intensive activities (as discussed in Section 3) reflects the levels of education embedded in the structure of employment by education level. Romania's share of employment for those with primary education is high by regional standards (Table 14). While employment for those with tertiary education compares relatively well with the other countries, the share of employment with secondary education is toward the low-end range among selected CEECs. Hence, as pointed out in Section 2, Romania's potential competitiveness in skilled labor-intensive activities depends on reforms that involve the upgrading of skills, economic restructuring, and improvements in the investment climate.

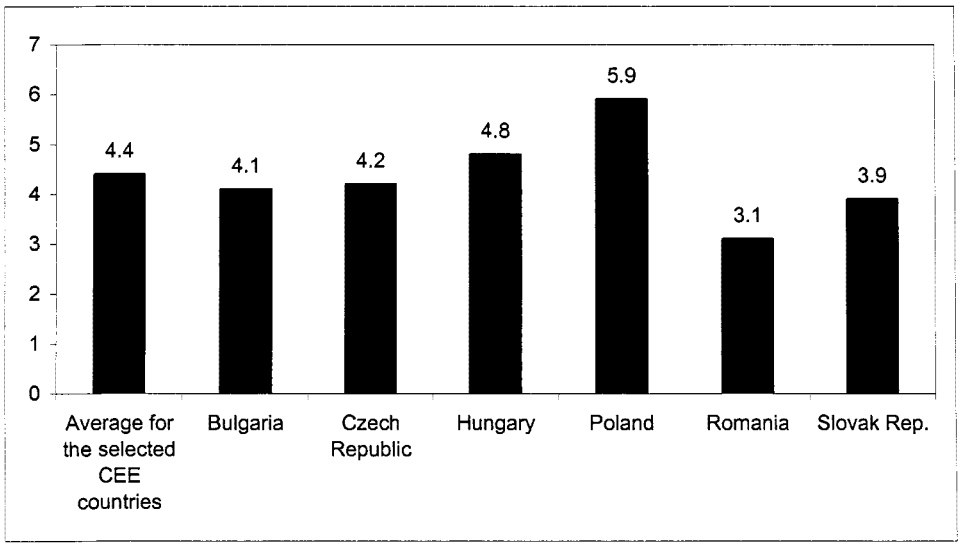
Table 14 Structure of Employment by Education Level (percent)

	Tertiary	Secondary	Primary
Bulgaria	11.6	86.3	2.1
Czech Republic	12.2	87.7	0.1
Hungary	16.4	82.7	0.9
Poland	14.7	67.8	17.5
Romania	**12.9**	**72.2**	**14.8**
Slovak Republic	12.3	81.0	6.7

Source: ILO: Bulgaria and the Czech Republic in 2001, the rest in 2000.

86. Reforms will need to address the challenge of investing in human capital and improving the quality of education. Romania's annual investment in education, at 3.4 percent of GDP, is low compared to CEEC average of 4.4 percent (Figure 11). This is the result of the poor use of public resources, rather than of limited resources. Public resources used to finance hidden subsidies and tax arrears relative to GDP are higher than the resources allocated to education. However, additional resources allocated to education should be accompanied by reforms that will improve the quality of education and correct the mismatch between the skills that the education system produces and the labor market demand. Based on the latest internationally comparable assessment results currently available (shown in Table 15), the academic attainment in mathematics and science of eighth grade students in Romania is below international averages, while many CEECs attainment levels are above international averages. Furthermore, the attainment levels in Romania did not improve during the second half of the 1990s as they did in Latvia, Lithuania, and Hungary.

Figure 11 Consolidated Government Expenditure in Education, Selected CEECs, 2000 (percent of GDP)



Source: World Bank database SIMA

Table 15 TIMSS Eighth Grade Student Assessment Results for Science and Mathematics for Romania and Selected CEECs, 1995 and 1999

	Mathematics		Science	
	1995 Mean Score	1999 Mean Score	1995 Mean Score	1999 Mean Score
Czech Republic	546	520	555	539
Slovak Republic	534	534	532	535
Slovenia	531	530	541	533
Hungary	527	532	537	552
Bulgaria	527	511	545	518
International Average	519	521	518	521
Latvia	488	505	476	503
Romania	**474**	**472**	**471**	**472**
Lithuania	472	482	464	488

Source: TIMSS1999: International Mathematics Report, International Association for the Evaluation of International Achievement, December, 2000, and *TIMSS1999: International Science Report*, International Association for the Evaluation of International Achievement, December 2000.

87. The significant mismatch between the skills that the education system provides and the labor market demand is evident from the high and long-term unemployment rates among new graduates and low-level educated youth. More than half of the discouraged population is younger than 35 years old and they report that they either do not have the skills suitable for the available jobs or that there are no jobs available.

5.5. Enhancing Labor Market Adjustment: A Reform Agenda

88. A large proportion of labor resources in Romania are mired in activities that are low in productivity, which results in low labor income earnings. The situation resembles, to some

extent, a human asset paralysis. The one exception seems to be the solid performance exhibited by some unskilled labor-intensive tradables such as clothing and footwear. The challenge is to extend that performance throughout the economy by enhancing labor market adjustment, upgrading labor skills and redressing the skills mismatch so as to make more efficient use of skilled labor in potentially competitive sectors.

89. Adopting and implementing policies to facilitate labor mobility and to reallocate labor across sectors in the economy are vital for Romania's economic restructuring from low to higher productivity activities and its integration with the EU. Key reforms include the following.

- *Increasing flexibility in entry/exit from employment by basing the justification and procedural costs of dismissals on economic rationale and performance.* These actions need to be supported by strengthening the unemployment insurance system in a fiscally sustainable manner (with the costs of unemployment benefits being assumed largely by beneficiaries) and by improving the targeting of the social safety net.

- *Adopting policies for the flexible use of fixed-term contracts and for working time* flexibility.

- *Strengthening the links between wages and productivity gains at the firm level* rather than at the economy or sector-wide levels, so that mechanisms are based on results, while implementing strict income policies and hard budget constraints for loss-making enterprises;

- *Adopting policies that support a more balanced participation of stakeholders in labor relations consultations*–including private sector representatives, trade unions, and independently associated workers—through appropriate labor relations consultation mechanisms with corporate governance ruled by corporate laws;

- *Eliminating the rigidities imposed by the new Labor Code.* Recognizing the importance of labor market policies for a globally competitive EU, the EU provides well defined principles and a wide scope for members and candidate countries in choosing the rules governing the labor code that best fit the country circumstances and the commitment to EU competitiveness in the global markets. The EU commitment to a globally competitive EU economy is well illustrated by the efforts of many EU members to modernize their respective labor market frameworks, which worked well 30 years ago but are not supportive of EU competitiveness today. Candidate countries face the challenge of choosing between adopting labor codes that served EU members well in the past or adopting labor codes that are likely to serve EU members well in the coming years in the context of increasingly competitive global markets.

  By introducing rigidities in the labor market and discouraging labor mobility, the new Labor Code is not supportive of progress in Romania's economic

restructuring and integration with the EU. In particular, the Code creates new impediments to enterprise restructuring and thereby adversely affects the competitiveness of the Romanian economy (Section 2). The political economy of these recent developments includes the role of entrenched powerful groups that are exercising their influence to maintain their privileged position in terms of employment and access to public resources. To a large extent, the costs are borne by Romanian workers employed outside of SOEs via the high taxes that are needed to finance current subsidies and debt write-offs, and by young and skilled Romanians who are facing limited employment opportunities.

Substantial changes to the Labor Code are required along the lines presented in the first item in this list of key reforms, if benefits from solid growth are to be more broadly shared on the basis of performance and productivity.

- *Increasing labor participation by bringing a large percentage of the working-age population back into the labor market.* Successful policies used in other CEECs to reincorporate discouraged workers, early retirees, unpaid family workers and the long-term unemployed into the labor market include eliminating disincentives for those who wish to continue to work beyond the retirement age, permitting temporary and part-time job creation and temporary working arrangements (TWAs), and adopting flexible rules for entry/exit from employment.

- *Increasing investment in human capital and addressing the skills mismatch gap.* The upgrading of skills is essential if Romania's trade performance is to be sustained, if integration with the EU is to be attained, and if the standard of living is to be raised. Reforms in this area need to address the challenges of investing in human capital, improving the quality of education, and addressing the skills mismatch. The education reform strategy needs to shift toward adopting automatic mechanisms and feedback rules to link the education system and labor market conditions rather than relying so heavily on centralized planning mechanisms. Stronger competition among education institutions, including universities, for public resources and private sector funding is needed. This would also help to attract the best teachers and students, and would improve the academic attainment and job performance of graduates (both of which should be monitored and disclosed at the level of individual institutions). The allocation of public resources on the basis of results and on a student capitation basis are necessary first steps;

- *Implementing fiscally sound reforms in the tax and benefits systems, in terms of policy and administration, so as to support* further *reduce labor costs.* The statutory rates of labor taxation remain high, despite the recent reductions in social assistance contributions, equivalent to around 5 percent of the gross wage. The deficiencies in revenue collection, combined with the nonpayment and barter settlement of arrears, have resulted in a low effective collection of statutory labor taxes as a percent of GDP. The combination of high statutory labor taxes and inflexible labor market rules contributes to a relatively large informal sector, as a

percent of GDP and as a percent of employment. Measures intended to address these challenges include: (i) the unification of revenue collection and administration, including social assistance, health and unemployment contributions, under a single agency; and (ii) further fiscal consolidation to support additional reductions in labor taxation (significant fiscal consolidation would be needed to support the government's plans for a reduction of 3 percent of the social contributions which would bring the total contributions, to 49.5 percent of the gross wage).

- *Accelerating the restructuring of the agriculture and food sector and strengthening the effectiveness of programs that will facilitate the redeployment of labor released from this sector.* To support agricultural transformation, Romania needs to strengthen the social safety net by ensuring its fiscally sustainability and by targeting it sharply to mitigate the costs of adjustment for the most vulnerable segments of the population in the sector—those in extreme poverty and the elderly. Fiscally sustainable and well-targeted income support mechanisms, such as the Minimum Income Guarantee (MIG) program introduced in 2002, are far more effective than subsidization in protecting the poor and the elderly, including those in the rural areas.

6. Risks and Vulnerabilities

90. There are risks and vulnerabilities involved in sustaining the macroeconomic stabilization and reform achievements to date, namely: (i) quasi-fiscal risks due to nonpayment and arrears accumulation; and (ii) fiscal risks due to financial weaknesses in the social security system and the costs of upgrading environmental standards.

6.1. Quasi-Fiscal Risks: Nonpayment and Arrears Accumulation

91. While Romania has made considerable progress in containing fiscal deficits and improving the allocation of public resources, spending has been controlled in part through nonpayment to suppliers of goods and services. Despite recent improvements in budget formulation and execution, including the reduction in the number of budgetary and extra-budgetary funds to streamline control over expenditure, total budgetary arrears to the economy increased from 0.8 percent of GDP at the end of 2001 to 1.0 percent in 2002.[28] About 70 percent of these debts are owed by the state budget, with the local government and the Health Insurance Fund accounting for most of the rest.[29] These arrears weaken the finances of enterprises fostering widespread use of nonpayment, and are clearly not sustainable.

[28] Estimates presented may underestimate government arrears owing to information constraints, and to items and entities excluded from consolidated general government accounts. Intra-governmental arrears, such as contributions to social insurance funds, are negligible in size and are cancelled in the consolidation of the various government budgets.

[29] The stocks public debt presented in this report exclude budgetary arrears.

6.2. Fiscal Risks: The Vulnerabilities of Budgetary Stability

92. While Romania has made progress in fiscal adjustment and consolidation, fiscal risks still remain. The monetary financing of quasi-fiscal expenditures from the National Bank of Romania was halted in 2000. Fiscal deficits have been cut by half compared to 1997 and budgetary consolidation has remained broadly on track. This progress has contributed to reducing the rate of expansion of public indebtedness, which increased from 26 to 34 percent of GDP between 1999 and 2002. However, two key areas of reform actions are needed to address fiscal risks: (i) deepening the reforms of the social security system to address its financial weaknesses; and (ii) containing the costs of upgrading environmental standards.

93. In the medium term the budget is exposed to considerable market risk. In particular, spending could increase substantially if there were a sharp rise in interest rates and large swings in major foreign exchange currencies. One way to see the interest rate sensitivity of budgetary expenditures is to note that about 2.2 percentage points of the 2.0 percentage point reduction in current spending were a result of interest savings. While total spending declined by 3.1 percentage points of GDP between 1999 and 2002, primary expenditure decreased by only 0.9 percentage points during this period.[30] Moreover, the primary surplus, a key determinant of debt sustainability, actually declined from 1.7 percent of GDP in 1999 to 0.4 percent in 2002 and turned into a deficit of 0.3 percent in 2003. Estimates of fiscal balances in this report clearly suggest that the inability to generate debt-stabilizing primary surpluses would jeopardize fiscal sustainability. Furthermore, the fiscal dominance of the adjustment mechanism suggests that the adoption of inflation targeting would be premature without a shift towards securing the independence of monetary policies from fiscal requirements.[31] Under generally favorable assumptions, a debt-stabilizing primary fiscal balance of 0.4 to 1 percent of GDP would seem to be sustainable provided quasi-fiscal deficits are eliminated and the macroeconomic adjustment mechanism becomes monetary dominant so that monetary policy becomes functionally independent of fiscal needs.

94. The social security system is a key source of long-term fiscal risk.[32] Pension system deficits, in particular, are likely to grow substantially without further reform. Since financing gaps are mainly covered by the state budget, overall government deficits and public indebtedness will tend to rise. Despite recent reforms, including a two-year increase in the statutory retirement age and a widening of the contribution base to include the self-employed, farmers and the unemployed, the pension system remains unsustainable. Under current arrangements, system imbalances will continue to grow, thus posing a serious threat to macroeconomic sustainability, particularly if the economy grows slowly. The urgency for reform is increasing, because of the projected slowdown of population growth and the steady aging of the population, which will increase the demands on the system while contributions tend to decline.

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[30] Primary expenditure equals total expenditure less interest payments.

[31] See Chapter 1 in Volume 2 of this report for an analysis of fiscal sustainability and an empirical examination of fiscal dominance and monetary dominance in Romania. Law 101 of 1998 established the central bank's legal independence. The functional independence of monetary policies (i.e., monetary dominance regime) refers to the ability to operate effectively irrespective of fiscal requirements.

[32] A comprehensive discussion of the issues is provided the 2002 Romania Public Expenditure and Institutional Review. The fiscal section of the 2001 IMF Selected Issues report provides a summary discussion.

95. In addition, a major challenge in the medium and longer term is for Romania to manage the costs of upgrading to EU standards: for this purpose, containing the costs of upgrading environmental standards is central. According to its Pre-Accession Economic Plan (PEP), Romania expects to make average annual outlays of 3.8 percent of GDP through 2004 to pay for reforms and the harmonization of institutions with the EU. Even if EU funding were to provide one-quarter of the total financing needs as envisioned in the PEP, Romania would still need to contribute 1.2 percentage points of GDP from central and local government funds. This would leave an estimated financing gap of 1.6 percent of GDP.[33] Furthermore, these investments would entail recurrent operating and maintenance spending to be met from Romania's own budgetary resources.

96. The total investment cost required for compliance with the 17 directives that address environment-related concerns amounts to approximately €29.7 billion. This figure is about 29 percent higher than originally estimated by the EC and is one of the highest among the CEECs. EU Funds committed to help finance the investments during the period 2004 to 2015 are estimated to be about €6.9 billion in total. Hence, the remaining €22.8 billion will need to be obtained from other sources, namely, central and local government, and the private sector. The experience of CEECs that have been successful in carrying out these reforms illustrates several of the key ingredients of public expenditure policy reform strategy. [34]

7. THE QUASI-FISCAL CHALLENGE: ENERGY SECTOR REFORM

97. As in many transition economies, the energy sector in Romania has been central in the persistently large quasi-fiscal deficits. While some progress has been made owing to reforms in the sector, these deficits remain large and are not sustainable. These losses have resulted in a significant deterioration in the basic energy infrastructure and have reduced the primary production of oil, coal, and gas. [35] Because energy is a critical component of production, energy subsidies have distorted relative prices and have generated costly inefficiencies throughout the economy. Furthermore, since energy company losses are often financed with tax arrears and unpaid loans, they have added to a rising stock of public debt. This first provides an overview of the role and instruments of state support in the energy sector. It then discusses reforms to date, and proposes a reform agenda. [36]

7.1. The Energy Sector and State Support

98. The energy sector in Romania has been a main source of persistently large quasi-fiscal deficits—more so than in many other transition economies. Cheap energy has been used simultaneously to support loss-making public enterprises and to provide an implicit subsidy to consumers. Subsidization has been provided implicitly through the tolerance of low bill collection rates and the pricing of electricity, gas, and district heating below their full cost-

[33] The gap, however, may be larger than anticipated if the limited absorptive capacity of EU funds persists.
[34] See Funck, Bernard, 2002, *Expenditure Policies Toward EU Accession*, World Bank Technical Paper No. 533.
[35] The inefficiency of electricity production is partly due to considerable excess capacity.
[36] See Chapter 7 in Volume 2 of this report.

recovery tariff rates.[37] As late as mid-2002, natural gas prices were about one-third lower than in OECD countries and one-half of EU accession countries.[38] Electricity prices are getting closer to full cost recovery for some units which operate efficiently, however there are many units which are very inefficient and as electricity tariff rates increase these units have less incentives to restructure. Although they are close to the level of several accession countries, district heating prices have been about half of the average price in the EU.

Table 16 Resource Transfers to and from the Energy Sector, 2001-02

	2001	2002	2001	2002
Total subsidization of energy	28,865	31,267	2.5	2.1
Direct subsidies to energy	4,250	5,166	0.4	0.3
Electricity	1,052	1,344	0.1	0.1
Mining	3,198	3,822	0.3	0.3
Gas	0	0	0.0	0.0
Other resource transfers	371	561	0.0	0.0
Hidden subsidies	24,244	25,540	2.1	1.7
Energy Fund (electr.)	3,068	4,175	0.3	0.3
Foreign loan guarantees paid	7,435	6,050	0.6	0.4
Tax debt	5,186	13,856	0.4	0.9
Change in end of year stock 1/	-3,330	13,550	-0.3	0.9
o/w social insurance	2,547	2,484	0.2	0.2
Cancelled interest and penalties	8,516	306	0.7	0.0
Bank payments overdue (domestic)	951	-187	0.1	0.0
Supplier arrears	7,604	1,647	0.7	0.1
Energy sector losses 2/	56,165	37,220	4.8	2.5
Low tariffs	45,792	32,527	3.9	2.2
Non-payment	10,373	4,694	0.9	0.3
Net transfers to the energy sector	-10,162	5,714	-2.3	-0.4
Memorandum:				
Rescheduled arrears	6,259	4,947	0.5	0.3

Notes: 1/ Excludes accumulated penalties.2/ Comprises implicit subsidies to both households and firms. Excludes district-heating companies that were not formerly units of Termoelectrica.
Source: Ministry of Industry and Resources and International Monetary Fund.

99. The resulting operating losses are financed with arrears and various budget and off-budget funds (Table 16). As has been mentioned, these losses have resulted not only in deterioration in the basic energy infrastructure but also in under-investment in modern machinery and equipment. This lack of investment has left many facilities obsolete and highly inefficient, which has led to increased import dependency.[39] As was noted above, energy subsidies have distorted relative prices and reduced efficiency throughout the economy, And as prices have been kept artificially low, there has been over-consumption and waste of scarce energy resources. In

[37] The pricing structure of the oil sector is considered undistorted.
[38] A detailed discussion of the pricing structure and financial performance of the sector in recent years is provided by the 2002 IMF Policy Discussion Paper "The Energy Sector Reform and Macroeconomic Adjustment in a Transition Economy: The Case of Romania."
[39] See footnote 35.

addition, the financing of energy company losses with tax arrears and unpaid loans have augmented a rising a stock of public debt.

100. Given the state of financial lack of indiscipline in the enterprise sector, the increase in prices may account for much of the growth in tax arrears, and possibly also for the greater rate of activation of loan guarantees. In fact, the 2.1 percent of GDP increase in tax arrears and loan payments for the economy mirrors the 2.3 percent decline in energy losses. The elimination of losses in the energy sector, therefore, is in itself unlikely to improve the prospects for long-run macroeconomic stability without the enforcement of tax payment discipline.[40] Without the elimination of nonpayment of taxes, smaller losses in the energy sector will give way to larger losses elsewhere and to increasing public indebtedness. As discussed in the following section, despite recent progress, much remains to be done to complete the energy reform agenda.

7.2. The Energy Sector: A Reform Agenda

101. More recently, particularly in 2003, the Government of Romania has acted to reduce the energy sector subsidy, and the energy sector-related quasi-fiscal deficit has been reduced significantly. In particular, power prices are now at cost recovery levels, there have been significant gas price increases, and power collections from residential customers are close to 100 percent.

102. *While good progress has been made in power tariff reform, further price adjustment and restructuring will be required as investments are undertaken.* In the gas sector, although there have been significant price increases, further large increases are required to meet import parity. The challenge for the government is make good on its commitment in Romania's Road Map to EU Accession, including its commitment to move to import parity in the medium term.

103. *Regarding the affordability consequences of tariff increases, these are not likely to be problematic in the power sector, where expenditure is small relative to income, and where an effective social safety net is in place.* Gas price increases, on the other hand, are likely to strain affordability in the gas and heat sectors. Targeted social safety nets for gas and heat will require additional financing if affordability risks are to be mitigated; part of the increased financing could be unlocked through the rationalization of the current blanket subsidy to the district heating sector.

104. *Payments discipline remains something of a problem in power and gas, notwithstanding increased collections in recent years.* If collections are to be increased to levels that would permit energy industry financial viability on a sustained basis, government action is required that would permit the disconnection of large SOEs, and would develop an industrial policy for their restructuring/privatization. Improved payments discipline in district heating will require the commercialization of this sector.

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[40] Disinflation may put further financial stress on loss-makers, as the erosion of the real value of arrears will tend to slow.

105. *As regards institutional reform (to support commercialization and hence the reduction of the energy quasi-fiscal deficit), Romania has progressed further than all of the South East Europe Regional Energy Market (SEE REM) countries except Croatia in regulatory development, and further than all of these countries except Bulgaria in industry restructuring.* In terms of power market development and gas industry regulation restructuring, Romania has outperformed all SEE REM countries.

106. Among the outstanding challenges is that of building on its track record in regulation through continuing to implement price increases as necessary in power and gas, to impose hard budget constraints in the enterprise sector including energy, and to move toward the introduction of tariff setting on a long-term basis. In industry restructuring, the challenges include the commercialization of generation subsidiaries and the introduction of the private sector in the unbundled gas structure. In market design, the proposals are consistent with those for the SEE REM countries, the challenges relate to detailed implementation issues.

107. *Regarding investment, Romania's continued status as a net power exporter to SEE will require large-scale generation rehabilitation.* The challenge here is to develop a framework to secure investment that is consistent with the objective of liberalizing the power market. Chapter 7 in Volume 2 discusses energy sector reform in more detail and argues that capacity contracts could provide a solution here, and that these would be consistent with the proposed market design in Romania.

108. In summary, if Romania is able to meet the challenges of setting appropriate energy tariffs (i.e., at a level of full cost recovery) and of improving operating efficiency, through applying hard budget constraints, closing unviable thermal generation units, and implementing institutional reforms, together with undertaking the necessary investments, this should bring about competitively priced domestic energy and should provide export opportunities. This would yield economic benefits in a sub-regional energy market context and also, more generally, in a regional market context.

8. FROM QUASI-FISCAL FINANCING TO EFFICIENT FINANCIAL INTERMEDIATION

109. Quasi-fiscal subsidization is crowding out financial intermediation in Romania—hence it is contributing to the low level of financial intermediation in Romania relative to other CEECs. Both loss-making and unprofitable companies rely on nonpayment and accumulation of arrears to finance their operations. However, the degree of use of tax arrears is inversely related to profitability, and thus it is far higher in SOEs. Clearly, large efficiency gains can be made through eliminating quasi-fiscal financing. Efficient financial intermediation mobilizes and directs resources to the most profitable investment opportunities. In contrast, quasi-fiscal financing channels resources to nonviable firms. This type of subsidization is not sustainable, nor are nonviable firms that benefit from this financing. Reforms that will develop efficient financial intermediation are needed. The 2003 Joint Bank-Fund Financial Sector Assessment Program for Romania[41] includes a comprehensive analysis and policy recommendations for addressing the

[41] Joint Bank-Fund Financial Sector Assessment Program, 2003, the World Bank and the IMF.

challenges of financial sector development. The present report is based on this work and builds it from the perspective of stability, growth, and integration with the EU.

110. Romania has made significant progress in consolidating the financial sector since 1999, when bank restructuring took hold. The regulatory and supervisory environment has improved, easing the way for progress in building a more solid foundation for financial sector development. However, the completion of bank restructuring, the further development of the basic financial infrastructure, and the elimination of the use of nonpayment and arrears which is crowding out banking intermediation, are all needed to ensure an efficient and secure financial market. Such a market would help the economy to sustain high growth rates because it would direct finance toward more productive investment alternatives. The present section first provides an overview of the structure of the financial sector in Romania. It then discusses the role of the banking sector and shows the extent to which quasi-fiscal financing is crowding out financial intermediation. The section then turns to an analysis of the soundness of the banking sector. This is followed by a discussion of regulatory and supervisory issues. The section ends with a reform agenda that highlights the need to strengthen the regulatory and supervisory framework.[42]

8.1. Structure of the Financial Sector

111. As in other developing economies, in Romania the banking sector dominates the financial system and holds about 90 percent of the total assets in the financial system, or about 31.1 percent of GDP (Table 17). Non-bank financial institutions are underdeveloped and consist mainly of insurance companies and financial investment companies (SIFs). Capital market capitalization accounted for 11 percent of GDP at end-2002.[43]

Table 17 Structure of the Financial System (as of end-2002)

		Assets	
	Number of Institutions	In ROL Billion	Percent of GDP
Commercial banks	39	469,712	31.1
Credit cooperatives	1 network	2,687	0.18
Credit unions	3,895	5,079	0.34
Financial investment companies (SIFs)	5	21,969	1.45
Financial investment service companies	77	723	0.05
Investment funds	26	1,288	0.09
Of which:			
Open-ended investment funds	23	999	0.07
Venture capital funds	3	289	0.02
Insurance companies 1/	49	22,841	1.51

Notes: 1/ The pension scheme authorities and Fund estimates is a state-organized "pay as you go" system and there are no private pension funds.
Source: NBR.

[42] See Chapter 6 in Volume 2 of this report.

[43] The insurance sector is very small, despite the large number of insurance companies. Its assets are estimated at only 1.5 percent of GDP. There are also five financial investment companies of a similar size. Credit unions and credit cooperatives hold, all together, assets of about US$230 million.

112. Bank restructuring had a comparatively late start in Romania and still remains high on the agenda, whereas it has been largely completed in other CEECs. As seen in Table 18, the state has largely withdrawn from the banking sector in most of the countries shown and the shares of assets in publicly owned institutions are in single digits. State ownership in Romania, however, continues to be high—at around 40 percent. [44] Not surprisingly, foreign ownership of banks is also substantially lower in Romania compared with more than 80 percent in the CEECs.

113. Presently the state continues to be one of the major players in the banking sector—out of the 39 banks operating in Romania in 2002, 3 are state-owned—BCR, the Savings Bank (CEC), and the Export-Import Bank of Romania (EXIMBANK). However, they account for nearly 40 percent of the bank assets, a similar share of deposits, and 31 percent of loans. The continuing strong presence of state-owned banks places Romania at a disadvantage compared to other EU accession countries, where the benefits of private sector ownership are already visible (including deeper financial intermediation, diversification and innovation of financial services provided, and increased competition leading to better and less costly services to support a stronger corporate sector). While these assets are concentrated in two state banks, both earmarked for privatization, the challenge is now to proceed with the actual and complete transfer of ownership.

Table 18 Asset Shares of State-Owned Banks, 1996-2002 (percent)

	1996	1997	1998	1999	2000	2001	2002
Lithuania	54.0	48.8	44.4	41.9	38.9	12.2	0.0
Estonia	6.6	0.0	7.8	7.9	0.0	0.0	0.0
Slovak Rep.	54.2	48.7	50.0	50.7	49.1	4.9	2.9
Latvia	6.9	6.8	8.5	2.6	2.9	3.2	4.0
Czech Rep.	16.6	17.5	18.6	23.1	28.2	3.8	4.6
Hungary	15.3	3.5	9.8	7.8	7.7	9.1	10.8
Bulgaria	82.2	66.0	56.4	50.5	19.8	19.9	14.1
Poland	69.8	51.6	48.0	24.9	23.9	24.4	26.6
Romania	**75.9**	**73.0**	**71.0**	**46.8**	**46.1**	**41.8**	**40.4**
Slovenia	40.7	40.1	41.3	42.2	42.5	48.9	48.6
Median (exc. Romania)	*40.7*	*40.1*	*41.3*	*24.9*	*23.9*	*9.1*	*4.6*

Source: EBRD Transition Report 2003, and NBR for Romanian data.

8.2. Role of the Banking Sector

114. To date, the banking sector in Romania has not been provided with incentives to mobilize resources to finance investment and long-term growth efficiently. The adverse macroeconomic environment, the uncertain and insecure legal framework and enforcement practices, and the lack of strong accountability mechanisms have hampered the deepening of financial intermediation and monetization in Romania. Compared to that of other CEECs, Romania's financial intermediation remains shallow (Figures 12 and 13) and it can be attributed to the slow pace of economic restructuring which has permitted the persistence of nonpayment in the economy. Firms have found it easier and less costly to accumulate arrears than to finance their activities by borrowing from the banks. At the same time, banks are reluctant to lend to firms with arrears.

[44] In May 2004, the government privatized 33 percent of the shares of BCR.

Overall, the low payment discipline in the economy, magnified by deficiencies in the legal and institutional environment, has been damaging to bank intermediation, in terms of both lending and deposit taking.

Figure 12 Broad Money to GDP, 2002
(percent)

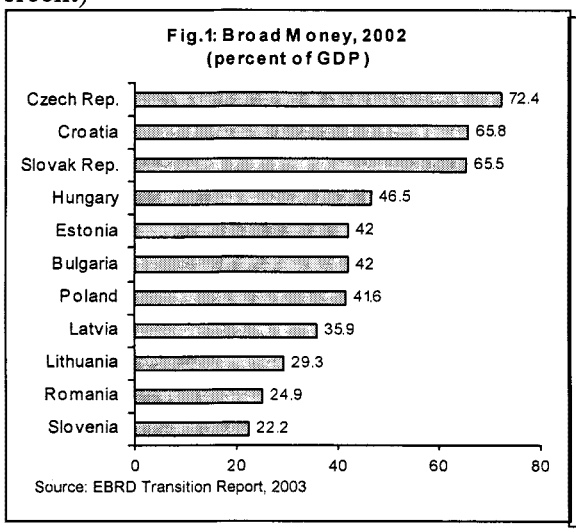
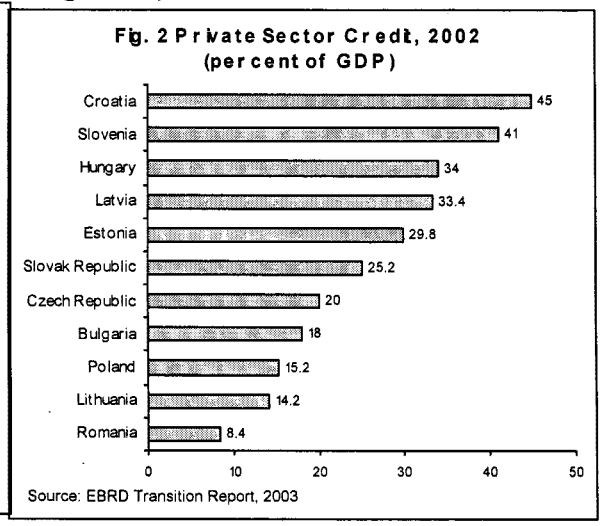


Figure 13 Private Sector Credit to GDP, 2002
(percent)



115. While some of the impediments to healthy financial sector development have been removed or mitigated because of the improved macroeconomic environment, the unfinished structural reforms in the country continue to significantly constrain the development of the banking sector. The use of nonpayment as a means of financing in the economy is crowding out bank lending. Nonpayment is common not only among companies that are supposedly facing hard budget constraints but also among healthy enterprises that choose to delay tax payments -- encouraged by a long history of tax arrears and forgiveness and the comparatively low penalties charged on outstanding tax debts.

116. As shown in Table 19, bank credit represents only 8 percent of total financing of the corporate sector and firms are predominantly financed by arrears. Banks are reluctant to lend to enterprises, either because they are perceived to be riskier or because they are unprofitable and lack growth opportunities. Only a few enterprises are profitable and liquid enough to commit an acceptable amount of their own equity to new investment projects. Moreover, only a few enterprises are able to establish their creditworthiness given the quality of the financial statements and the lack of audited reports. Despite the fact that since 1999 the corporate sector has shown improvement in its profitability, about one-third of firms are still unprofitable and do not generate a cash flow to

Table 19 Sources of Funds for Romanian Firms in 2001
(percent of total financing)

Stocks	1999	2000	2001
Number of Firms	1,155	932	726
Internal Financing	7.4	10	12.8
Retained earnings	6.8	8.9	11.9
Reserves	0.6	1.1	0.9
External Financing	58.8	51.8	52.5
Share capital	35.6	29.2	28.3
Bonds	0	0	0
Bank debt	10.1	7.6	8.3
Trade credit	13.1	15.0	15.9
Arrears	33.6	38.2	34.6
Taxes	19.2	22.6	15.2
Social security	6	5.7	7.2

Source: Ministry of Finance and staff estimates, Financial Sector Assessment Program, 2003.

service their debt.

117. The exposure of banks to firms with accumulated arrears seems to be small. Banks are reluctant to lend to those firms that rely on nonpayment and arrears accumulation as a means of financing. The bank credit for firms with high tax and inter-enterprise arrears is about half of that for firms with low arrears (Table 20). Banks are even more cautious with SOEs. Large state-owned manufacturing firms with high tax and inter-enterprise arrears have less than half of the bank credit of private firms with high tax arrears.[45] The bank debt of utilities with high arrears, both state and inter-enterprise arrears, accounts for only 1 percent of the liabilities. Enterprises with low tax arrears borrow more than 40 times as much from banks.

Table 20 Romania: Bank Debt for Different Levels of Arrears, 2001[46] (as percentage of liabilities)

Sector	High tax arrears	Low tax arrears	High inter-enterprise arrears	Low inter-enterprise arrears
Agriculture	6.18	16.22	5.53	11.91
Manufacturing	9.61	21.73	13.08	18.86
Utilities	1.27	43.43	0.40	13.33
Construction	6.33	9.15	7.18	7.94
Transport	5.41	9.39	5.97	7.99
Trade	9.64	13.53	12.27	12.40
Services	5.82	10.64	5.18	9.55

Source: Ministry of Finance and World Bank staff estimates.

118. The banks' ability to mitigate risks through collateral still remains limited in spite of a well-functioning collateral registry. In part this is due to inefficiencies in the courts and difficulties in selling reclaimed assets in secondary markets. In this regard, reference must be made to Emergency Ordinance 61, introduced in 2002 and effective in 2003, permitted the authorities to seize any collateral pledged to a bank in order to collect tax arrears. The government, however, abolished this ordinance in the first half of 2004. Further efforts are needed to simplify bankruptcy processes and provide a reliable framework for secured lending by banks.

8.3. Soundness of the Banking Sector

119. With the start of state-owned bank restructuring, and the introduction of stricter rules and regulations for bank supervision, the soundness of the banking sector in Romania has improved. The closure of Bancorex in 1999, and the transfer of the bad assets in the system to AVAB[47] improved the overall health of the banking system (Table 21). Since then, banks have seemed to be well capitalized, liquid and profitable and they have limited market and credit exposure. Capital adequacy ratios improved from 18 percent in 1999 to 23 percent in June 2003. Non-

[45] See Chapter 6 in Volume 2 of this report and the Joint Bank-IMF FSAP of Romania, 2003.

[46] Based on Ministry of Finance data on BSE traded firms and RASDAQ traded firms with more than 50 employees. High (low) tax arrears indicate the group of firms for which the share of tax arrears in total debt is above (below) the sample median. High (low) inter-enterprise arrears indicate the group of firms for which the share of trade credit arrears in total debt is above (below) the sample median.

[47] Close to US$2.3 billion bad assets from Bancorex and Banca Agricola were transferred at that time to the asset recovery agency.

performing loans declined from 53 percent in 1999 to close to 2 percent in 2002 and are now on a par with those reported by other CEECs. The return on assets has more than doubled over the same period, while liquidity ratios have been much higher than required.

120. Capital adequacy ratios show that banks in Romania are well capitalized—reported capital adequacy ratios have been constantly higher than the required 12 percent[48] although they have been declining lately. The recent introduction of International Accounting Standards needs to be fully implemented. Nearly half of the capital is in the form of fixed assets and full implementation of these new principles will reduce risks of overestimation. Until recently, there was no requirement for reporting on a consolidated basis, while a number of banks have subsidiaries outside of the banking sector. However, the government has introduced requirements to report on a consolidated basis which fully implemented strengthens the basic financial infrastructure.

Table 21 Financial Soundness Indicators, 1996-2003

	1998	1999	2000	2001	2002	2003[1]
Capital Adequacy Ratio[2]	10.25	17.90	23.79	28.80	25.04	22.82
Tier 1 / Risk Weighted Assets[2]	na	15.82	18.90	26.21	22.93	21.15
NPLs/ Gross Loans[2]	71.7	52.6	5.2	3.3	2.3	9.1
Return on Average Assets	0.06	1.47	1.49	3.10	2.64	2.43
Interest margin/gross income	na	na	-0.21	5.17	7.77	9.09
Liquid Assets/Total Assets[2]	na	na	na	77.10	78.59	70.88
Liquidity ratio (actual/required liquidity) 3/				1.30	1.37	3.48
Loans / Deposits	56.93	43.92	44.57	44.69	43.91	58.22

Notes: 1. Data as of June 2003, with the exception of NPLs/Gross Loans (as of November 2003), and liquid assets/total assets (as of May 2003). 2/ Foreign banks' branches are not included. 3/ There was a methodological change in June 2003.
Source: NBR.

121. Banks prefer to keep highly liquid positions rather than becoming involved in risky lending to the large block companies that are incurring losses and that maintain high stocks of arrears. Deficiencies in contract enforcement and bankruptcy also make bank lending riskier than would be the case with a more efficient framework. Economic rigidities in the economy, including low labor market flexibility and skills mismatch, limit growth and profitable investment opportunities in most sectors of the economy, except in some tradables (Section 2). Moreover, the interest rates offered by the NBR on non-reserve deposits have often been a better alternative than loans. In addition, the limited inter-bank market in Romania may force banks to hold additional liquid assets in order to self-insure against higher than usual demand for liquidity.

122. The quality of Romania's loan portfolio has improved since 1999 and compares favorably with good performing CEECs (Table 22), although there has been some worsening lately. Non-performing loans declined in Romania from more than 50 percent before 1999 to about 2-3 percent of loan portfolio in 2002. However, as a result of the rapid growth of lending

[48] The minimum capital adequacy ratio was raised in 1999 to 12 percent from 8 percent previously.

and the introduction of stricter rules for loan classification [49] and provisioning, the share of non-performing loans has quadrupled in a year's time and at end-November 2003 stood at 9 percent of total loans. This raises concerns about the sustainability of rapid credit growth in a system that is still dominated by large state-owned banks, that lacks comprehensive credit information and that has inefficient debt enforcement practices.

Table 22 Non-Performing Loans, 1996-2002 (percent)

	1996	1997	1998	1999	2000	2001	2002
Bulgaria	15.2	13	11.8	17.5	10.9	7.9	10.4
Czech Rep.	21.8	19.9	20.3	21.5	19.3	13.7	9.4
Estonia	2	2.1	4	2.9	1.3	1.2	0.8
Hungary	na	6.6	7.9	4.4	3.1	2.9	4.6
Latvia	20	10	6.8	6.8	5	3.1	2.1
Lithuania	32.2	28.3	12.5	11.9	10.8	7.4	5.8
Poland	14.7	11.5	11.8	14.5	16.8	20.1	24.6
Romania	**48**	**56.5**	**58.5**	**35.4**	**3.8**	**3.4**	**2.3**
Slovak Rep.	31.8	33.4	44.3	32.9	26.2	24.3	11.2
Slovenia	10.1	10	9.5	9.3	9.3	10	na

Source: EBRD Transition Report, 2003.

8.4. Basic Financial Infrastructure: Regulatory and Supervisory Framework

123. Important progress has been made in improving the regulatory and supervisory environment. A large number of new laws and substantial amendments to the existing financial legislation have been adopted since 1998 in an effort to harmonize the legislation with international standards and EU requirements. A broad range of measures has targeted all stages of the prudential supervision of banks, from licensing to exit proceedings. Appropriate licensing and sanctioning mechanisms have been set in place, a modern early warning bank-rating system is being implemented, and the frequency and coverage of on-site and off-site supervision has increased. At the same time, some of the instruments necessary to support supervision have been created or streamlined—namely, the Credit Risk Bureau and the Payment Incident Bureau.

124. Nevertheless, important challenges remain in developing a more solid financial infrastructure that ensures that the right incentives for financial market participants are in place. The financial sector, banking in particular, has the responsibility of safeguarding deposits and savings in the economy by channeling these resources to the best possible investment opportunities. This function cannot be performed well without a solid infrastructure. Challenges to improving the basic financial infrastructure in Romania include the following: (i) assessment of bank capital; (ii) access and coverage of the credit registry; and (iii) the capacity to assess and manage risk.

125. *Assessment of bank capital.* Capital adequacy regulation is largely compliant with the Basel Core Principle. The recent introduction of regulations for the supervision of banks on a consolidated basis is an important step forward which needs to be fully implemented. Similarly

[49] The old loan classification rules disregarded the borrower's financial condition and thus led to an underestimation of the non-performing loans in the banks' loan portfolio.

full implementation of International Accounting Standards is needed to bring national accounting standards and practices on par with other countries in the region. The centrality of supervision on a consolidated basis, capital figures, compliance monitoring with prudential standards and asset quality, is needed for meaningful assessment, since otherwise weak assets can easily be hidden in subsidiaries, and double gearing can take place. In addition, the capacity will need to be developed to exercise supervision on a consolidated basis, including through mechanisms for consultations with non-bank financial supervisors or supervisory bodies in other countries. In 2002, the NBR signed a Memorandum of Understanding with the National Securities Commission and the Insurance Supervision, with a view to improving the supervision of the financial sector as a whole.

126. *Access and coverage of the credit registry.* To create conditions for sound lending decisions, to increase transparency of the financial market, and to reduce financial risk, the credit registry should be expanded and made easily available. Currently, the credit history of loan applicants is neither complete nor widely accessible. The Public Credit Information Bureau only includes financial institutions regulated by the NBR and does not take account of small commercial loans or consumer loans. In addition, there is no available credit history of individuals, which is generally required for lending to new and small firms. To accelerate the expansion of the Credit Bureau, NBR may encourage a private bureau to operate and distribute credit information to banks, including additional end-user products such as credit scores and ownership links.

127. *Capacity to assess and manage risk.* To safeguard the health of the banking sector, and bank supervision, a methodology needs to be developed to "stress test" banks' portfolios for various risks—credit, foreign exchange, interest rate, systemic inter-bank risk, and the combination of shocks in these areas. Banks need to have a comprehensive risk management process to identify, measure, monitor and control all material risks and to hold capital against these risks. It is especially important that banks manage interest rate risk to mitigate risks arising from loans extended in foreign currency to non-foreign currency earners. More power should be given to off-site supervision to receive information on risk management. Currently, banks provide some of the information only during on-site examination, while the NBR does not have the right to require this information for off-site surveillance. New draft legislation is being developed, which is expected to address the issue of the right of collecting information.

8.5. Developing Efficient Financial Intermediation: A Reform Agenda

128. The Joint Bank-Fund Financial Sector Assessment Program for Romania includes a comprehensive analysis and policy recommendations intended to address the challenges of financial sector development. The present study is based on this work and builds on it from the perspective of stability, growth, and integration with the EU. In this context, this study highlights the following recommendations for supporting the development of a sound banking sector.

- *To privatize state-owned banks.* The completion of the privatization of the remaining state-owned banks will improve efficiency in the financial system and will bring Romania closer to its peers in the region.

- *To improve banking regulations and supervision.* Important progress has been made in improving the regulatory and supervisory environment necessary for adaptation to the demands of Romania's economic restructuring. Key challenges going forward are: to further strengthen supervision on a consolidated basis, to focus on adopting and enforcing risk assessment and management rules, and full implementation of recently adopted IAS. Progress in these areas is critical to deepening financial intermediation.

- *To eliminate the practices of nonpayment, arrears and barter settlement.* The reliance of firms on nonpayment as an important means of financing is crowding out regular banking credit and contributes to the low levels of financial intermediation in Romania. Abolishing the Emergency Ordinance 61 which came into force in 2003 and permitted the authorities to seize any collateral pledged to a bank in order to collect tax arrears is an important step forward. There is a need, however, to abolish the legal framework that allows compensation without cash of the bilateral obligations stipulated in the Government Ordinance No. 77/1999. Romania should rely on revenue administration reform as an appropriate and effective approach to eliminating the practice of nonpayment, arrears accumulation, and barter settlement;

- *To introduce and enforce international accounting and auditing standards and practices.* The government plans to introduce international accounting standards as a key step toward improving both the level and the quality of financial intermediation, since poor financial reporting, accounting and auditing norms and practices prevent banks from effectively allocating resources to productive investments and thus influence capital accumulation and long-term growth. The adoption of inflation accounting principles (IAS-29) is especially important because most Romanian companies have not revalued their assets since 1994 despite the high inflation in the period. As a result most of the current balance sheets underestimate the value of assets.

- *To improve credit risk information by expanding the coverage of and access to the Credit Information Bureau.* Despite a good start, the Credit Information Bureau at the NBR could still be improved in terms of the coverage of institutions and loans. Currently, it includes only financial institutions regulated by the NBR and does not take account of small commercial loans or most consumer loans. The credit history of entrepreneurs, which is generally used to grant loans to SMEs, is not accessible. A good and widely accessible credit registry would not only allow banks and other intermediaries to better assess potential borrowers, but it would also contribute to higher competition between lenders, and, last but not least, might have a disciplining effect on borrowers.[50]

[50] *Impediments to the Development and Efficiency of Financial Intermediation in Brazil*, Beck.

9. Containing the Costs of Upgrading Environmental Standards

9.1. Environment: Romania in a Regional Perspective

129. The experience of countries which joined the EU on May 1 of this year shows that estimates of investment costs cover a wide range depending on the their respective initial conditions and the choice of the type of investments which also cover a wide range of possibilities. Timetables also have varied across countries, with earlier reformers having more generous timetables than other countries. The experience of acceding countries thus far, also show that there may be important differences between planned and actual investments. However, the total investment costs do not stop at the accession date, since compliance with environmental standards, while providing a range of technology choices, is required to function in a single market.

130. Relative to other countries, Romania is starting out with a lower level of environmental capital and a poorer state of the environment in many dimensions, as is illustrated by indicators such as the country's low access rate to improved water sources and sanitation, and its low energy efficiency (Table 23).

Table 23 Key Environmental-Related Indicators, 2001: A Regional Perspective

Country	Percent of Population with access to sanitation	Percent of Population with access to improved water source	GDP per unit of energy (PPP$/Kgoe)	CO_2 emissions per unit of GDP Kg/PPP$GDP	Under 5 Mortality Rate per 1,000 live births
Bulgaria	100	100	2.8	0.9	16
Cyprus	100	100	6.3	0.4	6
Czech Rep.	-	-	3.6	0.8	5
Estonia	-	-	2.9	1.4	12
Hungary	99	99	4.9	0.5	9
Latvia	-	-	4.6	0.4	21
Lithuania	67	67	3.9	0.5	9
Malta	100	100	6.7	0.7	5
Poland	-	-	4.0	0.9	9
Romania	**58**	**53**	**3.4**	**0.7**	**21**
Slovak Rep.	100	100	3.6	0.7	9
Slovenia	100	100	5.0	0.5	5
Turkey	82	90	5.3	0.5	43

Note: Countries without data on sanitation and improved water generally have very high levels of provision.
Source: World Development Indicators, 2003, the World Bank.

131. Since it is difficult to predict with precision the total costs of upgrading environmental standards, and since estimates cover a wide range depending on the type of investments undertaken, the estimates used in this study are indicative. Current indicative estimates of the investment costs for Romania are substantially higher than those estimated by the EC in 1997 and would be the highest among CEECs. To provide an idea of the magnitude, the total investment cost required to comply with 17 directives that address environment-related concerns may amount to approximately €29.7 billion. Taking this figure as one possible estimate of total investment costs, it would be about 29 percent higher than originally estimated by the EC and this would make it one of the highest among the EU-8 and other candidate countries. EU Funds

committed to help finance the investments during the period 2004 to 2015 are estimated to be about €6.9 billion in total. Hence, the remaining €22.8 billion will need to be obtained from other sources, namely, central and local governments and the private sector.

132. Overall, Romania will need to devote more resources than other countries to upgrade its environmental standards to make them consistent with the concept of a single market of the EU. This highlights the critical role of the reforms discussed in previous chapters—the need for further fiscal consolidation will require containing the costs of upgrading environmental standards and the need for policy shifts to implement the privatization program and improve the business climate to increase FDI. This is necessary to provide the essential complementary financial resources needed to upgrade technologies and environmental standards.

9.2. Containing the Costs of Upgrading the Environment: A Reform Agenda

133. While estimated investment costs are only indicative, it is reasonable to expect that the estimated investments by the central and local governments will imply a major increase relative to the present levels. An estimate has been made of the investment needs, by year, over the period 2004-2015. It shows that the central government will have to allocate more for the environment and that local governments will have to mobilize more funds than they have at present if the schedule is to be met. With realistic expectations of what can be achieved, however, one must conclude that it is unlikely that the central and local governments will be able to raise their expected shares of the total, at least in the next five years. On a more optimistic note, the picture looks better after 2007, especially for the central government. For local governments the medium term will continue to be challenging, and an enhanced role for the private sector will be critical if the targets are to be met. Specific constraints on the environmental side for the private sector's participation in the supply of local public services have been noted and some suggestions offered for dealing with them.

134. The private sector also has a major demand being placed on it as a result of the *acquis*, and it is by no means clear that the levels of investment required can bemet. External resources will be vital to the success of the program here, and measures to make this easier should continue to be pursued actively by the government.

135. The government is seeking to mobilize more funds for the environment by using economic instruments such as charges and allocating them through an Environment Fund. However, to be effective the Fund needs to adhere to principles of sound finance, expenditure control, and financial accountability. These environmental charges serve not only to raise revenues but also to reduce (in the first place) the emissions that are the source of the investment needs. Examples of potential instruments that can be adopted in Romania, in addition to those already introduced, are the carbon tax and other product charges. These would need to be investigated further.

136. Environmental benefits also expected from the environmental investments are such benefits as reduced risks to health and the protection of ecosystem. Estimates of these benefits have been reported for Romania and other countries (Table 24). They show that Romania will derive the greatest benefits from air pollution reduction, followed by water and waste directives.

There is, however, great uncertainty about the magnitude of these benefits, and more information is needed, especially at the local level, so that the data can be used in sequencing the investments. In particular, an effort needs to be made to better understand the benefits of the drinking water and solid waste directives, and to select those investments that generate the greatest benefits first.

137. Another major factor that could limit the rate at which investments are made to meet the environmental directives is the affordability of the ensuring tariffs for the environmental services. A simple analysis for the water charges shows that the number of people who may need some support in paying these charges will increase sharply if rates go up from their present levels. The problems naturally become less as economic growth raises incomes, but even with the projected growth, increases in charges that are feasible without raising the social protection burden unacceptably will remain modest.

Table 24 Total Benefits over the Period 2005–2020 (€ Billion)

	Water		Air		Waste		Total Benefits		Per capita Euro 000
	Low	High	Low	High	Low	High	Low	High	
Bulgaria	1.58	4.20	1.07	11.00	0.20	6.62	2.85	21.82	3.01
Czech Republic	15.23	24.05	7.10	35.10	0.93	11.20	23.26	70.35	9.09
Hungary	2.72	10.49	5.74	39.92	1.12	18.50	9.58	68.91	7.77
Poland	13.59	31.96	25.80	149.90	1.60	26.30	40.99	208.16	6.44
Romania	3.96	12.15	7.59	56.95	0.83	26.30	12.38	95.40	4.79
Slovak Republic	3.00	6.61	3.40	21.90	0.29	4.28	6.69	32.79	7.31
Slovenia	1.47	3.44	0.68	4.62	0.24	2.82	2.39	10.88	6.64
Baltics									
Estonia	0.26	0.99	0.39	2.05	0.09	1.75	0.74	4.79	3.95
Latvia	0.38	1.34	0.49	3.12	0.05	1.07	0.92	5.53	2.69
Lithuania	1.23	2.75	1.56	7.98	0.06	2.00	2.85	12.73	4.21
Total	43.42	97.98	53.82	332.54	5.41	100.84	102.65	531.36	6.06
As percent of total	42.00	18.00	52.00	63.00	5.00	19.00	100.00	100.00	

Note: Net present value at a 4 percent discount rate.
Source: Ecotech. 2001. *The Benefits of Compliance with the Environmental Acquis for the CEEC.* Brussels: European Commission.

138. Finally, the successful execution of the environmental directives does not depend solely on the availability of funds. Another important factor is the strengthening of the institutional capacity to implement the directives. Perhaps even more than in CEECs, there is a need in Romania to further integrate the environment into their policies. Environmental regulatory institutions must be complemented by judicial, legislative and data collection institutions. The enforcement and monitoring of environmental regulations requires the backing of such strong complementary bodies.

10. Conclusions

139. In the last four years, Romania has made good progress in stabilization, growth, and poverty reduction. These recent policy reforms have brought important rewards. Growth has

been re-established at around 4.5 to 5 percent, led primarily by investment and exports rather than consumption.[51] Inflation had declined from above 40 percent to 15 percent in 2003, the lowest level since the start of transition. Fiscal deficits have been cut to about half the 1997 levels, but the external current account gap, estimated at 5.8 percent of GDP in 2003, is high. Good macroeconomic performance has contributed to official reserves reaching a record level of over US$8 billion in 2003—an impressive increase of US$4.5 billion since 2000. The banking sector is on a firmer footing, and direct lending by the central bank has been eliminated. International market sentiment towards Romania has continued to improve—Standard & Poor's upgraded Romania's sovereign currency risk from B+ to BB- in February 2003. Improvements in macroeconomic performance and growth have contributed to a reduction in poverty to 11 percent in 2002.

140. This recent reform momentum has been provided, in large part, by the prospect of EU accession. As a result of reforms to date, trade integration with the EU and global markets is progressing faster than in other CEECs.[52] This report lays out the policy agenda needed to accelerate the pace of restructuring for EU integration.

141. *Strengthening macroeconomic stability.* Measures in this area include further fiscal consolidation and the implementation of a stricter incomes policy, supported by efforts to rely more heavily on fiscal adjustment to safeguard fiscal sustainability, with monetary policy more sharply focused on disinflation and containing the growth of debt. There is also a need to extend hard budget discipline to the transactions between the state and enterprises. The sustainability of growth depends on expanding the recent solid trade performance throughout the economy.

142. *Building on trade integration.* Recent progress is due, to a large extent, to Romania's solid trade performance. To deepen this integration and fully exploit the economy-wide growth and competitiveness potential, three areas of reform are central:

- Restructuring the enterprise sector by implementing the large privatization agenda decisively and in a transparent manner and improving the business climate.

- Transforming the agricultural and food sector by expanding the role of the private sector and increasing reliance on market driven mechanisms to determine investment and production in the sector.

- Increasing labor market flexibility by adopting entry/exit rules with justification and procedural costs based on economic rationale and performance. At the same time, these changes need to be supported by strengthening the unemployment insurance system on a fiscally sustainable basis and following sound contribution benefit principles.

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[51] Although consumption occasionally resurfaces as a key driver reflecting sporadic reflationary pressures that result from high wage increases in SOEs.

[52] The share of imports in total imports and the share of exports in total exports from and to the EU and other markets are increasing at a faster pace than most CEECs.

143. *Implementing reforms to eliminate quasi-fiscal financing.* First, energy sector reform needs to move forward. The challenge is to implement the reforms on Romania's Road Map to EU Accession. These include: (i) implementing import parity in the medium term; (ii) improving collection rates to achieve sustainable financial viability; and (iii) imposing hard budget constraints on the public enterprise payment interface. In industry restructuring, the challenges include the need for the commercialization of generation subsidiaries and the introduction of the private sector in the unbundled gas structure. However, the dangers of vertical integration should not be underestimated, given the weight of global industry players.

144. *Developing efficient financial intermediation.* The completion of banking restructuring, further development of the basic financial infrastructure, and the elimination of financing through nonpayment and arrears, which has thwarted efficient financial intermediation, are all needed to develop efficient financial intermediation. Strengthening the basic financial infrastructure includes: (i) adopting and implementing supervision on a consolidated basis; (ii) strengthening risk assessment and management; (iii) improving the valuation of capital by completing the adoption and full implementation of international accounting and auditing standards and practices; and (iv) improving the coverage and access of the credit risk information system. In this context, the government is commended for having abolished Emergency Ordinance 61/2002, which permitted the authorities to seize any collateral pledged to a bank in order to collect tax arrears. There is a need, however, to abolish the legal framework that allows compensation without cash of the bilateral obligations stipulated in the Government Ordinance No. 77/1999. Romania should rely on revenue collection and administration reform as a more appropriate and effective approach to eliminating nonpayment of taxes.

145. *Addressing fiscal risks.* Two areas of reform are needed to address the fiscal risks, which emerge from financial weaknesses in the social security system and from the costs of upgrading environmental standards. The issues and reforms regarding social security are discussed in depth in the recent Public Expenditure and Institutional Review of Romania, 2002, by the World Bank. On the environment, this report finds that Romania is starting out with a lower level of environmental capital and a poorer state of the environment, and hence it will need to invest more than other countries. The estimated costs of environmental investment are large -- around €29.7 billion during the period 2004-2015—the highest among CEECs. Even if EU funds finance about one-quarter of these costs, 75 percent of these costs are to be financed by the central and local governments and the private sector. A two-pronged approach is needed to contain the costs of upgrading environmental standards. First, estimates of total costs and benefits for each of the 17 environmental directives should guide the sequencing of the investments and the implementation. Those investments that generate the greatest benefits should be selected first. The estimates show that Romania will derive the greatest benefits from air pollution reduction, followed by water and waste management. Second, enhancing the role of the private sector will be critical if targets are to be met and fiscal risks are to be reduced.

146. Ultimately, Romania's success in integrating with the EU depends on its implementing the policy reforms outlined in this report, and achieving its goal of EU accession is predicated on its implementing the institutional, administrative and governance reform agenda.

MAP SECTION