

# ANNUAL POLICY & FORECAST REPORT

ROMANIA  
2010

The end of  
crisis, the  
Greek  
model and  
the real  
reform  
agenda

Romanian Academic Society (SAR)

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**T**he crisis will probably be over in 2010, but the recent example of Greece proves that one doesn't need a global crisis to run into major structural problems, if the state is misgoverned year after year. Equally, simply being a Eurozone member is no automatic protection against turmoil. What does Romania need to do to avoid such a fate in the future (assuming we are not there yet, in many respects)? Are political and constitutional reforms currently pondered by the political class in Bucharest a guarantee that Romania will be better governed, once the economic growth resumes, or we will go back to the old ways as soon as the financial constraints disappear? SAR thinks that the current reform agenda is wrong, at least in part, and suggests a list of practical proposals.

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## Summary

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# Forecast 2010

Uncertainty diminishes, but there will be some time until economic growth and optimism return

As SAR was indicating last year by this time, the economic volatility and uncertainty reached a peak in 2009<sup>1</sup>. None of the important institutions publishing forecasts managed to foresee the magnitude of the economic decline – or the surprising positive trends appeared during the crisis. Therefore, SAR's own panel of experts has difficulties with predictions on certain indicators. But we are glad to discover today that we were closer to reality than many others.

For example, while at the end of 2008 IMF and EIU were still seeing positive economic growth (4 and 2.6%, respectively), our panel has predicted 0.7%. Eventually, as we all know, it turned out to be -7.2%. Our RON/Euro exchange rate for Dec 09 was 4.4, much closer to the real value (4.23) than the wild forecasts predominating at the beginning of the last year, which expected an uncontrolled drop of the national currency towards 5 RON/Euro.

## Main indicators 2010

	Average	(min-max)
<b>GDP growth, %</b>	<b>1.2</b>	<b>0 ÷ 2</b>
<b>Inflation rate, %</b>	<b>4.2</b>	<b>3.2 ÷ 5.2</b>
<b>RON/Euro rate, 31 dec 2010</b>	<b>4.1</b>	<b>3.9 ÷ 4.3</b>
<b>Budget deficit, % GDP</b>	<b>6.1</b>	<b>5.8 ÷ 6.5</b>
<b>Current account deficit, %</b>	<b>5.5</b>	<b>4 ÷ 8</b>
<b>Unemployment, dec 2010, %</b>	<b>8.4</b>	<b>7 ÷ 10.2</b>
<b>Stock exchange growth (BET) in 2010, %</b>	<b>22</b>	<b>5 ÷ 50</b>
<b>Real estate prices, Dec 10 / Dec 09, %</b>	<b>0</b>	<b>-15 ÷ 15</b>

<sup>1</sup> "Romania 2009: the economic crisis and the rule of law", Annual report SAR, feb 2009.

"Our" unemployment rate for end-year was 7.1%, not far from the real 7.8%; for comparison, EIU gave 9%. Finally, nobody could anticipate the few positive developments occurring in 2009, such as the spectacular drop of the current account deficit below 5%; or the BET index rise by 60%. Still, unlike other forecasters who thought the stock exchange would completely melt down, we saw a modest 5% rise. (Sadly, SAR doesn't have resources to create a portfolio and put its money where its mouth is – otherwise we would have pocketed a nice return in 2009).

Therefore, in line with our tradition, in Jan 2010 we assembled again our panel of economic experts and practitioners, asking them for their views on this year's trends. Remarkably, the predictions' dispersion is smaller than in 2009, which is in line with the idea above: **the uncertainty diminishes**. The problems are far from solved, but at least the discussion is over of where the bottom of the economic collapse may be.

The international environment does not seem to affect too much the chances that the government will implement its 2010 program, though Europe is agonizing these days over the "Greek crisis". This is because so many warnings were issued last year about Romania collapsing that now, when at least a modicum of stability was achieved (political and financial), markets seem to consider business as usual the perpetual and cacophonous political noise coming from Bucharest. However, long-term imbalances will persist and they must be addressed with deliberate policies – crisis or no crisis.

Our panelists see the economic growth resuming, though at a modest level (1.2%), and inflation and exchange rates unchanged significantly from those at the end of 2009. They also look optimistic regarding the chance that the government will bring the budget deficit down to 6%, though slightly

above the level agreed with IMF. The upsurge of the current account deficit will reflect precisely the resuming of the domestic demand, after the severe contraction in 2009.

The stock exchange and the real estate markets remain the most unpredictable items in our analysis, with a broader range of predictions. The BET index will rise further, but it is impossible to say what will happen with the price of land and houses: half of the experts think it will continue to drop, probably by 15%, and the other half that it will start to increase, by about as much. The lack of transparency on the real estate market is regrettable and makes real trends difficult to discern. Creating an official index – an idea much discussed lately – would be more than welcome.

As always, we have also asked the panelists **two open-ended questions**. There is a remarkable consensus on the answers, in spite of the quite diverse professional profile of respondents (public / private; analysts / practitioners), which outlines a clear action plan for the government. This is what we based our analysis on in the chapters below.

#### ***A. Do you think in 2010 Romania will overcome the economic crisis?***

Most analysts believe that, technically, the crisis will be over in Romania this year (maybe in its second part), but this does not mean the end of our problems. First, since it is clear we will emerge from the crisis only together with the rest of Europe, we have to wait and see what happens when the Western governments stop flooding the markets with easy money in the form of stimulants: a new, milder recession? Slow growth?

Second, some panelists think a few more quarters are needed before the social indicators (salaries, unemployment) will also mark an improvement. In other words, the

crisis will be over in 2010 on macro indicators, but not on social ones.

Finally, even after the growth resumes we will be left with the structural shortcomings of the Romanian economy: the competitiveness and efficiency deficits in the public and private sectors. Such problems must be addressed separately, through a dedicated set of reform policies, because in these respects we compete with Europe, and not necessarily rely on it for support.

***B. What is the most urgent measure the government should take at the beginning of 2010?***

The answers to this second question also converged – towards a rather neo-liberal view. For example, three panelists say in a way or another that the government doesn't have to be very involved in managing the economy, but it must urgently rein in the public sector and bring the budget deficit below the 3% target.

In general, our respondents insist on higher standards of discipline and transparency in public spending, on effective cuts in public staff (by at least 10% but, if possible, selectively, not across the board) and on strict implementation of the agreement with the IMF. The priorities in the public sector are:

- (i) a new salary system;
- (ii) cuts in current expenditure, other than investments;
- (iii) better and more transparent tax management.

**The central idea in all the comments is that:**

- **Without such reforms the government lacks the moral authority to try painful tax reforms, bringing more funds to the budget;**
- **And without such a revenue increase in terms of % GDP it will not be able to sustain the infrastructure and social**

**services at European standards.**

One comment we quote here is especially telling for the reform agenda we sketch in the following chapters:

"An *Investment & Action Plan* is necessary to keep every ministry within its budget envelope, especially on salary and operational costs between 2010 and 2013. We should not reduce personnel at random, just to discover later that we cannot function properly.

On the other hand, the investment programs should be discussed publicly and posted on each ministry and agency's websites, and the information on their implementation updated in real time. The projects must be prioritized in order to ensure the maximum multiplicative effect in the economy at large. " ❧

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# Reforming the state: the real agenda

## What should the government do to avoid a long-term structural crisis – “the Greek model”

What we see these days is one of the biggest humiliations an EU member state has ever suffered: Greece may have its vote suspended in the next European Council. Athens has reached in this situation because of lack of fiscal discipline, opacity, politicization of the administration and irresponsibility of successive governments, socialist and conservative.

The historical opportunities of joining the EU and the Euro zone have led to improved country perception, the diminishing of risks and costs of investing in Greece – i.e. eventually have produced substantial benefits for everyone. Unfortunately, as it happens, such social benefits are diffuse and tend to be overlooked by ordinary citizens.

On the other hand, the Greek governments, together with the trade unions from the public sector and other pressure groups, decided to postpone as much as possible the necessary spending reforms, because they incurred political costs. The political class dragged their feet over salary and pensions reform. Instead, data were doctored so that the statistics looked good and the country could leave beyond its means, borrowing unsustainably.

Like Greece, Romania suffers from a number of **chronic ills in the public sector** which the global crisis only

made more visible:

- Bloated and politicized administration, which may sometimes perform reasonably well routine tasks, but fails to implement projects or encourage growth and creativity, even when the government honestly tries to promote such ideas (see EU funds absorption);
- Opacity and manipulation of official statistics, usually to fool external monitors or the voters during the electoral cycle (see the budget deficit in 2008, which was reported by the outgoing Tăriceanu cabinet at -2.3%, to be subsequently revised to -5.2%; true, the magnitude of the deception was much smaller than in the case of Greece, but the pattern is the same);
- Superficiality – at best – in dealing with the demographic bomb ticking in the state pensions sector. In spite of the agreed calendar to raise the legal retirement age, the real one in Romania in 2009 was 54, due to special laws, the permissive regime of early retirement, and the massive fraud in the disability retirement system. In Greece, the retirement age is also 55; by contrast, it revolves around 65 in the Nordic countries that are now

called upon to bail out Athens (or Bucharest).

Only on the last item, for example, the state pension funds (pillar I) was technically blown by the populist measures adopted in 2007 by the Parliament and the government: a structural deficit was created, to be covered by the general budget, which in 2009 amounted to €1.5bn. This hole in the budget equivalates with a virtual surcharge to finance the pensions which, if made transparent, would amount to a VAT increase from 19% to 22%, or a corporate tax increase from 16% to 25%.

The reality will have to be admitted sooner or later, as on current projections the yearly deficit will reach €4bn by 2025. With the current structure of revenues to the general and social security budgets, a VAT surcharge of 8% (ie. a 27% VAT rate) will be needed to sustain the state pension system in fifteen years from now.

Romania has not yet reached the staggering deficits of Greece and, unlike its southern neighbor, is likely to have in 2010 an easier year than the preceding one (which is a way of saying that 2009 was extremely difficult for us). As the previous section shows, the forecasts for this year are prudent, with a touch of optimism: the decline has stopped, there is less uncertainty and more political stability. The government in office looks determined to enforce the tough conditions agreed with the IMF, even if at a certain point it may not need to use all the money from the loans (hence, the discussion about a precautionary accord).

Nevertheless, there are **three strategic errors** the cabinet and the ruling coalition may make, confronted with the realities of the crisis and the need to reform Romania for the long haul. The rest

of this report will analyze these possible errors and suggest ways to avoid them.

## 1. Error by diversion

Instead of implementing those changes that really yield results, the Romanian political class gives signs that it is ready to embark upon grandiose projects of constitutional or administrative change, with no evidence of a cause-effect connection between such changes and the presumed final goal: better governance. For example, we hear about:

- New laws for depoliticization of the civil service (they exist since 1999 but are systematically broken);
- Better mechanisms for "a more politically balanced" allocation of funds to local communities (these also exist, based on objective criteria, but were ignored by *all* governments since they were created, in 1998);
- Territorial-administrative reform, in various guises (possible, but it will not change much in the way the institutions function);
- Finally, the much-debated reform of the Parliament, by abolishing one chamber (the Senate) and cutting the number of MPs left in the other (also possible, but again, unlikely to improve the functional performance of the institution).

Instead of these diversions, which will eat up the time and energy of the Romanian political class – in short supply anyway – for years to come, SAR proposes **two useful and urgent changes** that might really improve the quality of governance.

**The government must avoid three big errors: investing effort in irrelevant changes; poorly communicating the relevant ones; and reversing important reforms**

- a. First, if something is to be fixed in the political machinery, we suggest that this be **the electoral calendar**. Under the current rules, half of the time during the 2010-2020 decade will be consumed with electoral campaigns: five out of ten years will have elections, more than in any of the preceding decades (see Textbox 1 in the next chapter). And we saw during the 2007-2009 cycle how unprepared the Romanian parties and administration are to govern responsibly in the months before ballots. The situation is unlikely to improve soon, irrespective of the changes in party statutes and leadership that may occur.
- b. However, since Romania's most intractable problem is not the adoption of a certain set of rules, but their enforcement, which those in power tend to do selectively to their own benefit, the real solution here appears to be **a pact among the main parties** which would co-opt the opposition and the civil society into the checks-and-balance institutions, especially those that monitor the allocation and use of resources, and supervise appointments in the administration.

Both proposals are detailed in the first chapter below.

## 2. Poor communication

Ever since it renewed its mandate in December 2009, the current cabinet has been surprisingly inapt to explain the content – and especially the reason – of some of the unpopular decisions it must adopt. The communication was fragmentary, with ministers appearing to contradict each other, and reactive, allowing distorted and incomplete ideas about its policies to entrench in the public opinion, against a background of scarce official information.

Occasionally there were hasty attempts to remedy this flaw with press releases and statements, but which were equally foot-in-mouth. Other times the public was courted with tired and populist rants ("shameless pensions", "smart boys" from the energy sector) which do not clarify much about the root of the problem, create unrealistic expectations that complex situations could be solved with a silver bullet, and eventually increase the general disappointment and cynicism.

Maybe the most important such communication error, given the current budget constraints, is related to the **multi-annual effort to broaden the tax base**. This failure to come up with a coherent and convincing narrative about the necessary fiscal reforms dates back to 2005, when the introduction of the flat tax was portrayed merely as a tax cut (which was true), with little attention paid to the second part of the plan: closing the loopholes and raising to the new flat rate of 16% all the taxes on income which were below this level, so that the same amount of money would be taxed similarly, irrespective of its source (horizontal equity).

The logic applies to the social security contributions as well, which finance the state pensions and the health system: the idea was to take less money but from a larger number of taxpayers who in practice benefit from these public services, in order to be able to make the social redistribution promised in the spending laws.

While the economy was roaring ahead and the public budgets were buoyant, it was convenient to forget that only the pleasant part of the fiscal reform was implemented, ie. the nominal reduction of rates: on personal revenue in 2005, and on social security contributions over the following years. The unpleasant part (eliminating exemptions from social security contributions of certain types of work contracts, income from



real estate transactions, revenues from farming, etc) was largely abandoned.

Unfortunately for the government and society, the problem could not be ignored any more when the crisis hit and it became obvious that the tax holes are very expensive. But the top officials proved surprisingly unable to frame properly an issue which is essentially one of social fairness. The succession of individual and hesitant measures adopted at the beginning of 2010 were not placed into the broader picture; the impression was created that "new taxes and fees are introduced" in a desperate search for additional revenues to the budget.

This communication deficit has generated confusion, public hostility to the proposed changes and a lot of time lost with partial and convoluted explanations most people do not want to believe. Chapter 2 below is an example of what the government should have said (and done), applied to the case of the social security contributions and the pension system.

### 3. Backtracking on reforms

This section is about pro-active mistakes the government may be tempted to make.

The first example is still a theoretical possibility, albeit a dangerous one: pushing back the calendar of Euro adoption – ie. learning the wrong lesson from the Greek case. Noting that joining the Euro zone reduces the range of tools with which governments can cover for a while their incompetence (or populism) – for example, devaluation – Romanian officials may try to tacitly postpone the moment when the country switches to Euro, beyond the rumored date of Jan 2015, which is still realistic if we do our homework. The convergence program is a real straightjacket for those ministers who would like to become popular by over-spending, and so a tight

discipline in office is needed for its implementation.

The second example is much less speculative: implementing wrong-headed strategies, for example in the energy sector, which amount to a real counter-reform. The first step was already made when the two national energy champions were created in early 2010, by re-integrating various types of electricity production and distribution (after the '90s were spent with the effort to unbundle them). We chose this example – about which more details are provided in Chapter 3 – because the stakes in this game are extremely high, and so is the chance that Romania will confront an unprecedented energy crisis due to under-investment on the medium term.

The following chapters in this report offer each of them an illustration of the three types of mistakes identified above. They describe the current situation, warn on the wrong solutions contemplated or unnecessary diversions, and recommend appropriate measures that add up into what we called **the real reform agenda**. ☞

# 1. Political reform

The pace of deep reforms has slowed down after 2007, while the measures discussed today are not likely to improve the quality of governance

Romania's accession to the European Union has triggered, for obvious reasons, a backlash in the state reform. The European Commission has lost its main instrument to speed up changes (the threat to delay accession) even if it took the unprecedented decision to continue monitoring for Romania and Bulgaria. The instrument now used – the threat to cut European money, a solution already used in the Bulgarian case – is a much weaker incentive. As a result, the Liberal Justice Minister Cătălin Predoiu did not reappoint the chief anti-corruption prosecutor Daniel Morar in 2008; his staying in office was eventually made possible only by a new political context: the broad right-left alliance in government after the 2009 elections.

With less European pressure, the domestic momentum of state reform has stalled. The IMF conditionality is not sufficient to generate a real agenda: the underlining requirement is expenditure cuts, without a proper analysis of the sources of problems. The political context – no party is positioned as a champion of reforms, unlike years ago when PDL took this role – is not likely to make reforms easier. Minority governments, as well as minimal coalition such as the current one between PDL-UDMR, cannot survive unless they spend

public money to buy political support in Parliament and in territory. The reasons undermining the reform agenda precisely when it was used as an electoral flag are listed below according to their relative importance:

- The European Commission lost the main sanctioning instrument in relation to Romania, the delay of EU accession;
- Traian Băsescu has lost his high moral ground vis-à-vis political parties in general, as his own party in particular. This is due to nepotism and cronyism, or immoral alliances (or actions – such as the use of the referendum as a tool to advance his electoral campaign) for re-election. All these have weakened him as a champion of integrity standards in PDL;
- The efficiency of the civil society, which was at a decent level two years ago, is now reduced because many NGOs were co-opted by political parties. There is little civil society left capable of collective actions as powerful and objective as the Coalition for a Clean Parliament in 2004. Various parties (or TV stations) enrolled civic activists or pseudo-activists, thus leading to the disappearance of genuine popular dynamics indispensable for the support of the reform of the state.

The result was a negative trend leading to the downgrade of Romania's ratings after the accession into the EU. This trend is visible in:

- ***Intense politicization of administrative positions, thus breaching laws and commitments undertaken towards the EU.*** Public positions which by law are non-political, such as those of prefect, director of health department or school inspectorate, are now completely politically dependent – all potential candidates have been compelled to become affiliated to a political party. Those that were reluctant to fulfill this requirement were eliminated from the competition, thus leading to a massive counter-selection with regard to human resources in the public sector. This practice has been constantly upheld after 2007 by successive governments PNL, PDL-PSD and now PDL, obviously undermining the reform of the state.
- ***The return of discretionary public spending,*** in breach of the legal and institutional framework that requires and allows for more objectivity in the allocation of funds, and in breach of the electoral promises made in 2004, when a break with the past was supposed to occur. Allocations from the state budget were made in a discretionary manner by the PNL government in 2007 (by passing exemptions to the law), the following governments continuing the practice to a lesser extent (also due to the economic crisis) in order to secure a majority that would approve the budget. Majorities being very slim in Parliament, the practice of buying support through discretionary fund allocations is likely to continue.
- ***The come-back of political migration,*** favored by the voting system dependent on uninominal

constituencies, generating the risk of "the independents' group" becoming one of the important forces in Parliament (reminding of the major problem of Russian and Ukrainian Parliaments in the 90s). As a result "the independents' group" negotiated for the formation of the current government and received one ministerial portfolio in exchange for their support. The number of those resigning from their political parties to support the government is rising, as the government is in a position to offer various rewards to them.

The strategies circulated at present as potentially leading to the reform of the state may be grouped in the following three categories:

1. **Staff cuts** and cuts of expenditures in the public sector. In view of the issues presented above there is a major risk of such measures not being done based on objective criteria. As long as governmental stability remains the main objective, allocations will be made to ensure political support. The cuts will thus be made only at the expense of political opponents. Some of the restructuring measures, such as the elimination of one chamber of the Parliament, will not solve any of the problems presented above (see also the list of indicators presented in table 1), but are likely to generate new ones (one of the horizontal forms of control, that had a certain anti-corruption role, disappears).
2. **Decentralization.** At present there is considerable evidence globally, mainly from countries where it was used as main solution (such as Indonesia), but also from research studies published about Romania<sup>2</sup>, that

<sup>2</sup> Sorin Ioniță (2005) "Money for Our People? Fiscal Decentralization and Corruption in Romania" *Public*

decentralization without proper control mechanisms, transparency and absence of the rule of law leads to a significant increase of corruption, without a similar increase in the efficiency of public services. Ensuring proper controls in the absence of any civil society at regional and local level while facing serious political dependence of control bodies (presumed to be independent) is a difficult endeavor.

3. **Reform of the judiciary.** There is evidence that reform of the judiciary in Eastern Europe and world-wide works only when there is a meeting of minds between three groups: political leaders, magistrates and the public. Unfortunately in Romania the will to reform of political leaders and, more importantly, of magistrates is rather low. The public, on the other hand, is inconsistent and reacts only seldom through a hand-full of NGOs, all Bucharest based, that act more in their expert capacity than as representatives of the general public.

Since 1996 when the World Bank started to promote judicial reform, no significant improvements were recorded anywhere. In Eastern Europe none of the evaluations of World Bank or Freedom House shows significant progress. The decisive factors of judicial reform are not technical: a statistical model of quality in the judiciary shows that the operational details (who appoints the judges) does not matter if proper anti-corruption and democracy controls are ensured (for the 28 European post-communist countries). In other words the key to justice reform is political, not technical.

The Superior Councils of Magistracy have not generated the expected progress anywhere, but at the same time the return to the control of the executive is not a solution either. The experience of developed countries shows that building an impartial and non-political judicial system is an endeavor that takes decades which is not finalized even in the most advanced democracies. To base the reform of the state on the reform of the judiciary, as it was attempted in Romania, is strategically a mistake. The reform of the judiciary must continue, but it will only succeed if supported from within the judicial system.

An analysis of the main good governance indicators from the last report on global competitiveness issued by the *World Economic Forum* shows that Romania looks rather bad in this respect. If in some area such as property or the efficiency of the legal framework Romania made

**Judicial reform  
will not succeed  
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from within the  
judiciary**

some progress, when it comes to governmental opacity, waste of public money due to corruption or due to the favoring by the government of private interests

Romania ranks below Sub-Saharan Africa. No advertisement campaign may offset the effect the reading of such publicly available data would have on potential investors. The forecast is bad otherwise Romania would not have a brain-drain rate higher than Burkina Faso.

To have an impact on these indicators a country must change the institutional practices, and not to promote legal or constitutional reforms. Moreover, the frequent changes of the framework might be in itself become an obstacle and a diversion. The few countries from the region that have made progress (such as Poland) owe it to the consensus reached by political parties on a public reform agreement

**Fig. 1. Romania's government rankings.** *Source: World Economic Forum*

<b>Report on global competitiveness 2009</b>	<b>Romania's rank out of 134 countries</b>	<b>The country above</b>	<b>The country below</b>
Policymaking	124	Surinam	Kirghizstan
Favouritism in government decisions	113	Hungary	Senegal
Wastefulness of government spending	111	Cameroon	Nicaragua
Burden of government regulation	54	Guyana	Egypt
Diversion of public funds	80	Hungary	Serbia
Efficiency of legal framework	86	Check Republic	Croatia
Property Rights	85	Croatia	Nigeria
Brain drain	102	Burkina Fasso	Benin

and not to their superior constitutional framework.

Therefore, the simplest solution would be an agreement between the main political forces to include the opposition and the civil society in the control mechanisms to ensure a higher degree of impartiality and put an end to the practice of political appointments in administration. The way forward in this regard for PD-L, if indeed this is the real goal of the party, would be to open the debate on a possible agreement with the opposition and the civil society on these objectives. Any attempt in this regard deserves the support and should not be met with suspicion by the opposition. The rest is no more than diversion and electoral rhetoric.

### **What should be done**

This is the genuine reform agenda for the Government in two steps:

- First, **an agreement for impartiality and transparency** negotiated and endorsed by both the ruling majority and the opposition. In the absence of such agreement the practices of going around the legal provisions

adopted. Otherwise, the reform of the state cannot be performed by one party alone, nor can it be achieved by a fragile coalition that is dependent on the vote of political migrants and on the budgetary allocations made to their respective constituencies. Such an agreement would mean a strict monitoring of public expenditures of ministries and local administration through publishing in real time and in a proper format of budgetary allocations and budgetary executions of the main sectoral programs and major projects. The new law on fiscal responsibility, which provides for an Independent Fiscal Council, is a step in the right direction, but an insufficient one: this Council will endorse only proposed indicators and budgets (i.e. plans for the future), but will not be able to supervise their implementation. Only transparency and permanent pressure coming from the public may restrain Governments' temptation to play with the data and resources, as the (Greek-) Romanian model shows.

### Textbox 1. Electoral years in Romania and the decrease of governance quality

Between 2007 and 2009, through decisions taken in view of each electoral campaign, the state budget was constantly weakened by the decisions on future structural allocations of funds (salaries and social expenditures) at a higher level than that which could be handled by the state budget. The number of employees in the public sector rose in few years from approximately 1 million in 2004 to 1.4 million in 2008. During the same period the pensions' fund was lead to bankruptcy: for the first time since it's creation, the idea that the fund would pay structurally and massively more than it would ever collect was institutionalized, as well as the fact that the fund would be financed through subsidies from the state budget.

It follows that a clear link exists between electoral cycle on the edges of completion and public policy errors: unlike US or other consolidated democracies, the Romanian political system proved to be incapable to adapt to a continuous and frequent election calendar. Considering the human resource at their disposal, political parties cannot handle simultaneously electoral combat and reasonable governance, therefore opting for one of the above, usually for the first.

Similarly, the media was under immense pressure and regressed in qualitative terms throughout this cycle. After two-three years of institutional and individual selection based mainly on the capacity to comment on conspiracies (real or imaginary), on political inter-linkages, on non-issues and to actively promote a distorted agenda, the return to normality during non-electoral years is professionally difficult, even for those that have good intentions.

First decade	Second decade	Third decade
1991	2001	2011
<b>1992 Loc, Nat, Prez</b>	2002	<b>2012 Loc, Nat</b>
1993	2003	2013
1994	<b>2004 Loc, Nat, Prez</b>	<b>2014 EU, Prez</b>
1995	2005	2015
<b>1996 Loc, Nat, Prez</b>	2006	<b>2016 Loc, Nat</b>
1997	<b>2007 (EU)</b>	2017
1998	<b>2008 Loc, Nat</b>	2018
1999	<b>2009 EU, Prez</b>	<b>2019 EU, Prez</b>
<b>2000 Loc, Nat, Prez</b>	2010	<b>2020 Loc, Nat</b>
<b>3 out of 10 years (30%)</b>	<b>4 out of 10 years (40%)</b>	<b>5 out of 10 years (50%)</b>
<i>Loc = Local elections</i>		<i>Prez = Presidential elections</i>
<i>Nat = National elections (Parliament)</i>		<i>EU = European elections</i>

In the current context, even if the economic crisis will pass and the economy will once again start to raise, the governance quality in Romania will not improve. Most likely, it will continue to deteriorate, and the EU will not be able to do much about this, as we have seen after 2007. The biggest danger is that the inter-elections period of 2-3 years in the following decade will furthermore shorten the temporal perspective of the political actors and link the debate exclusively to the electoral fight.

Due to the different timeframes for the election of the President and of the Parliament, the chances of co-habitation between a President and a Government having different political orientations increased. These co-habitations proved to be extremely instable in Romania. The years that follow presidential elections become years of governmental change or ministerial replacements, by means of complicated presidential-parliamentary combinations as we have seen after the last elections. The same thing will happen the other way around if parliamentary elections give a majority that is not approved by a President which is in the middle of his mandate: the President does not have the power to directly dismiss the Government, but may, in his turn, block or decisively influence the appointment of the new Government. After such episodes, long frictions, disputes and threats with snap elections and referendums follow.

To cut a long story short, until 2016 no Government will have a timeframe longer than one-two years and this will be reflected by the governance agenda. During 2019 and 2020 Romania will have a continuous electoral campaign of the like of that just concluded. Judging by the recent experience of the it is difficult to see how populist errors will be avoided taking into consideration 2012 and 2014 which are electoral years – that is exactly the period during which extreme prudence should be exerted towards the macro level of the country's administration, so that disequilibrium is avoided and the national currency is kept (through market mechanisms) within a narrow variation margins so that Romania will adopt the Euro in 2014-2015 as planned.

Also, it is still unclear who and when will adopt painful decisions with regards to the reform of the pensions' system, as the demographic trend throughout the region is unforgiving, no matter what Governments and Unions might like to believe. Disequilibrium induced through electoral promises will only be fixed if courageous measures are taken for at least three-four years. Looking at the Romanian political calendar for 2010-2020, it is not at all clear who and when will show such courage.

### **What should be done?**

- The common sense but hard to implement solution would be to re-unite the presidential and parliamentary elections. We could thus return to the previous situation when, at least, national elections (local, parliamentary, presidential) took place during one single year, leaving only European elections to be organized outside this calendar.
- Another solution would be to increase the national election cycles to five years, so that local, parliamentary and presidential elections are held in the same year with European elections.
- Though discussions existed about dropping the direct election of the President, this will not be a measures easily accepted by the electorate which wants to continue to decide directly who will occupy the most important positions in the state. Anyhow, this would not solve the issue of the election calendar as the number of electoral years would stay the same.

All these options have the main disadvantage of requiring constitutional amendments which would mean an enormous task from the political and administrative perspective which is not likely to be undertaken considering the current political configuration of the Parliament. However, no other option exists, so these issues need to be considered in the perspective of constitutional amendments at moment not yet fixed. If we will undertake this time and energy consuming endeavour, the least we should aim to achieve is results which would improve the current state of play, and not irrelevant changes as those done in the past.

Everything must be complemented by the efforts of the media and the civil society to oversee public procurement and the distribution and use of European money.

- **Second, a change of the electoral calendar must be agreed to recouple the parliamentary and presidential elections**, if we really want to embark on the difficult task of amending the Constitution (see Textbox 1). So far, the

**Frequent elections shorten the time horizon of cabinets and threaten the adoption of Euro in Jan 2015**

decoupling operated in 2004 created only disadvantages: the parties were not able to stay away from the battle for Presidency, as it was expected (unrealistically); the flaws in the Constitution, in particular regarding the relationship between the President and the PM, became apparent; the strategic games of parties became unnecessarily complex, reducing the efficiency and stability of the Government during election cycles. *CB*



## 2. Pensions reform

The public pension scheme was pushed into bankruptcy in 2007-2008. Is there a way back?

The pension system has become a hot topic in Romania lately, with many people embracing the line of reasoning "I accept the revision, but nothing should be changed". There are two issues that press for a major reform, even though such a move may be unpopular: the rapid ageing of the population and the dire state of the finances in the public scheme.

Romania has now a relatively young population but the low birth rate from the last 15-20 years is already influencing the demographic structure. The forecasts for the following decades are worrisome.

Eurostat estimates that in 50 years Romania will be among the first three countries with an ageing population. In 2050, in Romania, one in three persons will be over 65 years. The old-age dependency ratio (meaning the ratio of the population of 65+ to the working age population 15-64) will increase three-fold from 21% at present to 65% in 2060. For the pension system, it means a significant larger number of pensioners and much fewer contributors.

With these challenges on the horizon, the public scheme (which is most exposed as all PAYG schemes) needs to be robust. Unfortunately, the situation is far from that. Currently, the public system is

already unbalanced with a ratio between contributors and pensioners of about 1:1<sup>3</sup>, meaning that a contributor pays the benefit for a pensioner. This situation is not the outcome of the demographic changes which will produce effects only from now on. But it is the exclusively attributable to unsound public policies.

The entire economic restructuring during the '90s and afterwards relied heavily on early retirement. Instead of creating incentives for attracting investors and solving the existing labour market rigidities, several

governments preferred to burden the public pension scheme. Moreover, attempting to balance the social insurance finances, at the end of the '90 the government decided to increase the level of the

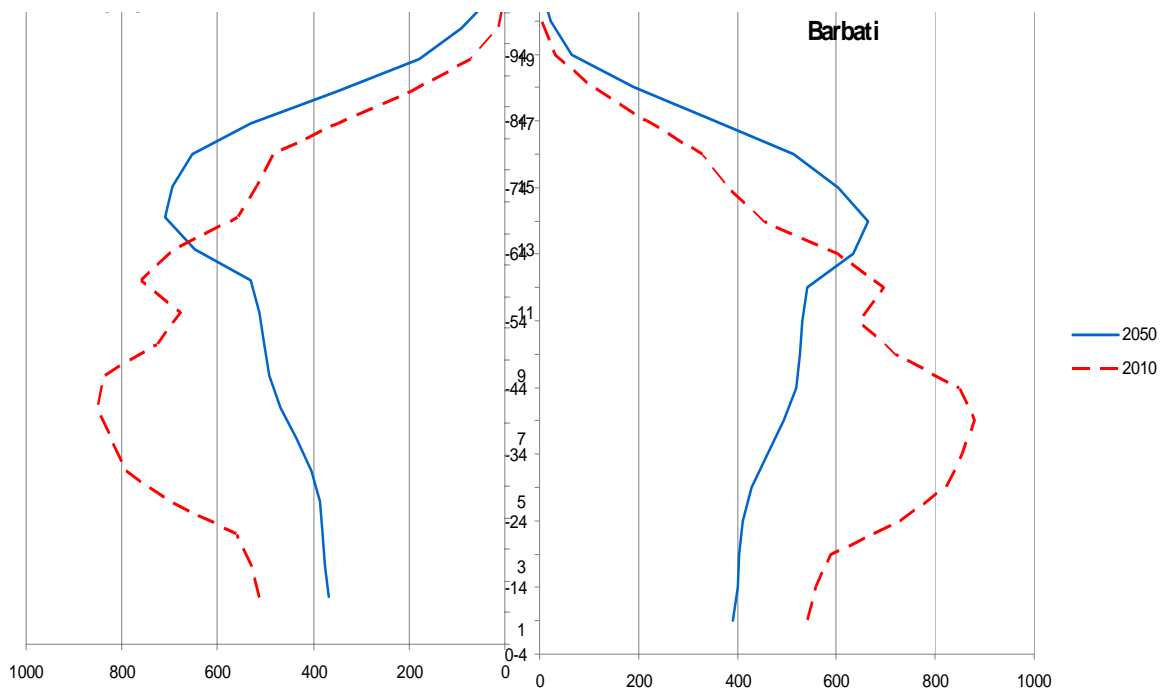
contributions. The only result was a large number of contributors exiting the formal economy<sup>4</sup>. The Governments regarded these

**The deficit of the pension fund created in 2007-08 amounts to a VAT rise from 19 to 22%; in 2025 the VAT should reach 27% to finance it**

<sup>3</sup> If the recipients of special pensions and the agricultors are counted, the ratio is 1:1.2 (the Report of the Presidential Commission for the Analysis of Social and Demographic Risks)

<sup>4</sup> Stanovnik T (2004). Contribution Compliance in Central and Eastern European Countries: Some Relevant Issues, *International Social Security Review*, Vol. 57, 4/2004

Fig. 2. Demographic Trends 2010-2050 (Source:UN)



pseudo-solutions as opportune, but the positive effects are only short-term and illusory. When the real costs are due to payment, these solutions prove to be extremely expensive and inequitable.

The budget of the public pension scheme has been a victim of political caprices. Sometimes it was backed by some economic justification but more often it was purely populism. After couple of years of attempting to balance the public fund, in 2007, the politicians gave a final hit by increasing massively the value of the pension point. This decision was taken with no impact assessment whatsoever although just a quick calculation would have indicated the impossibility to fund such decisions even on short term.

Now, we bear the fruits of these decisions. In 2009, the costs for pensions reached €39bn which is about 8% of GDP. It is about the same amount that was spent for health and education altogether. Furthermore, the deficit of the public pension fund was €1.5bn funded by transfers from the state budget,

widening the deficit of the consolidated budget with a quarter.

To fund this deficit, the necessary amount is the equivalent of increasing the VAT to 22%, of raising the flat rate tax to 25% or of raising the tax on companies' profit from 16% to 25%. Sooner or later this problem has to be dealt with as IMF estimates the pension fund deficit to reach €4bn, by 2025. If the budgetary and social insurance revenues structure will not change, such deficits will require a supra-taxation on VAT of 8% (meaning 27% overall) to support the pensions in payment in 2025.

### What must be done?

#### a. Discouraging early retirement

The ageing trend means, on one hand, that the ratio of the elderly in the general population will increase and, on the other hand, that we will live longer. Under these circumstances the public pension needs to be adjusted. There is a common opinion in the public debates that the short life

expectancy (claimed to be close to the retirement age) doesn't allow the rise of retirement age. In reality, the life expectancy at 65 is about 14 years for men and 17 years for women. This is slightly lower than the UE average (see Fig. 3 and 4) but the trends indicate that the gap will narrow significantly in the following decades.

Most public pension schemes are structured in such a way to provide the payment of benefits for approximately 15 years after retirement. In Romania, taking into account the standard retirement age, the system pays benefits for an average of 15 years for men and 22 years for women. However, when taking into account the effective retirement age of 54 years, one can notice that people enjoy the benefits of retirement for about 1/3 of their lives. Such arrangements are quite

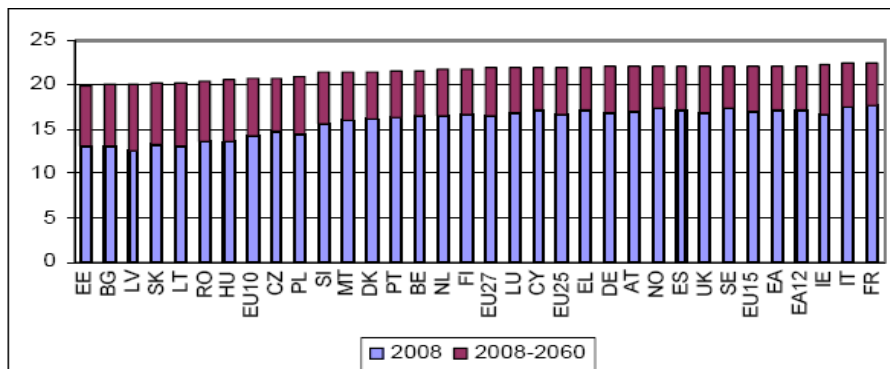
generous considering the relative poverty of Romania.

Moreover, we engage these costs at the expenses of future generations while we leave behind such a poor legacy, especially regarding the financial situation of the public scheme. In this context, the need to increase the effective retirement age is imperative and it can be done by limiting the early retirement (stricter eligibility conditions and higher penalties), by equalizing the retirement age for men and women, by increasing the retirement age for those covered by special laws.

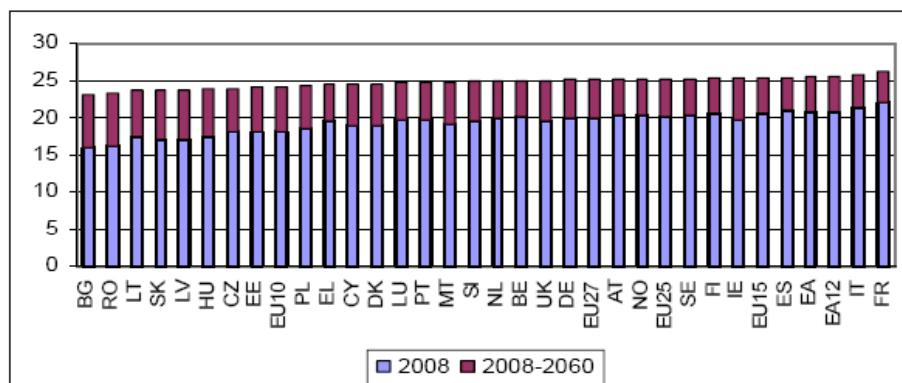
**b. Equalizing the retirement age for women and men**

The demographic data and trends legitimise an open debate on the equalization of the retirement age for men and women. The European legal framework asserts the progressive

**Fig.3. Life expectancy at 65 for men**



**Fig.4. Life expectancy at 65 for women**



Source: EC&EWA (2009) *The 2009 Ageing Report: Economic and Budgetary Projections for the EU27 Member State (2008-2060)*

implementation of the general principle of equal treatment for men and women in the field of social security, however allowing exceptions and long transition periods. The public pension schemes can be excluded from the application of the equal treatment principle, specifically on different retirement age for men and women if such discrimination is compensating for gender inequalities existing in society (art. 7.1 Directive 79/7).

In EU, the approach on this issue is mixed, but most countries are moving towards equalizing the retirement age for men and women (Fig. 5). According to the European Directive, the Member States have to assess periodically the social context the exceptions from equal treatment are based on and have to decide if these exceptions are still grounded in the social reality.

In Romania, the retirement age for women is five-year lower than for men. This creates a gap in the value of pensions received by men and women. Part of it is attributable to the existing payment gap during active life because of the concentration of women in hierarchical positions and fields with lower salaries. However, the most important factor is the early exit from labour market. The calculation

of the pension is based on the number of points accumulated while in employment and, by default, it penalises those who exit early. Women are obviously more affected.

Women that retire at standard age with full period of contributions have an average pension lower with 10% than men's. Fewer years of contributions mean fewer pension points and a smaller benefit. Even more, women are using the early retirement schemes more frequently and that can lead to a decrease of the average pension with 50%. The preservation of the current situation can add to the poverty risks which are already higher for women over 65 relative to the men of same age.

**In Romania a woman can spend a third of her biological life on state pension**

The pension system doesn't impose a mandatory retirement age, but usually the age eligibility limits have a significant impact, especially when the

retirement is perceived as an alternative to unemployment. The risk to lose the job is present for all ages, but it is higher for those that would qualify for retirement (considered therefore somehow protected). Preserving differentiated retirement age limits for men and women is actually encouraging the early exit of women from labour market, thus going against any

**Fig. 5. Statutory retirement age in EU Member States**

	AT	BE	BG	CZ	DE	DK	ES	FR	HU	IE	IT	NL	PL	PT	RO	SK	SE	UK
<i>F</i>	60	64	60	65	65	66	65	60	62	65.5	60	65	60	65.0	58.8	62	64	60
<i>M</i>	65	65	63	65	65	66	65	60	62	65.5	65	65	65	65.0	63.8	62	64	65

Source: Eurostat (2009, data for 2005); in Romania the retirement age is gradually increasing to 60 years for women and 65 years for men, by 2014.

#### Equalizing retirement age in EU

Equal retirement age	Moving towards equalizing	Different retirement age
Cyprus, France, Ireland, Netherland, Portugal, Sweden, Spain, Luxembourg	Austria, Belgium, UK, Estonia, Germany, Latvia, Malta, Slovakia, Hungary	Bulgaria, Czech Rep, Italy, Lithuania, Poland, Romania, Slovenia, Greece

Source: Report by the Commission's Network of legal experts in the fields of employment, social affairs and equality between men and women (2007)

Another claim in favour of a reduced retirement age for women is the role played by women in the family and household. Currently, the statutory child care period is counted for the vesting period, limiting the negative impact on the eligibility for pension. The role played in the household is somehow more complicated. As in Romania the women have "two jobs" (at work and at home), the decision-makers consider that earlier retirement for women is solving the problem. However, early retirement is not a solution for the existing gender inequalities but rather an aggravating factor. It actually encourages women to exit earlier the professional life. The decision on the role division in the family should belong to the couple and not to the state.

**The argument that a "social right" cannot be withdrawn is not true, especially when it comes to benefits based on redistribution**

The negative impact of early retirement of women and the demographic reality (women live a longer and healthier life after 65) combined by the financial constraints are sufficient arguments for equalizing the retirement age limits. To preserve the gender discrimination is no longer justified in this situation.

### **c. Elimination of special retirement schemes**

Special pensions reflect the privileged position of some professional categories, concentrated especially in the fields that formed the repression or the power circles in the past. For regular people, it is used the system of work categories (*grupe de munca*) that takes into account the difficulty and the risks attached to the working place. The retirement age and vesting period are reduced for those working in more difficult conditions.

For the privileged groups, the retirement is regulated by special laws that created and consolidated in

time much higher benefits and laxer retirement conditions compared to the rest of the people. The system is deeply and unjustified inequitable. The responsibility of a medical doctor could be equally high to that of a judge and yet they have very different retirement conditions. The claim of the special role played in society of these professional categories is 100% discretionary.

It is also claimed, especially by the magistrates, that no changes of the retirement conditions can be adopted because it affects the incentives of entering the profession, breaching therefore a virtual contract between the state and the individual. Such an argument is by far unreasonable because it would imply the freezing of any reform in any field whatsoever.

Similarly, the claim that a right acquired in the past can't be diminished or withdrawn (which, by the way, is not a general legal principle) should be brought forward with much caution, especially when discussing social rights provided via redistributive social legislation. European Court of Human Rights (ECtHR) considers that the state has a very large discretion when deciding social policies<sup>5</sup>. Furthermore, ECtHR regards the government as in the best position to decide social policy changes in order to adjust them (including the decrease of benefits) to the social and economic context. The only direction that ECtHR may take in the future is for the state to ensure a minimum applicable to extremely small benefits (by

<sup>5</sup> See *Stec & others v UK* 65731/01 and 65900/01, par 52. Article 1 Protocol 1 could include the pension under property rights but subject to several conditions, including how the system is structured; even here the state has a wide discretion, including in the decreasing of the benefit. Most cases on social rights are not admissible to ECtHR

**Fig. 6. Special pensions in Romania**

	No of recipients	Average Pension (lei)		
		TOTAL	From Pension Fund	From State Budget
1. Diplomats - Law 36/2003	704	4,295	1,961	3,282
2. Pilots – civil aviation - Law 223/2007	1,539	9,177	1,814	7,541
3. Other technical personnel – civil aviation - Law 95/2008	108	-	1,713	-
4. Parliamentaries - Law 96/2006	522	3,648	2,121	1,600
5. Public Servants – Parliament - Law 7/2007	388	2,767	1,823	2,008
6. Magistrates (judges and prosecutors) - Law 303/2004	2,684	8,589	1,709	7,498
7. Court technical personnel - Law 567/2004	1,952	2,934	1,108	2,172
8. Court of Accounts - Law 217/2008,	300	5,474	2,087	4,145

Source: CNPAS

applying Art.3 prohibition of inhuman and degrading treatment)<sup>6</sup>. This situation is obviously not applicable for special pensions, as it can be seen in Fig.6.

The unification of the pension system is necessary when considering the general interest and the financial capacity of the state to fund it. The competence of such decisions lies entirely with the executive and legislative. The alteration of these regulations using judiciary decisions would represent the overstepping of the constitutional boundaries of the judicial power. The judge would become in such situations a legislator.

To conclude, the special role of different professions is reflected in the payment. The scaled payment

<sup>6</sup> Speech of Jean Paul Costa, president of EctHR, Oct 2008, Sorbona ([http://www.echr.coe.int/NR/rdonlyres/42BD71A1-099A-4B88-B907-185CFF3B3968/0/2008\\_Strasbourg\\_colloque\\_déclaration\\_universelle\\_16\\_10.pdf](http://www.echr.coe.int/NR/rdonlyres/42BD71A1-099A-4B88-B907-185CFF3B3968/0/2008_Strasbourg_colloque_déclaration_universelle_16_10.pdf))

levels and work categories are instruments that can properly preserve the status also in retirement. Special laws reflect only the tendency of power groups to place themselves above the general rules applicable to every other citizen of Romania.

#### **d. Breaking the link between the value of the pension and the average wage**

One of the circulated myths is that pensions in Romania are low. In reality, people who retire at standard age with full contribution period receive on average a net pension of €240, representing 74% of the average net salary. Such replacement rates are well above the poverty line and among the highest in the region (World Bank, 2009). In Western Europe this replacement rate is reached only by cumulating the compulsory pensions with the voluntary private ones (OECD, 2007).

In Romania, the many of the small pensions are the result of early

retirement. Out of the 4.7 million pensioners (excluding agriculture workers and recipients of special pensions), only 1.9 million fulfil all conditions of age and contribution period, all the rest are receiving a diminished benefit.

A study conducted by OECD<sup>7</sup> found that a replacement rate of 80% from the net incomes during active life would generally allow the preservation of the standards of life in retirement. However this doesn't imply that such replacement rate should be provided by pillar 1 (public scheme). Each person should be responsible for her own savings, either directly or via voluntary schemes and it is happening in practice. World Bank<sup>8</sup> shows that the preservation of life standard in retirement is not dependent only by the replacement rate of the public scheme: people tend to save more in the countries with low replacement rates and vice versa.

Therefore, breaking the link between the pension point and the salaries increase could contribute directly to the balancing of the fund and indirectly to the stimulation of individual savings. The current draft law proposed by the Government is a compromise as the indexation of the pension point is linked to both inflation and wage increases.

#### **e. Broadening the tax base**

The financial situation of the pension fund cannot be balanced in due time only by limiting the eligibility and pension value. The Government has to find ways to increase the revenues, but without increasing the nominal contributions: in the '90s the rise of the contribution rates lead

actually to a decrease of the revenues.

It is necessary to increase the tax base and to enforce more firmly the existing legal provisions. Now, the legislation allows for a widespread usage of service contracts and intellectual property contracts, although in reality the nature and workload would require a work contract. Therefore, no matter how unpopular it will be among some professional categories that are privileged by the status-quo, the government needs to act: first, to include different types of incomes assimilable to salaries for the calculation of the social insurance and second, to limit the abuse of alternative contracts.

The proposals discussed here – equalizing of retirement age, limitation of early retirement, elimination of special pensions, broadening of the tax base – are all included in the draft law proposed by the Government, although in a moderate version, with long transition periods. If the Parliament fails to pass the law in an acceptable form, or if the implementation will be sabotaged by court decisions, the future looks bleak, even in the short run. ☞

<sup>7</sup> OECD (2001) *Ageing and Income: Financial Resources and Retirement in 9 OECD Countries*, OECD.

<sup>8</sup> Holzmann, R., Guven, U (2009) *Adequacy of Retirement Income after Pension Reforms in Central, Eastern and Southern Europe*, World Bank

### 3. (Counter)reforms in energy

We went too far, too fast – and now backtrack towards our usual position at the bottom of the heap

Romania has succeeded in just a few years, from 1997 to 2005-2006, to reform from the grounds its energy sector, particularly electricity and gas, a reform praised by international organizations and the European Commission. The pace of the reforms in district heating and energy efficiency was somewhat slower. The comprehensive restructuring of the energy sector would have led to higher energy security for Romania by diversifying energy sources, freedom of choice for the consumer, more efficient consumption and competitive prices.

Our reforms followed the EU principles to establish a single, competitive energy market, and Romania advanced faster than some old member states, such as France, to achieve this goal. Even though the reform was never finalized, some of its advantages had become visible: the performance indicators in some companies improved significantly (Turceni, Rovinari, which doubled their productivity even though they remained in state hands); a competitive energy market emerged and has the potential to turn into a regional exchange (OPCOM, on which about 30% of the Romanian electricity is put up for sale competitively).

Among the newly-created institutions were an independent regulator, which became a good practice model for the region in its first years, and an impartial transport system operator, not involved in any energy deals, which has managed to upgrade and connect our national system in the European network UCTE. We finally introduced tariff structures that promised to cover the operational costs of gas and electricity systems, avoiding cross-subsidies; private investors became interested in energy, not only for distribution, but also for production, a crucial element considering that the state did not have after '90 money or capacity to make any significant new investment in production, except to finalize units 1 and 2 Cernavodă. Last but not least, we gained new competencies in managing a decentralized energy system and electricity markets.

Unfortunately, reforms have stalled since 2005, despite our commitments to the EU and the consumer interests. Here are the crucial issues in the energy sector and the bad ideas that could be the undoing of the Romanian energy sector for a long time.



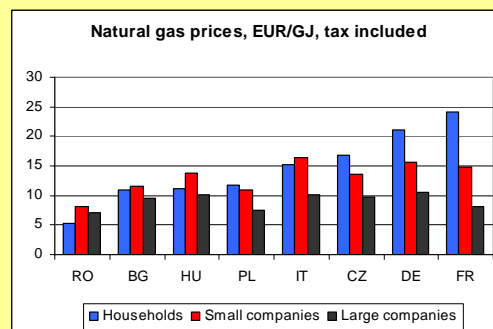
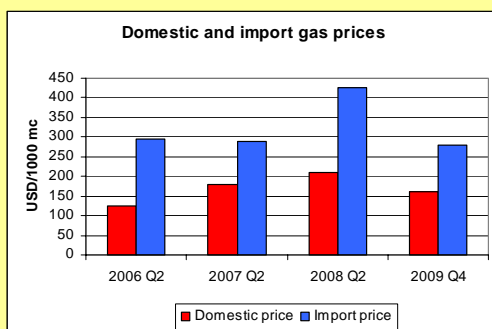
### Textbox 2: The “cheap domestic gas” illusion

The reason why Romgaz was never privatized is the fact that cheap gas is an excellent political instrument in election years, but also because favored companies can benefit cheap energy. However, the cheaper the gas, the faster the demand surges to unsustainable levels, leading to waste of limited resources. At the current extraction rate, Romanian oil and gas resources would be exhausted in about 15 years, whereas the only alternative today is Gazprom, which will remain the sole source if we go for South Stream instead of Nabucco. The domestic gas consumption was around 60% of total, but in 2009 the domestic gas share reached 80-90%, however, from a declining demand. The main consumers are the industry (72%), particularly steel and petrochemicals; residential consumption amounted to 20%; and the remaining 8% consisted of technological consumption.

In addition, if some benefit cheap gas, not only will resources be depleted faster, but the allocation will be distorted, possibly also the competition within or among sectors. The priority for cheap domestic gas in 2009 thus represented an additional state aid for the petrochemical industry (RAFO-Oltchim-Arpechim; Azomures) and for steel (ArcelorMittal). The access criteria to cheaper gas were contested by other companies in the sector, and the Competition Council started an investigation on these criteria (interruptible consumers with a minimum daily consumption of over 1 million cubic meters, so SMEs were excluded).

We have agreed with the EU to eliminate such distortions by end-2008, by aligning domestic to import gas prices but, under the pretext of the crisis, Romania has asked for an extension until 2010, even though the import gas price was decreasing. Efficiency and competitiveness are disregarded not only by decision makers, but also by most commentators, which encourage decision makers to adopt the populist solution. However, Romania faces the possibility that the European Commission might launch an infringement procedure, just like in the case of electricity now (for the regulated tariffs and failure to continue market liberalization). In addition, at today's prices, well below the true market value, the exploration and development of new resources is not economically feasible, because Romgaz could not cover the costs at current tariffs.

Like in the case of electricity, there is really no reason why gas could not be traded competitively, maybe even on OPCOM, where Romgaz would auction its production and sell to the highest bidder. There are only three gas suppliers in Romania – Petrom, Romgaz and Gazprom (through intermediaries) – but there is a certain competition with oil (gas and oil are fairly good substitutes). Regarding the social protection of the residential consumers, a more appropriate solution would be to target the poorest households (income support) and reduce energy losses in residential buildings by thermal insulation (where losses amount to 40-50% of energy consumption).



*Figures: Domestic gas prices are well below market values (import price); we have the lowest prices in the EU for gas, which could trigger the infringement procedure from the EC, because our industry is not competing fairly in the single market. Sources: Petrom; Eurostat.*

### Textbox 3: Downsides of the integrated energy companies

In our previous reports on energy we explained why setting up integrated energy companies is a bad idea. In a nutshell, instead of regional champions, we create locally dominant companies, because our cross-border interconnections are limited to 10% of consumption; some companies (Termoelectrica, mines) could hide their inefficiencies by cross-subsidies from Hidroelectrica, for which the EC might sanction us; the two companies cannot obtain better lending terms on the financial markets than their components today, whereas in the next 5-7 years all existing thermal production must be replaced; and the trading on OPCOM would be seriously impaired because of higher market concentration. In addition, the well functioning of an energy market with two giants would be a challenge to the regulators (ANRE, Competition Council).

The uncertainty caused by the creation of these companies has already affected investment decisions: private investors have put on hold investment plans in new generation, but not because of the crisis. Power plants with a total capacity of 4000 MW are in this situation: GDF Suez - Constanța (800 MW) and Borzești (400 MW); EON and Enel - Brăila (800 MW); Alro - Turnu Măgurele (900 MW); Energy Holding - Sărdănești (700 MW); CEZ - Galați (400 MW). On top of this, PPPs already agreed upon by Termoelectrica with private investors share the same fate: Galați – EON, Enel; Brăila – CEZ; Borzești – GDF Suez, all postponed until the government clarifies the market domination issues surrounding the creation of the two companies.

On top of that, there are older uncertainties in the sector, such as the Tarnița project, delayed for years because we cannot make up our minds whether we want to export ancillary services or use them locally, or with what money to finance the project; and Energonuclear, a consortium of Nuclearelectrica and private companies to build units 3 and 4 Cernavodă, postponed because the state has not firmly stated whether it would participate with 25% (what is doable) or 51% (wishful thinking with no money). In electricity generation, the only certain private projects are Petrom's gas power plant in Brazi (860 MW) and the CEZ' wind farm at Cogealac-Fântânele (600 MW). Without investments, we will soon face major energy security issues like nothing we've seen before. *Source for data: [http://j-constantinescu.org/\\_Noutati.html](http://j-constantinescu.org/_Noutati.html)*

## What should be avoided

### 1. Abandon reforms if there are no external pressures

As soon as our EU accession became certain, from 2005-2006, the implementation of the energy Road Map agreed upon with the EC during accession negotiations was stalled and then practically abandoned. All parties, regardless of color, including the authors of the Road Map, are currently proposing ideas that are contrary to the principles in that strategy, mainly supporting the reconsolidation of the energy production units, which remained fully state-owned, in integrated giants (PNL one, PSD one, PDL two) and, accordingly, discouraging

private investments in the energy sector.

Though what had not been finalized in the *Road Map* was reasserted as priority in the first draft of energy strategy 2007-2020, in the final, approved strategy the reform was also officially abandoned. Thus, the government proposed the creation of one (then two) energy champions which would concentrate almost all generation, and practically cancel other measures (Textbox 3). Uncertainties surrounding this restructuring and the negative effects of consolidating dominant market players cause major delays in all key actions needed in the energy sector, mainly investments and the development of truly competitive

markets, with real, economically justified prices.

Privatizations, stalling since 2006, are now explicitly abandoned: some of the companies for which privatization strategies had been prepared under PHARE projects, such as Turceni or Rovinari, will now become part of the energy giants. Instead of moving forward with the liberalization and increasing competition in the energy sector, the consolidation of the sector in two companies (almost certain, despite strong opposition in the sector) reverses the reforms pursued until 2005-2006.

In addition, because of elections or to support favored companies, the liberalization of wholesale and retail markets froze; poor tariff regulation distorts markets, eliminates the price signals for the investors and "justify" contracts with the "smart guys"; gas from domestic sources continues to be cheaper than that from imports and is either preferentially allocated to companies (such as petrochemical industry, supported "during crisis" just as much as it had been before), or we get a "basket price" that aggravates the lack of transparency, all in the name of (artificially) cheap gas for the population (Textbox 2).

Keeping regulated prices at low levels does not support sustainable use of resources and, in addition, dissuades the entry on the competitive markets. For example, in the electricity market, consumers (households, but not only) benefiting regulated prices would rather remain "captive" with their current supplier than enter the competitive market, where they would have to pay much higher prices, above the marginal costs of generators which do not participate in the "basket".

## 2. Sales at a loss to the state

In the Romanian energy sector, a major source for corruption and / or distortions of the competitive market is the sale of resources below true market value to preferred customers. This happens in a variety of ways, in both electricity and gas sectors. The media has highlighted many times the issue of the bilateral contracts signed by Hidroelectrica with private energy intermediaries in 2001-2004, at state loss-making prices (Textbox 4); there are also customers who benefit cheap gas from Romgaz, by so-called anti-crisis measures to save the petrochemical industry in 2009.

While some contracts with the "smart guys" have been successively

### **Textbox 4: The Centralized Market for Bilateral Contracts (PCCB) and Hidroelectrica**

One of the facilities available on OPCOM is the option to trade electricity competitively on the wholesale market. PCCB is very flexible and one can auction here electricity at terms and delivery dates specified by the supplier (that is, also long term contracts), plus standardized contracts (Forward) on the continuous negotiation market. There is no reason why Hidroelectrica cannot sell electricity in long term contracts, at terms it deems favorable, using the centralized auctioning option, to the highest bidder. What is more, this market facility exists since 2005 and was created specifically to avoid what happens now with the "smart guys" contracts.

Currently, Hidroelectrica does not sell electricity on OPCOM, and the prices it negotiates with buyers are about 50% of prices on the competitive market. Hidroelectrica doesn't sell to the highest bidder, as it should; on the contrary, in December 2009 it sold at the first price offered by a buyer. In draught years, such as 2003 or 2007, Hidroelectrica made losses from firm selling contracts, as it had to purchase electricity from the most expensive generators to cover its obligations.

extended until 2014, others expired in 2009. One must watch whether the “non-committed” energy will be sold now competitively on OPCOM, as it should. But worryingly, now, Hidroelectrica’s management publicly supports the idea that the company needs to negotiate new long term contracts, in order to guarantee for loans needed for investments, suggesting that such contracts cannot be traded on OPCOM.

### 3. South Stream instead of Nabucco

The more choice we have on gas sources, the safer the supply. Gazprom’s tests and the ambiguous responses from the Romanian decision makers have no effect but to compromise us in the EU, because the South Stream project is exactly the kind of bilateral agreement between Russia and an EU member state which renders the EU’s common energy policy a joke. Every time a member state defaults on its commitments to the EU policy (beginning with the agreement for the North Stream between Germany and Russia in 2005), EU loses some of its power to negotiate with Russia good supply terms for all member states, on a relatively equal footing with Moscow.

But even from a selfish point of view, for Romania in isolation, South Stream means nothing more than an additional gas supply from Gazprom. Nabucco is strategically important for the EU and for us, as it brings to the European market gas from Azerbaijan, Turkmenistan and Kazakhstan, possibly from other countries which would eventually connect to the pipe, thus limiting the EU dependency on Russian gas.

Last but not least, Nabucco and South Stream both eliminate Ukraine’s monopoly on the gas transit. But as South Stream maintains Gazprom’s supply

monopoly, eliminating only Ukraine from the chain, Russia would gain more power in its relationship with the EU. In previous years, the conflict with Ukraine has checked the otherwise stronger supply monopoly powers of Moscow.

### 4. Incoherent policy measures (decoupling energy efficiency programs, abandoning district heating reform)

Romania faces various challenges: competitiveness, energy efficiency, environment protection. For example, a World Bank study evaluates our total costs to meet the environment constraints from the EU’s “20/20/20” strategy at 12.5 billion € by 2020 (6.1 billion by 2015). A large portion of these costs are directly connected to the energy sector, such as investments in hydro and nuclear generation capacity, with zero CO2 emissions.

On the other hand, inadequate measures in one subsector generate negative consequences on commitments in other areas. For example,

supporting the mining sector by (cross)subsidies stimulates the electricity production in polluting thermal power plants, canceling the environment benefits gained by trading green certificates or emissions; cheap gas for industry leads to waste and higher energy intensity (energy consumption per unit of GDP).

The 2007-2020 strategy correlates these aspects, but the implementation in recent years has fully disconnected the measures in various sectors. For example, the district heating strategy of 2004 was abandoned, rewritten after 2005 and abandoned (delayed) again. Currently, building insulation is implemented chaotically; where something is done (districts 1 and 2 of Bucharest), thermal insulation does not consider priorities or the

**It is unclear why Hidroelectrica does not want to sell transparently on OPCOM; the Minister’s Order 445/2009 must become a law**

empowerment and motivation of the beneficiary, and the metering / thermostatic valves program has not been finalized yet. As the efficiency of investments in district heating networks and combined heat and power plants depend on demand for heating, the lack of information regarding what the consumer can pay spills over investments. Worse, in the "District Heating strategy 2005–2007", about 600 million € were spent in projects later abandoned.

### 5. Stopping privatization for the wrong reason

Because privatizations in the past have not been transparent enough, the last governments were afraid to continue them with strategic investors; on the contrary, public voices reinvented the argument "we are not selling our country (anymore)". PDL and the president strongly opposed the privatization of Romgaz, for example, because of the "PETROM precedent". But the worst mistake was to stop privatization of thermal power plants when the context was favorable, before the crisis, when for each of the plants there were 4-5 interested investors.

Privatizations started, naturally, with distribution and supply, to create credible customers for the thermal production. The sale of electricity distribution companies to ENEL, CEZ, EON, were later linked to corruption scandals which hid the real success story of these privatizations: the performance and profitability of these companies improved significantly, mainly by expenditure rationalization, and the value of Electrica's minority shares in the privatized companies became higher after privatization than the original value of the full branches. But populism and lack of attention for the real reform agenda transformed any rational discussion in political buzz.

### What should be done

Without enforceable external threats to do what we should do, we systematically fail to see the really important and urgent challenges in the energy sector:

**A. We urgently need major investments in the sector; otherwise we will have a major energy supply crisis in just a few years**

#### Textbox 5: Financing sources for investments

As the money the state can use in the energy sector is limited, one must prioritize public investments, considering inter alia also that the EU is very strict on state aid rules. In reality, the public interest justification for state intervention applies for networks and hydro services only, whereas for the remaining projects private financing and management must be sought. As **state resources** we could use the money obtained from privatizations so far (Electricas, Distrigaz N and S, Petrom).

In electricity, **private sector financing and management** does not affect energy security, as the state would continue to own Hidroelectrica and Nuclearelectrica, which is about half of the domestic production (after finalizing units 3 and 4). In addition, energy security issues concern transport-interconnection services (natural monopolies) and ancillary services (continuity of supply), 90% of which are supplied by Hidroelectrica. Because of this, privatizations in the thermal generation sector and private investments, PPPs included, are not a hazard, but a must (Turceni, Rovinari, Craiova, Deva, Bucuresti, PPP-uri pentru Borzești, Doicești, Brăila, Galați etc.).

The investments needed to meet our environment commitments, which would also upgrade the inefficient, polluting generation capacities, could be financed also from **CO2 emission ("AAU") sales proceeds** from the Kyoto agreement. Depending on market prices, the amount that can be obtained is of 2.5-3 billion €.

Specialists estimate that as early as 2015 we would face real energy security issues, because the generation capacities are old and obsolete, inefficiencies accrue in the system, we make mistakes in strategies and our EU commitments are approaching the deadline, particularly the environment (Textbox 5).

Between 2008 and 2013 we must upgrade or close polluting thermal power plants, at Deva, Turceni, Rovinari, Craiova, Paroşeni, ELCEN,

**B. Instead of creating giants to become important in the region, we should use our existing assets and advantages**

The Romanian energy sector has some leading institutions in the region: Hidroelectrica, Nuclearelectrica, OPCOM, Romgaz, Transelectrica, all of which are well performing and could potentially become best practices. One must however use the advantages of this privileged position. Thus, OPCOM can become a regional market, and

**Textbox 6: An alternative strategy: "20x5"**

The more the energy supply sources are diversified, efficient and clean, the higher the energy security. In electricity, instead of focusing on maintaining old coal-based power plants as last resort supply, specialists propose a balanced energy mix from equal shares of renewables (wind, geothermal, micro hydro power plants, biomass); large hydro power plants; gas; coal (lignite); nuclear (including units 3 and 4). The novelty consists mainly of the high share of renewables (40%, including large hydro). However, there is significant interest for wind plants. Transelectrica received requests to approve connections for 3,900 MW, and there are requests for approvals for wind farms totaling well above 10,000 MW.

*Data source: [http://j-constantinescu.org/\\_Noutati.html](http://j-constantinescu.org/_Noutati.html)*

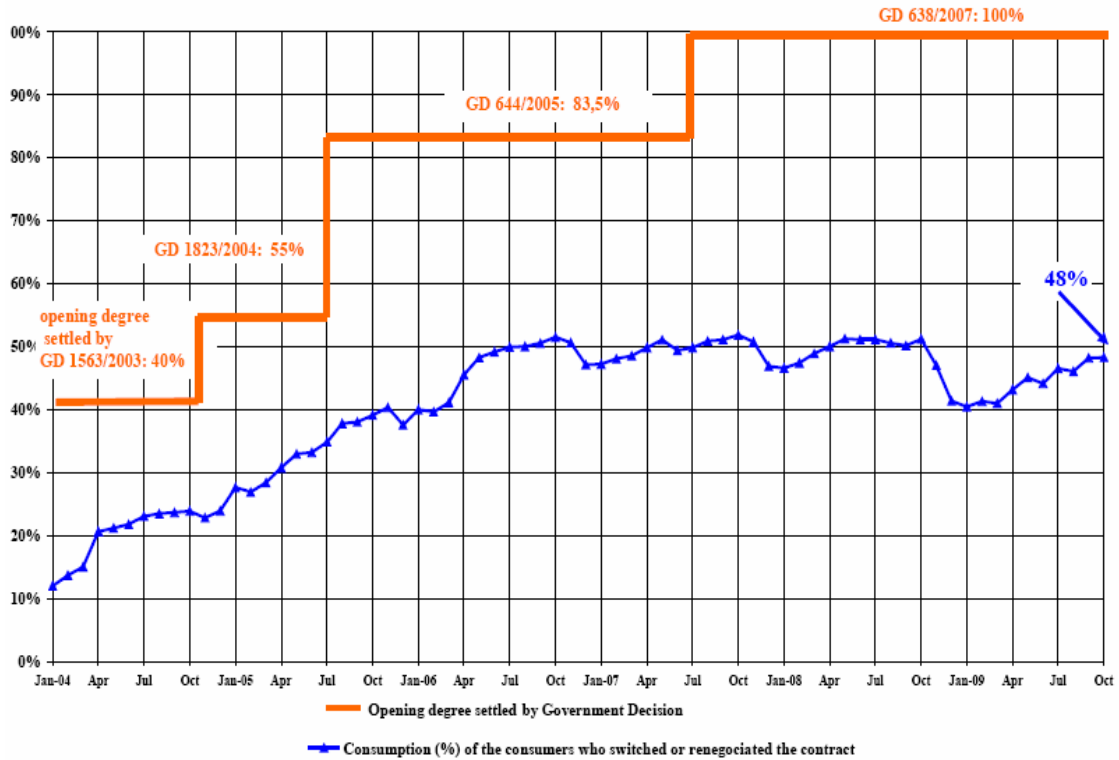
Termoelectrica. These do not meet EU standards for NOx emissions and dust<sup>9</sup>. For the moment we have not done much to upgrade these units and the state will never have enough money for replacements. Only in the thermal generation we would need about 5-7 billion €, considering that our plants have a very low productivity – on average 35%, 20 pps below European averages. The money cannot be supplied in full by the state – the government doesn't have enough funds and there would be state aid concerns, except for environment investments – and we cannot count on EU funds either, from which we could get a maximum of 3-400 million €.

Romania a "regional hub" for energy and ancillary services: we are negotiating now the extension of OPCOM's trading platform towards the West (Hungary, Austria), but a more interesting option would be the extension towards the South (Bulgaria, Serbia, possibly Greece). This would help to diversify the electricity supply on national markets and would lead to lower prices for consumption peaks, when more expensive generation units are used.

In other words, when Romania has a consumption peak (during the winter), in Greece the electricity consumption is low; so we could buy energy from there, which would be cheaper than in our most expensive plants we now have to put into operation to cover the peaks; and the reverse. Also, by finalizing the Tarnița pumping station we would cover the ancillary service needs and could operate at maximum capacity

<sup>9</sup> The full list can be read here: [http://www.mmediu.ro/pdf/legislatie/controlul\\_poluarii/29oct2009-proiectHGinstalatii-mari-de-ardere.doc](http://www.mmediu.ro/pdf/legislatie/controlul_poluarii/29oct2009-proiectHGinstalatii-mari-de-ardere.doc)

Figure 7. Legal and effective electricity market liberalization. Since 2006, effective liberalization remained at 50%. ANRE, 2009



the Iron Gates. Hungary and Austria are also interested in purchasing ancillary services from us. Regarding nuclear energy, we must speed up the Energonuclear project, before the private partners are permanently discouraged by the delays in the project.

In the gas market, Romgaz could become a much stronger company if allowed to collect the real value of its supply. It should focus more on the West than on becoming more dependent on Gazprom, for example through the gas storage project at Mărgineni.

In the region, the first concern in the gas sector should be our active involvement in the Nabucco project. The EU is considering the option to create one company which would act as a single buyer of gas from Nabucco (Caspian Development Corporation), which would increase EU's negotiation capacity and could also guarantee the supplier a steady market for large quantities of gas (mainly to Turkmenistan), so that

suppliers view CDC as an interesting counterpart. Instead of defaulting on EU's dream to establish a common market, by negotiating also the South Stream project with Gazprom, Romania should get involved more seriously in the Nabucco project, which would increase our regional credibility.

### C. Adequate tariffs

Energy prices must reflect economic realities: scarcity of resources, sustainable use and allocation based on economic criteria. Domestic gas prices must converge rapidly to import prices, as we committed to the EU and to avoid wasteful use of national resources. In addition, the energy must not be used to grant nontransparent state aid which distorts markets.

Also, regulated electricity tariffs for "captive" residential consumers must not be below market levels, based on "cheap supplies" from Hidroelectrica and Nuclearelectrica. For social protection we need a targeted,

means-tested system, with no connections to the energy market.

The paradox is that regulated tariffs are non-transparent in Romania. We don't know why and how some thermal generators get high prices, why retail prices increase by 4% when on the liberalized wholesale market prices drop by 20%. Regulated tariffs today force Hidroelectrica and Nuclearelectrica to sell for 50% of the market at low prices, which generates losses for the two companies, and the consumers have no incentive to leave the regulated market for the competitive one. This is the main reason why liberalization has stopped at about 50% since 2006 (Fig. 7) and why the EC has threatened Romania with an infringement procedure. What is more, the tariff setting on gas and electricity markets must be correlated, to avoid possible distortions between the markets.


#### D. Competitive sale

Electricity produced by state-owned companies must be sold competitively, with no exception. For electricity there is the Order 445/2009 which requires state-owned electricity producers to sell on OPCOM. However, a Ministerial order is not powerful enough and can be amended many times depending on interests and punctual crises, as shown by the fact that since 2005 the order was adopted and suspended several times, with a lot of scandals.

For this purpose we should have a law, with the same power as Ordinance 34 for public procurement, so that the state cannot sell cheaply without fair competition. The debate on the "smart guys" in the energy sector must not eliminate intermediaries on the market, but to promote transparent, competitive trading so that intermediaries which bring added value are rewarded (e.g., adapting energy supply according to consumer needs).

In short, a law must regulate the way in which the state sells its assets or products, mirroring the principles in public procurement, to avoid a governance risk: the temptation to favor some customers, at the expense of the citizen. Corporate governance legislation must apply to state-owned commercial companies rules similar to those applicable to public institutions, allowing them to compete on markets.

#### E. Institutional reform

For the energy markets and system overall to work well, we need independent, competent regulators (ANRE, ANRSC); also, a good cooperation of these regulators with the Competition Council is crucial to properly regulate the market; and state owned companies and regulators must employ their management based on clear performance indicators, on a fixed term. If indeed the integrated companies are to be created, the electricity market regulation will be a challenge for all regulators, so it is vital that their capacity improve accordingly. 

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