POLITICS

TREND: INSTITUTIONAL INSTABILITY

The central government keeps growing instead of improving its efficiency. Bad omens for the business environment.

Too many Institutions in Charge of Economic Policy

One year ago, in the first issue of the Early Warning Report, we were arguing for a downsizing and simplification of Romania's central administration[1]. The main reason for this recommendation was not related to the potential savings resulting from such a measure – although this would undoubtedly represent a positive effect – but rather to the ineffectiveness of decision-making processes, caused by the expanded and unstable structure of the central government. In brief, the EWR's conclusions were that:

- The current Romanian government is by far the largest in the region, with 26-27 ministry portfolios (whilst the average size of cabinets in other EU candidate countries is 16).

- The large size of the cabinet is affecting the speed and coherence of decision-making, which contributes to the perception that Romania is a laggard in the process of reforms and EU accession negotiations.

- Many new public institutions are created, but very few are ever dismantled when they eventually accomplish their mission – or when they blatantly fail to do so. As a result,

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[1] Focus: Central Administration Performance, in *Early Warning Report*, May 2001.

the policy-making bodies become increasingly fragmented, and there is an ever-growing overlap in their attributions.

- Instability of structures means that institutional memory is lost, staff becomes de-motivated and permeable to political pressure, and policy making very much personalized. As a consequence, the real balance of power amongst public agencies does not rely on transparent rules, but rather on the personal influence and political control that their heads can exert informally.

- The excessive plurality of structures and their unclear mandates increase the probability of turf wars, rent-seeking behaviour and confiscation of public agencies by private interest groups. The more agencies deal with one issue, the more numerous are the entry points for lobbying. Fewer, larger central ministries would be able to integrate better many issues before bringing them on the cabinet's agenda, thus producing more coherent strategies, saving time and cutting down on the overhead costs associated with multiple ministries.

- Apart from the line ministries, which are numerous anyway, there are simply too many bodies in charge with economic policy and administrative coordination within the government. Some offices are redundant (e.g. the secretaries of state for the relation with the Parliament, since there is a special ministry for this purpose), others do not have a clear mandate (e.g. Ministry of SMEs, Ministry of Development and Prognosis – the prognosis component). The crosscutting attributions and the complex pattern of subordination approximate a matrix-management structure, which would require, in order to function properly, a higher administrative capacity than Romania's government currently has.

After making a comparative analysis of the structure and attributions of the Romanian government and of nine other CEE and EU governments, the EWR recommended that Romania's government be drastically reduced in size and simplified in structure. One suggestion made was that the PM's office take charge of – or delegate more clearly – three fundamentally important policy areas, namely economic coordination, institutional reform, and European integration. In particular, the EWR highlighted one year ago the urgent need to consolidate economic policy making, and offered an example of best practice from France, namely a single umbrella structure for economic strategic management, in the form of a Ministry of the Economy.

Sadly, things have not improved over the past year; on the contrary, the flaws identified then tend to aggravate. Fig. 1 presents the structure of economic coordination in comparative perspective. While the other CEE and EU cabinets have on average 2-3 positions in charge with economic policies, typically strong central ministries with clear attributions and political responsibility, Romania has split this job among no less than six autonomous units (including the Trade Department, until now part of the Ministry of Foreign Affairs). Even the representatives of the junior member of the current ruling coalition (PUR) noted recently that parallel ministerial structures (SMEs and Development-Forecast in this case) lead to internal struggles for controlling the development programs.

Fig. 1. The ever-expanding Romanian government: autonomous units involved in economic coordination

Departments	OMANIA astase	ROMANIA Isarescu	HUNGARY	CZECH R.	BULGARIA	POLAND	ESTONIA	LITHUAN.	FINLAND	FRANCE	ITALY
Min. of Finance	X	X	X	X[1]	X	Xx[2]	X	X	X		Xx[2]
Min. of Economy		X	X		X	X	X	X		X[3]	
Min. of Industry	X	X		X					X		X
Min. of SMEs	X										
Min. of Devt. and Prognosis	X										
Privatization (APAPS)	X	X	X		X	X					
Min. of Enterprise	X[4]										
Prime Minister's Office:											
Economic coordination unit	X[4]			X					X		
Dept. of Trade	X[5]										
Total	**8**	**4**	**3**	**3**	**3**	**4**	**2**	**2**	**3**	**1**	**3**

Legend:
1 Finance and economic policy
2 State Treasury separated from Finance
3 Super-ministry of economy, finance and industry
4 To be set up in 2002
5 To be detached from the Ministry of Foreign Affairs (and formerly part of the Ministry of Industry)

As if the old structure were not complex enough, new innovations have been announced for 2002:

- the **Trade Department** will become an independent unit directly subordinated to the Prime Minister's Office;
- an **economic policy coordination unit** will also be established within the PM's Office;
- and a new **Ministry of Enterprise** will be set up "to reform enterprises and modernize their management".

Moreover, PUR, the junior member of the ruling coalition, also circulated the idea of creating a **Ministry of Energy and Resources**, following the pre-1990 tradition. It seems that PSD is not yet convinced about the utility of this ministry. But the proposal has vocal supporters among the special interest groups connected with the old structure of “industrial directorates” (*centrale industriale*) and public companies in the energy sector, who want a more substantial state intervention in this domain than the one realized by the newly set up regulatory bodies. Such a creation will represent – again – a Romanian innovation resembling the command-and-control structures in CIS countries rather than the modern market mechanisms adopted by other EU candidates, and it will be at odds with the current reform and liberalization strategies.

With a Ministry of Energy or without it, the changes will push even further the fragmentation of the cabinet, raising the number of autonomous economic policy agencies to 8 (or 9), instead of 2-3 like in the other candidate countries. Right now not only the process of decision making, but even that of producing and circulating information is difficult enough among institutions that keep changing and relocating. Increasing their density would make the problem worse. And the failure of the previous institutions (APAPS, Industries, SMEs, Agriculture) to push the reform further will become even more apparent after the new duplicating structures are created to try again where the first have not succeeded.

The first measure mentioned above comes as a consequence of the failure to integrate the Trade Department within the Ministry of Foreign Affairs. The last two reflect the need for a unitary structure of economic policy coordination. However, neither is likely to produce stable arrangements: Trade is relatively large, with more than 200 staff, which will more than double the PM’s apparatus. Their mission here, among other departments and offices they are not functionally integrated with, will be just as difficult.

The economic policy coordination unit, whatever its final name will be, is supposed to be headed by Mr. Eugen Dijmarescu, a technocrat, currently advisor to the Prime Minister. Its formal role and real power are yet to be seen, but they will depend very much on the personal relations of Mr. Dijmarescu with other government heavyweights, such as the minister of Industry. This is bad omens for the stability of the cabinet structure in the long run.

A Ministry for what Enterprises?

A Ministry of Enterprise is something revolutionary, even when measured against Romanian standards of institutional creativity. It is not clear yet whether its task will be

a) to promote institutional reforms and contribute to improving the business environment in general, or

b) micro-manage public enterprises.

In the first case, the task can be accomplished without creating a new ministry. There are currently enough policy instruments and expertise at hand to make the business environment in Romania more transparent and user-friendly. Many commissions, foreign and domestic advisors and independent business associations have written studies and proposed action plans; the requirements of the international financial institutions and the EU acquis also cover most of this area. All that is needed is the political will to make things happen, and a new agency cannot contribute very much in this direction.

If the Ministry of Enterprise will have to reform companies' management, as the latest public statements of the government seem to suggest[2], it is not clear what would be its instruments for doing this, and why would it be more successful where the Ministry of Industry and the Agency for Privatization (APAPS) have failed. APAPS has actually sold most of its assets, and has enough power to restructure the firms left in its portfolio. The Ministry of Industry, legally controlling most of the public companies (regies autonomes) and other "strategic" industrial assets excluded from privatization in the early nineties, also has all the competencies it needs to implement whatever changes it wishes in their management procedures, reform them and eventually sell them. Since it is inconceivable that the new ministry will get involved in the management of private companies, it is hard to see what else is left in its exclusive competence. Most likely, it will become a competitor for power and influence to the two ministries mentioned before – actually, it might very well be that its creation has precisely this purpose, reflecting the cleavages within the ruling party.

However, there is an even more fundamental problem with the (b) approach. The question is: can the state improve the performance or corporate governance of firms by directly intervening in their management? And if it can, why didn't it do it earlier, when much more enterprises were still under state control?

This material argues that option (b) is wrong, and that the state just cannot micromanage enterprises on a large scale. Since the only companies where a new Ministry of Enterprises would be able to intervene directly are the ones that are still state owned, a good part of the economy will be outside the scope of its actions from the outset – which may actually be a good thing. But even for the rest, the assumptions of public intervention, and its instruments, are very different from what the Romanian government has in mind.

[2] The government has recently deplored the fact that, although it has proper instruments to intervene at the macro-economic level, it lacks such instruments for intervening at the micro level.

The latest comprehensive report of the World Bank on the transition countries[3] proposes a useful test for the end of transition: the process is over when the historical differences in performance (more precisely, productivity) between the three main types of enterprises existing in these countries will fade away. The three types are: (i) old firms, still state-owned; (ii) restructured firms, part of them privatized; and (iii) new firms, established after the fall of Communism. In theory the last are the most efficient, whilst the first are the least efficient. According to this view, the ultimate goal of the reform strategy is to apply the best mixture of policies in order for the first two categories to catch up in terms of productivity with the third, to the benefit of society at large.

However, the situation is more complex than that – and here is where the institutional fundaments of the society play a crucial role. **Because it is not necessarily the public or private status of a company that makes the difference, but its rent-seeking power.** Newly established or privatized firms can be just as welfare-destroying as the old, state owned ones, if they are allowed to behave uncompetitively, bend the market rules, steal resources from the rest of the society through direct or indirect subsidies (such as tax exemptions), or even colonize public institutions in order to shape public policies to their advantage.

Some attempts mentioned above to create new central agencies are probably not unrelated to the desire of such groups to advance their private business interests through a public institutional channel (for example, in the energy sector).

The first winners from the early market liberalization and privatization deals (often "oligarchs and insiders", as the World Bank report calls them) have every incentive to lock the market in its current configuration and oppose further reforms that may destroy their competitive advantages. **Therefore, the conflict that the government has to arbitrage is not necessarily that between public and private, but between socially productive and parasitic agents.**

It is precisely in weak and over-extended states, with proliferating and ineffective institutions, that public and private rent-seekers thrive, at the expense of the rest of society. The Communist legacy makes the category of public parasitic firms very numerous; such firms can only live through subsidies from the rest of society. The transition in turn gave birth to private rent-seekers, through both privatizations and the setting up of new firms. Private buyers act rationally when they plunder public resources,

[3] *Transition: The First Ten Years. Analysis and Lessons for Eastern Europe and the Former Soviet Union*, World Bank, 2002.

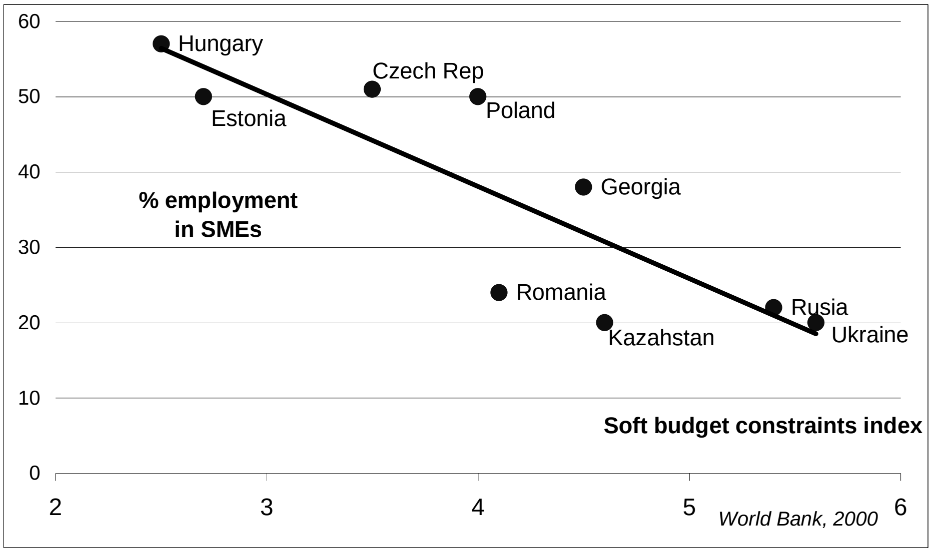
and cannot be blamed if they are allowed to continue to function in the same distorted structure inherited with the assets of a value-destroying firm. And no government office, no matter how much goodwill and effort it invests in the process, will ever be able to alter the behaviour of a large number of public and private parasitic agents, as long as the rules of the game are left unchanged.

This is an important fact that one has to acknowledge**: the government cannot do much when trying to micro-manage companies, even state-owned ones.** Quite often, it is precisely the well-meant public intervention that creates unintended effects such as public agencies' capture (especially in line ministries, where they are supposed to regulate a small number of powerful and specialized market actors – energy, IT, public works; or when the lobby structure is paid with public money – SMEs, trade unions, etc). But even when this does not happen, the government still cannot overcome the so-called principal-agent problem: the management of an organization has much better information about its day-to-day operations and will always be one step ahead the external owners or state agencies that try to control it.

There were many ways in which parasitic firms, public or private, were able to subtract value from society over the last decade in Romania. For many years the banking sector, mostly state owned, was the source of soft loans to various public companies and private business groups. As the privatization of the sector advanced, the direct soft loans were replaced by indirect credits – tax exemptions, preferential regimes, and arrears of payment. The state budget, pension fund and the energy sector thus became the new public creditors of value-destroying firms. As long as they will continue to function in this way, no command-and-control measures imposed by a Ministry of Enterprise will be able to discipline the economic agents. And there is no need for a new ministry in order to impose hard budget constraints. On the contrary, the more public institutions are created to design economic policies, the more entry points in the system the lobby groups will have.

That hard budget constraints improve, not decrease, the social welfare, is fairly obvious after one decade of transition. Though many small and medium enterprises (SMEs) can also be parasitic, in statistical terms they are more likely to be newly established, productive agents. Therefore, a high proportion of labour force employed in SMEs in transition economies is generally associated with a better overall economic performance. Fig. 2 illustrates precisely the consistent pattern of correlation between corporate discipline and economic performance, and thus vindicates the strategies of fast reformers in CEE.

Fig. 2. Financial discipline and reforms



Conclusions and recommendations

The main implication of the above considerations is that the government is not very good – and cannot be – at practicing clean corporate governance of firms. Its role should be limited to creating the conditions for good corporate governance, in public and private enterprises alike, through a transparent and neutral business environment. This objective is perfectly achievable with the current institutional framework, and there is no need to establish new agencies for this purpose.

- The government should eventually consider a **simplification of its structure** that is more than just a mere reshuffle. Ministries such as Industries, SMEs, Trade and Prognosis could be very well placed under one roof – a **Ministry of Economy**. Such a ministry would be responsible for Romania's industrial and trade policy, and would be able to better integrate the policy making process in this field. The idea of setting up a Ministry of Enterprise should be abandoned.

- A special department within the new super-ministry, equivalent to the old Industry ministry, could remain provisionally in charge with the restructuring of the regies autonomes, especially in the energy sector. Divesting enterprises in sectors characterized by **natural monopoly** (where average production costs decrease with the scale of production, so that the society is served better by one or a few large enterprises) must proceed with caution. Fortunately, advances in technology make such sectors increasingly rare. But where they exist (gas, electricity etc.) the government must ensure that an efficient regulatory regime pre-exists the divestiture. Otherwise, an inefficient public monopoly will turn into a poorly regulated private one.

- The business environment must be improved, but this cannot be done by ministries taking over firm management. Rather, **the discipline would be self-enforcing** if the government stops the multiplication of agencies and addresses instead long-neglected issues such as hardening the budgetary constraints on all economic actors, promoting rules against insider dealings and conflict of interests, introducing better creditor surveillance, improving auditing and disclosure standards, and improving the takeover, insolvency and collateral legislation. No new institution is needed to this effect. The job can be done in the current structure, with temporary task forces working on specific issues and on strict deadlines.

- Attention should be paid not only to drafting and passing legislation, as it often happens in Romania, but also to enforcing it. **The judiciary is actually more important for the quality of corporate governance in Romania than any conceivable ministry.** Unless the problems of the judiciary are sorted out – especially in the commercial court system – the self-policing potential of the business community cannot be fully mobilized.

WARNING: Local Governments Reform

Mishandling local issues may create a bad image in Europe for the government – and prove counterproductive at home

Starting with the end of 2001 the government has been perceived as pursuing a sustained campaign on local issues. It all started with the spectacular decision to dissolve the General Council of Bucharest, allegedly because too many local councillors were involved in murky deals with their own institution, which created conflict of interests situations. Subsequently, as the decision was contested in court by some of the councillors, the ruling party got entangled in a row with the general mayor of the Capital, Traian Basescu, over the split of attributions (ex. issuing building permits) or equalization funds between the general mayor and the six mayors of Bucharest sectors. Things got even more complicated when another issue became a matter of dispute: who should manage the

EBRD investment loans that had been negotiated and approved for improving the Capital's infrastructure.

It is not all about Bucharest. The draft Status of Local Officials, initiated recently by the government, was meant to create an oversight (disciplinary) council at the county level that would have the authority to impose penalties on mayors "who do not perform their duties properly", including, in the most serious cases, suspension from office. This proposal received a lot of public attention and was criticized unanimously by the local and foreign experts, and the media. As a result, the initiators backtracked. But since other legislation concerning the local governments is in the pipeline – such as a special law on the municipality of Bucharest, an older idea of the ruling party – it is worthwhile discussing here the relationship between the central and local governments in Romania.

It may not be immediately obvious, but local autonomy is a litmus test for the quality of democratic governance in Europe, and international organizations are very concerned about possible infringements of local autonomy. The Council of Local and Regional Powers (CLRP) affiliated with the Council of Europe is such a lobby group.

If the Romanian government makes unnecessary gestures that may be perceived as attempts to limit local autonomy, this will affect its international standing and its credibility to discuss and possibly reject proposals that may not be appropriate for Romania – such as regionalization. In October 2002, when CLRP will hold its conference on regionalization in Bucharest, only a government that has a proven record of promoting local autonomy will be credible when saying, for example, that setting up a third tier of local governments (regions) may not be a good idea in the case of Romania.

There are a number of issues that the Romanian decision-makers may want to pay attention to:

- The **disciplinary council**, as envisaged in the draft Status of Local Officials, would have been an additional administrative mechanism, besides the prefects and courts of accounts, to oversee the activity of elected mayors. However, Fig. 3 shows that even now there are enough instruments in Romania, more than anywhere in the region, to ensure the checks and balances in local governments and promote the legitimate interests of the county and central authorities. Already in place are the prefects (central government's representatives) to check the legality of decisions, the courts of accounts to check the legality of public spending, and counties that can intervene in money allocations to lower-level local governments. It is hard to see any justification for a fourth controlling instrument, which would single out Romania in the region.

Fig. 3. Accountability and control in local government

CONTROLLING BODY		OMANIA	UNGARY	ZECH R.	ULGARIA	OLAND	STONIA	RANCE
Citizens – elections	Political legitimacy	X	X	X	X	X	X	X
Central government representatives in territory	Administrative control	X				X		X
Upper local government (county, region)	Political control	X				X		
Local government bodies	Peer control	X						

- Moreover, no justification was provided as to why such a body was urgently needed: no examples of irresponsible mayors were given, or of cases where their carelessness was so blatant as to require outside, peer censorship. In such circumstances it is very difficult for the initiators to convince public opinion that their concern for the good of local communities was genuine.

- It may be tempting to proceed expeditiously when a crisis occurs and use whatever instruments are at hand to sort things out. This is what happened when the government **dissolved the General Council of Bucharest** on a technicality, while the real problem was corruption among councilors. But in a democracy the process is as important as the results coming out of it, and appropriate measures should be taken to deal with the source of the problem, not only with its effects. **In this particular case, a clear set of laws and regulations should be initiated to deal with conflicts on interests in the public sector – local governments included.** Simply removing the current councilors from office does not guarantee that the next ones will be cleaner, as long as the rules of the game remain unchanged. Moreover, such emergency measures only undermine the credibility of the local governing bodies, without solving anything – see the current drag over the issue while the case is slowly moving up in circuit courts. The messy handling of the whole affair by the ruling party reflects badly on its democratic credentials.

- A **special law for the municipality of Bucharest** may be an option to consider, if the draft is discussed thoroughly with opinion leaders, stakeholders, domestic and foreign experts and, most important, the citizens. The habit of producing overnight legislative pieces and adopt them quickly as emergency ordinances is unacceptable in this case, given the sensitivity of the issue. The problem may be that such a law is passed at a time when the current government and the Bucharest mayor are political opponents. True, in real world political rivalries often end up by shaping institutions, but there has to be a limit to that. Stripping the general mayor's office of a significant part of its attributions may leave the capital city unmanageable, with very serious consequences in the long run. The over-activism of the Prefecture does not represent a good substitute, since prefects are not elected local government. Many CEE governments were tempted to do the same thing at one point or another, in order to cut down to size opposition mayors – in Budapest, Sofia, or Bratislava. It turned out that capital city administrators were surprisingly resilient and this unproductive trench warfare drained the resources of the central governments. **In the case of Bucharest, the special law should ideally be postponed until after the next elections**, when the composition of different tiers of government, and the relations amongst them, are likely to change.

- The spirit and the text of the laws regulating the activity of local governments (Law of Local Administration, Law of Local Public Finance) are quite clear about who should approve and manage **borrowing and investments**: the local council passes the budget and approves the documentation, and the executive (mayor's apparatus) runs the operations and signs financial documents. The attempt to create a special executive body subordinated directly to the Bucharest council to manage the EBRD investment loans is at odds with the current administrative practice in Romania, and may even be interpreted as a break of the public finance laws. While it is perfectly legitimate for the Council to prioritize investment objectives, and stick to its decision once it reaches one, the head of the local executive is responsible before the law for dully executing the projects.

- The government would be well advised to moderate **hyper-active prefects** who engage in activities that are much beyond their attributions, from enforcing ceiling prices of vegetables to patronizing local football teams. In Romania, Prefectura is an institution meant to oversee the legality of local governments' decision and acts. In addition to that, the prefect coordinates all the branches of central agencies that are represented at the county level, and heads the security and emergency services when a crisis occurs. If so, there is little point in prefects organizing inspections in outdoor markets, trying to hunt "speculators" and impose "fair prices". Such actions create expectations in the public that are impossible to fulfill, and undermine the separation of attributions in the public sector, which certainly is more socially damaging in the long run than a 10% increase in the price of eggs sold on a competitive market.

- The central intervention on the **local sources of revenue** must also be limited to a minimum. Many times the impression is that the public officials in Bucharest do not even realize what these are, and distribute generously tax exemptions at the expense of budgetary funds that are not theirs, but local governments' – which is very much like doing charity with your neighbor's money. This happened during the last negotiations between the government and the union confederations, where personal income tax (PIT) cuts were again brought on the table. The problem is, about 90% of the PIT collection in goes to the local budgets. We do not discuss here that it's not PIT, but social security contributions that represents the heaviest taxes on labor; nor the fact that the corrections proposed by unions would make the PIT even more progressive than it currently is, going against the general strategy of the government. The point here is that the permanent interference in PIT and other income sources of the local budgets, without consulting all the interested parties, creates an uncertain environment for local governments in which the autonomy and professional budgetary planning become empty words.

- Another example is that of the discount food shops: businesses that were promised a favorable regime if the begin selling food at reduced prices to low-income groups. The idea was generous, but the special regime was to be created also by reducing taxes that happened to be local. Often mayors tacitly oppose such indirect subsidies, and so the policy becomes ineffective, generating confusion and distrust amongst the public. Such plans should be more carefully thought through from the very beginning.

- Finally, on the **spending** side, local governments should not be regarded as a dumping ground for unmarketable products manufactured by state owned enterprises. The government should refrain from pressing local governments into buying, for example, buses produced domestically, just to solve temporarily the problems of a failing bus company. This not only impoverishes the local communities (and asymmetrically, since money are transferred from buyers to the few large cities where the manufacturing plants are located, and which thus benefit from taxes on artificial salaries), who pay for poor and expensive products, but also distorts the business environment, running against another important objective of the government.