ECONOMY

THE ECONOMY:

SIGNPOSTS TO WATCH IN 2003

by Daniel Dăianu

WARNING

Macroeconomywise 2002 was Romania's best year since 1989. As expectations: the annual inflation rate came close to 18% (as against a 22% target), though one can harbor calculational qualms in relation with the dramatic change in the relative price of energy. But all in all, the macroeconomic picture validates the upgrading Romania has gotten from leading rating agencies. Can the evolution mentioned above be sustained in 2003, on account of structural weaknesses lingering on in the Romanian economy and a highly uncertain economic recovery went on the GDP grew by cca. +4.7% (**Table....Liviu, pune un tabel cu GDP, inflation, current account, budget deficit, foreign reserves: 2000-2002**); the current account deficit narrowed substantially, to about 5% of GDP (from 6% in 2001), against the backdrop of surging remittances from abroad; National Bank'sforeign reserves (including gold) bulged to over 7 billion euro; the public budget deficit stayed around 3% of GDP; and, most remarkably, disinflation exceeded international environment? This question gets additional salience after the Prague and Copenhagem summits of last year, which raised the economic problematique in Romania's quest to join NATO and, particularly, EU.. The analysis below focuses on some key spots related to this question and should be seen in conjunction with the budget examination done in the last report (EWR, no.7/2002).

I. STRUCTURAL POLICY

Is financial discipline improving?

It is an open secret that financial indiscipline still plagues the Romanian economy; for years now arrears (inter-enterprise debt; arrears to banks and the budget) have become a feature of the way companies try to make ends meet financially; some of them do it by using a perverse system of incentives in order to increase their profits, others do it with the aim of mere surviving. As several previous EWR reports highlighted emphatically, inflation has become a means for the system to achieve a certain state of "balance" by keeping arrears relatively constant in real terms (for, there are payments, like wages, which cannot be made unless actual liquidity is available). At a time of substantial disinflation, and unless financial discipline improves accordingly, the economic machinery would suffocate after a while –when the amount of real arrears goes beyond threshold limits.

2002 has been a year of substantial disinflation. Moreover, the big rise in the price of energy could not but strain the financial balancesheet of numerous energy suppliers to the extent households and industrial users were not capable to pay their bills properly. On the other hand, on the positive side, one can mention the decline of interest rates (during 2002), which do help firms' refinancing costs, the *Ordinance* which linked the reduction(or rescheduling) of past debts with orderly current payments, and, possibly, more prudent wage policy in a series of state companies and regies. It may be that the latter positive tendencies put a lid on the expected rise in real arrears following the pace of disinflation. But only hard data can provide a clear answer in this respect. Unfortunately, critical data on the volume and structura of arrears in 2002 are not yet available publicly. Arguably, this is the most important missing link in the overall picture, in order to make a judgement on the pace of structural changes in the Romanian economy in the last couple of years.

The evolution of arrears would indicate, fairly clearly, immediate and longer term consequences for the public budget, the course of disinflation, and sustainable growth. Should arrears decline in real terms, this would mean less burdensome quasi-fiscal deficits for the public budget, more downward pressure on interest rates, higher efficacy in bringing inflation to a one digit level and higher propensity of firms to committ themselves to longer term investment. And viceversa, a resurgence of arrears would be ominously negative. Arrears should be a top priority on the radar screen of Government policy makers in 2003.

Arrears can be battled against by more determination in fending off vested interests, by political will in clamping down on those firms (state, or private), which ask for undue favors. Privatisation can, surely, help, but it should not be seen as a miraculous device per se in hardening budget constraints. Experience shows that, frequently, private companies, too, engage in "the game" of producing arrears. Moreover, there are companies for which it is hard to find would be investors. To complicate matters even more, the situation of public utilities cannot be dealt with in a simplistic manner, by simply assuming that the way to raise the ratio of collected energy bills is to privatise utilities, whatever it takes. In their case one has to be concerned, first and foremost, with securing investments which do enhance efficiency in production and distribution, and reduce, thereby, prices to end users. This should be another top priority for the Government.

THE CAPACITY TO ABSORB UE FUNDS

The decision in Copenhagen to set a time target for Romania's accession – assuming that critical economic criteria are met—is likely to put huge pressure on policy-makers. They, have to do the utmost of what is possible, while "time cannot be compressed at will" in certain respects. Romania faces enormous challenges in undertaking institutional reforms and in trying to cope with a formidable developmental handicap. This is why making good use of the preaccession funds is a must for policy-makers; these funds could go to cca 2.5% of GDP yearly by 2006, were Romania to prove an effectice capacity to absorb them; but they can also stagnate, or even go down, should Romania bungle its way.

It goes without saying that Brussels would pay much attention to procedural aspects (like transparency, fairmess, etc). In the end, however, what matters mostly is that the funds have the highest possible impact –via direct and indirect effects-- on the Romanian economy and society. Thence arises the importance of the selection of good projects and their effective implementation.

II. MACROECONOMIC POLICY

Disinflation and monetary policy

Disinflation has been accompanied by a steep decline of nominal interest rates, especially in the second half od the year (**see table: iflation and interest rates...**). The reduction of inflation was facilitated by a major breakthrough in fighting inflationary expectations, which, in its turn, was much helped by the nominal quasi-stability of the ROL (Romanian leu) during 2002 , following the sharp appreciaiton of the euro vis-à-vis the USD –by 17.8%. The cut in interest rates is also illustrated by the dynamic of yields for government paper (bills), which match rates for banks' time deposits.

The decline in nominal interest rates was overdue, against the backdrop of considerable disinflation. But, arguably, there is not much scope for further decline of passive interest rates unless disinflation continues; an overemphasis, now, on the reduction of these rates could harm individuals' propensity to hold their savings into ROL denominated deposits. It is true that the Central Bank's policy of ROL real appreciation creates an additional cushion in this regard, but it would be quite risky to assume that ordinary citizens combine interest rate differentials with exchange rate dynamics in their computations, on a systematic basis.

The key issue with respect to interest rates is the spread between active and passive rates; this spread continues to be pretty high (**see table: spreads...**) and makes borrowing in ROL costly. Bank lending expanded substantially in 2002 (**table: bank lending .....**), but most of it was hard currency denominated , which was due to cost incentives and the ROL's real appreciation policy. Commercial banks complain that the high(and poorly remunerated) reserve requirements imposed by the NBR compel them to raise the spreads; and they make a valid point here. But the Central Bank does it not as a simple operational exercise; it has been forced to use all available means in order to sterilise the liqudity surplus in the economy in the quest to bring inflation down. Another argument, namely, that risk premia cannot be much lower in Romania yet, is also valid. But, there is, clearly, much inefficiency in the banking sector, which is rooted in high operating costs and raises the temptation to charge borrowers as much as possible. Low efficiency in this sector is also the result of poor competition and the relative neglect of lending to the corporate sector (as the alternative, for years, has been buying highly yielding government bills).

There is a long way to go in diminishing real interest rates; the process will go in step with deeper restructuring in the real sector and a better business climate (which would reduce risk premia) and with more competition in the banking industry, in the financial industry in general (for banks would have to compete with non-banking financial institutions).

EXCHANGE RATE POLICY AND PRODUCTIVITY GAINS

Preliminary numbers indicate better external accounts(both the trade and the current account balances) for Romania in 2002, in spite of ROL's real appreciation against a currency basket (made up of 60% euro, 40% USD). There have been favorable influences which lie behind this situation: the euro's sharp appreciation vs the USD(which bolstered tremendously the revenues of EU oriented exporters) and the remarkable surge in private remittances from abroad (which, might have surpassed 1.4 billion USD in 2002). As a matter of fact Romania has become a large exporter of labor force, which include both highly skilled and less skilled workers. Another positive influence could be the "learning" Romanian companies have acquired over time and an increased ability to export.

The less rosy side of the story is that the structure of exports is skewed, seemingly, increasingly, towards low value added products: textiles, footware and furniture make up almost 50% (Liviu, este adevarat?...) of exports. This would not be necessarily bad unless it relied, primarily, on labor cost motives. Are these exports resilient? An optimistic answer would underline their rise despite the economic slowdown in the Euroland and the USA. A pessimistic answer would argue that, always, cheaper labor can be found elsewhere. The bottom line is that Romania has to find and develop its export niches and strive to climb the ladder of higher valued added exports. Does the Government have a role to play to this end? Supposedly, it does, as each and every clever government in this world does, in one way or another. From this perspective, NBR's policy of ROL real appreciation has to keep a keen eye on productivity gains in the manufacturing sector. Arguably, it would be a myopic strategy to overlook this linkage by betting on a steadily increasing flow of remittances from abroad and Romania's turning into a major touristic site. It would be good for both these to happen, but policy-making cannot rely on optimistic scenarios only; contingency plans need to be put in place, always! On this line of reasoning one comes to the use of capital account liberalisation.

III. CAPITAL ACCOUNT LIBERALISATION (KAL)

The EU imposes on all candidates to open their capital account by the time of accession, but makes no specific demands on the speed and procedures to pursue. In 2001 Romania, unilaterally, committed itself to liberalize movements of capital, practically, by 2004 -- well in advance of its prospective date of EU accession. According to the current timetable, the KAL is sequenced over two years left, with only two exceptions – one regarding specific money market instruments, and another one regarding inward land purchasing by foreigners (annex:Liviu, ataseaza anexa...). Although the effort to catch up with other candidate countries is quite laudable, the KAL decision begs very serious and responsible examination in view of its possible, less benign, consequences[1].

Following the series of wild financial and currency crises worldwide, during the last decade, there is, currently, a wide consensus among economists that the full opening of the capital account should not be hastened (premature) in emerging economies; that major prerequisites for liberalization of capital transactions are the existence of a solid growth-supporting macroeconomic framework, the elimination of major structural imbalances and the functioning of a healthy and tested operational and regulatory framework of the financial system. It is fair to say that Romania has improved considerably its economic performance in the last couple of years and a series of indicators look quite good: the overall public debt is pretty low (under 30% of GDP); the domestic poublic debt is only 8% of GDP and its financing is done increasingly at longer maturities; the external indebtedness of the country is low (below 30% of GDP); the reserves of the NBR amount to cca 5 months of imports; the share of external short term finance of public external debt is low; etc. On this ground one might try to justify the decision to open the capital account at a swift pace..

[1] This issue was highlighted in previous EWRs as well. A thorough analysis of KAL in the case of Romania is undertaken by Daniel Daianu, Ion Dragulin, Liviu Voinea, Radu Vranceanu, "Opening Romania's Capital Account-An Optimal Approach", Bucharest, Romanian European Institute, 2002 (this study can be consulted on the site of the IER)

But Romania still has major KAL-related vulnerabilities, which need to make public authorities more cautious and, eventually, reexamine the current sequencing of KAL.

Inflation is still high; there is a very low level of monetization and financial intermediation, which makes wide swings of capital flows highly disturbing and sterilisation operations (by the NBR) very costly; there are insufficient restructuring in the real sector and poor governance at the enterprise level, which create inflationary pressures and strain the public budget; there is still weak law enforcement in the financial sector and the new prudential rules are still to be tested; low banks' profitability and efficiency. On account of these traits of the economy one can imagine scenarious of sharp rises in the prices of domestic assets (bubbles), following substantial speculative capital inflows (which are stimulated by ROL's real appreciation), which may create instability; reckless internal and external over-indebtedness of local firms and municipalities may also ensue, which would be quite threatening in view of the still soft budget constraints operating in Romania; the trade deficit may grow again sharply, abetted also by the real appreciation of the leu, while it is not solid-proof that the currently growing transfers from abroad would not stop, or even decline, as a consequence of possible international adverse events.

There is another KAL-related issue which should concern policy-makers to the utmost. Full KAL cripples, or even annulls the ability of public authorities to conduct an autonomous monetary policy while they try to achieve some stability of the exchange rate. In the latter case the burden of macroeconomic adjustment would fall overwhelmingly on budget policy and a deflationary bias may very likely be imparted to its stance. In order to restore some autonomy to monetary policy a free floating of the exchange rate would have to be practiced, but this could be highly destabilizing itself and could ask for extremely restrictive monetary policy (following sharp depreciation of the exchange rate). Is the Romanian economy ready to accept the consequences of full KAL from this perspective, of a much diminished room of meneuver for macroeconomic policy? This question gets even higher profile by judging the the likely time of Romania's accession into the UE. This is why the "look good" indicators, mentioned above, and the confidence some entrust in the ability of Romania to rely increasingly on remittances from abroad and revenues from tourism do not warrant complacency; the latter is equally unhelped by. the 2007 time target for EU accession.

Arguably, policy-makers would be well advised to reexamine, in practical terms, the current KAL program by considering the need to make an effective preference for long term flows against short term flows (the liberalization of short term flows be accompanied by adequate prudential measures); the need to make effective preference for capital inflows against capital outflows; and the need to avoid an undifferentiated and complete liberalization of capital inflows. Likewise, more attention should be given to the principle of contingency:actual liberalisation should proceed only when only well-defined macroeconomic and structural conditions and criteria are fulfilled.

Among concrete measures to "shape" the compostion of flows policy-makers might consider[2]: impose unremunerated reserve requirements (URR) for short term investment or credit taken in foreign currency[3]; the NBR could practices a system of discriminatory reserve requirements on foreign exchange deposits of banks; restrictions on corporate and public sectors' short term (less than one year) credits from banks and financial institutions located abroad; do not allow banks the use of short term debt instruments (T-bills, corporate debt, local state debt instruments) as a collateral for borrowing in foreign exchange abroad; maintain the requirement of NBR's authorization for any short term financial credits and loans, and guarantees of the corporate sector (.the authorization should be given based on combined criteria, such as a clear improvement in the arrears record, on a case by case analysis); support the creation of an independent rating agency for Romanian corporate and municipalities' debt instruments.; keep purchase abroad of bonds, shares and other securities, dealt and not dealt on foreign capital markets, subject to authorization by the competent supervisory body. e of a corporate performance indicator – to be later defined), etc..

Since the EU does not impose on Romania a timetable for its full KAL readjustments of the program can be operated. It would be also wise for the Government and the NBR to consult with IFIs experts (from both IMF and World Bank) on the sequencing of KAL, for this is a matter of utmost importance for the rules of functiong of the economy. As to the IMF, this specific item of consultation would be more than timely and appropriate for its work in Romania.

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The consolidated public budget (state budget and other funds) can be judged along two lines. First, how budget policy does support the main goals o WARNING

[2] These measures are mentioned in Daianu et.al(Op.cit).

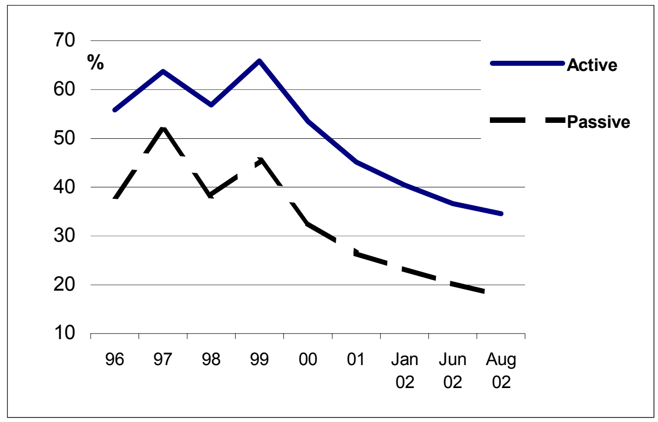
[3] In November, last year, Russia adopted such a measure as a means to discourage short-term, speculative, inflows. This measure is advocated by Daianu et.al (Op.cit)

economic policy. And second, by looking at the budget itself, at the balance between revenues and expenditure, their structure and the management of public debt.

BUDGET POLICY IN THE CONTEXT OF OVERALL ECONOMIC POLICY

The principal targets for economic policy in 2003 continue to be disinflation and bolstering economic recovery (economic growth). Another strategic target for the Government should be that the public budget support the EU accession process. And against the increasingly complicated international environment a new policy target should be that the budget take into account the new, non-conventional threats.

Fig. 1. Interest rate for non-banking customers, %



Source: BNR

Disinflation may backfire unless arrears are brought under control

Disinflation*:* the programmed cut in the budget deficit (from 3% in 2002 to 2.66% in 2003) indicates the intention of continuing the downward pressure on interest rates and enhancing overall policy credibility, which would, assumedly, help reduce inflation further. Less crowding out by governmental borrowing would relax credit markets and help heavily indebted companies to cut their debts/arrears. Inflation has come down remarkably during 2002 (for January – September the cumulated rate is around 11.5%), and there is a reasonable chance that it may go even below 17% this year, December on December. This would be a dramatic improvement over 2001, when inflation stood at 30.3%. There is, however, a big caveat here: the evolution of arrears. There is conflicting data in this respect, but unless arrears are reduced in real terms rapid disinflation would backfire sooner or later; large arrears of state companies, which are quasi-fiscal deficits, burden the public budget and undermine growth. Large arrears create inflationary pressures as well. This issue has been highlighted by several EWR analyses (including the previous report) and it is worthwhile reminding it. Arguably, the budget policy can deal with this challenge by clamping down firmly on those firms which do not pay their debts. The financial state of public utilities should be closely monitored in this regard.

Economic recovery/growth is helped by lower inflation, a more friendly business environment, more capital formation (investment), etc. The budget draft for 2003 assumes lower inflation, of around 14%. The sharply declining interest rates (during 2002, Fig. 1) have been a bonanza for many firms, particularly those which are heavily indebted. But this positive impact can be felt more acutely to the extent that real interests come down as well, which remains a lingering concern in the Romanian economy. A highly welcome development is the substantial cut in social security contributions (by 5% of the wage fund in 2003, after a 3% reduction this year), which will alleviate the tax burden for many companies and stimulate job creation. The budget draft envisages a slight increase of public capital formation – from 3.4% this year to 3.6% in 2003; the latter has to be seen in conjunction with the considerable rise in non-governmental credit in 2002 (by more than 25% % in real terms, during Jan.-Sept.), which overlaps with a rising, albeit slowly, propensity to save and invest. Should the Ministry of Finance be successful in better tax collection, by cutting the favors that some companies enjoy, this would improve the business environment and enhance, thereby, the functioning of the sound portions of the economy. The lower budget deficit would also help keep the current account deficit under control.

Fig. 2: Structure of budget (2002, 2003)

General Consolidated Budget	2001	2002	2003 (budget draft)
Total revenue (%of GDP)	32.7	30.5	30.0
- fiscal revenues	30.5	28.8	27.9
direct tax	18.7	17.5	16.7
- profit tax	2.3	2.2	2.1
-income tax	3.4	3.0	3.2
-Social security contributions(SSC)	11.9	11.6	10.4
indirect tax	11.9	11.2	11.2
-VAT	6.5	6.2	6.6
-custom tax	0.8	0.6	0.4
-excises	2.6	2.5	2.4
-other taxes	1.9	1.8	2.0
-non fiscal revenues	2.1	2.2	1.7
Overall expenditure (%of GDP)	33.4	32.6	
-wages and salaries	5.0	4.9	
-goods and services	6.8	6.7	
-interest payments for public debt service	3.3	2.9	
-subsidies, bonuses and transfers	14.8	14.3	
-capital formation	3.4	3.6	
Budget deficit (% of GDP)	3.5	3	2.6

Source: national statistics

EU candidacy. The budget does include the co-financing for EU funds; these funds are likely to go up to 900 million Euro in 2003. The main issue in this respect is making best use of these resources, which should prepare the ground for additional funds in the next few years. EU funds are variable and their variability hinges on Romania's absorptive capacity, which in turn depends on the performance of public administration. Increasing the absorptive capacity should become a priority for the Government, given that the pre-accession funds allocated to Romania may increase dramatically after the first wave of enlargement in 2004. The decision in Copenhagen to set a tentative date – 2007 – for Romania and Bulgaria's accession should prompt to focusing on increasing absorptive capacity and on bringing Romania's economy as close as possible to a benchmark functional economy.

New Threats. The reserve fund of the Government increases considerably (a tenfold rise), which would help formulate and implement contingency measures should the need arise. Ministries themselves should be more alert and ready logistically to deal with non-conventional threats. Money does matter to this end, but training and mental preparedness are also key to effective response.

PREMISES OF THE BUDGET DRAFT

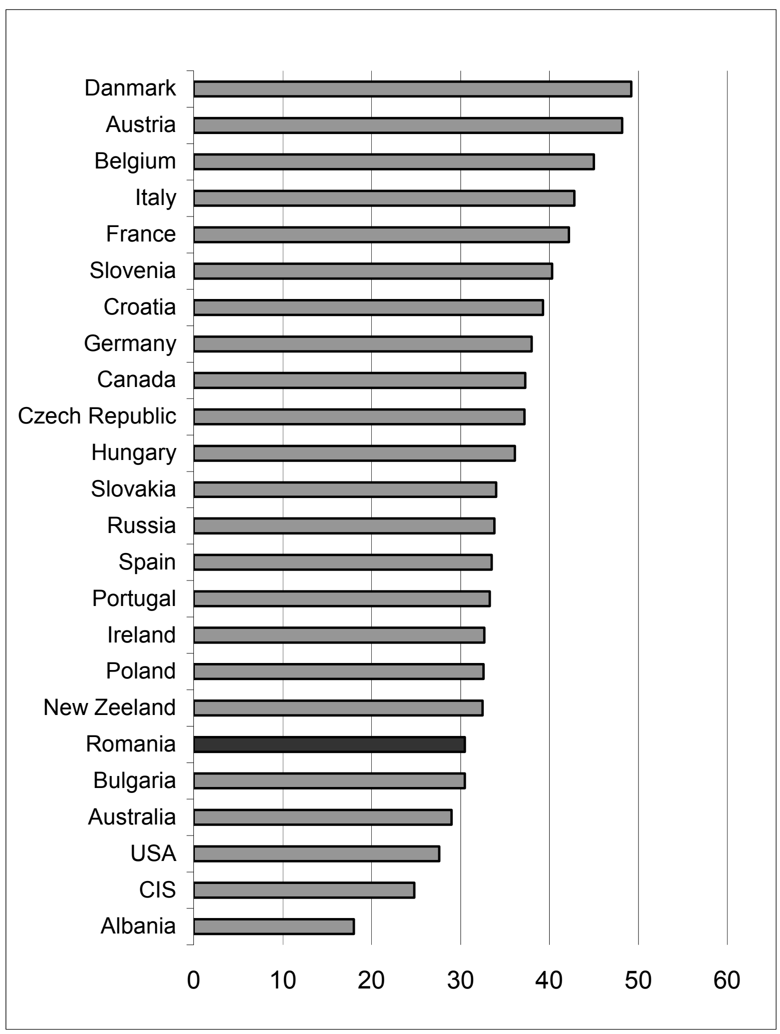
The budget fundamentals look optimistic

The budget draft relies on a *growth rate of the GDP of 5.2%*. This rate seems fairly optimistic in view of the growth prospects in the Euro area (which is by far Romania's main trading partner) and of the uncertainties in the international economy. These uncertainties are amplified by the possibility of a double dip recession in the USA and by possible negative effects (at least, in the short run) of a military campaign against Iraq. The forecast growth rate for 2003 hinges also on an acceleration of investment; the signs in 2002 are encouraging in this respect (gross capital formation is likely to rise by 7% in real terms this year), but higher investment is needed in order to support the 2003 forecast. Grants from the European Union can play a major role in the provision of additional public goods, which could enhance private sector output. Nonetheless, the proper absorption of these funds remains a real challenge in view of Romania's track record in using external financing. Moreover, the issue of the absorptive capacity has to be judged in connection with the type of expenditures required by the *acquis communautaire*. The challenge posed by the adoption and implementation of the acquis communautaire will increase in the coming years – some estimates put the additional expenditure required for the acquis at between 4 - 4.5% of GDP .

The inflation rate of 14% (December on December) was already revised downwards; initially the target was 15-16%. It seems that inflation-wise the construction of the budget is facing the uncertainty created by a more rapid than expected disinflation in 2002. There is a dilemma here for policy-makers. If disinflation were to go on at the average pace of 2002, the actual rate in 2003 could amount to just 10% (annualized) – which is substantially below the assumption used in the budget draft. Other conditions unchanged, a much lower than forecasted inflation rate would strain the execution of the budget since revenues would be lower while expenditure would stay at the programmed nominal level. Ways out of such a situation could be either a new downward correction of the targeted inflation rate (before the start of the budget execution), or a budget rectification during 2003. The latter option, however, is hardly feasible under the new law of public finances. As a matter of fact, the new Law does away with the main tool used by public authority (during the last decade) for keeping the budget deficit under control. Thence arises a formidable challenge for public policy in the future. Because of this challenge policy-makers may be tempted to underestimate budget revenues for the sake of not exceeding the targeted budget deficit. The other option – of reducing the inflation target below 14% – would have the advantage of diminishing the potential damage that an actual inflation rate below the programmed rate can provoke. However, this solution is not as simple as it may appear. One reason is that it is not clear whether the current pace of disinflation (which has relied considerably on the nominal stability of the exchange rate USD-ROL during the sharp real appreciation of the Euro vis-à-vis the USD in 2002) is sustainable; second, external shocks in 2003 may create inflationary pressures; and last, but not least, financial indiscipline in the economy may cause additional inflationary pressures. Such kind of reasons (and threats) may lie behind NBR's recent policy of resuming a more vigorous nominal depreciation of the ROL vs. the USD.

The exchange rate used in the budget draft suggests a further – although small – real appreciation of the ROL. This policy assumes an easy financing of the current account deficit, which, unless conditions change dramatically in international financial markets, is likely to fit the pattern of the last couple of years. Private transfers from abroad (remittances) play an increasing role in financing the current account deficit; almost 1 billion USD were sent home by Romanians living or working abroad between January and August 2002. Moreover, better macroeconomic performance has brought an upgrading of Romania's sovereign risk, which in turn has contributed to reduce the spreads on Romanian bonds lately. But there is an important source of uncertainty to the exchange rate policy, namely the dynamic of the exchange rate between the USD and the Euro. During 2002 the sharp real appreciation of the Euro vs. the USD on the one hand helped disinflation (by basically quasi-fixing the ROL-USD exchange rate for several months); on the other hand, it created major dilemmas for the National Bank. The NBR and the MOF would be well advised to increasingly take into account in their calculations the exchange rate ROL-Euro, since most of Romania's trade links are with the Euro area. As a matter of fact, the NBR has announced that in 2003 its exchange rate policy will keep a much closer eye to the Euro.

Fig. 3. Tax revenues as a ratio of GDP, 1999-2000 (average)



Source: Pradeeb Mitra and Nick Stern, 'Tax Reform in Transition", World Bank, manuscript, 2002

THE STRUCTURE OF THE BUDGET DRAFT

Budget revenues

In general terms, the 2003 budget draft does not bring radical changes as compared to this year's budget. In addition, the 2003 budget draft signals quite clearly that austerity is still a silver line of budget policy in Romania, which involves painful trade-offs and insufficient resources assigned to education and healthcare (Romania has the lowest GDP share for such budget expenditures among EU candidate countries).

Nonetheless, there are some notable differences as against the 2002 budget.

The most significant is the reduction of social security contributions, from 11.6% of GDP in 2002 to 10.4% of GDP in 2003. The purpose of this reduction is to diminish the tax burden on firms and encourage job creation in the official economy. Another ensuing difference is the fall in fiscal revenues and, consequently, in budget revenues (see Tab. 1). Fiscal revenues are to reach 27.9% of GDP in 2003, as compared to 28.8% in 2002; and the overall revenues are to be 30% in 2003, as compared to 30.5% in 2002.

It is noteworthy that fiscal (and overall budget) revenues have declined over the last three years. One could argue that this is a good tendency, since it leaves more resources for the use of the non-governmental sector. And partially this is true when considering the fiscal measures adopted in 2002 and 2003 in order to reduce the tax burden on firms. However, it is clear that tax collection has not improved correspondingly, as a means to compensate the expected fall in revenues due to lower taxes. Moreover, the fall in overall revenues does not permit a rise in public allocations for human capital build up, such as education and healthcare.

Having said that a caveat should be made with regard to the fall of budget revenues. Romania benefits from substantial EU grants, which supplement the traditional budget revenues. As a matter of fact, the EU funds are non-fiscal revenues, which should be transparently included in the Budget. Together with the EU funds the budget revenues for 2003 exceed substantially the figures in the draft budget.

The EU cannot finance Romania's poor tax collection

But the EU funds cannot obscure poor tax collection. Tax collection continues to be the main weakness of budget policy in Romania, for it constrains its room for maneuver and restricts the provision of public goods. Among Central and Eastern European countries Romania seems to stand aloof, with fiscal and non-fiscal revenues fluctuating around 30% of GDP, whereas the same revenues are between 35-40% in Central European and Baltic countries (see Fig. 2). One can argue that the better off countries (those which are presumably more advanced in reforms as well) have better functioning fiscal systems and superior tax collection. The reasons which underlie this state of affairs are better public administration, better enforcement of rules and regulations, more transparency and less proclivity of firms to avoid taxes and operate in the underground economy, and, last but not least, the structure of fiscal burdens. It may be that income per capita does play a role in explaining tax collection and budget revenues.

The tax administration needs urgent reform

But it is certain that tax collection can be much improved in Romania, and the intention of the Government to undertake a thorough reform of the fiscal administration is more than welcome in this context.

BUDGET EXPENDITURE

The 2003 budget does not envisage significant shifts in the distribution of expenditure. But there are some features of the budget draft that deserve to be mentioned. One such feature is the attempt to raise the share of public capital formation financed from domestic sources, which together with the EU grants may bring the total to above 6% of GDP. The Ministry of Finance and other ministries have to practice multi-annual budgeting in order to prioritize and adequately use the EU funds. The modernization of roads, ports and airports, the construction of highways, the amelioration of the environment can be financed with EU funds, but this is contingent on credible programs and a good track record in the utilization of funds.

The interest payments will decline in 2003 (following the decline of interest rates), which frees resources for other uses. There has been substantial improvement in the management of public debt, which stood at around 27% of GDP at the end of July 2002 (out of which domestic public debt is of 7% of GDP). The issuance of longer maturity state bills and bonds has reduced the debt service, against the background of declining interest rates (interest rates for Treasury bills have come down from more than 50% in January 2001 to around 20% in September 2002).

The Draft also provides for expenditures to assist low income persons, who have been severely affected by the sharp rise in the price of energy; more than 6,000 billion ROL are assigned to this end. Overall, however, transfers decline – from 12.9% of GDP in 2002 to 12.6% in 2003. A large part of these transfers are pensions, which do not actually represent social assistance; pensions are citizens' entitlements for what they paid as social security contributions over their work lifetime. There is also a surprising decline (in real terms), albeit small, of expenditure for healthcare.

There is definitely waste in the use of budget resources, part of which is due to poor budgeting, and part of which is due to vested interests and corruption. But those who argue that there is too much social protection in Romania are mistaken. Too much social protection does take place as an unintended consequence of condoning massive arrears in the economy and soft lending to loss making companies. But as the structure of the budget shows, Romania assigns much less to education, healthcare and other social programs than other Central and Eastern European countries.

Pensions are wrongly considered social assistance – they should be entitlements matched with the savings made in working years

Fig. 4. Medium term budget framework, %GDP

	2001	2002	2003	2004	2005	2006
total revenues	30.5	30.5	30.0	29.4	29.1	29.5
total expenditure	33.7	33.4	32.6	32.0	31.8	32.2

Source: official *forecast*

SUMMING UP

In view of the competing claims on the public budget the Romanian authorities have to reexamine the current medium term program which forecasts a somewhat surprising tendency of stagnating or even declining budget revenues as percentage of GDP in 2003-2006 (Fig. 4). Would this tendency illustrate a tax reform (alleviation of tax burden) together with an extension of the tax base and a rationalization (reduction of waste) of expenditure, together with an adequate rise in the funding of education and healthcare, the emerging new pattern of budget size and structure should not cause worry. This would be particularly the case if the EU funds will represent an increasing addition to the official budget revenues, which would bring the actual revenues to between 34-35% of GDP. But is this the case?

The stagnation of budget revenues could be reversed if tax collection improves substantially (assuming that better collection is not entirely used to offset a reduction of the tax burden). The plans to create a unified tax administration department and a large taxpayer directorate may prove to be a step in the right direction.

The budget for 2003 needs to consider the implications of contingency plans which may be needed due to the proliferation of non-conventional threats and to uncertainties in the world economy. The budget draft should consider also the possibility that the forecast for GDP growth may be too optimistic, and should take into account the uncertainties related to the inflation target. In order to take full advantage of the EU grants, Romania needs to increase its absorptive capacity, and this should be a systematic policy concern; it involves an overhaul of public administration. Good projects have to be worked out and embedded into multi-annual budgeting programs of ministries, and a careful monitoring of their implementation has to be exerted so that waste and diversion of resources (fraud) be avoided to the utmost extent.

The budget priorities need to be more closely aligned to the stated general policy goals

Budget policy needs to focus more on defining priorities, reduce waste and combat corruption; the latter is intertwined with financial indiscipline, which undermines budget revenues and creates moral hazard. The Ministry of Finance should be much firmer in dealing with debt offenders and in this context pay much closer attention to the financial state of public utilities; unless arrears decline in real terms, persistent quasi-fiscal deficits will burden the public budget in the years to come, creating inflationary pressures.

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