ECONOMY

CATCHING UP

The development gap and its causes

by Sorin Ioniță

TRENDS

Ever since Romania has entered, after 1989, various comparative performance assessments aimed at rating the transition countries, it scored consistently poor, being placed towards the bottom of the table. The European Commission's annual reports evaluating the progress of candidate countries put Romania in the last place – even after Bulgaria, a country which, arguably, begun the transition facing harsher adverse circumstances and with an equally poor infrastructure. There is a growing consensus among local and foreign analysts on what the main culprit may be: the insufficient capacity to design, adopt and implement public policies, irrespective of their nature. This has created a sense of drift and uncertainty in the Romanian society, and has demobilized many social actors that might have taken the hardships of transition on their own, had they only been provided with a stable environment.

Unfortunately, this has not happened. There are just four years left until 2007, the prospective date of EU accession, and Romania is facing a monumental task: not only to adopt the EU acquis, but also to implement it and, moreover, to remedy the poor physical and administrative infrastructure of the country. This section documents with the most recent data available the problems that Romania faces in its attempt to catch up with the developed Europe; and tries to explain what why we consider weak governance as the main obstacle along this way.

Fig. 1. Wealth and competitiveness

Your country's companies compete on: 1=low cost or natural resources; 7=unique products and pocesses

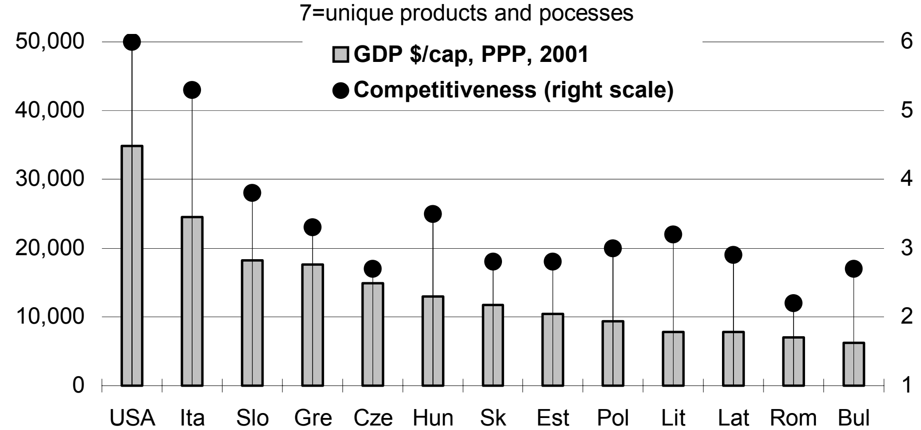
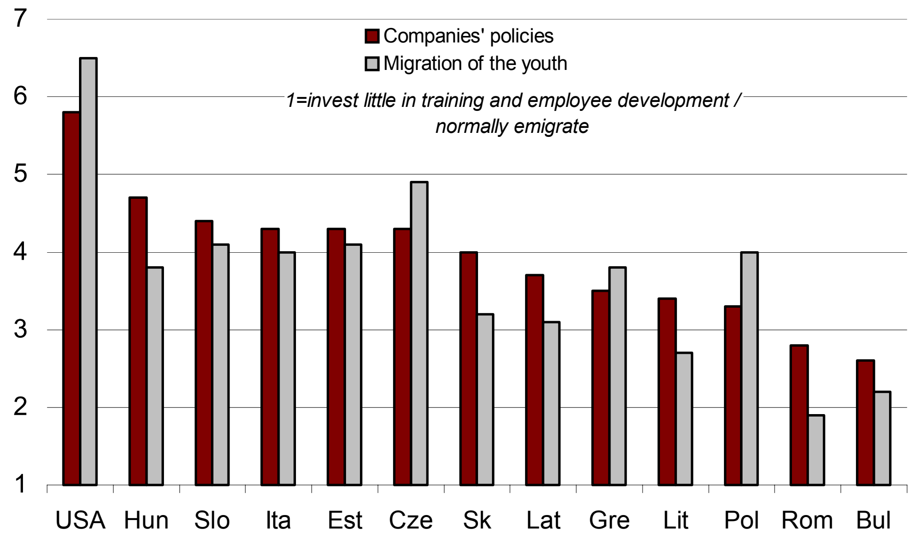
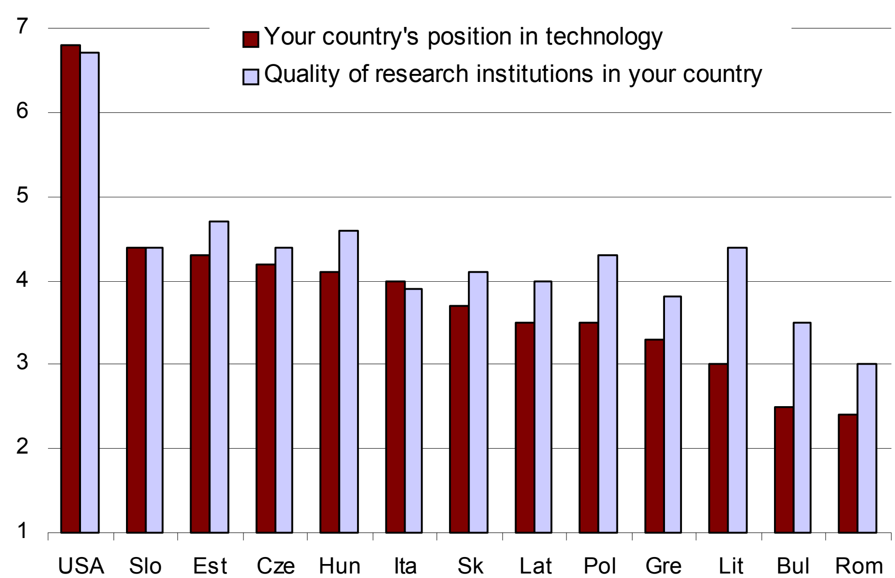


Fig. 2. Human resources



Source: IMF, 2002

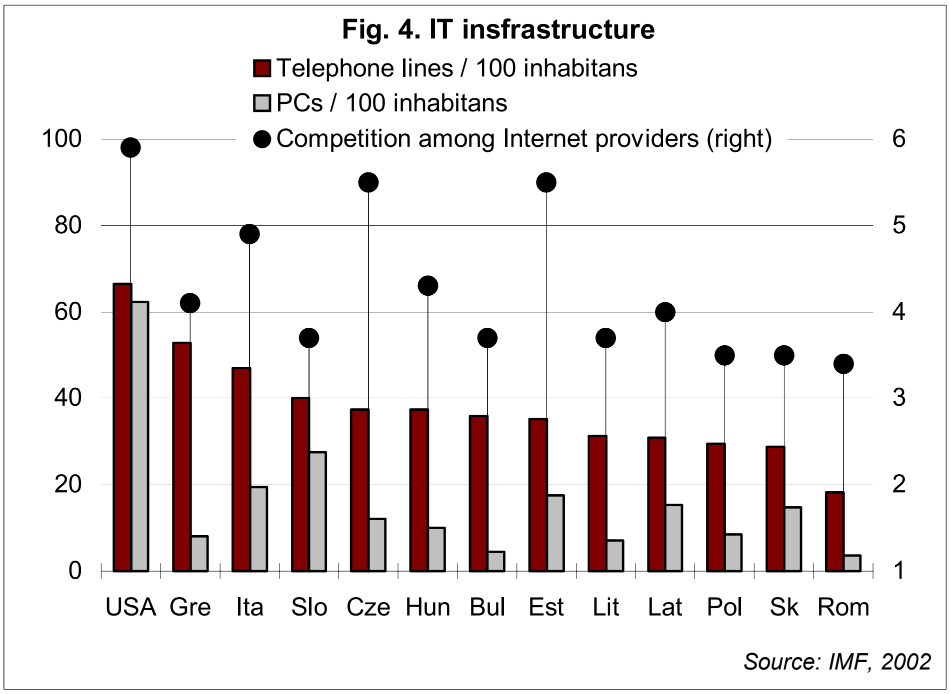
Fig. 3. Research and Development

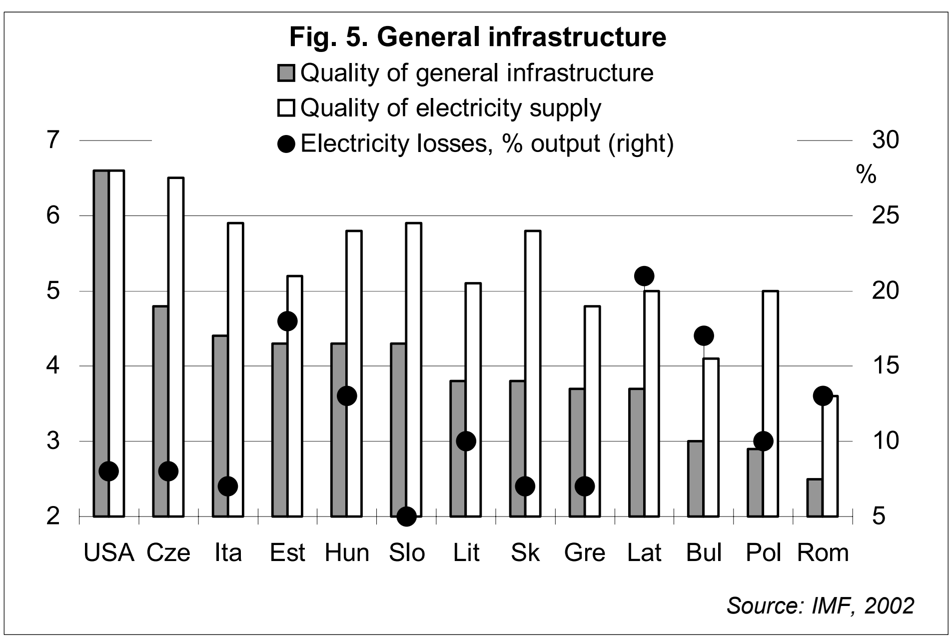


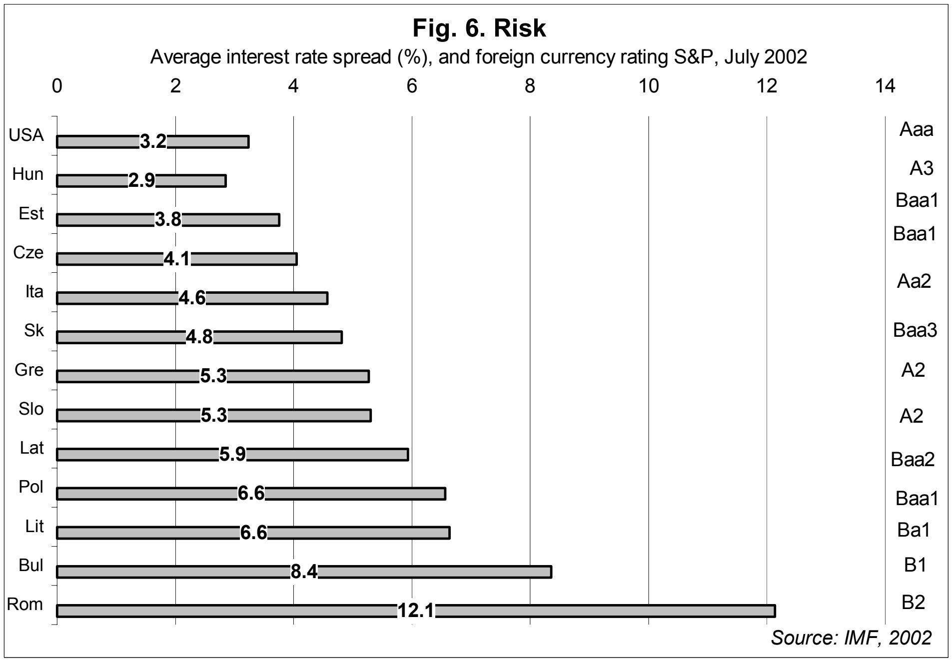
Source: IMF, 2002

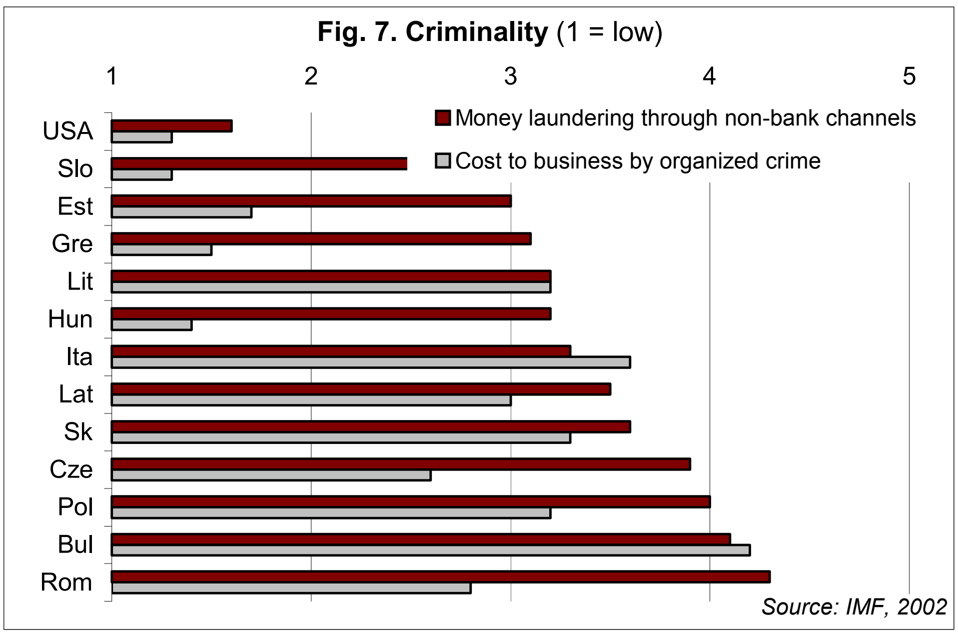
Low social wealth per capita, lack of firm competitiveness, poor state of research infrastructure, low level of technology and high emigration rate of the young and talented – these are all effects rather than causes of the country's backwardness.

Companies do not invest in / or reward / their human capital, most probably because it does not pay off to do so in an environment where other things than competition and performance make the difference between success and failure. Similarly, the low quality of research institutions in Romania is not only due to the lack of funds, though this plays a role of course. Primarily, it is also related to the outmoded and rigid organization, state control and subsidization, lack of incentives and clientelism.



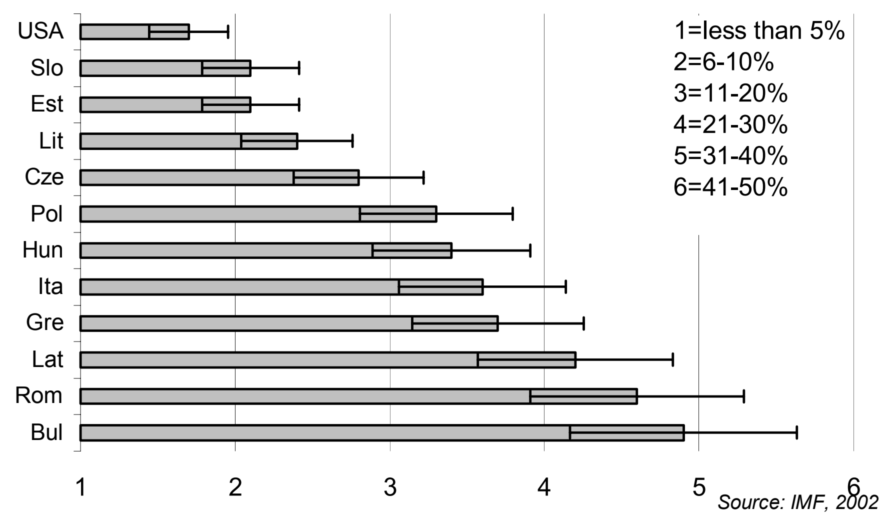






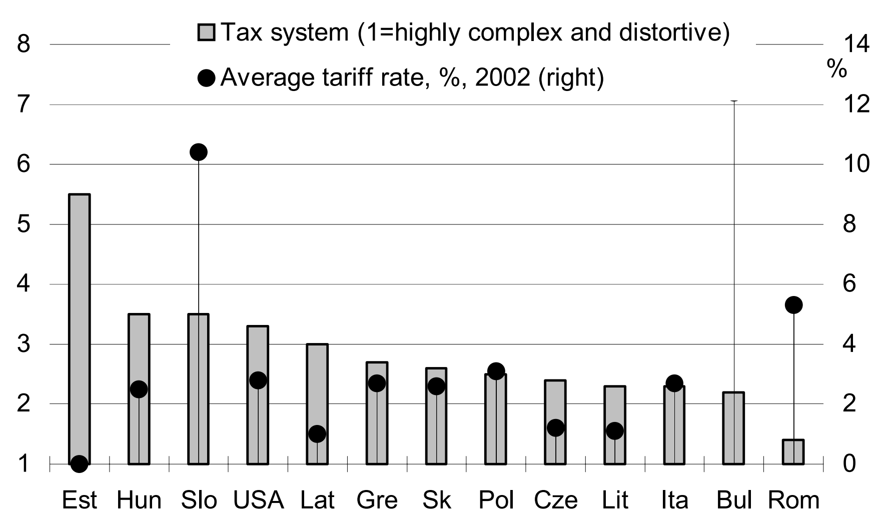
Romania appears to be a risky place for doing business. But the main culprit seems not to be private mafias – they do not extort more money than the regional average, and are perceived to be even less burdensome than in Italy. The problem is again the state, which has not managed to create a more stable environment for businesses or gain their trust. Lack of trust and high taxation (see also below) determine private actors to go underground (Fig. 8), where they clear out transactions outside banks. The wide spread between active and passive interest rates, also a measure of risk in the economy in general and the banking sector in particular, also contribute to this effect. It would be wrong to conclude from here that the solution is to force the commercial banks through administrative measures to reduce the interest rate (or the spread), as the government appeared to try at some point last year. Trust among domestic actors and international financial institutions has to be built in time, by pursuing coherent, stable and reasonable policies. The state burden has to be reduced by fixing the complex and distortive taxation system (Fig. 9) and decreasing the relatively high tariffs, which impoverish Romanian consumers.

Fig. 8. Unregistered businesses

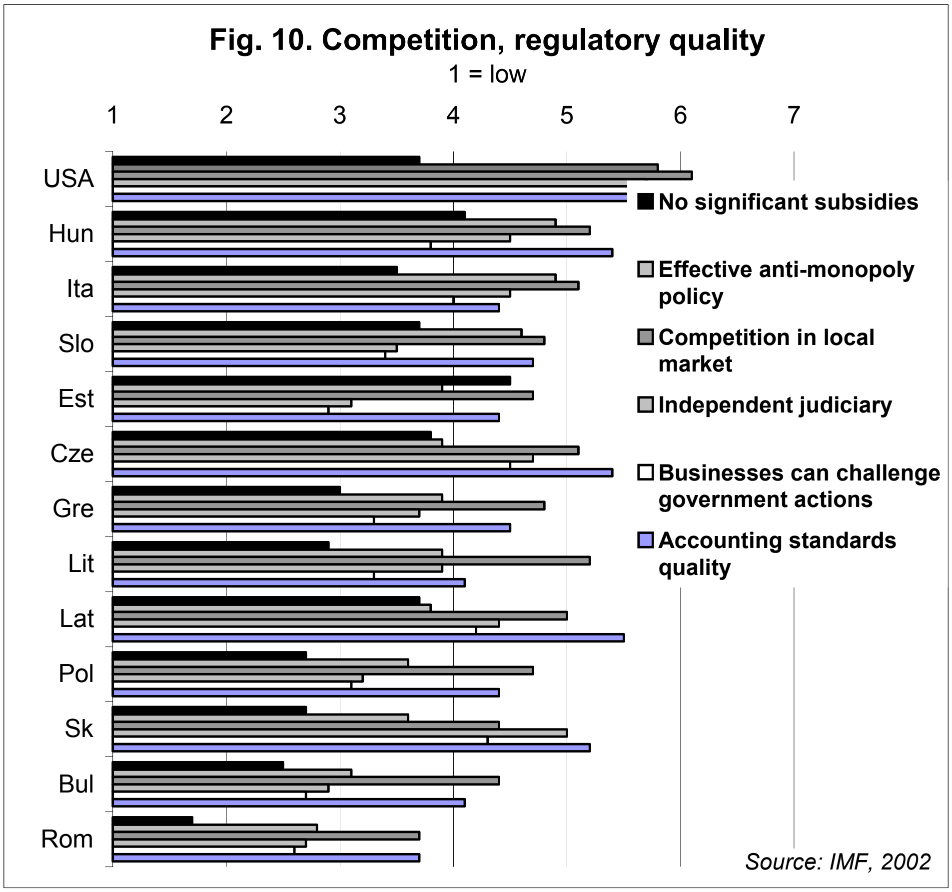


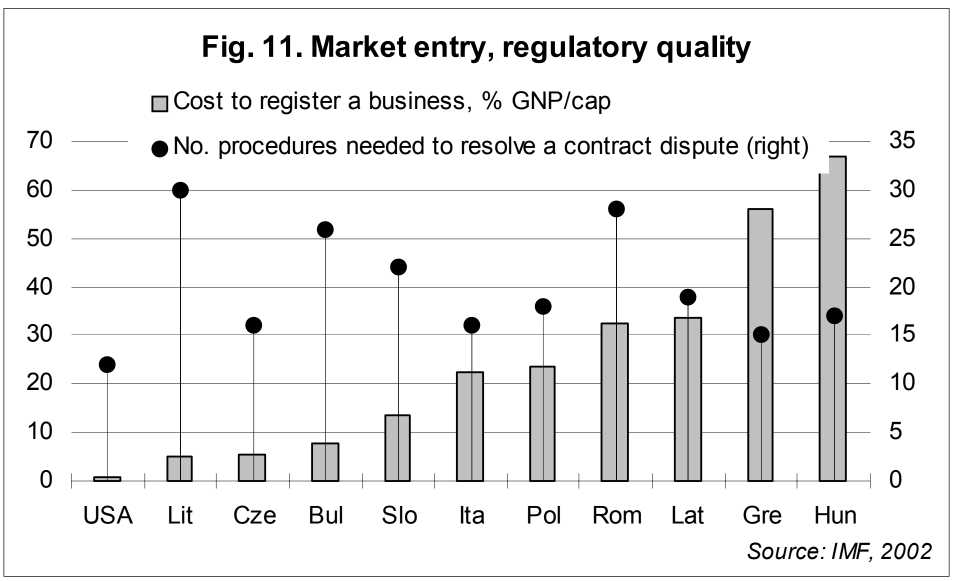
Source: IMF, 2002

Fig. 9. State burden



Source: IMF, 2002





The core of the matter is the quality of regulations put in place and the supply of basic public goods by state institutions – public goods in the broader sense of the term, including law and order, protection of property rights, impartial judiciary, enforcement of contracts, stability of the business environment. On top of the problems mentioned above, the following should be highlighted:

- Market distortions, through subsidization
- Government arbitrariness and unpredictability
- Lack of an independent and (in commercial matters) professional judiciary, which makes private agents avoid the courts of law
- High cost of regulatory services supplied by the state

All these make property rights appear insecure, and the state seems to be more of a problem in itself than a tool of reform. The charts below illustrate this with additional data. Both the Romanian legislative body and the civil service are considered to be the least competent in the region, while the financial propriety of politicians is at its lowest. Party finance irregularities happen in other countries too, as the Romanian politicians often point out. The problem is, their behavior here appears worse in comparative terms (Fig. 13).

Which leads to the issue of corruption, a theme much debated lately. Unsurprisingly, it is regarded to be high in Romania, a society with traditional and clannish patterns of public action. But clientelism is not confined to the public sector; it also permeates the private one, which is typical for the Balkan countries (Fig. 14: the public perceives that public and private managers alike tend to form family networks). Still, Romania's seems to be the state in the region most captured by private interest groups. The structure of supply of corruption by private businesses shows that the phenomenon is most closely associated with domestic policy areas (Fig. 15).

The missing policies model

Too much politics, not enough policies

There is ample evidence that all across Central and Eastern Europe, like in other regions of the world, citizens' satisfaction with the public institutions, political class, and the whole democratic setting is very much correlated with the effectiveness of the state in performing its functions: rule of law, security and order, stability of the rules of the game, delivering basic public goods and services. On these dimensions, none of the 103 post-communist governments in the region has scored very well, and as a result, with 2-3 exceptions, no cabinet was re-elected in office in CEE after 1989. The adverse initial conditions and the monumental task of reform are probably part of the explanation. However, they were often compounded by indecisiveness, political squabbling, incompetence and corruption. The new rulers have very quickly come to cherish the formal beauties of democratic politics – campaigns, electoral promises, pluralism, PR techniques – but did not pay the same attention to the other, more substantial part of it: coherent programs, consistent policies, and implementation mechanisms.

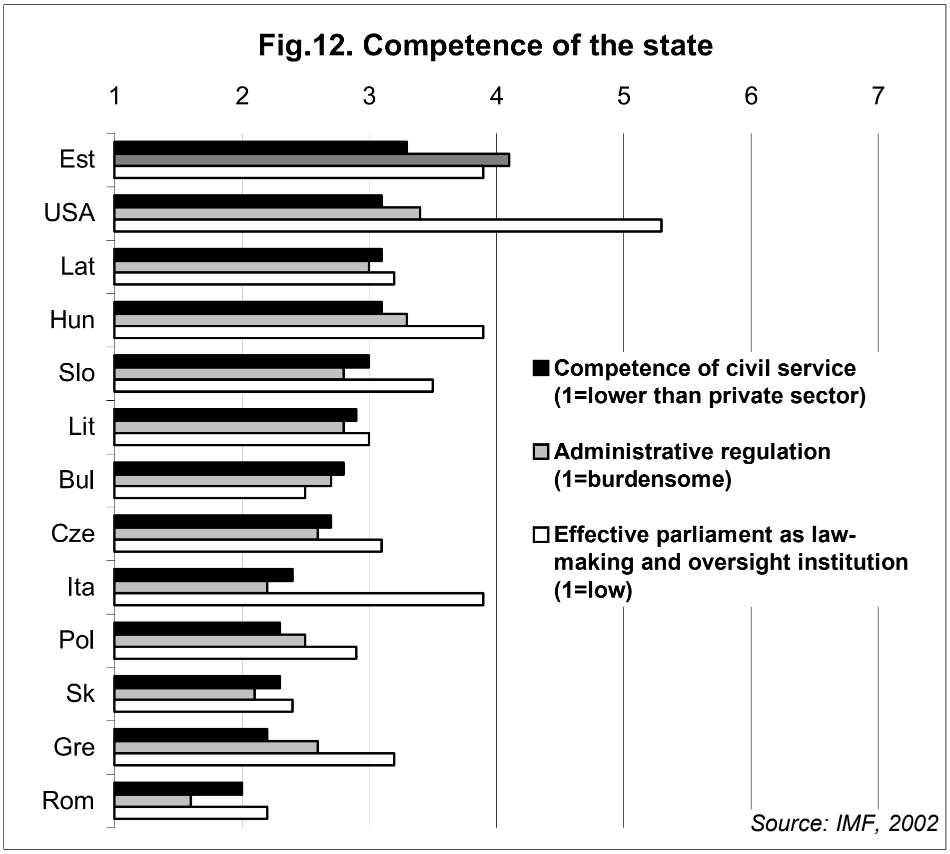


Fig.12. Competence of the state
1
2
3
4
5
6
7
Est
USA
Lat
Hun
Slo
Lit
Bul
Cze
Ita
Pol
Sk
Gre
Rom
Competence of civil service (1=lower than private sector)
Administrative regulation (1=burdensome)
Effective parliament as law-making and oversight institution (1=low)
Source: IMF, 2002

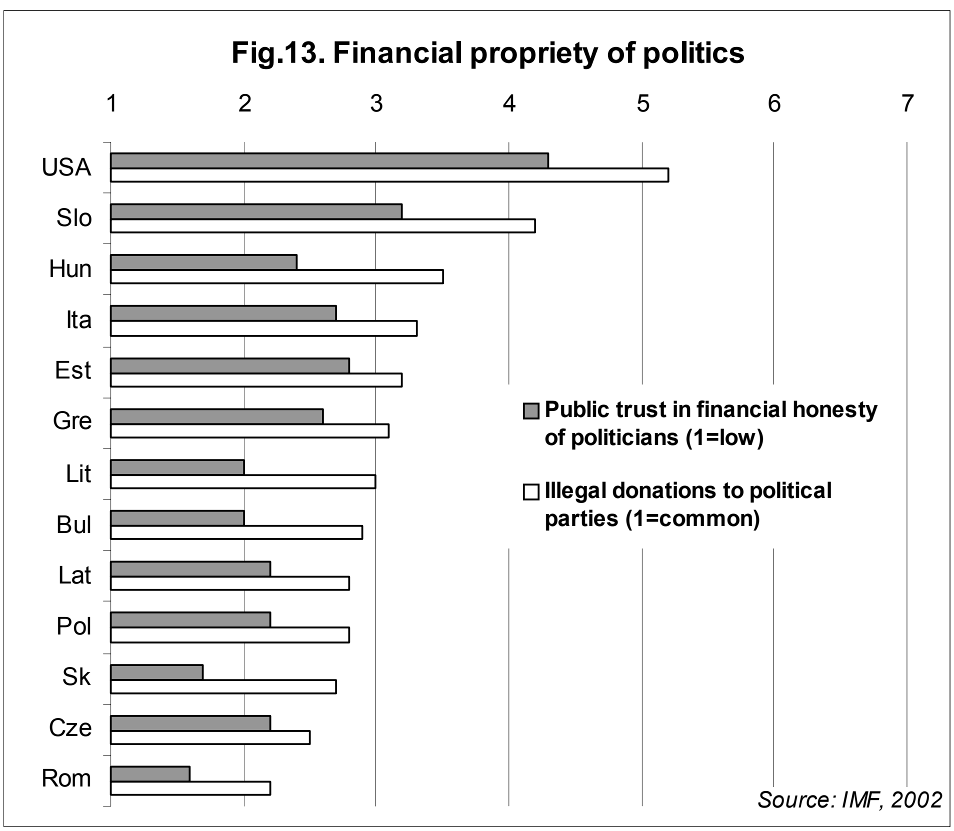
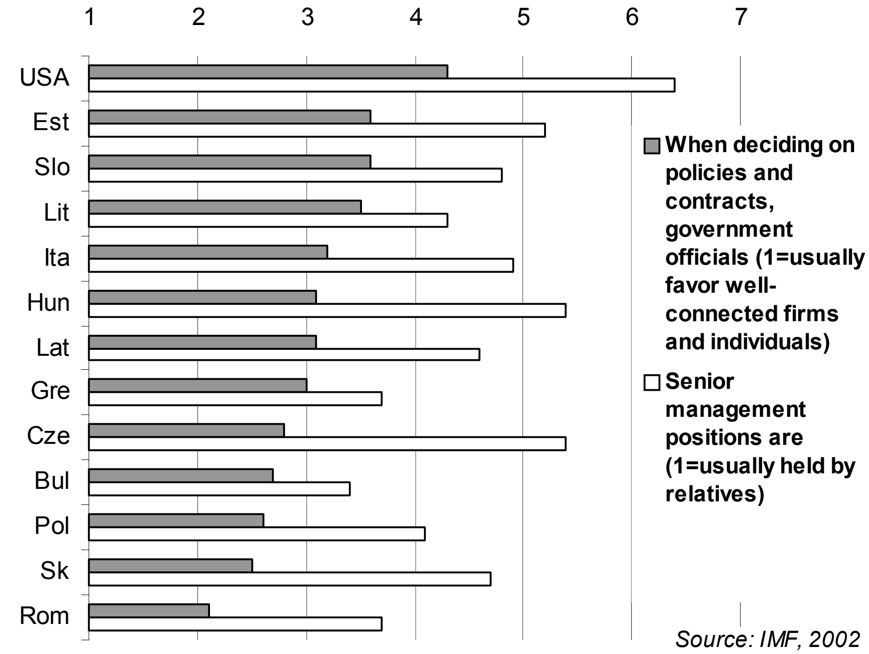


Fig.13. Financial propriety of politics
1
2
3
4
5
6
7
USA
Slo
Hun
Ita
Est
Gre
Lit
Bul
Lat
Pol
Sk
Cze
Rom
Public trust in financial honesty of politicians (1=low)
Illegal donations to political parties (1=common)
Source: IMF, 2002

Fig. 14. Clientelism



This lack of attention for policies may seem strange at first glance since, as previously mentioned, performance in delivery is related precisely to this second, capability component of the democratization process. But it is understandable at a closer look: generating and implementing policies in a democratic environment require professionalism, openness and acceptance to be held accountable for results, qualities that are still scarce among East Europeans. The focus on *policies* (programs and results) as opposed to *politics* (competition for office) may trigger a massive restructuring of the whole national elite, and so it is understandable that all the entrenched power-and-prestige groups (be they part of the politics proper, or public life at large: cultural circles, academia, the media, etc) are tacitly resisting such changes. This also explains why so often governments begin to talk about early elections halfway into their mandates: because they feel uncomfortable in stable environments where policy performance can be observed and measured, and when things get tough and the pressure to reform mounts they prefer to rely on what they know best – campaigning.

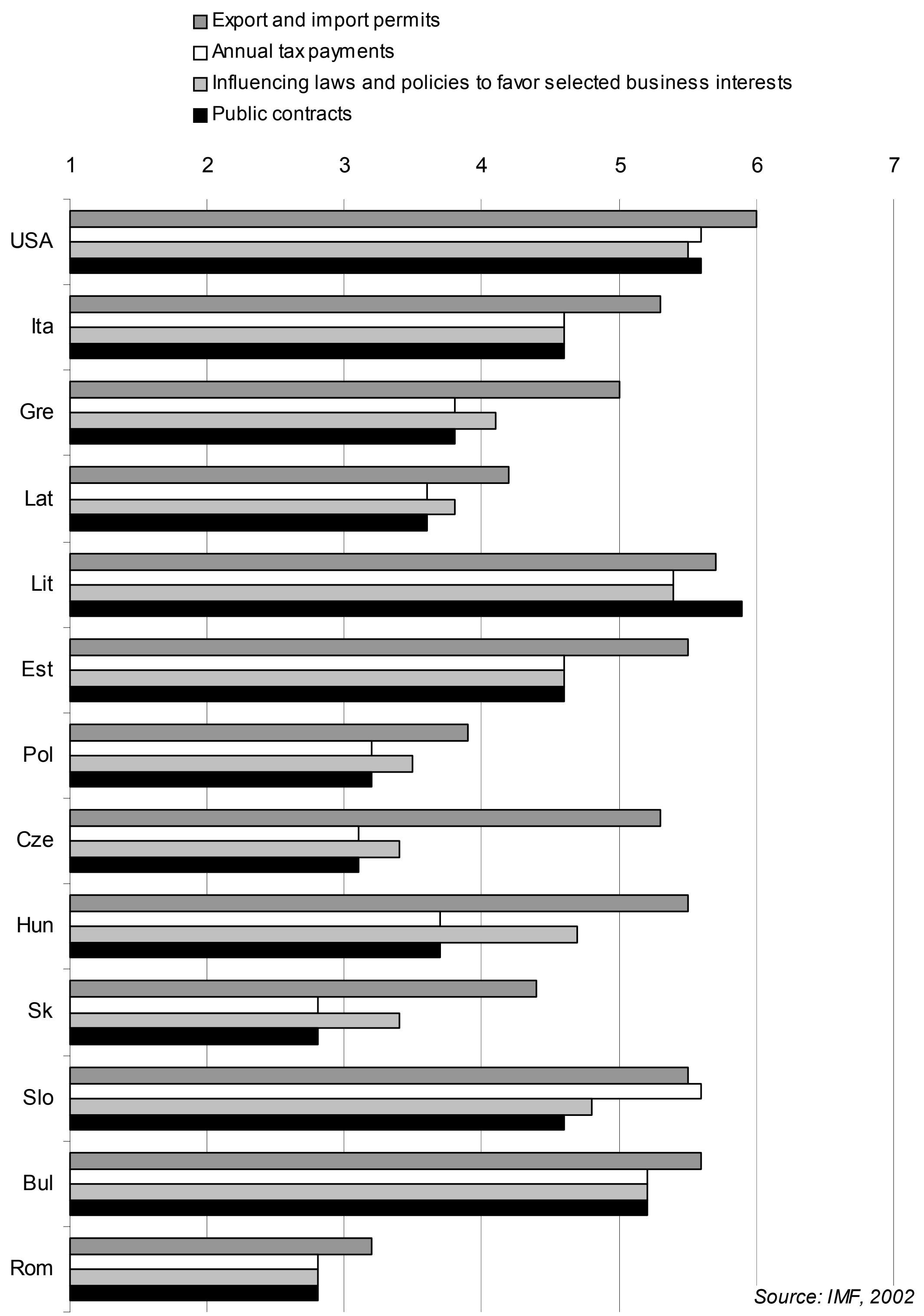
The problem is serious. The policy shortcoming also affected substantially the pace of human development. Most indicators were inherited at reasonably high levels from the previous regime in all ex-communist countries. UNDP measures human development through a combination of education, health state and economic output indicators. If the literacy rate and life expectancy change only slowly in time – and even those marked a slight decline across the region after 1989[4] – the GDP/cap figures were much more volatile and started the '90s with a downwards trend.

[4] True, the pre-1989 figures are questionable in many countries, and in Romania first of all, due to the propensity of the old regime to tamper with statistics.

Fig. 15. Supply of corruption

In your industry, how often do firms make undocumented extra payments and bribes in connection with…

(1=common practice)



The lack of consistent and sustainable growth in some parts of the region in the past decade is largely attributable to domestic policy failures. Wrong institutional arrangements, lack of political will and of implementation skills – all can be grouped under the heading *weak governance,* which, this section argues, explains why some countries have fared worse than others. Romania is a laggard among transition countries. One of the most comprehensive evaluations of the governance quality in the nations of the world, run jointly by the World Bank and the Stanford University[5], only confirms with quantitative data what EU, OECD and other international reports have noted before: that there is a deficit of governance in Romania that spans over many aspects of the public life (Fig. 16). Two things are particularly concerning in this analysis:

- Romania scores last among CEE nations on the quality of governance indicators, being relegated into the second league together with crisis-torn Balkan and CIS countries.
- Not only is the average score low, but also the quality of governance in Romania worsened slightly between 1998 and 2001.

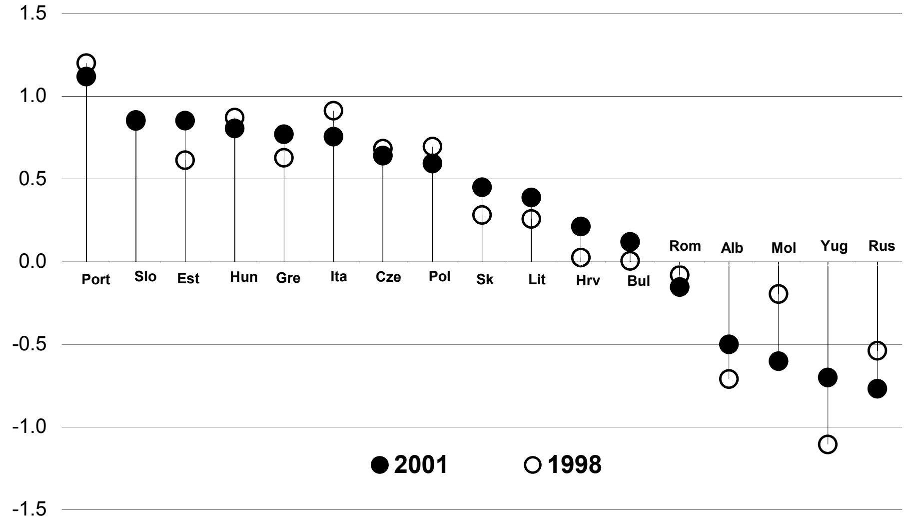
The political and economic liberalization of early '90s was not followed up with good policies

No other EU candidate has experienced this combination of unwelcome developments; even Croatia, crippled by war, seems to push ahead faster – which explains its recent advance on the road of EU accession. A disaggregation of the total country score shows more precisely where the problem is. While in the political areas (voice, political stability) things look reasonably well, the policy implementation areas are those that hold the score down: government effectiveness proper and the control of corruption (Fig. 17). In addition, the quality of regulation has worsened significantly between 1998 and 2001. This is an important point to stress when talking about the first decade of transition in Romania: the country has failed to follow up with sound policies the political liberalization achieved in early '90s. There are many reasons why this happened, in Romania more than in other places, and they will be explored in depth in this section of the report.

When something eventually gets implemented and functions, there are usually two reasons why that happens. First, because external conditionality was strong and detailed enough to keep things on the right track. This is the case with certain measures to stabilize and liberalize the Romanian economy, adopted largely in two waves: early '90s and 1997-98. Or, second, when a bad crisis suddenly occurs and forces the implementation of a solution that had been long debated without any decision being reached. Arguably, this is how one the most important policy achievements of the last years came about: the cleaning up and strengthening of public and private financial sectors after the 1997-2000 bank collapses and near-default of payments. In some instances a combination of external conditionality and crisis-driven measures may function, as it was the case with the issue of orphan children: strong pressure from Brussels and Strasbourg to do something about Romania's gloomy orphanages, plus a string of scandals related to international adoptions forced the government into action and a more modern system of foster care was eventually implemented.

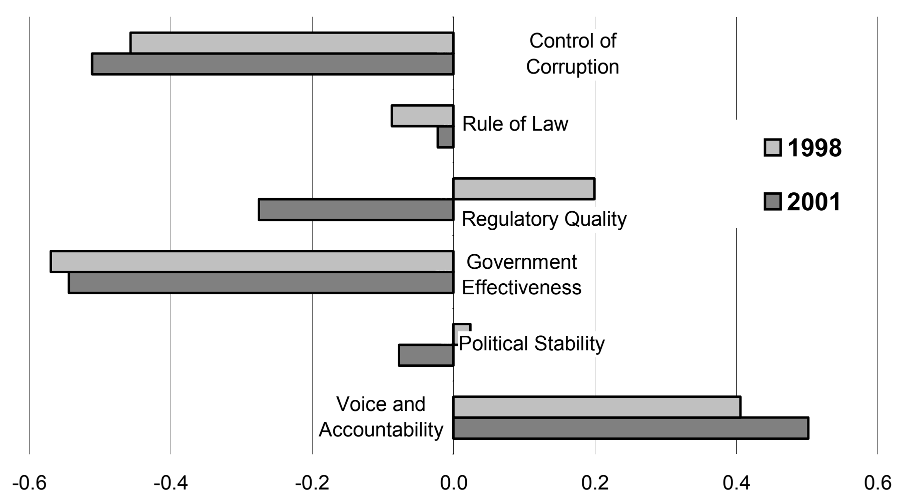
[5] Kaufmann, D., A. Kraay and P. Zoido-Lobaton, 2002. *Governance Matters II: Updated Indicators for 2001.* The World Bank and Stanford University, www.worldbank.org/research/growth

Fig. 16. The quality of governance score: developments between 1998 and 2001



Source: Kaufmann et al, 2002

Fig. 17. The quality of governance in Romania: developments between 1998 and 2001



Source: Kaufmann et al., 2002

The problem is, these two factors can only work in some areas. The external or crisis-motivated push may not function with the same efficiency in other sectors of economic or social policy, where standardized solutions do not exist (as they do in banking, for example) and domestic expertise is necessary in order to filter and adapt locally the pool of international best-practices. If the Romanian policy community continues to be weak and non-committed, things will not change for the better. At present there are obvious problems in this respect, starting from the very design of the policy cycle.

Once this vicious structure of interests has adapted to the circumstances of transition and consolidated, even the process of privatization could not be of much help. Private actors, either resulted from the privatization of old institutions or newly appeared, perpetuate successfully the *state capture society*. One can distinguish between *ordinary corruption* (when an official uses its public function in order to extract personal benefits), *state capture* (when private actors manage to buy portions of the public apparatus for their own purposes) and *influence* (when actors from outside the policy decision apparatus influence the rules of the game, but without recourse to private payments). The third situation characterizes, for example, large state owned (or formerly state owned) enterprises, which, if restructured, may give rise to social problems. This influence is mostly inherited.

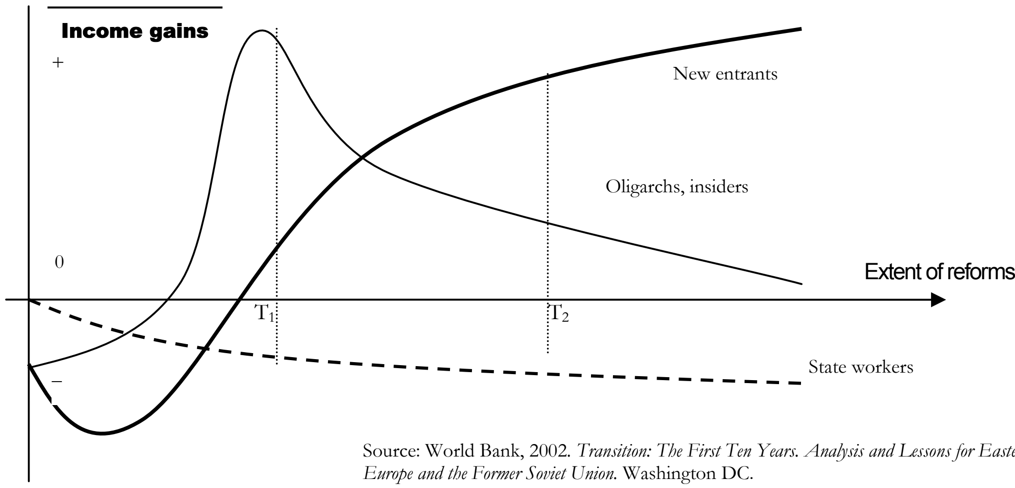
'State capture' by private interest groups is the main threat to social stability in Romania today

But it is *state capture* that is both dangerous and peculiar to the post-communist environment. When the state under-provides the public goods necessary for entry and fair competition, the most rational thing to do even for new entrants is to turn to state capture and rent-seeking as a strategic choice. Captor groups purchase directly from the state a customized package of services, including access to markets, property rights and enforcement of contracts, which is not available to the competition. On the other hand, since public officials are able to sell privately for a price what otherwise should be provided freely to all, they have no incentive to improve the provision of public goods because this would diminish their rents – on the contrary, they have every incentive to decrease production and start blackmailing all potential clients. This perverse dynamic shows why the line of reasoning that considers corruption legitimate civil disobedience, or a grease for the wheels of commerce, is blatantly wrong in this case. The general uncertainty and instability of the rules of the game make actors engage in short-term transactions, where costs and benefits are simultaneous and upfront, and the contracts are more or less self-enforcing[6]. This is a bazar-like market. On the contrary, modern societies are wealthy and dynamic because actors are able to make long-term deals and invest in their future. These transactions are not self-enforcing, but *rights-intensive*: a dense network of impartial institutions exists that protect social agents from being cheated or robbed, by their business partners or by the political power. It is exactly this institutional network that is missing or incomplete in transition countries.

---

[6] Olson, M., 2000. *Power and Prosperity: Outgrowing Communist and Capitalist Dictatorships.* Basic Books, NY.

FIG. 18. WINNERS AND LOSERS FROM THE ADVANCE OF REFORMS: INCENTIVES CHANGE AS REFORM ADVANCES FROM THE INITIAL STAGE (LIBERALIZATION: $0\text{-}T_1$) TOWARDS CONSOLIDATION OF PROPERTY RIGHTS AND COMPETITION RULES (T_1-)



Source: World Bank, 2002. *Transition: The First Ten Years. Analysis and Lessons for Eastern Europe and the Former Soviet Union.* Washington DC.

Many of those who benefited from the early stage of reforms have an immediate interest in blocking further reforms

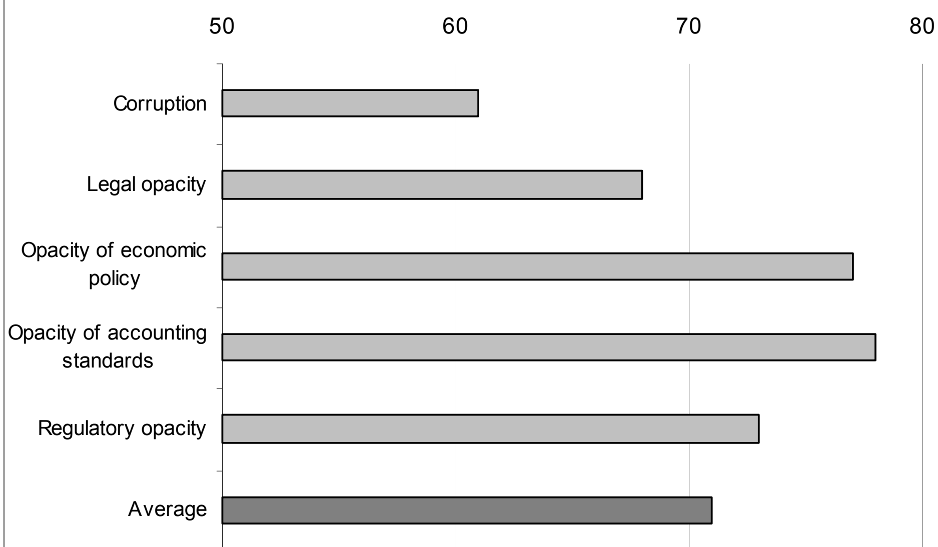
The post-communist societies are not confronted any more with a Leviathan state, as it happened under their previous régimes, but with a cluster of powerful private oligarchs who manipulate politicians, shape institutions and control the media to advance or protect their empires at the expense of public interest. The fact that the communist régime left behind a weak and over-extended public sector, permeable to case-by-case negotiations, only made the capturing process easier after 1989 through the numerous existing entry points. The most likely to take advantage of these opportunities were individuals with substantial de facto control over state assets and close ties to the old political elite. Once they have consolidated themselves in the current positions, the early entrants into the system have every incentive to stop reforms after its first stages (point T_1 in Fig. 18). This first stage typically consists of some trade and price liberalization, privatization and removal of state control over private economic activity, and this is when early entrants can convert their informal control over public resources into substantial personal gains through rent-seeking, arbitrage or asset stripping. However, this stage does not include strengthening property institutions, contract guarantees and liberalizing competition. The early entrants were shaped by the characteristics of this first stage of reforms, and know that they would not survive if competititiveness and professionalization of their lines of business increase. As a result, from the moment T_1 on they tend to become natural allies of the state sector workers in opposing further reforms and access by new entrants.

The implications are clear. Rent-seeking and asset-stripping reduce the overall social welfare through thwarted distribution, while opposition to reforms blocks the rise of new entrants, stifling innovation and growth. In state-capture societies, the overall growth of the enterprise sector is found to be about 10% lower over a three-year period[7]. These societies also display a high degree of *opacity* – both as a symptom and cause of state capture, and the main generator of confusing policies and circuit breaker in the rational policy circle (Fig. 19). If the estimates of PricewaterhouseCoopers are correct, Romania pays a high price in terms of foreign direct investment foregone for its policy opacity and state capture: the FDI is at less than half of its virtual level in conditions of transparency (Fig. 20). The society functions in a sub-optimal state and efficient public policies are harder to initiate as time passes, because they would threaten the establishment. Hence, the missing policies model described above.

Moreover, there is ample evidence that the provision of *second-order* public goods – such as education and healthcare, which are long-term investments in the human capital of a community – cannot be organized efficiently unless *first-order* public goods are guaranteed (law and order, property rights, accountable governance). Romania has one of the lowest levels of spending on education and healthcare among CEE countries, as a percentage of GDP. What is more, the equality of access to social services (such as healthcare) is also lower than it might be expected in an ex-communist state (Fig. 21). Reducing corruption usually results in significant social gains as measured by decreases in child mortality rates and primary dropout rates, as many studies have shown[8].

Fig. 19. Romania's opacity score

0 = transparency; 100 = opacity

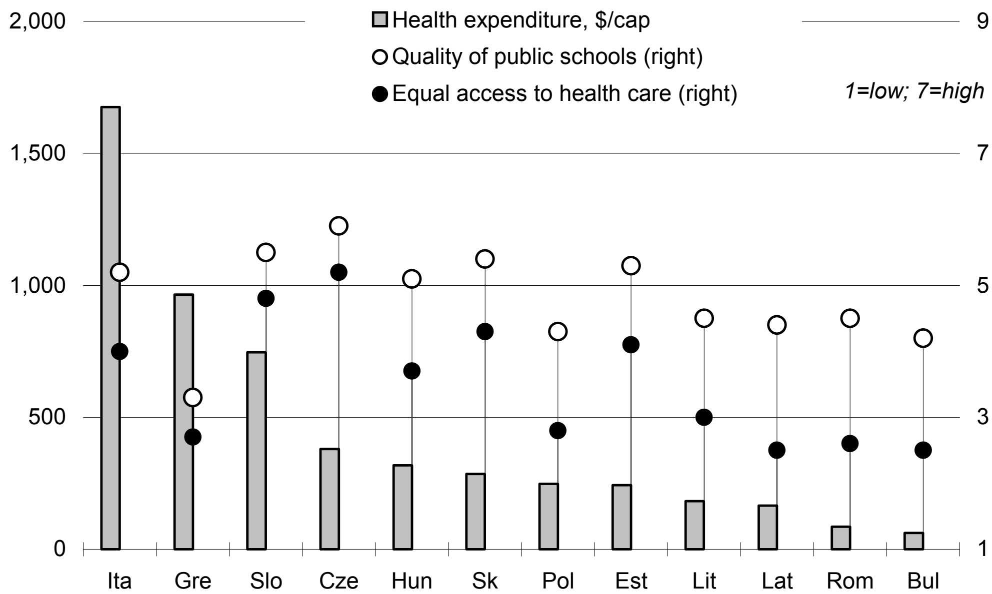


Source: PricewaterhouseCoopers, 2001

[7] Hellman, J. et al, 2000. *Seize the State, Seize the Day: State Capture, Corruption and Influence in Transition*. Policy Reasearch Working paper 2444, World Bank.

[8] Gupta, S., et al., 2000. *Corruption and the Provision of Health Care and Education Services*. IMF Working Paper 116.

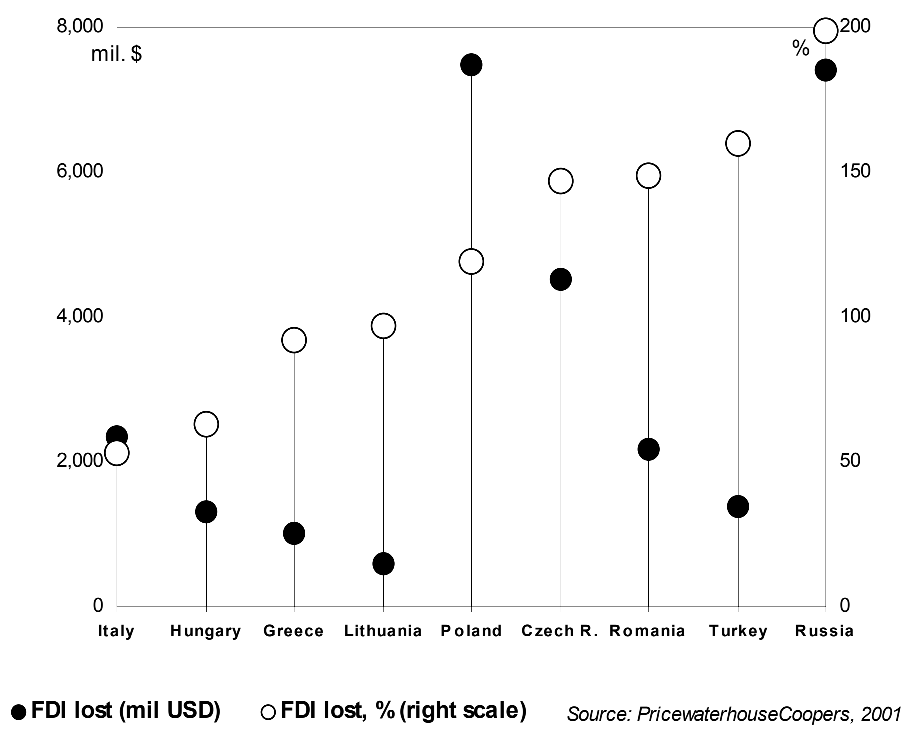
Fig. 21. Social services



Source: IMF, 2002

Fig. 20. Cost of opacity in terms of FDI foregone

Aggregate opacity index based on evaluations of: corruption; legal opacity; economic policy opacity; accounting standards; regulatory opacity



Source: PricewaterhouseCoopers, 2001

After Copenhagen: A Few Thoughts on the *Roadmap*

by Daniel Dăianu

FOCUS

The Copenhagen summit has brought good news for Romania, last December. The EU Commission put forward 2007 as a tentative date for the country's admission and a considerably increased accession related financial assistance was worked out; consequently, the EU grants could reach about 1,000 million euro by 2006 should Romania make good proof of its capacity to absorb these funds efficiently.

Since 2000 – as Romania was invited to start accession negotiations, at Helsinki, in December 1999 – the Commission issues monitoring reports on the Romanian economy and society on a regular basis. These reports provide screening rods for measuring the accession process. At Copenhagen, the Romanian officials insisted on getting a *Roadmap* that should provide technical nuts and bolts of needed reforms, which assumedly, should make accession a quasi-safe journey. Some Romanian analysts hurried up to say that admission is almost a preordained affair should authorities observe the provisions of the Roadmap with minutiae – as if the country's march towards accession would be put on "automatic pilot".

Although the *Roadmap* is pretty eloquent in many respects it does leave a number of issues unanswered. Therefore it does make sense to draw attention to some of these issues, which, arguably, deserve public attention and debate.

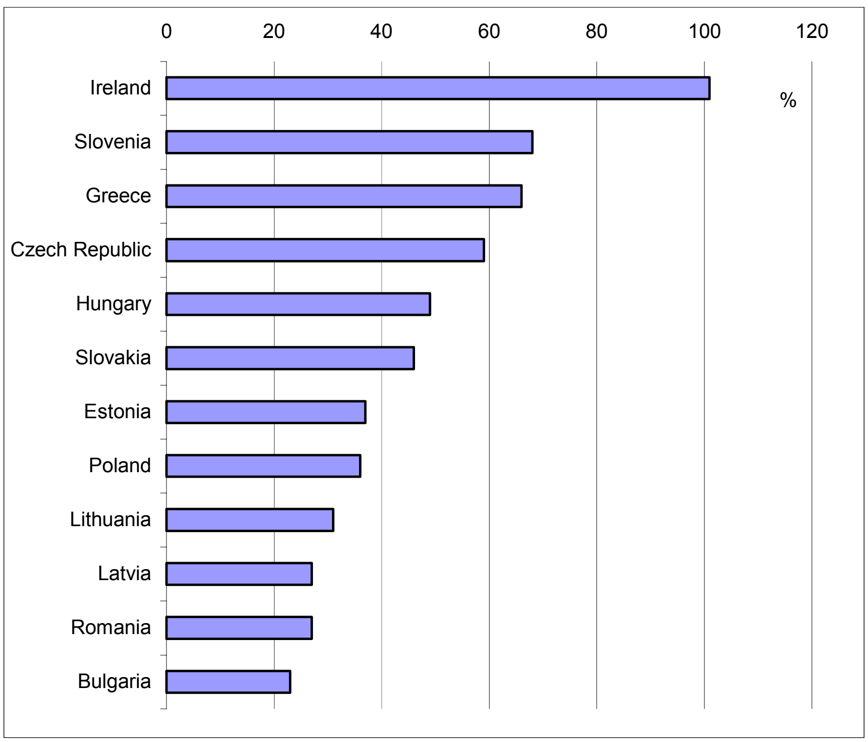
What the *Roadmap* does not say

The adoption of the acquis communautaire (the set of EU norms and regulations) is only very partially a technical operation – of transposing the EU rules into the Romanian legislation. In a deep sense, the assimilation of the acquis concerns the actual functioning of local institutions, as a precondition of economic and social performance. And it goes without saying that this functioning cannot be *decreed*, or achieved in a very short while. For this reason the European Commission does not relent in stressing the need for the reform of public administration and justice, and the fight against institutionally entrenched corruption.

I would submit that the reforms, which are asked for by the accession into the Union, are more demanding (complex) than the creation of a "conventional" market economy together with a liberal democracy. This is because the Union is the fruit of organic development, and also of meticulously engineered institutional construction. The latter, in particular, is meant to bring national contexts – of relatively close economic development levels – nearer in institutional and functional terms. Accession demands a series of institutional adaptations, which otherwise would not be asked for[9] – and these adaptations could complicate reforms owing to inherent ensuing costs of complexity.[10]

In spite of lingering economic discrepancies the Union is made up of prosperous economies/societies. Therefore, one sees easily that Romania is confronted with a major developmental handicap, which cannot be done away with rapidly (Fig. 1). One could nuance this by pointing at the similar income per capita of Latvia, which will, very likely, join the Union in 2004. But Latvia is a comparatively small country (territory- and population-wise), with a much less complicated economic structure and less hard to deal with sectoral imbalances. At the same time, the Maastricht criteria (with regard to the level of inflation, interest rate differentials, budget deficit limits, and limits of variation of the exchange rate) are not easy to fulfill and are likely to constrain economic growth[11]. And not least, the autonomy of economic policy would be severely constrained, even during the pre-accession period, which may reduce the capacity to deal with adverse shocks considerably.

Fig. 1. **Per capita income levels in Europe (1998, PPP, % of EU average)**



Source: "Progress Towards the Unification of Europe"World Bank, Washington DC, 2000, p. 40.

[9] For example, the provisions of the acquis regarding social security legislation and enviromental protection.

[10] This is the main argument of those who claim that the EU (continental) model is less suitable for catching up economically with rich countries. One direct hint is made at what some claim to be overregulated labor markets in the Union.

Fig. 2. Years required to close per capita income gap (PPP) with the EU

	Assuming 5% long-term growth rate average		
	EU average	**75% of EU average**	**50% of EU**
Slovenia	13	3	
Czech Republic	18	8	
Hungary	24	14	
Slovakia	31	16	2
Estonia	34	24	10
Poland	34	24	10
Latvia	40	30	16
Lithuania	40	30	16
Romania	45	35	21
Bulgaria	50	40	26

Source: "Progress towards the unification of Europe", World Bank Report (2000), p. 42.

Clarification: assuming that the accession countries grow at an average per capita long-term rate of 5%, and that the similar rate for the EU area is 2%, it will take between 13 years (for Slovenia) and 50 years (for Bulgaria) to achieve convergence to the EU average. Romania would need 45 years in order to do so.

The "political economy" of enlargement is also an issue which is likely to have a significant impact on Romania' accession; if the first wave of Eastern enlargement (in 2004) can be taken for granted, the following sequence of this process is far from being a certainty[12]. Future waves of enlargement depend on the internal metabolism of the Union, which could be severely tested by rising divergence of economic performance – due to mounting economic difficulties all over the EU in recent years – and the formation of various "coalitions", with different views on the management of EU internal issues and the formulation of a common security and foreign policy.

A main inference is that the assimilation of the *acquis* implies both benefits and costs, and the latter are not to be underestimated. Moreover, costs are not easy to illustrate and measure, which could create a credibility problem to Romanian authorities should these costs reveal substantially higher than anticipated.

Admittedly, benefits would go much beyond costs. The accession negotiations would discipline policy making and make EU accession related reforms more consistent and steady; against the background of the assimilation of the acquis the link with the UE looks far richer than that with the international financial institutions. The European Union could provide Romania with a *big push*, which she needs so badly in order to overcome a developmental and modernization challenge. In a

[11] This is due, among other things, to the so-called Balassa-Samuelson effect.

[12] Bulgaria's and Romania's chances hinge also on how smoothly the 2004 wave of acceesion occurs.

previous report[13] reference was made to Paul Rosenstein Rodan's famous injunction (which he made decades ago), that South East Europe needs a *big push* on order to defeat economic backwardness[14]. His analysis, in many respects, is still valid and the multifarious link with the EU could result in enormous economic progress assuming that Romania can upgrade its economy and achieve higher competitiveness. Aside from the benefits brought about by institutional reforms, the financial assistance – which can amount to 2.5% of GDP – can make a huge difference, if it is used wisely. The Union can also provide an economic (and not only) "shelter" at a time when uncertainties and vagaries multiply in the world.

The above qualifications prepare the ground for observations on a series of issues which, arguably, the *Roadmap* leaves open, or fails to address. The Roadmap puts forward venues for policy action and useful benchmarks for judging progress, but it cannot provide a sufficient framework for effective public governance. Many of the dilemmas and questions, which confront Romanian society can find answers at home only, and effective policy making cannot but remain in Romanian hands; policy ownership cannot be transferred to Brussels. Such observations are made below.

1. Since the Roadmap is incomplete (for it cannot be otherwise, as a matter of fact) and in addition there are issues which do not have clear-cut solutions, there is negotiating room in Romanian policy makers' continuous dialogue with the Commission. This dialogue should rely on several premises such as: **different policy options are, frequently, and in many fields[15], available**; despite the deepening of the EU and the acquis there is significant institutional and policy variety in the Union, which indicates that Romanian policymakers can and have to make choices; they should try to optimize such choices according to our domestic circumstances and likely external conditions (such choices can be made for instance in the field of fiscal policy and agricultural policy).

2. Economic policy choices need to serve the main policy goals (economic growth, disinflation, social cohesion, etc) by considering **inevitable trade-offs** (ex: pushing growth too far harms external balance). Policy needs to observe the ABC of sound economics (achieve low inflation, keep fiscal balance over the business cycle, make hard budget constraints operate ubiquitously, etc) and be pragmatic at the same time; it is inimical to succumb to theoretical fundamentalism when it comes to real life. For example, previous EWR reports underlined the need to regulate markets effectively (and connect privatization in the energy production and distribution sector with effective regulation of markets, which should protect end users).

[13] "Is catching up possible?", Annual EWR, 2002

[14] Rosenstein Rodan referred to key inter-dependencies in an economy, which may preclude its development, unless there is effective coordination among its constituent parts (industries). Development asks for complementary changes of action and resources. And such simultaneous endeavors may not be possible in the absence of a strong stimulus, of a "Big Push". This is a fundamental question to be addressed by policy makers. (Paul Rosenstein Rodan, "Problems of Industrialization of Eastern and South-Eastern Europe", Economic Journal, vol.53, June-Sept., 1943, cited in Daianu,2002)

[15] it is commendable that Romanian policymakers are arguing arduously so that Romania be able to protect her agriculture until after 2010.

3. **Policy needs to focus on real issues and avoid hasty decisions**, which may, apparently, score points image-wise (prestige), but are likely to be quite costly unless addressed properly. One example is, in the author's view, a hasty full liberalization of the capital account, which is foreseen (with a few excepted items) to take place during 2003-2004. EWR no.1/2003 made a strong case in favor of reconsidering the current timetable, which is not imposed by the EU. Although Romania has witnessed economic recovery in the last few years, and several macroeconomic indicators do look quite good (low external debt, substantially higher foreign reserves, low current account deficit, etc) major vulnerabilities persist and policy-making would be mistaken to ignore them for the sake of temporary, and possibly illusory benefits.

4. **The fate of national industry depends on how domestic sectors (enterprises) get into main European industrial networks.** Public authorities do have a role to play in this regard by using various policy tools (including tax incentives and a better business environment for inward investment in industry). This assertion does not imply continuing subsidizing heavy loss makers and denting on the profitability of successful companies.

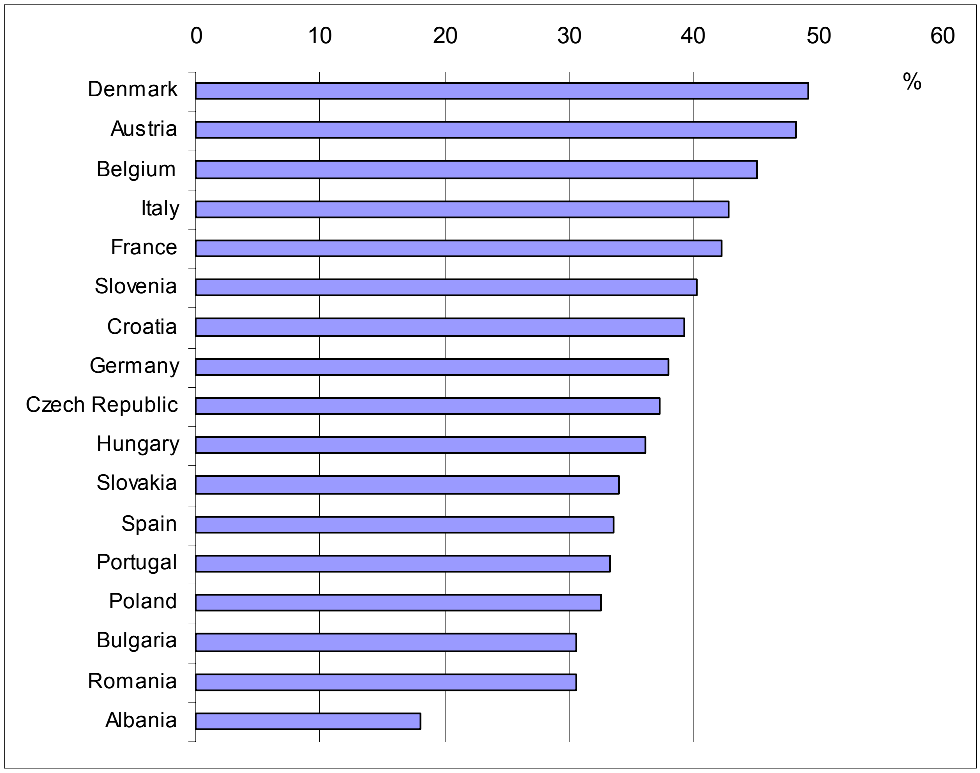
5. **Infrastructure needs a lot of improvement.** Funds from the EU and from other specialized institutions (the European Investment Bank, in particular) have a key role to play to this end. The experience of Portugal, Spain and Greece shows what tremendous progress can be made in this respect by making good use of EU structural funds. But the Government needs to use funds much more efficiently. Quite obviously, most of the initiatives in this field would have to be undertaken by public authorities. The more the budget would rationalize its expenditure and the more tax collection would improve, the more could be assigned to infrastructure – when the latter is seen as a public good (Fig. 3).

6. **Romania has to assign more resources – via the public budget – to her citizens in terms of educational and healthcare services.** This issue will be increasingly challenging in the years ahead. As in the case of infrastructure, a better performing economy and better tax collection would allow significant improvements in this respect

7. **Agriculture will very likely be a major stumbling block in Romania's accession; for it holds a relatively large share of the GDP (around 18%) and keeps busy much of the active population.** Romania's agricultural dossier is more complicated than Poland's, which had agriculture as the most difficult portion of her negotiations with the EU (Romania is more rural and less developed economically than Poland). One should also consider the heavy subsidization of this sector in the EU, and the decision to reduce subsidies gradually – which would have an impact on Romanian agriculture by the time of the programmed accession. In addition, **the pure economic problem could be much compounded by a possible reversal of recent years' exodus of people toward the countryside.** Farmland consolidation would likely force younger people to try to find jobs in the urban areas and this might recreate the

old "rural overpopulation problem"[16] unless other sectors do not provide a sufficient number of jobs.

Fig. 3. Tax revenues, % GDP



It may be that, in view of the demographic ageing in Europe and Romanians' increasing propensity (because of wage differentials) to work abroad, the export of labor may offer a venue for alleviating/averting a major social problem. Romania needs to avoid a Latin-American type evolution in this regard and proper agreements with the EU would be a means to tackle it. As a matter of fact, a "Grand Bargain" may be in the offing, in this respect. Thus, transition/accession economies would supply labor to the EU, which would make it possible for these citizens (who work abroad) to send home substantial amounts of money; and these private transfers would make up a *sui generis* safety net.[17]

Absorption capacity

[16] This issue was hotly debated in Romania in the twenties and thirties of last century. One of the leading proponents in this debate was the famous economist Nicholas Georgescu Roegen, who during the forties was forced to flee Romania and, subsequently, taught at Vanderbilt University in the USA.

[17] Private transfers from abroad made up almost $1,600 million in Romania in 2002. These transfers contributed massively to bringing the current account deficit to cca 4% of GDP in 2002, and exceeded by more than 50% the volume of inward FDI.

The capacity to absorb EU funds will play a critical role in the next few years. EU officials[18] have expressed some reservations as to Romania's ability to absorb funds properly and Romanian authorities reacted immediately to this viewpoint. There are several things to clarify in this respect. One is that absorption capacity regards all accession countries. Secondly, the countries that are more fragile institutionally and have a harder time in fighting vested interests (and corruption) are less likely to use EU funds efficiently. Thirdly, structural funds are more important the poorer is the economy. One has to stress, however, that the marginal benefit of an efficient use of structural funds is higher in less developed economies. And not least, the use of EU funds should be seen in a wider context, of Romanian's ability to use all available domestic and imported resources for investment productively.

One needs to distinguish between an acute shortage of resources and the capacity to absorb (use) them efficiently. In general, poor countries, despite their huge hunger for resources, have a limited capacity to absorb funds efficiently. And their precarious institutions explain much of this poor capacity. Absorption capacity can be seen in a static and in a dynamic way. But in both cases, this capacity, though not unlimited, is variable. This means that, at one point in time, a country can use more or less resources, less or more efficiently. In both static and dynamic terms, absorption capacity depends on parameters and variables. The institutional setup is very much a parameter in the short run, but it turns into a variable over the longer term. Policy choices are a variable both in the short and the longer run. Defining priorities (as a policy choice) is also a variable. And the formation of coalitions of interested parties in favor of reforms is a variable as well.

It is not sufficient to examine Romania's absorption capacity in a purely national context. **The international context** and EU policy dynamics need to be considered very attentively. A few arguments are a good advocacy to this assertion. There was much debate at the Copenhagen summit on the amount of financial assistance to the accession countries. There are powerful voices in the Union (donor countries in particular), which argue that regional policy has not been successful over the years. In addition, mounting economic difficulties in the Union reduce the appetite of the richer countries to assist the poorer ones financially, and this syndrome is likely to shape future policy choices in the field of regional policy. Some argue that the EU should provide more assistance to the Western Balkans in the years to come, while powerful tensions persist in that region and the USA has embarked on a disengagement process (financial and military). More resources granted to the Western Balkans would compete with other uses; the outcome would hinge on the way Brussels judges future costs and benefits of its assistance. If Croatia (and not only) achieves better economic performance, her claims to be put on a faster accession track (on a par with Bulgaria and Romania) could turn into reality and she would be entitled to more assistance.

All EU funds should be included in the multiannual national budgeting; the MoF should set up a special unit to monitor their use

For reasons such as those highlighted above Romanian policy makers need to define better the challenge of absorption capacity, analytically and operationally. All EU funds (PHARE, ISPA, SAPARD) should be included in the multi-annual budgeting of the Ministry of Finance; their use should be considered in an overall framework, which accounts for all resources used by the public budget; there is also need to make sure that co-financing is secured through the public budget. We need to learn from other

[18] Eneko Landaburu , a high EU official, was quoted by Romanian newspapers in late January.

countries' track record in using such funds, in order not to repeat avoidable errors. Likewise, it would be wise to set up a special task force in the Ministry of Finance to monitor the use of these funds[19].

Public goods and budget policy

Poor tax collection does not allow for the provision of public goods that are commensurate with the needs of the economy. Aside from institutional fragility, it may be that income per capita does play a role in explaining tax collection and budget revenues. It would be quite implausible to state that budget revenues in Romania should not be a cause of worry if one looks at public budgets in the Anglo-Saxon world (with ratios of around 30% of GDP in the USA, or Australia). Such type of argument would sound quite speculative and unrealistic in view of the highly different social structures and welfare mechanisms.

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 (the tax collection authority) is more than welcome. The significant difference in mobilisable public resources, unless corrected, would favor a rise (to Romania's disadvantage) in income per capita differentials in the years to come.

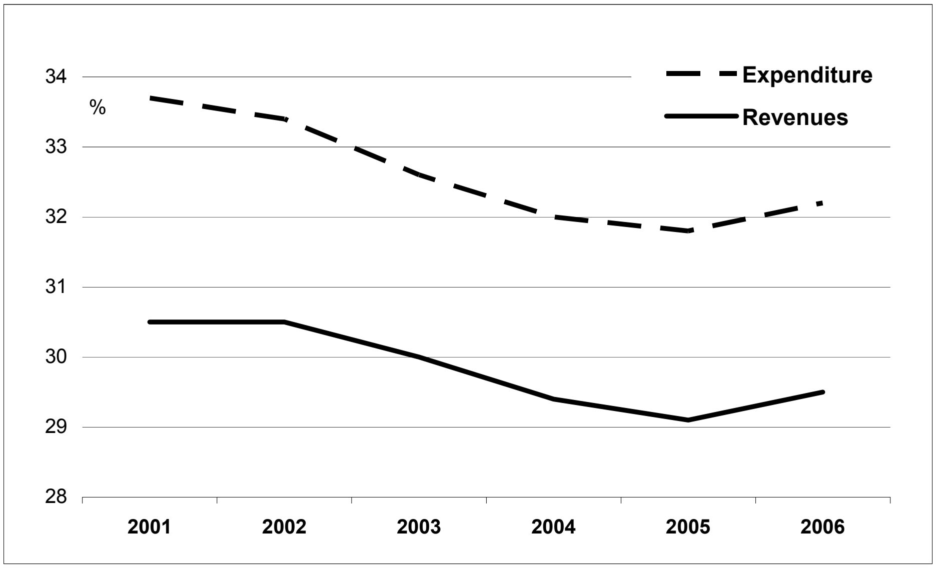
In view of the intense competing claims on the public budget *the Romanian authorities have to reexamine the current medium term program which forecasts a somewhat surprising tendency of stagnating or even declining budget revenues in the period 2003-2006* (Fig. 4). Would this tendency illustrate a tax 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 necessarily cause worry. This would be particularly the case should the EU funds 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 can be reversed should tax collection improve substantially (by assuming that better collection is not used totally for reducing the tax burden, thereby, diminishing budget revenues). The plans which aiming at creating a unified tax administration department and a large taxpayer directorate may prove a step in the right direction. The tax system needs to be simplified, in order to ease its administration and reduce compliance costs. But the simplification of the tax system should not turn into policy fundamentalism. One should keep in mind that the EU member countries themselves use the logic of non-distortionary taxation in a flexible way.

---

[19] The issue of absorption capacity is discussed from an institutional perspective elsewhere in this Report ("Can we spend their money?" in the Politics Section).

Fig 4. Tendencies of the budget revenues 2003-2006



Summing up

Is the Roadmap and the efforts to adopt the *acquis communautaire* the equivalent of an effective strategy for rapid economic growth and modernization? In many domains, it may well be so, to the extent that good institutions are smoothly assimilated/adapted and function effectively, and to the extent that technology transfer and upgrading of production (including via FDI) occur intensely, for the benefit of a majority of the citizens (*social cohesion* is not impaired). Empirical analyses show that the opening of the economy and integration with the outside world (in this case, with the EU), have better chances to foster economic growth when there is an intense inflow of foreign direct investment, which upgrades the capital stock and human capital of the recipient countries. It is no surprise, therefore, that the frontrunner accession countries have received a disproportionate share of FDI. Romania bets on a rising share of FDI, and more transfer of know-how in general, in the years to come.

An important caveat is needed, however, regarding the linkage between EU integration and convergence, nominal and real. Some of the premises for catching-up may clash with the strict conditionality of the Maastricht Treaty criteria, in case accession countries intend to join the Exchange Rate Mechanism (ERM2) and, later on, the Monetary Union. A related situation is entailed by the implications of the *Balassa-Samuelson Effect*, which threatens to make it impossible for accession countries to comply with the requirement of a very low inflation rate in order to fit the EU (ERM) area. And, should they try to attain a very low inflation rate, this may undermine growth and, therefore, catching-up. If this is the case, should some of the accession criteria be made more flexible? The current pains of several EU member countries in meeting the demands of the Financial Stability Pact shows that some changes in this respect might be considered. But what would be the implications of changes in the criteria, for current and future members of the Union, and for the EU as a whole? To what extent can the logic of a "variable geometry" play a role in this context? It may be that the only way for keeping enlargement an open process would be to have a sort of variable geometry in the making (the talk about a “core” inside the EU points into that direction), but this would, clearly, raise hurdles for deepening.

Romania has to continue reforms resolutely and consistently; she has to make good use of the current period of economic recovery in order to address the economy’s major structural vulnerabilities and fulfill the critical mass of requirements, which fit what the Commission calls a “functional market economy”.

Using EU grants according to the needs of the Romanian economy requires a systematic concern for raising its absorption capacity; the latter depends on a deeply going overhaul and reform 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. Budget policy needs to focus more on defining priorities, reduce waste and combat corruption.

Over the longer term, the main critical issues, which are related to the sectoral composition of industry (its competitiveness), the state of agriculture, the huge costs of restructuring the energy production and distribution sector, and the imbalance between retired people and the working population, will come increasingly at the forefront of public policy and will dominate the dialogue with the Commission in Brussels.