GEA
Group of Applied Economics

ROMANIA JUST BEFORE EU ACCESSION

SUSTAINING GROWTH AND FOSTERING JOBS IN AN EMERGING ECONOMY
(4th REPORT)

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Bucharest
November 2006

This report has been prepared by research team of the Group of Applied Economics (GEA). GEA's mission is to provide an independent research capacity for all aspects of applied economics in Romania, to contribute to the economic policy debate in Romania and to provide public policy solutions for the economic problems currently faced by Romanian society.

Acknowledgements:
The authors would like to thank Cătălin Păuna for the support in drafting and documenting a section of this report.

This report benefited on financial support from the Volvo Foundation in Bucharest.

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FOREWORD

This is the fourth GEA report assessing Romania's economic performance by using Lisbon Agenda benchmarks. It is published a little time before Romania's accession into the European Union. This should be a most uplifting, gratifying moment for all Romanians who trust the political and economic project of the EU; for those who bet on accession as an historical opportunity for overall modernization.

Spectacular economic growth rates in recent years, the consolidation of the financial system, disinflation, low unemployment rates, etc have changed the perception of the Romanian economy both domestically and abroad. The international rating agencies have not procrastinated in giving Romania investment grade and capital inflows have poured massively in the country in the last couple of years. Nonetheless, lucidity and intellectual honesty ask for poise in examining a series of challenges that will confront Romania's economy after accession. And this is what we have tried to do in this report.

Recent political stumbling in several new EU member countries (from Central Europe) should give us food for thought. Arguably, higher economic growth rates are a must for catching up, but not sufficient for securing social cohesion and sound domestic politics. This leads us to the ongoing debate on the links between economic growth and social stability, democracy. In this context the need in Romania of a post-accession strategy is looming more saliently.

Romania needs a post-accession strategy in order to capitalize on the opportunities offered by EU accession and reduce economic gaps over the next decade. Bits of the conceptual and operational contours of such a strategy are present here. But, clearly, there is need for much further work.

The first GEA report (March 2004) provided a scorecard based on a brief evaluation of the main objectives set in the Lisbon Agenda.

The second report (November 2004) focused on Romania's competitiveness challenge.

The third report(November 2005) has been undertaken against the background of the revised Lisbon Agenda; it uses structural indicators in order to assess the Romanian economy comparatively and examines the linkage between policies and the economic recovery/growth of recent years, the challenge of competitiveness in the local context, the ability of Romanian policy-makers to foster job creation as a means to mitigate migration.

This fourth report is, to a significant extent, a continuation of the previous one, with its emphasis on conditions for durable economic growth and job creation. Likewise, it revisits the state of structural indicators and takes a closer look at domestic labour markets against the backdrop of substantial migration and the proliferation of pockets of labour shortage.

As previous reports[1] stated the Lisbon agenda may seem a luxury for Romania's emerging economy; because catching up (emerging) economies rely mainly on the absorption of available modern technologies in their quest to achieve rapid economic growth. Likewise, although substantial economic progress has been achieved in recent years the structural foundations of the Romanian economy need to be further strengthened. Under these circumstances, the effort to move towards a knowledge based economy would appear as a pretty daring endeavour. Nevertheless, this effort should be undertaken in a form that fits the specifics of the Romanian economy. The reasons behind such an endeavour are several: the Lisbon agenda ranks very high on the list of priorities of the club which Romania will soon join; a knowledge based economy is Romania's chance to upgrade its products and services decisively in the medium and long run, and for that to happen the seeds of change have to be sown starting now; and last, but not least, global competition, the rise of heavyweight emerging economies, like China, India, Brazil punishes those who think that wage differentials are the infallible recipe for catching up in Europe.

Confirming the current status of the Romanian economy, knowledge diffusion indicators (including the extent of the information society) are advancing faster, while many knowledge creation indicators are under-performing. But this is not surprising under the circumstances. Having said that one has to note that the key to longer term growth is the production of higher value added products and services, and this policy challenge demands constant focus on education, steady melioration of skills, and technical progress based on the new information and communication technologies. The development of software firms in Romania indicates that there is motion in the right direction in this regard.

This fourth report acknowledges the progress made in specific areas of the Lisbon agenda, particularly business investment, relative GDP level, and labour productivity. It also provides a series of policy recommendations in order to improve Romania's capacity to conform to the revised Lisbon Agenda's policy guidelines. It is not redundant to say again that Romania's performance should be judged realistically, since we are not even close to the EU 25 performances in most regards of the Lisbon agenda and our priorities have to fit our challenges.

The report has the following sections: 1/ The Lisbon Agenda and Romania; 2/ Romania according to structural indicators; 3/ Policies for stability and growth; 4/Competitiveness, innovation system (enterprise policy) and structural funds absorption.; 5/ More and better jobs; and 6/ A list of policy recommendations.

Some of the policy recommendations contained in this report are listed below.

- *a post-accession strategy is a must; it implies a comprehensive vision that should focus on reducing economic gaps over the longer term;*

- *public policy (the post-accession strategy) has to come up with a number of well defined strategic national projects, which should outline Romania's economic geography by the year*

[1] Dăianu et al. (2004, 2005) Romania and the Lisbon Agenda, GEA/CEROPE;

2015; multi-annual budget programming is a must in this context;

• macroeconomic policy should reconcile the exigencies of a higher budget expenditure with disinflation and the need to control external deficits;

• the strengthening of the capacity to absorb EU funds is urgent; these funds can help build up infrastructure (highways, roads, ports); the modernization of the rural economy also depends on the absorption of EU funds;

• a consistent reform of public expenditure is needed in order to improve their prioritization and direct them towards areas that strengthen the country's human capital, infrastructure and administrative capacity;

• budget policy should be related to monetary policy in a longer term timeframe;

• a vigorous competition policy should prevent market power abuse (the case of privatized utilities is highly relevant in this regard);

• education should be the top priority for public policy; more resources assigned to education should be accompanied by a focus on engineering and technical schools; it is necessary to stop the degradation of primary and secondary school education;

• public policy has to foster innovation; this asks for adequate institutional measures;

• it is good that R&D public expenditure has been raised and that it is planned to reach 0.7% of GDP in 2007; business R&D expenditure needs to be supported by indirect financial measures, which are allowed by EU regulations;

• public policy should encourage young people to acquire skills and enter the job marke; public education has to play a major role in this regard; the policy has to target the youth from the rural area as well;

• non-wage components of labour costs should be reduced; hiring and firing costs should be reduced; encourage lifelong learning;

• given the inefficient energy production and consumption and the international context on the demand side (the economic rise of Asian economies), it is wise to invest in order to reduce energy intensity;

• because of climate change policymakers have to make proper room for contingencies when they allocate state revenues. There is need to deal forcefully with deforestation, inadequate damming, etc. The financial implications of building up proper infrastructure highlight the need to absorb EU funds to the utmost and efficiently.

1. The Lisbon Agenda and an emerging economy (Romania)

The goals of the Lisbon Agenda reflect an increased awareness at EU level that, in most of its old member states, traditional public policies have run out of steam in the new economic context given by globalisation, the impact of new information and communication technologies, and the aging of population. Though the relative worsening of the EU competitiveness is not non-controversial[2] it would be a mistake to be complacent about employment and growth related trends in most of the old EU member countries. These trends are particularly worrisome at a time of rapid economic ascendancy of China, India and other Asian economies, which flood world markets with increasingly sophisticated products[3]. Likewise, the Lisbon goals are an expression of the centripetal attitudes and forces within the EU, which are worried about the possible dilution and stalemate of the "deepening" side of the European integration process.

1.1. The Race for Competitiveness

In his most recent State of the Union address, US President George W. Bush touched on competitiveness challenges, voicing concern that the United States risks falling behind in science and technology. For citizens in the EU, this "wake-up call" may have seemed surprising: from a European perspective, the United States appears to be ahead. A 2005 report from Conference Board, a high-profile business organisation, showed that productivity growth in the 15 "old EU" member states was 0.5 per cent, as against 1.8 per cent in the United States (and 1.9 per cent in Japan). For the period 1995-2005, annual growth in national output for every hour worked in the EU-15 averaged 1.4 per cent, compared with 2.4 per cent in the United States.

Likewise, data compiled by the European Commission (EC) in Brussels also suggest the EU lags behind the United States in key areas. Research and Development (R&D), for instance, represented only 1.93 per cent of the bloc's GDP in 2003, as opposed to 2.58 per cent in the United States and 3.15 per cent in Japan. True, there is a broad variety in performance across the EU, with the Nordic countries overtaking the United States in terms of amounts invested in R&D. For Sweden, Finland and Denmark these figures are above 3 per cent. And there is some very recent date that would suggest some catching-up lately[4]. However, the stark truth is that

[2] The global trade balance of the EU is not bad. See for example Weder di Mauro (2005). For the heightened debate on competitiveness, as it applies to Germany, see Sinn (2004) and Bofinger (2005);

[3] The stakes in the current global economic game/competition are quite different from what Servan Schreiber was pointing at three decades ago (1968), or Thurow two decades later (1993); both analysts were examining economic trends and clashes inside the western world (at a time when Japan was the exception that strengthened the rule). Nowadays, we are witnessing the economic rise of a large portion of the old developing world which is undermining entrenched hierarchies;

[4] More efficient Europe helps hold down rates, International herald Tribune, 16 October 2006, p.16. Other date would indicate, however, the reverse: in 2005 R&D corporate spending rose by 8.2% in the US as compared to 5.8% in the EU (US widens gap with Europe on R&D, Financial Times, 30m October, 2006, p.1);

the heavyweights of the EU do not spend nearly as much in this area as the EC thinks would be adequate - namely, 3 per cent of GDP.

The ambitious EC blueprint known as the Lisbon Agenda was formulated with an eye to the performance of US companies and the excellence of the American way of blending academic research with high-tech and industrial pursuits. For instance, the EC proposed setting up a European Institute of Technology, modeled after MIT. The idea was criticised as being a "top-down" approach, sucking money and resources from the alternative option of supporting high level research through a European Research Council. Indeed, controversies have often arisen over specific measures aimed at implementing the Agenda, and much remains in the hands of European national governments. However, it is clear that the United States represents a kind of benchmark for policymakers, and it is also clear that the EU, on average, has been sluggish in achieving its goals in terms of competitiveness. The bottom line is that the bloc faces a growing challenge.

The success of the EU's Nordic fringe has been due not only to major R&D efforts undertaken both by governments and private companies, but also results from flexible product and labour market, as well as a clever overhaul of welfare networks. The newer EU member countries seem to fare comparatively well in terms of productivity growth[5]; the 2005 report of the Conference Board indicates an increase of over 6 per cent in these economies, which have capitalized on their catching up potential. Arguably, however, just catching up isn't enough. Over the longer run, demographics and an expected sharp rise in wages (according to the Balassa-Samuelson effect) will diminish the growth differential sharply, unless appropriate policies are put into effect.

If we are comparing the EU and the United States, then, Bush's concerns might strike some as unjustified. However, there is another factor to be considered: Asia. China, India and other Asian economies are increasingly a source of competitive pressures in the global economy. These economies are absorbing advanced technologies at a rapid pace and excel in innovation -- India's remarkable engineering institutes, like those in Bangalore, can match the best in the Western world. Scientists from Asian nations are becoming an ever more noticeable presence in top scientific journals, illustrating the region's potential to shape the research agenda of the future.

When we introduce Asia into the picture, we can see that the United States and the EU both face competitiveness challenges, although the nature of those challenges is somewhat different. For the United States, they appear to be mainly related to global strategic interests, which in turn are affected by the emergence of new global powers. For the EU, they involve worsening demographics and the crises of the welfare state, together with insufficient resources devoted to

[5] The divisive and acrimonious domestic politics in some of these countries would suggest that things are not as good as they look according to economic growth rates;

R&D and the difficulties in managing complexity. There is a common denominator, however: both the United States and the EU will face increasingly stiff competition from Asian economies.

A couple decades ago, global competition was defined in a triangular formation: US-EU-Japan. The picture today cannot be seen so simply. The evolving global economy brings with it new major competitors and a change of competitive hierarchies. Unless governments and companies are clairvoyant and adjust to trends by investing more in R&D and education, painful corrections will likely be in store.

Those who believe that only non-zero games prevail in the world economy do need a "wake up call" to reality. The dramatic changes under way open up the possibility for co-operative relationships, but also for emerging tensions. Consider, for instance, the growing need for energy and basic commodities in Asia, with China and India as the prime consumers, the unsolved geopolitical crises in various parts of the world (in the Middle East in particular), nuclear proliferation, and the visible and hidden aspects of the struggle against terrorism. An array of developing trends points the way to a highly uncertain world ahead.

1.2. Who fears globalization[6]

Usually, the less benign side of global free trade is ascribed to effects on countries that either cannot make good use of their comparative advantages, or face stiff protectionism from wealthy economies in certain domains --as in the case of farm products. In general, such economies are to be found in the developing world, which are afflicted by poor governance and inability to absorb new technologies.

Recent years, however, have witnessed a rising choir of disquiet in advanced countries as to the impact of global trade on their economies. In the USA, leading politicians have voiced their concerns over what they perceive as multiplying runaway jobs –due to outsourcing/off-shoring. This feeling is even more acute in Western Europe, where, some top national policy makers have not demurred from making their worries about industrial relocation public. And they have not refrained from blaming new EU member countries for, allegedly, practicing unfair competition via lower taxes; fiscal competition would, arguably, further entice jobs to the less affluent East of Europe. How does it come that advanced economies, which have traditionally been staunch supporters of free trade, seem to have second thoughts about it and resurrect a new brand of economic nationalism (some would call it patriotism)?

As a matter of fact, there are both theoretical and more down to earth reasons for this apparent partial turnaround in the public rhetoric displayed in rich economies. Economics-wise, the arguments which stress the virtues of free trade form the basics for rationalizing commercial

[6] Daianu (2005a);

exchanges among countries; nonetheless, these arguments lose some of their appeal when the distribution of gains is largely asymmetric and dynamic competitive advantages dominate. Years ago, Brander and Spencer, Krugman and Grossman, respectively, wrote seminal pieces on what they called "strategic trade"[7]. One can posit that the economic rise of Asian economies (and most impressively of China, in the last couple of decades) is to be judged through such policy lenses; namely, strategic trade policy, which was embedded into a sort of development, focused industrial policy by using market forces in a smart way.

Nowadays, the new information and communication technologies (ICTs), bring about great opportunities for developing economies which benefit on well educated people. Again, Asian countries fare quite well in this respect. "India unbound", of the last decade, is the outcome of market-oriented reforms against the background of a vast pool of English-speaking engineers and computer/ software specialists. Although one has to admit that only parts of India have been touched by rapid economic progress, and much of it is still mired in abject poverty.

What matters in the global economic game, and which drives industrial relocation, is the existence of substantial wage differentials among countries and regions; these differentials induce globally oriented companies to shift operations in areas which combine cheap labour with adequate technologies. The intensity of this process depends on wage differentials and the quality of other production factors. Leading mainstream trade economists (like Jagdish Bhagwati) would argue that advanced economies have not much to fear since they are increasingly specializing in higher value added products and services; and that all countries will be better off in the end. This train of thought has been counteracted by an illustrious name in the economics profession, the Nobel prize winner Paul Samuelson, from MIT; in an article in the Journal of Economic Perspectives he says that "sometimes a productivity gain in one country can benefit that country alone, while permanently hurting the other country by reducing the gains from trade that are possible between the two countries (2004, pp.142). He further says that "post-2000 outsourcing is just what ought to have been predictable as far back as 1950", in the sense of other economies in the world assimilating advanced technologies and catching-up with the US economy, more or less. Samuelson's argument finds solid underpinning in empirical research done by the well known labour economist, Lawrence Freeman from Harvard[8].

Against the backdrop of the new ICTs and considerable wage differentials among economies in the world, important shifts in the global distribution of industrial and services activities

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[7] Brander and Spencer (1983), Helpman and Krugman (1985);

[8] Professor Freeman estimated that the entry of China, India and countries from the former Soviet bloc into the world economy resulted in a doubling of the number of workers, to almost 3 Bn. Consequently, the ratio of capital to labour fell to 60% of what would otherwise have been. Moreover, the newcomers have good technical skills and much lower wages than their western counterparts. This exerts a strong downward pressure on wages in western economies. It pays to recall that some German workers have accepted cuts in their wages (S.Brittan, Globalisation depresses western wages, Financial Times, 20 October 2006, p.13);

looks unavoidable. It appears also that some leading industrial economies do not keep pace sufficiently with this process as far as restructuring is concerned; this lagging behind harms some of their labour segments (and puts pressure on their real wages). At the same time, public budgets are increasingly under strain due to population ageing[9]. Thence comes out the fear of outsourcing/off-shoring. One can easily understand this fear in western European countries, where wages are a high multiple of what well educated workers in Eastern and central Europe earn. The Lisbon Agenda sprang out of this fear, albeit the perspective was framed in global (and not continental) terms. The big EU member countries fear Asian countries and the US economy mostly and regard the Lisbon Agenda as a competitiveness policy response[10]. The EU Commission updating of the Agenda has scaled down the super-ambitious ultimate goal, but the policy thrust is unaltered; the EU wants to perform better in world competition.

The fear of outsourcing/off-shoring can be examined analogously with the anguish surrounding the transformation depression of the last decade in post-communist economies. The latter went through a dramatic fall of output because resource reallocation –at the newly market clearing prices—could not happen rapidly enough. Similar pains can be detected nowadays among some groups of workers in rich economies, who cannot compete in the new global economy, and policy-makers react one way or another.

The theoretical explanation presented above can be complemented by the reality of protectionist measures in various countries, which makes the picture fuzzier. The bottom line is that countries which have skilled people, which invest in education and have forward looking public policies, are more likely to enjoy the fruits of technology dissemination on a global scale.
For the countries in Central and Eastern Europe industrial relocation is a piece of very good news: since their populations are relatively well educated, and, since local wages are pretty low, they stand a good chance to gain handsomely because of out-sourcing within Europe. But they need intelligent public policies in order to make the most out of it and pay attention to competition from economies with even lower wages.

1.3. The revised Lisbon Agenda: the policy thrust is unchanged

As the Kok Report[11] says unambiguously, the central goal set a Lisbon in 2000, to transform the EU into the most competitive, knowledge-based economy in ten years time has already proved to be over-ambitious. Other reports of the European Commission or prepared by independent

[9] See also Gros (2005);

[10] See also E.Maincent and L. Navarro, "A Policy for Industrial Champions. From picking winners to fostering excellence and the growth of firms", DG Enterprise and Industry, Brussels, April 2006;

[11] Former Dutch Prime Minister Wim Kok was mandated by the March 2004 European Council to lead a high level expert group in order to provide an independent review of the progress achieved in the implementation of the Lisbon strategy. The Report, entitled "Facing the challenge – the Lisbon Strategy for Growth and Employment", was issued on November 1, 2004, and served as an important input for the preparation of the Mid-Term Review, which took place during the 2005 Spring European Council;

experts have shown that the overall performance of member states is disappointing. This is why a revised Lisbon Agenda has been adopted and the EU Commission has issued policy guidelines for the member countries[12]. The fundamental goal of the Agenda stays the same: to improve the functioning of EU member economies so that higher growth and better quality jobs be secured. Thence the emphasis put on human capital build up (better education), more innovation (better links between R&D and business), and better functioning of single markets –product, financial, and services. All these policy directions look very commonsensical, but they are not easy to turn into practical measures. Let us remember all the bickering on the Boelkenstein directive. It is also clear that pressure in the direction of change (reforms) is building up, irrespective of espoused views. The recent intention of the Commission to scrap a series of cumbersome regulations points into this direction

How to achieve the LA goals is the big challenge. Not only that economic policy recipes involve major trade-offs frequently, but they may be hard to define in concrete terms. On the other hand there is a stark reality in the Union, which can provide policy inspiration and clarity in not a few domains: the existence of a significant variety in terms of policy effectiveness when it comes to stimulating economic growth, innovation and job creation (reform of labour markets). While some member states may be considered overachievers (e.g. the Nordic countries), several others are considerably lagging behind. Part of the answer for such developments can be found in the mix between market-oriented reforms and public policy, in particular institutional national set ups, in the ability to act timely and consistently over time, etc[13]. But, again, there is no miraculous formula that can be applied in order to reach an ideal policy balance. There is general agreement, however that the Lisbon principles of investing in research and human capital, of promoting innovation, of consolidating the internal market etc. are important guidelines for increasing EU wide economic prosperity.

At the current level of development of the Romanian economy the urge for furthering structural reforms tends to obscure the more subtle issue of developing knowledge-based oriented sectors of the economy. Older EU member countries are mostly concerned with enhancing job creation, economic growth and assigning more resources to research and innovation. Arguably, this policy thrust would be less applicable to Romania where restructuring (that may involve job destruction), wage control, disinflation and improving the business environment are still priorities. As a matter of fact, Romania has embarked on a growth path that matches the experience of most of the countries that joined the EU in May 2004; these countries grow by more then double the average rate in the EU 15. What Romania needs, nonetheless, is to consolidate its disinflation, improve financial discipline, foster more capital formation, absorb new technologies on broader

[12] For instance, "Working together for growth and jobs. Next steps in implementing the revised Lisbon strategy", EU Commission staff working paper, Brusells, 29 April, 2005;

[13] Answers are not easy to provide if one keeps in mind that, as the Nordic experience shows, it is not the size of the public budget or the level of taxation that lies, necessarily, at the roots of problems. Sweden, Denmark, Finland show that market oriented reforms can be combined with smart state intervention policy to achieve goals;

scale and more profoundly so that it can withstand competitive pressures after EU accession. Otherwise, the Romanian economy could face severe consequences in the longer run.

For accession countries, which embark on catching up trajectories, technology assimilation (diffusion) is more important for productivity gains and, further, for sustained high economic growth rates. Recent decades' spectacular evolution of Asian economies, and of Ireland in Europe, confirm the above statement. The same could be said, though in a more qualified manner, about Spain. Romania would benefit by setting ambitious goals, but only if such effort would be enforced by clever public policy; the latter would have to combine market flexibility with effective regulations, the development of adequate infrastructure and considerable investment in human capital.

The targets set by the Lisbon and subsequent European councils are not compulsory in the sense that failure to comply with them does not attract direct negative consequences of an administrative nature. Yet, Romania's coherent development within an enlarged EU may be at risk, in the medium and long run, were national public policy to underestimate the need to cope with inescapable future pressures.

A key thesis should be highlighted with regard to the relevance if the Lisbon process for Romania's emerging economy: investment in education and intense assimilation of technology represent the pillar for achieving sustainable and high economic growth, for reducing economic gaps.

Over the last decade, Romania has experienced a rather turbulent macroeconomic history, with episodes of recession (1990-1992; 1997-1999), recovery (1993-1996) and recovery/growth (2000-2006). Disinflation has made substantial progress in recent years and inflation may descend in the vicinity of (even lower than) 5% in 2006; unemployment is low compared to other economies in the region, but this owes, on the one hand, to hidden unemployment in the state sector and in subsistence agriculture and, on the other hand, to emigration of a large part of the working population. The budget deficit is well within Stability Pact's limits, but EU accession obligations could produce a "budget shock" unless budget revenues improve considerably over the medium term.

How can the Lisbon process contribute to macroeconomic stability in Romania, with the latter judged in a wider timeframe? Firstly, it could help to reduce the structural trade deficit (and the current account deficit) over the longer run. More intense domestic research and innovation would help increasing the value added of domestic production; it would also help increase value added in domestic output, in export-oriented activities. Secondly, better access to education and knowledge can help increasing saving and investing behaviour (as opposed to simple consumerism), on the one hand; and, on the other hand, it would support a dynamic life as an employee (increases employees' mobility). Thirdly, active employment and social inclusion policies would help foster more local jobs and diminish individuals' propensity to migrate.

Fourthly, support for start-ups would improve the business climate and spur gross domestic capital formation.

Investment in research and development, and innovation in particular, are essential to changing Romania's current development paradigm. Various studies and data indicate that foreign capital controlled firms are promoters of R&D in Romania, in the form of technology transfer. But this technology transfer is not infrequently used for less value added products and the technology imported is, in many cases, not one of last generation by international standards; export products compete on price, not on innovation. A piece of good news is that expenditure for R&D has been growing lately in Romania, though from a very low level.

1.4. Which model to evolve toward

A major issue, which will, probably, shape increasingly the public policy agenda in the years to come, is which model the Romanian economy would evolve to. The EU represents a certain social and economic model, which underlines the need for preserving social cohesion and extols the virtues of social solidarity. However, inside Europe, too, there is a significant social and economic variety, which makes people differentiate between a Scandinavian variant (with its emphasis on social redistribution, but quite flexible labour markets), a "core" variant in Germany and France, the British variant (which is closer to the American model), and a Mediterranean variant.[14] Likewise, some new EU member countries (from Central and Eastern Europe) practice a more liberal (in the European sense) form of market economy.

The EU project does influence national public policies by spreading common standards and imposing common rules of policy-making and institutional set ups. However, the Union is strained by a visible contradiction between its entrenched welfare model and the need to make markets more flexible. This contradiction would not be so acutely felt in the absence of tremendous pressures exerted by globalization, by the competition from low wage economies. Social assistance and pension systems are, or have to be overhauled; this painful and politically very sensitive undertaking is taking place against the background of population aging. The experience of Finland, Denmark and Sweden (in going from welfare to workfare) provides interesting policy venues for other EU member countries.

Although globalization has a non-trivial ideological component the forces at work have acquired a powerful momentum of their own, which is driven by technological change and intensified competition. The latter can be restrained by bouts of protectionism (in trade and competitive devaluations) and security concerns, but its power seems to be unstoppable. The rise of Asian economies in the world economy changes hierarchies and can turn non-zero into zero-sum economic games; hence it appears the fear of outsourcing/off-shoring, of globalisation. For it

[14] See also Sapir (2005);

is quite impossible to compete with economies where labour costs are 10, or 15, even 20 times lower, other conditions being fairly similar.

Romania has to adopt EU rules. But it needs to do it in such a way that its economy improves its performance steadily and catching up becomes reality. Romania's labour costs are hugely lower than in most EU member countries, but similarly lower is its overall productivity. Therefore, which "European model" to evolve to is a relevant policy issue for Romanian policy-makers and heads of companies.

The EU can play an exceptional part in Romania's transformation and modernization drive; it is an extraordinary chance to overcome the trap of backwardness, to accomplish a secular quest for modernization. Romania has an income per capita that represents roughly 35% out of the average of the European Union, being at the same time a country with a relatively large population (cca. 22 million), as compared to the average in Central and Eastern Europe. Under the hypothesis of an average rate of economic growth of 6%, over the longer run, while the EU average rate of economic growth would be 2%, and considering the Balassa-Samuelson effect, Romania would need 10 years to reach half the average income per capita in the EU. The catching-up of the average income per capita (at purchasing power parity) would take about two generations by assuming that a substantial growth differential (in Romania's favour) is maintained.

A sustained economic progress would require higher saving and investment ratios in Romania, a public policy geared to the development of human capital and infrastructure, and Romanians' using increasingly what the new ICTs offer. Romania would have to absorb the EU structural and cohesion funds to the utmost. But such evolution depends, in its turn, on the functioning of institutions: a strengthening of the judiciary (the rule of law), a competent, honest and innovative (central and local) public administration, a solid financial and banking system, good structures of corporate governance (orientated towards higher economic performances), an education system offering equal chances to children and adults, laws that enjoy social acceptability and a favourable social ethos. The quality of public policy itself depends on the functioning of our institutions[15].

[15] For why good institutions are essential for long term growth see Helpman (2004);

2. Romania according to structural indicators

Romania has improved recently in a number of structural indicators of the Lisbon Agenda. Most notably, GDP per capita, labor productivity, gross R&D expenditure and gross fixed capital formation (business investment) have recorded significant progress**.** These 4 indicators reflect Romania's economic progress, now in the 7th consecutive year of high growth rates. Business investment is a component of GDP, and so is the gross R&D expenditure.

Regarding the gross R&D expenditure, its increase owes to the higher public investment. While the aggregate figure improved (from 0.4% of GDP to 0.63% of GDP), its composition has not actually bettered when considering to the Lisbon targets. Now 60% of the gross R&D expenditures is public, compared to 52% a year ago. The Lisbon target requires only one third of the gross R&D expenditure to be public. However, as we demonstrated in the previous GEA reports on Romania and Lisbon Agenda, there is a strong correlation between public and private expenditures. Private R&D expenditures might rise in the coming years as an effect of higher public R&D expenditures – provided that the increase in public R&D expenditures stimulates the academic – industry cooperation.

Table 2.1. Progress made by Romania relative to the key structural indicators, 2005 vs. 2004

	2004	2005	**Evolution**
GDP per capita in PPP, EU25=100	32.9	36.0*	↗
Labor productivity per person employed, EU25=100	37.4	40.7*	↗
Employment rate	57.7	57.6	→
Employment rate of older workers	36.9	39.4	↗
Youth education attainment[16]	74.8	75.2	→
Gross R&D expenditure, % GDP	0.40	0.63	↗
Comparative price levels, EU25=100[17]	43.2	53.1	↗
Business investment	19.1	22.6*	↗
At risk-of-poverty rate, after social transfers	18	n.a.	

[16] Percentage of the population aged 20 to 24 having completed at least upper secondary education;

[17] Comparative price levels of final consumption by private households including indirect taxes;

Long-term unemployment rate	4.2	4.4	→
Dispersion of regional employment rates[18]	3.5	4.9	↗
Greenhouse gas emissions[19]	53.9	n.a.	
Energy intensity of the economy[20]	1386.5	1226.9	↘
Volume of freight transport[21]	96.1	100.2	↗

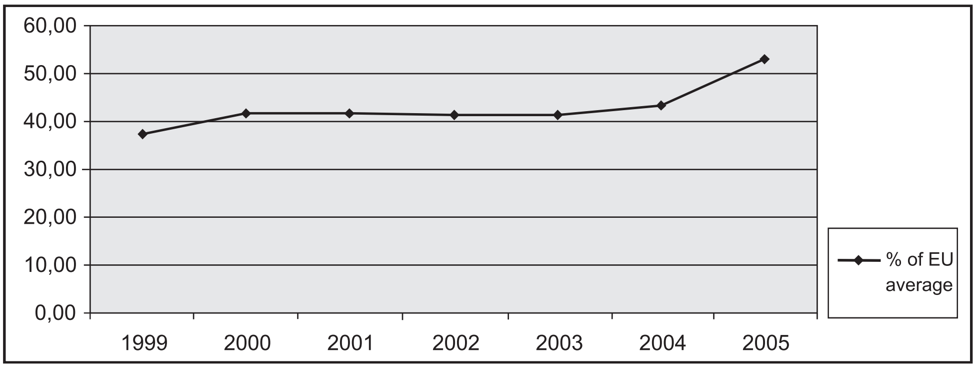
*2006

Source: adapted from Eurostat, Structural Indicators online, 2006

The signs of some indicators in table 2.1. are to be interpreted. The increased dispersion of regional employment rates is not a good thing – quite the opposite, it might signal lower social cohesion. The decrease in energy intensity, on the other hand, is a good thing. It reveals an economy moving away from heavy industries towards services.

Arguably the most conspicuous indicator in table 2.1. is the rise in relative prices. The comparative price level jumped from 43% to 53% of EU average in only one year**.** This data, from Eurostat, seems to clash with the official inflation rate in Romania (only 8.6% in 2005, Dec.on Dec.); it would also change the scope of real wage dynamics in recent years.

Figure 2.1. Romania's price levels, comparative to EU



Source: based on Eurostat data

[18] Coefficient of variation of employment rates (of the age group 15-64) across regions (NUTS 2 level) within countries;

[19] Percentage change since base year. The target according to Kyoto Protocol/EU Council Decision for 2008-2012 - (in CO2 equivalents) is 92.0 by 2010;

[20] Gross inland consumption of energy divided by GDP (at constant prices, 1995=100) - kgoe (kilogram of oil equivalent) per 1000 Euro;

[21] Index of inland freight transport volume relative to GDP; measured in tonne-km / GDP (in constant 1995 Euro), 1995=100;

There could be a number of explanations for the rapid increase in price levels:

- the Balassa-Samuelson effect (price convergence during catching-up periods);
- the appreciation of the local currency against euro;
- the liberalization of utilities' tariffs;
- the incorporation of compliance costs to the EU acquis (standards) in certain manufacturing sectors;
- the insufficient competition on certain market sectors which has allowed oligopoly rents to be obtained.

Another consequence of the rapid convergence in price levels is the erosion of competitiveness in a range of sectors. Romania's foreign trade deficit has constantly worsened in recent years (by 40% in the first half of 2006). The rapid convergence in price levels also pinpoints to the catching-up process, which seems to be underway**.** Romania is not alone in this process – that is demonstrated by an analogous evolution of structural indicators in other Eastern European economies. Recent EU reports linked to the Lisbon Agenda (2006 Innobarometer and 2006 Innovation in Services, but using 2004 data) place Romania in the catching-up group (high growth rates on some innovation specific indicators).

Table 2.2. Progress on key Lisbon structural indicators, Romania vs. New Member States, 2005 vs. 2004

		NMS-8 and Bulgaria (average trends)	
		Progress	Stagnant or regress
Romania	Progress	- GDP per capita - Labor productivity - Comparative price levels - Employment rate of older workers - Energy intensity - Volume of freight transport	
	Stagnant or regress	- Employment rate - Long term unemployment - Dispersion rate of regional unemployment	- Youth education attainment

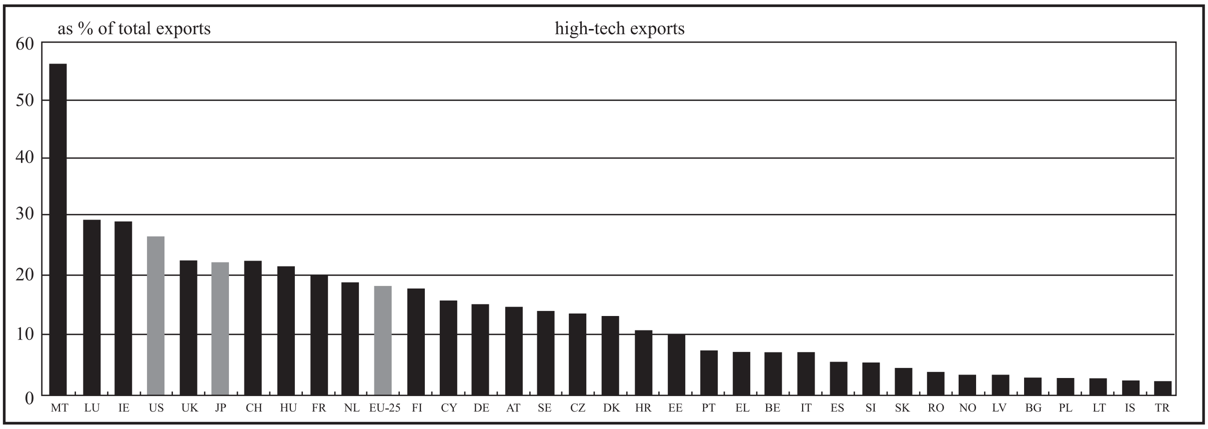
Note: there are no comparable date for 2005 on missing indicators

One can observe from table 2.2., however, that Romania's improvement regarding the key Lisbon Agenda indicators is in line with the performances of the new member states and Bulgaria. Moreover, Romania underperforms, as compared to these countries, as far as some social indicators are regarded (employment rate, long term unemployment, dispersion rate of regional unemployment). This would highlight a weak social underpinning of Romania's current economic growth.

The Global Competitiveness Report 2006-2007 downgrades Romania from the 54^{th} rank in the innovation index to a mere 68^{th} position. An important component of the innovation index is the index of university – industry cooperation. The low level of university–industry cooperation has recently been stressed by the EU Commissioner Potocnik, as a major weakness of Romania's national innovation system.

There is also a quite limited capacity to create knowledge in Romania, despite higher rates of technology transfer. While high tech imports represent 12% of total imports, high tech exports[22] only account for 4% of total exports.

Figure 2.2. Romania's high tech exports, as % of total exports, compared to EU countries



Source: Eurostat, Statistics in focus 14/2006

[22] By EU taxonomy, high-tech sectors include certain sub-sectors from the following industries: aerospace, computers-office machines, electronics-telecommunications, pharmacy, scientific instruments, electrical machinery, non-electrical machinery, chemistry, armament;

3. Policies for stability and growth

The first half of 2006 has seen the Romanian economy cruising at a quickened pace, beating even the most optimistic expectations. Provisional GDP figures put growth in the first semester at 7.4%, with services and construction sectors bringing more than half of the total sectors contribution to GDP. Dynamic investment, driven by the certainty of EU accession in January 2007, could push the medium term trend GDP growth in the vecinity of 5.5-6%. Real gross domestic product (GDP) growth has already averaged 5.7% between 2002-2005 and is expected to follow the same trend in the medium term. Although in 2005 GDP per capital[23] was only a third of the EU average, amounting to cca. 6,600 euro, sustained income convergence could see per capita income rising by almost 40% by the end of the decade.

Helped by an appreciation of domestic currency, the RON, inflation has continued to fall faster than expected. Year-end annual inflation is now expected to be below 5%, down from 8.6% in 2005. Notably, so far, the speed of the disinflation process has failed to harm economic growth. Likewise, the rapidly rising external deficits should warn us about future risks. Industrial production has had a remarkable recovery following a series of large shocks. A severe appreciation of the domestic currency caused by massive capital inflows and a sharp rise in energy prices (as a prerequisite of adjusting domestic relative prices to EU levels) have strained quite a few industries over the last couple of years. The speed of industrial production recovery tends to suggest that Romanian manufacturers are on course to adapting their management techniques and upgrading their capital with new technologies in order to deal with the competition in the EU.

Budget revenues may jump above 32% of GDP this year, up from last year's 30.3%. The public budget has been running a surplus of 1.7% of GDP at the end of July. This dynamics should give comfort to those who supported the introduction of the 16% flat tax in early 2005. However, it is fair to point out that much of the revenue increase is due to a very rapid growth of consumption and the broadening of the tax base (much beyond the initial design of the flat tax application).

3.1. The economic context

The private sector's contribution to GDP is nearing 70% while it accounts for over 55% of social capital in the economy and more than 70% of the employed population. The steady expansion of the private sector in the economy has been accompanied by more entrepreneurial drive, more capital formation and export orientation. There has also been a significant rise in foreign trade and integration into EU markets; trade with the EU means cca. 2/3 of overall trade currently.

[23] At Purchasing Power Parity;

The openness of the economy is mirrored by the share of foreign capital in the banking industry and telecommunication. These markets, as well as energy markets, have opened quite rapidly, incidentally, more than in some of the old EU member countries. One has to stress here the importance of effective regulations so that new owners of pubic utilities should not abuse their market power.

The banking system is much sounder nowadays, after a massive clean up operation in the late 90s and the introduction of a new regulatory framework that fits the BIS new recommendations. This evolution has taken place on the background of increasing foreign ownership in the banking sector[24] which has meliorated corporate governance. The banking system has increased its capacity to provide effective intermediation between savers and investors, and lending and borrowing rates have decreased substantially. The range of financial products has increased remarkably and has fuelled non-governmental credit;[25] the latter has boomed by over 80%, in real terms, in the last couple of years. It is noticeable that despite this rise prudential indicators are still in safe territory[26]. The non-banking financial sector has developed rapidly; the best indicator is the market capitalization of the Bucharest Stock Exchange: from 1.04% of GDP in 1999 and 3.3% of GDP in 2001, it moved to 8% of GDP in 2003 and cca. 20% of GDP in the second half of 2006.

But the Romanian economy has weaknesses that can harm its growth over the longer term unless they are addressed steadfastly. These weaknesses are rooted in:

- fiscal and non-fiscal budget revenues are around 32% of GDP (estimates are for 2006) while financing needs are bulging. Romania could face a “budget shock” after accession because of inescapable financial obligations: co-financing of EU funds; the EU budget contribution; reform of the pension system, the contingent liabilities arising from the “Proprietatea Fund”, etc. Unless budget revenues grow remarkably the budget deficit could rise again above -3% of GDP, which would worsen public finances; it would also involve a further rise in the current account deficit, which might be unsustainable.

- the energy efficiency of production and consumption is pretty low and this harms competitiveness over the longer run.

- the pensions system is under increasing strain; it is unbalanced, with much of its financing coming from the health insurance budget. The problem is of a chronic nature, because the

[24]BCR’s takeover by Erstebank has occurred this year;

[25] The annual yield for t-bills, which was a major attraction for banks’ investment policy, decreased from 76.0% in 1999 and 35.7% in 2001 to 17.3% in 2002 and cca 8% in June 2005; this has prompted banks to orient increasingly toward consumer and production finance;

[26] Even if some numbers are likely to be overstated the overall picture evinces a remarkable turnaround as against the late 90s;

number of the retired population exceeds the number of statistically official employees (the ratio is nowadays 3:2, as compared to 1:2 in the early nineties). Massive migration has also complicated the story. An unreformed pensions system would strain the public budget in the years to come.

• the state of agriculture is an issue of concern not only in itself, but also in Romania's relations with the EU. About 40% of the population lives in the rural area, while agriculture contributes a mere 12-13% to the GDP formation and hardly, if at all, to the public budget. In the EU there is an ongoing debate to further reform CAP, which could involve even lower agricultural subsidies and Romania would be adversely affected by such a reordering of priorities.

• labour markets are rigid; unemployment has been kept at a reasonable level because many Romanian found an outlet abroad. Some estimates put the number of Romanian citizens who work abroad over 1.5 million. The recent changes in the labour code and reduced social security contributions might help improve the situation, but more has to be done in this respect.

• the investment climate is plagued by administrative and red tape barriers, by corruption; this relates to the functioning of public administration, in general.

3.2. Disinflation, growth and rising external deficits

The salient feature of the macroeconomic picture in the last few years has been the combination of economic growth (over 6 percent, on average, annually), disinflation and rising external deficits.

Tight monetary and budget policies have not harmed growth. Arguably, the latter has been driven by structural changes. The Central Bank has focused more clearly on fighting inflation and fiscal consolidation has helped it. Likewise, budget subsidies have diminished and energy prices are, more or less, at EU wide levels. These changes on relative prices have bettered resource allocation and cost management, though they are quite painful for low-income people and inefficient companies.

Disciplined monetary and fiscal policies pursued over the last years have improved considerably the macroeconomic picture (Table 3.1). Over the last two years, domestic consumption has taken the lead role in keeping the economy growing, being the main engine of economic growth. Household consumption has continued to grow strongly[27], partly driven by the effects of last year's tax cuts. However, structural constraints on the domestic production side of goods and services continue to exist. As a consequence, the persistence of excess demand has fuelled

[27] Its contribution to GDP growth has increased from 79% in 2005 to over 82% in Q1 2006;

imports growth widening further the current account gap.

Table 3.1. Romania — Selected Macroeconomic Indicators (Actual and estimated values)

	2003	2004	2005	2006e
Real GDP growth (%)	4.9	8.4	4.1	7.2
CPI Inflation — Dec., annual change (%)	14.2	9.3	8.7	4.8
Current Account Balance (% of GDP)	-6.2	-8.5	-8.7	-10.5
Trade Balance (% of GDP)	-7.8	-8.9	-9.9	-12.5
Exchange Rate (e.o.p., RON/EUR)	4.11	3.97	3.68	3.54
Unemployment Rate – Year End (%)	7.4	6.2	5.8	5.5
Government Budget Balance (% of GDP)	-2.4	-1.0	-0.9	-1.3
Public Debt (% of GDP)	27.0	22.4	18.9	20.3
NBR Reserves in Months of Imports	4.6	5.9	6.6	6.8

e – estimate values. Source: IMF, NBR, and own calculations.

For 2006 the current account deficit is estimated to exceed 10% of GDP, a level which is likely to be maintained, or even grow, in the following years driven by the country's needs of large capital investment and the ongoing consumption expansion. Although so far, FDI inflows together with remittances, privatisation receipts and other capital inflows have continued to finance the expansion of current account, a slowdown in any of those might raise concerns over its sustainability.

Since the adoption of inflation targeting by the NBR in the late 2005 disinflation has continued its downward trend with August data showing the first month with deflation since 1989. Annual inflation fell in September to 5.5%, the lowest value in more than 16 years. This have raised hopes that he NBR's 2006 year-end central inflation target, the 5% within a +/- one percentage point band, might be met, against initial expectations. However, a stringent issue of concern for monetary authorities remains the evolution of domestic credit[28]. Credit growth has been particularly driven by strong demand for loans by households, reaching 66% in 2005 after a peak of 214% in 2003. This reflects, in part, a trend of falling interest rates and raising incomes. The confirmation of EU accession on 1st of January 2007 also plays an important role by creating a greater confidence in the economy thus making people to borrow against future income with much of the household credit directed towards purchases of durable goods and real estate.

[28] Between 2002-2005 real non-governmental credit growth averaged 34% annually and, although this figure looks impressive when compared to other countries in the region, it reflects to a great extent the initial level of small non-governmental sector lending. Total credit stock as percentage of GDP stood at 21% at the end of 2005, which is still very low compared to values observed in developed economies - in the euro area credit stock to GDP ratio is around 95%;

Measures taken by the NBR to curtail credit expansion focused on two dimensions, restricting demand for credit by imposing a ceiling on households' debt service and targeting the supply side in order to achieve a reduction in credit and a change in the currency composition of household credit.

The economic implications of the 2005 tax reform have started to be felt in 2006. One of the government's aims has been to increase the share of its budget revenues in GDP. In the period January-August 2006 the general consolidated budget revenues grew by 18% in nominal terms, raising hopes that the share of revenues in GDP could go up from 30.4% last year to 32% in 2006. The changes have also made the tax system simpler and more transparent and improved the business environment. Tax collection revenues have risen while the tax base has been widened. It should be emphasised however, that the flat tax has been implemented on a considerably wider area than initially envisaged, which implies a broadening of the tax base. Likewise, the boost in consumption and the rapid growth of the economy explain the bulging budget revenues, especially those due to VAT. On the expenditure side spending has been kept under strict control so far. Although the year-end projected budget deficit is 2.5% of GDP, the first eight months of the year recorded a surplus of 1.6% of GDP. The government's restricted ability to spend such a large amount of money in the remaining months could see the budget deficit target undershoot. However, spending is bound to go up in the years post EU accession and, unless tax revenues improve markedly, it could see the budget deficit pushed above 4% of GDP. Such a budget deficit could drive the current account deficit beyond 12-13% and bring about a substantial depreciation of the exchange rate.

Higher budget revenues would help finance badly needed investment in education and infrastructure at a time when EU accession puts pressure on the government to boost the production of public goods. Unemployment is well below 6%, though this is largely due to massive migration

The fall in interest rates and improved macroeconomic conditions has made the country's access to foreign credit easier, with spreads on both sovereign and domestic private bonds falling in international capital markets. This fact has been reflected by the international rating institutions in their country rating updates (Table 2).

Table 3.2. Romanian foreign and domestic sovereign currency ratings by international institutions

Rating Agency	Foreign Currency			Domestic Currency			Date of last announcement
	Long term	Outlook	Short term	Long term	Outlook	Short term	
Fitch	BBB	Stable	F3	BBB+	Stable	-	August 2006

Moody's	Baa3	Stable	-	Baa3	Stable	Aa3	October 2006
Standard&Poor's	BBB-	Positive	A-3	BBB	Positive	A-3	September 2006

Source: international rating companies websites.

Although all three major international rating agencies have improved lately their ratings/outlook on Romania, their press releases highlighted a number of potential risks Romania could face in the near future. In particular, the deterioration in the current account coupled with the boom in both domestic demand and credit growth, if left unchecked, could lead to a worsening of the macroeconomic picture. The forthcoming EU accession has given further impetus to FDI inflows. Net FDI has only started to pick up in 2004, the year when Romania joined NATO and when the country's prospects of adhering to the EU improved markedly. Preliminary data shows that net FDI amounted to over € 5 bn. in 2005 and is forecast to peak this year to over € 7 bn. Added together, the net FDI inflows over the years 2004 and 2005 amounted to almost 60% of the cumulative FDI inflows for the period 1990-2005. This indicates the increased attractiveness of the Romanian market for foreign investors. However, as experience in other EU countries has shown, after EU accession, FDI inflows tend to decline as gains in competitiveness force factor price equalisation.

The Romanian financial sector is, in general, relatively sound. However, apart from commercial banks, other financial institutions have a limited strength. The non-performing loans ratio (which includes substandard, doubtful and bad loans) has been hovering around 8% for the last 5 years[29] and profitability indicators are good. This is not surprising given the large margin between lending and borrowing rates. In part this reflects the low level of financial intermediation – at the end of June 2006 the estimated total banks assets to GDP ratio stood close to 50%. The privatisation of the country's largest bank, Romanian Commercial Bank (BCR) in December 2005 has been hailed as a success by the government. However, the structure of the banking system still presents the characteristics of an oligopoly, with the largest three banks accounting for almost half of the total[30] – in terms of their assets. In addition there is a low level of competition from other credit institutions.

The stock market capitalisation to GDP ratio has been growing steadier over the last years. At the end of August 2006 stock-market capitalisation was € 18.5 bn, which implies – in comparable terms - an estimated market capitalisation to GDP ratio of cca.20%.

[29] If only doubtful and bad loans are considered the ratio is much smaller, around 1%;

[30] At the end of June 2006 BCR had assets worth 25.6% of the total banking system, the Romanian Bank for Development (BRD) 15.48% and Raiffeisen Bank 7.9%. As a matter of fact, after Unicredit has taken over HVB a fallout is that the emerged new entity is now ahead of Raiffeisen in the Romanian banking market;

Macroeconomic Policy Challenges Ahead

The stock market capitalisation to GDP ratio has been growing steadier over the last years. At the end of August 2006 stock-market capitalisation was € 18.5 bn, which implies – in comparable terms - an estimated market capitalisation to GDP ratio of cca.20%.

In spite positive achievements, the macroeconomic outlook is still vulnerable to a number of factors. Some of them have been persisting now for a number of years[31], others have tended to accentuate over the last year, as the EU integration deadline draws closer and the economy's initial conditions of getting into the EU become known better.

A legitimate question is whether the pace of economic growth is sustainable in the medium and long term. Answering this question implies devising a set of adequate economic policies over the longer term. A recent World Bank report praises Romania's reforms and fuels high economic growth expectations for post-accession years. However, an annual growth rate between 5.5-6% would be more in tune with the current underpinnings of the Romanian economy. Were these underpinnings to move in the right direction a higher durable economic growth rate would be feasible. The Romanian economy needs more fixed investment and a better infrastructure for sustaining growth rates of above 6% yearly, on an average, over the longer term. More significantly, it needs faster absorption of the new information and communication technologies. From this point of view it is good news that R&D spending is planned to rise to 0.7% of GDP in 2007, which is still far away from the Lisbon Agenda requirement of 3%. Even if this figure came close to 2% by the end of the decade the essential for Romania is the intensity of innovation in its economy, the pace of new technology transfers. For this to occur, on a wide range, good management practices have to be under-girded by better training. High technology absorption would raise overall productivity and allow Romania to catch economically up inside the EU.

If the Romania-EU growth differential stayed around 4%, and in conjunction with a possible 2% average annual exchange rate appreciation of the domestic currency (until the single currency would be adopted), income/per head in Romania could become around 50% of the EU average in a decade. A high ratio of EU funds absorption would help modernize the rural economy and reduce migration.

Inflation has been falling at an accelerated pace over the last quarters. However, the danger of resurgence in inflation remains. The supply side constraints could see inflation creeping up in the near future if public sector wage policy turns loose. A further impetus to upside inflationary risks could be given by fluctuations in world commodity and energy prices. To this, further volatility would be added by changes in domestic prices - increases in gas prices are expected to go up by a significant margin in 2007. Increased public spending and restitutions to the

[31] Romania and the Lisbon Agenda, 3rd Report, Group of Applied Economics, September 2005;

shareholders of 'Proprietatea' Fund are additional threats to the 2007 inflation target.

The danger of higher interest rates, needed to keep inflation in check, is that it could induce further capital inflows and currency appreciation[32]. The latter could undermine the competitiveness of the tradable goods sector, especially if accompanied by loose wage policies[33]. However, the upward pressure on exchange rate has been a common phenomenon in all new EU members coming from Eastern Europe. This has been mainly driven by three factors, increased foreign capital inflows following expectations of higher return, a reduction in the inflation differential between domestic and average EU rates and improved macroeconomic conditions and greater confidence in domestic economies following their EU accession.

While currency risk is a distinct concern, the NBR has enough foreign exchange reserves to prevent any excessive depreciation of domestic currency. However, given the attractiveness of Romanian market, barring any unexpected macroeconomic disequilibrium, the tendency of the exchange rate is rather to appreciate slightly in the short and medium term. The RON/€ volatility[34] might be quite high at times as, in certain circumstances, capital markets foreign investors might take decisions concerning their investments on a regional level. The exchange rate volatility could be further exacerbated as a consequence of the removal of the remaining capital control restrictions in September 2006. Thus foreigners are now allowed to make transactions with domestic denominated instruments on the Romanian capital market, which could see a rise in the demand for domestic financial instruments[35].

However, the risks to a currency depreciation stay relevant. Rapid changes in the valuation of asset prices could leave borrowers and lenders alike exposed. For instance, house prices to earnings ratio is much higher compared to EU-average. While higher ratios are common for transition (emerging) economies any shocks to disposable income could leave borrowers vulnerable in meeting their interest payments especially to loans taken out in foreign currency.

Would large current account deficits pose a threat to macroeconomic stability in the medium term? Over the last months a series of international financial institutions, including the IMF voiced concerns over the growth pace of the current account deficit. Exports have been increasingly outpaced by imports in recent years and the current account deficits are expected

[32] As a consequence, the RON/euro exchange rate appreciated by around 13% in nominal terms from 4.11 at the end of September 2004 to 3.60 at the end of June 2006 with real exchange rate recording an even higher appreciation;

[33] This is what the previous reports highlighted as a possible "Dutch-disease" (Daianu et.al, Bucharest, GEA, 2004, 2005);

[34] The evolution of the euro against the RON is of more interest since almost two thirds of Romania trade is done with the euro area;

[35] Over the last year the RON/euro exchange rate has been fluctuating between 3.47 and 3.68 and market expectations envisage a slight appreciation of the domestic currency in the medium term as increased productivity and investment in domestic capital should start to yield higher returns;

to be in the vicinity of (or go well beyond) 10% of GDP in the medium term, mainly due to the vigor of consumption dynamics and the need for capital and equipment investments.

Although financing the deficit has not been a problem so far, largely due to sizable inward foreign direct investments, the situation may change in the years to come following the end of big privatization deals. Even if green-field investment grows after EU accession one should not bet on a complete offset effect. Higher consumption worsened the trade balance which has been on an upward trend and could be around 12.5% of GDP this year (Table 1). Moreover, threats to the sustainability of current account deficits of above 10% of GDP have to be judged in the context of free capital account rules, which is a must for a EU accession country, the tightening of monetary policies in the USA and the EU, and, not least, the heavy borrowing in foreign currency done by individuals and resident companies.

The increase in current account deficits has been largely driven by growth of the non-governmental domestic credit. Thus, at the end of July credit to the non-governmental sector has grown by over 100% compared to July 2005. Moreover, commercial banks data show that the share of internal credit to GDP in Romania is at the low end of the spectrum in Europe; likewise, they try to capitalize on the assumed bright prospects for an economy that would become a member of the EU in 2007. The NBR’s response to control credit growth by administrative and regulatory measures has had mixed effects so far. Measures aimed at curtailing the domestic credit expansion could see further restrictions placed on household borrowing. However, these might have a small effect as the complete liberalisation of the capital account should, in principle, make financing readily available from other EU-based financial institutions.

3.3. Policy dilemmas and options

The weaknesses mentioned above and developmental challenges create policy dilemmas which Romanian policy-makers need to address carefully after EU accession; the effectiveness of the policy needs to be secured amid a series of trade-offs such as:

- in order to bring inflation down to cca. 3-4% by 2008 budget policy has to remain tight while needed infrastructure and environment related projects ask for substantial public financing; there is here a contradiction between a budget policy imbyed with a Keynesian flavour (what is entailed by substantially higher budget expenditure after EU accession) and the monetarist flavour of disinflation policy;

- low trade protection, or non-existent vis-à-vis EU partners, and substantial exchange rate appreciation would entail further rises in the current account deficit so that the burden of adjustment would fall on the public budget increasingly; overburdening of the budget policy would be intensified by inflation-targeting at a time when EU accession demands higher budget revenues.

• severe exchange rate appreciation could cause a “Dutch disease”[36] unless productivity gains are adequate; this relates to the current type of competitiveness, which is based on wage differentials in the main.

The dilemmas outlined above constrain policy and suggest policy guidelines and options.

• in terms of economic and market structure there is need to harden budget constraints in the energy sector and streamline state aid --which should fit EU requirements.

• privatization in the energy sector can bring in needed inward foreign direct investment and help modernization and restructuring decisively. But energy markets (like financial markets) have to be well regulated so that market abuse be prevented –which is particularly important in a much less affluent society. The experience worldwide and, also, at home should be a lesson to Romanian policy-makers.

• tax collection and the broadening of the tax base have improved considerably during 2005-2006. But much more is needed so that the co-financing of EU funds and the provision of public goods respond to Romanian economy’s needs; the latter are linked with coping with competitive pressures inside the Union without entailing a big rise in the budget deficit. Hopefully, own budget revenues would go up by, at least, 4-5% of GDP in a few years time[37].

• multi-annual budget programming has to help policy set priorities according to judicious, long term based, cost and benefit analysis.

• the ongoing crisis of the pension system puts an additional burden on the public budget; a new pensions system is required, that would include several pillars. The private sector pillars have to be under very strict prudential regulation in order to avert financial debacles.

• the capacity to absorb EU funds is a huge challenge. EU financial assistance (structural and cohesion funds) could supplement budget revenues substantially and increase the provision of essential public goods (infrastructure, education and health care). EU assistance would crowd in other funding, from private and public sources. But the track record of absorption is poor[38] and unless this capacity grows significantly EU funds may diminish in the future --

[36] “Dutch disease” refers to a financial bonanza that befalls a country following the discovery of, let’s say, major oil fields. Greatly increased oil related export revenues would appreciate the national currency exceedingly and harm the manufacturing sector, ultimately, unless adequate productivity gains are achieved;

[37] There are pieces of analyses (including a recent World Bank study), which show that with proper a reform of the tax collection system would bring in between 4-5% of GDP additional budget revenues in Romania; this would involve a broadening of the tax collection base;

[38] Currently, this capacity is quite inadequate; for instance, the absorption of ISPA funds (infrastructure and environment related projects) is a mere 12%!

against the backdrop of the dispute between donor and recipient countries over the structure of the Union's budget. Spain's experience in using EU funds should be studied by Romanian policy-makers.
For this reason our team has advocated the creation of a special vehicle for administering large projects (of national, strategic importance – see the previous report).

• Romania needs to spend substantially more for education and R&D as a strategy for long term development (for endogenous growth), even if local research and development would be linked primarily to the assimilation of imported technology. This is quite normal in an emerging economy, which tries to capitalize on the world stock of knowledge.
A challenge is to reduce the dependency on labour-intensive production (exports), which increasingly is dominated by low wage Asian manufacturers. The expected and unavoidable rise in wages in the years to come would price out many firms (sectors) in labour intensive production unless productivity gains are commensurate and higher value added products are gaining share in output. The degradation of primary and secondary education has to be stopped and more emphasis should be devoted to engineering and technical schools.

• in the current context of rising current account deficits and expansion of non-governmental credit, fiscal policy needs to be prudent. However, this would pose a challenge for the government as pressures on the budget are set to mount in the years to come. In addition to the attention devoted to long-term fiscal costs, such as reforming its health and pension systems, Romania will have to address the costs of the EU accession.
The country's contributions to the EU buget together with other co-financing requirements to EU projects could require around € 3 bn per year from the government budget. Education is another area where spending is below EU-average. Romania allocates around 4% of GDP for education currently while the EU-average stands at 5.22%. Such low rates of investment in human capital could see Romania falling further behind in the catch-up process.
There is a need for a clear strategy that would devise a multi-annual plan for investments in the education sector, possibly involving the private sector.

• increasing demand for raising government expenditure would require bolstering government revenues. In 2007 alone, government expenditure (that would include EU funds) is forecast to be close to 38% of GDP; this would be more than 20% higher than what was spent by the 2005 budget. Although tax revenue collection has exceeded expectations in the first eight months this year, the growth of the general budget revenues has been mainly driven by strong VAT revenues, generated in turn by robust household consumption growth.
A slowdown in consumption could see VAT revenues to the budget dwindle. In addition, the effects of the flat tax on government revenues should not be overstated. These have been raising partly due the large increase of the tax base, which generated additional revenues to the budget, partly due to improved tax collection.

• the impact of EU funds on GDP growth would depend whether implementation constraints at all levels of contracting[39] would diminish considerably. The capacity to absorb EU funds needs to be greatly improved in order to capitalize them properly. There is a need for a greater coordination among the government's planning instruments. To date there is a number of planning instruments such as the newly adopted Medium Term Expenditure Framework, the Sectoral Operational Programmes (SOPs), the Regional Operational Programme (ROP), the Implementation Plan for the Acquis and range of sector strategies and implementation plans prepared by the line ministries and agencies. Taken together and unless coordinated (restrained) these spending plans could seriously hamper government's stated fiscal strategy and might see government spending accelerate to 45% of GDP[40]. For this reason multi-annual budget programming is a must, a top priority for public policy after accession.

• large investments are also needed to upgrade the country's poor physical infrastructure such as roads and railways. These are set to be a priority and could cost the economy as much as 1.45% of GDP, or some € 30 bn, over the next 20 years. A realistic assessment of such costs could prevent Romania following in the steps of other countries in the region, such as Czech Republic, Hungary, Poland or Slovakia, which joined the EU in 2004 and now face sizeable budget pressures due to unexpectedly large environmental and infrastructure costs. The government would need to prioritise spending so that rail and road expenditure programs could be materialised. In spite of government's rhetoric, the number of newly-built road/motorway kilometers over the past years has been dismal. Also the roads rehabilitation costs are deemed to be pretty high, which drains the budget of valuable funds.

• low monetisation, the wide use of the[41] euro and the US dollar in local transactions, complicate the conduct of monetary policy. Likewise, future pressures on the government budget (such as the high cost of pensions expenditure or fiscal costs in the run up to EU entry) require an enhanced co-ordination of monetary and exchange rate policies with budget policy. NBR has introduced inflation targeting in August 2005. Arguably, a 'soft' form of inflation targeting is appropriate[42].

• a rapid expansion of rural credit mechanisms (that involves the efficient use of EU rural development funds) and land consolidation would be among the solutions for rural development. The fate of Romanian agriculture depends on how the Common Agricultural Policy will be shaped in the years to come and on how Romania will use the EU financial assistance oriented toward this sector.

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[39] For instance, only 15% of the EU committed funds coming through the 'Instrument for Structural Policies for Pre-Accession' programs have been disbursed over 4 years;

[40] See for instance "Romania, Public Expenditure and Institutional Review", World Bank, September 2006;

[41] See also Antohi et. al (2003);

[42] Daianu and Kallai (2004);

• the labour code has to protect workers against abuses. But it has to make labour markets flexible enough so that industrial/economic restructuring occurs at an appropriate speed. Romania should not get into a sort of a mess one encounters in some of the old EU member countries. The labour code issue brings to the fore the model the Romanian economy would evolve toward.

• the impact of climate change needs to be taken into consideration as huge floods and dramatic fluctuations of temperature have produced havoc in recent years. Policymakers have to make adequate room for contingencies when they allocate state revenues; there is also need for dealing forcefully with deforestation, inadequate damming, etc. The financial implications of building up proper infrastructure can be quite large and give more salience to the need of absorbing EU funds to the utmost and most effectively.

Summing up

The medium term prospects for the Romanian economy are positive. The economy is expected to keep growing at a strong pace in the years to come. However, concerns over refinancing risks of the current account deficit together with the evolution of household consumption and credit growth warrant a careful monitoring of these indicators. Moreover, budget policy needs to be maintained prudent in order to avoid the risks of overheating the economy.

There is urgent need for multi-annual budget programming (MABP), which should assess future pressures on the budget thoroughly. This is increasingly asked for since inflation targeting could overburden the budget policy in case of adverse shocks.

In view of possible pressures on the budget in the years to come, income and structural reform policies will have to play a more important role in fiscal consolidation and support of disinflation. A consistent reform of the public expenditures will be needed in order to improve their prioritization and redirect them towards areas that strengthen the country's human capital, infrastructure and administrative capacity. Together with a broadening of the tax base and better tax collection this would make room for sustaining the additional EU related accession costs while avoiding the implementation of a risky pro-cyclical fiscal and budgetary policy.

The reform of the health and pension systems is crucial to counter the expenditure pressures of an aging population and to improve the sustainability of the public finances.

The development of the institutional capacity to absorb EU funds is a huge challenge; the absorption of EU funds conditions rural modernization.

The years to come should consolidate the inflation targeting regime; this implies a refining of the econometric models on which this regime of monetary policy rests. An adequate understanding of the monetary transmission mechanism in the Romanian economy (which should enable the

NBR to have good forecasts for its policy moves) and further fiscal consolidation, as well as other features of the Romanian economy (degree of euroization, low monetization, intensity of structural change) determine the evolving content of the inflation-taregeting regime.

Romania's successful integration into the EMU depends critically not only on the fulfilment of the Maastricht criteria (of which inflation is a crucially important one), but also on diminishing the gap in real convergence criteria.

4. Competitiveness, innovation system and structural funds absorption

4.1. Growth and Competitiveness – an overview

The revised Lisbon strategy addresses the relatively weak economic performance of the EU and aims to set out the appropriate answers to achieve higher growth. What are the means to increase growth? The 2004 Spring European Council emphasized that "competitiveness, innovation and the promotion of an entrepreneurial culture are defining conditions for growth"[43]. The European Commission considers that reversing the trend of slowing productivity is a precondition for growth and the major competitiveness challenge facing the EU[44].

In all Lisbon strategy related official EU documents the words growth and competitiveness are repeated obsessively. If the EU will become more competitive, growth is a normal consequence. Then, the question remains how to ensure the right competitive setting.

An important volume of research was dedicated to the issue of competitiveness. Competitiveness is associated with four important schools of thought[45]. The first one is based on the comparative advantage and/or on the perspective of price competitiveness. The second one relies heavily on empirical studies. The third encompasses the strategic and managerial standpoint. Last but not least, the forth one is related to historical and socio-cultural investigations. Any comprehensive assessment on competitiveness should include concepts and analytical tools at least from all the above-mentioned perspectives.

The present analysis does not claim to be all encompassing; it focuses more on the strategic and managerial view of competitiveness. The main reason for choosing this research path is the important link between microeconomic competitiveness and sustainable economic prosperity. At a macro level, as seen in the previous sections of this report, Romania has a robust growth performance since 2000. However, macroeconomic performance is not enough. Romania is now on a favourable trend, but foreign investor mood swings, political developments or resource price sways may alter considerably the fragile macro equilibrium.

The only secured foundation of prosperity is microeconomic competitiveness assuming that macroeconomic policy does not entail major blunders[46]. The best proxy for this level of competitiveness is productivity. Therefore, the main public policy goal for increasing Romania's competitiveness should be to create the framework and provide the instruments for a fast

[43] Presidency Conclusions, Chapter III, Brussels European Council, 2004;

[44] Integrated guidelines for growth and jobs (2005-2008), COM (2005) 141, Brussels, 2005;

[45] see Dwyer L. and C. Kim (2003);

[46] Such as running unsustainable large budget deficits, that may produce high inflation and a short-termism in investment behavior;

productivity growth.
The microeconomic foundations of productivity rest at least in two interrelated areas: company sophistication and the quality of the business environment[47]. On one hand, Romanian companies must upgrade their modes of competing in order to ensure successful economic development. Companies must shift from competing on inputs and create competitive advantages arising from efficient and distinctive products and processes.

On the other hand, the quality of the business environment is key to attract capital, to foster innovation and to provide all the other resources and competitive pressures to create the right competitive incentives.

The Lisbon strategy framework for encouraging growth is structured differently, but it certainly addresses the two areas described above.

As regards company sophistication, the European Union is committed to encourage Research Development and Innovation (RDI) at firm level in order to boost competitiveness. The goal of the EU is to increase company spending on R&D and to enhance the firms' capacity for innovation.

In terms of improving the business environment, the Lisbon agenda follows priorities such as building ICT infrastructure, ensuring better regulation and providing more efficient enterprise development policy. All these in the overall regional context of consolidating the Internal Market.

As in the previous reports, the analysis will present and discuss the main lines of reform suggested by the EC and will assess Romania's readiness to participate and contribute to this process.

The RDI system in Romania

The gap between Romania and the EU in RDI was outlined in the section analysing the Lisbon structural indicators. The results based on the situation up to 2005 show that Romania is significantly lagging behind the EU average in developing RDI.

Through public intervention, the Romanian Government tried to push for the development of the R&D sector in 2006, when the public budget available was almost doubled reaching 0.4% of GDP as compared to a meagre 0.27% of GDP in 2005. This was the main factor that led to an increase of the General Expenditures on R&D (GERD). For 2007, the public budget for R&D is estimated at 0.7%. However, there will be a clear lag before the private expenditure will outrun

[47] see Porter (2006);

or even match the public one. This is why, beyond the welcomed policy to increase public spending, there is a need for providing the right set of incentive for private RDI investment.

Data availability and collection regarding R&D was considerably improved, mostly due to Eurostat conditionality. Therefore company level R&D spending can be better monitored. Statistics show that private R&D spending is correlated to company size. Given the fact that 95% of Romanian companies are micro-enterprises, the base of companies carrying applied/ industrial research is quite weak.

As regards the efficiency of expenditure from the increased public budget for R&D, this is still questionable, as it may be too early to have an objective evaluation. However, more money available for research does not ensure automatically more efficiency. On the short term there is a serious risk that the initial low efficiency in spending public R&D funds will became a major setback in further increasing the dedicated budget to reach the 1% of GDP aimed by the EU.

From a strategic viewpoint, the Government has commissioned a multi-annual strategy for the R&D sector, which provides relevant guidelines of the steps to follow. Nevertheless, quick implementation is critical, given the need to put into practice the strategic framework as fast as possible, starting with the shift from fundamental to applied research. There is a clear need to go from supply-based to demand-driven research. A lot of funds were wasted in the past years in order to support “research for the sake of research”. In the end, the link between the research and the productive sector remained very weak, allowing scarce technological transfer.

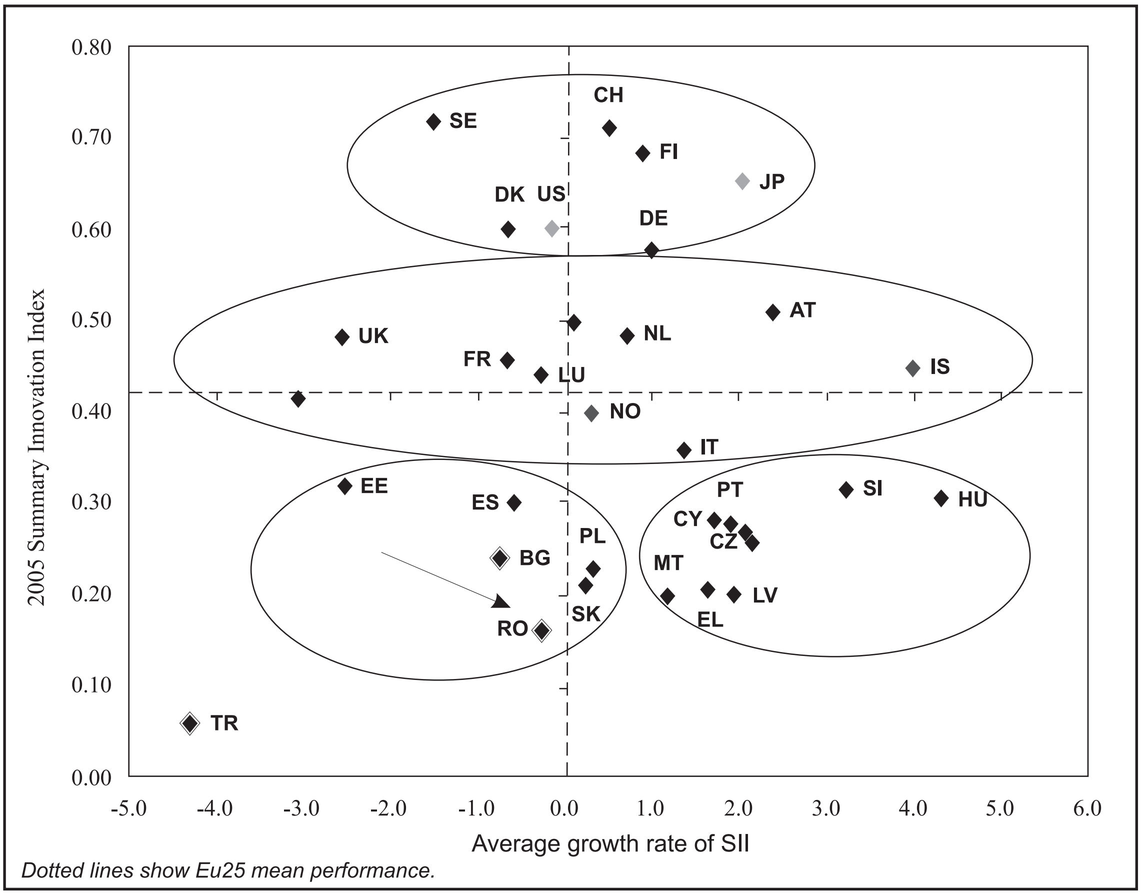
In terms of EU strategic framework, in 2005 was established the Competitiveness and Innovation Programme (CIP) for 2007-2013 to provide support for enhancing micro competitiveness and innovation. Part of the CIP, the Entrepreneurship and Innovation Programme was directly dedicated to help companies, and especially SMEs, to increase their competitiveness.

Romania has participated in 2005 at the CIP meetings, being invited to submit semi- official views on several debate topics, such as state aid reform, industrial policy revival, lack of SME financing or R&D coordination. Unfortunately, this exercise did not trigger a real debate within the Romanian society, with proper consultation of the business environment. It is true that in the few occasions when consultations did take place, business representatives provided only limited value-added to the discussions. However, Romania needs to have a vision and a clear expression of its interests when debating on European issues. After accession, Romania will be required to take sides on controversial issues, such as intellectual property rights. Such approach needs to be also bottom-up and not always top-down.

As regards the capacity for innovation, despite the efforts to push for a knowledge-based economy, Romania’s situation deteriorated from 2004 to 2005. If in the 2004 European Innovation Scoreboard (EIF) Romania was considered a catching-up economy from the viewpoint of innovation dynamics, in the 2005 EIF it was downgraded to the status of “losing ground”.

Arguably, this downgrade is due to peculiar dynamics in 2005: namely, a siginificant slowing down of the economy (because of enery price shocks and a severe exchange rate appreciation, plus a poor harvest)

Figure 4.1. Summary Innovation Index 2005



Notes: The circles in Figure 4.1. identify the four main country groupings: top = leading countries, middle = average performers, bottom right = catching up, and bottom left = losing ground.
Source: European Innovation Scoreboard 2005

It should be said that supplementing the budget is quite helpful, but it will not enhance automatically innovation dynamics.

According to the calculation of the European Commission, Romania seems more efficient in terms of innovation output than on innovation input. Innovation efficiency can be measured as the ability of firms to translate innovation inputs into innovation outputs. The ratio between the EIS composite index for inputs (education, investment in innovation, etc) and outputs (firm turnover coming from new products, employment in high tech sectors, patents, etc) provides a measure of this relationship for national innovation systems. However, this apparently positive feature of the Romanian innovation system may just be the cause of an advanced precariousness of the input, as education quality, on average, is very poor.

Building Information Communication Technology (ICT) infrastructure

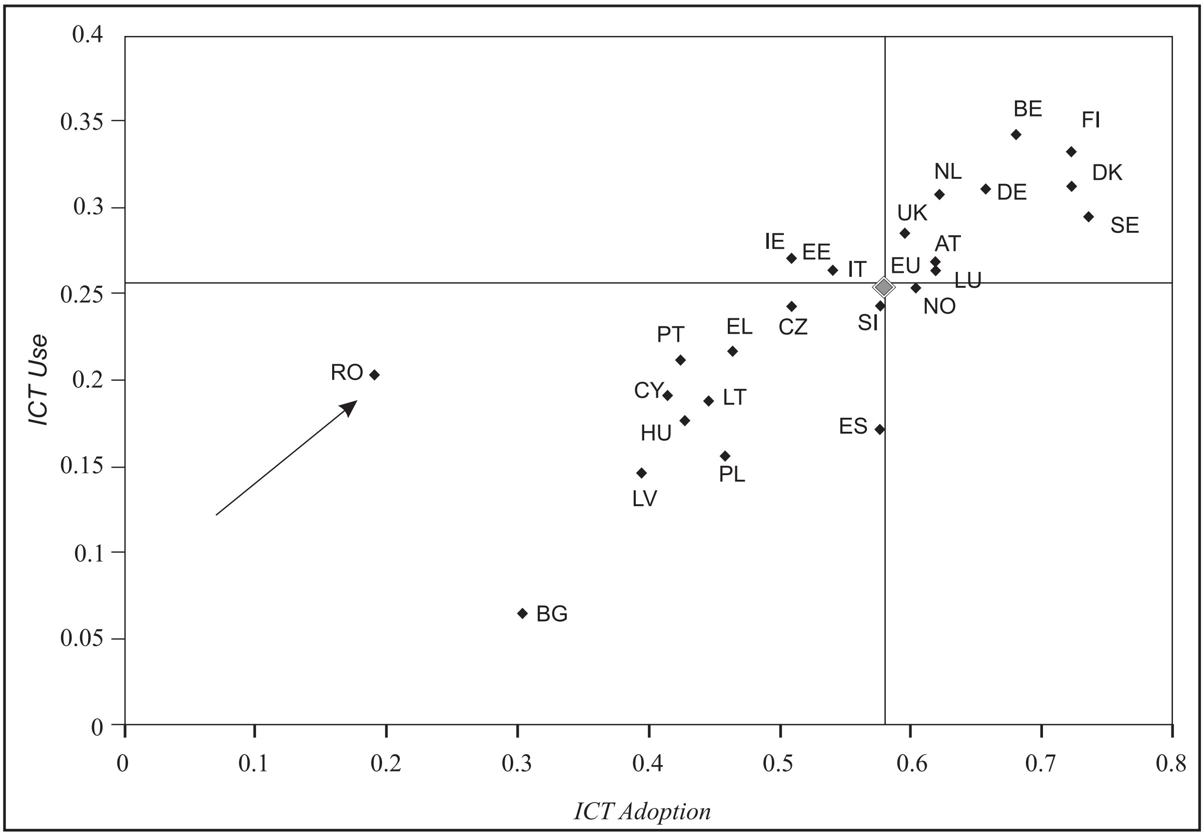
The uptake of ITCs by both the private and public sector is a key element in improving innovation performance and competitiveness.
The information systems and technologies provide the backbone for the knowledge economy and are a catalyst for organisational change and innovation. In addition to being a high growth sector, ICTs represent a substantial and increasing part of the added value of all products and services.

In June 2005, the European Commission launched the "i2010 – A European Information Society for growth and employment" initiative, as a framework within the revised Lisbon Agenda for addressing the main challenges and developments in the information society and media sectors up to 2010. The i2010 initiative rests on three pillars - creating the single European Information Space, which promotes an open and competitive internal market for information society and media services, increasing investment in innovation and research in ICT and fostering inclusion, better public services and quality of life through the use of ICT. The link between ICT and competitiveness is also acknowledged by the inclusion of the ICT policy support programme within the Competitiveness and Innovation Programme (CIP).

Despite the considerable progress scored by Romania in developing ICT, the information technology infrastructure and use still remains far from the level of older EU member states. The 2005 Information Society Benchmarking Report, prepared by the European Commission, shows that Romania is last from all EU 27 countries in terms of internet penetration in households[48]. This may not be an indicator directly related to economic competitiveness, but still provides an image of the ICT gap that needs to be bridged in the following years.
The same report analyses the extent to which companies invest and adopt ICT in their business. Enterprises may invest in ICT for different reasons e.g. to increase sales and market share; to improve efficiency of internal business processes or reduce costs through e-procurement. The EC calculated an experimental composite indicator to capture e-business readiness for each EU27 countries.

[48] based on 2004 data (last available for benchmarking);

Figure 4.2. ICT adoption and ICT use in 2004: composite indicators



Source: 2005 Information Society Benchmarking Report, European Commission

Romania's positioning in the bottom-down quadrant is quite different from the cluster of other member states, and even from the situation in Bulgaria. Data confirms that ICT solutions are hardly available for general business adoption and infrastructure is limited to narrow areas of urban concentration. However, the good news is that where ICT solutions are available, the companies have decided to invest and use them to build a competitive advantage. This situation is also explained by the fact that in Romania ICT development was pushed more by private initiatives rather than by public investment. As a comparison, in Bulgaria ICT infrastructure was supplied more under the form of public goods, with a more limited involvement from the private sector.
The current situation confirms once again the high potential of the ICT market in Romania and gives hopes for strong development of the emerging ICT clusters around significant urban concentrations such as Bucharest or Cluj.

Nevertheless, as shown in the previous GEA report, Romania is still confronted with a high digital divide. Beyond low levels of technology penetration (PCs, mobile phones, Internet etc.), there are large urban-rural and intra- and inter-regional disparities and also low assimilation of digital technology by older population.

There are good reasons to believe that Romania has engaged on a convergence path, as success stories have already emerged in the domestic IT industry. Software companies have emerged as international players in fields such as antivirus programming (ex: Softwin with BitDefender) or gaming (ex: UbiSoft Romania). However, the ITC sector in Romania is still the sum of disparate corporate investments, as opposed to the case of Bangalore, India, where branding the region as an ITC hub contributed significantly to gain the competitive edge.

Structural funds will provide resources for public intervention in consolidating ITC infrastructure (especially broadband access). At the same time, Romanian SMEs will be eligible for support in their investment related to the productive use of IT.

4.2. Public policy and the innovation system

The institutional framework for stimulating RDI: An European perspective

Internal institutional infrastructure represents an important variable for integration in general and for the pressures of adjusting to the Europeanization process (Paraskevopoulus and Rees, 2002). Institutions matter, by means of all their functions – regulation, cognitive and normative – and at all governmental levels. Companies do not innovate in isolation, but within a system; the particularities of this system are essential to the innovation performance (Smits and Kuhlmann, 2004); the same authors consider that the role of systemic instruments in the innovation policy – including here institutional mechanisms – is growing. Institutional reform is important for managing the convergence to European policies and efficient governmental research and development structures are particularly needed for converging to the Lisbon Agenda targets (Stankiewicz, 2003).

The Trendchart Report published by the European Commission (2004) comprises a series of recommendations regarding the governance of the innovation policy, among which we mention: the need to ensure the coordination and efficiency of the innovation policy, either through a competent and result-oriented central structure, or through a density of flexible agencies and councils; and the need to accompany functional institutions with functional policies, especially by using periodical evaluation instruments and benchmarking.

Furthermore, the Sapir Report (June 2005) underlines the same idea: the necessity of better economic governance for the success of the Lisbon Agenda, which implies a clearer governance system at all levels and more efficient institutions, including those at member states level.

Nevertheless, there is a rich diversity of national innovation systems within the EU. Our research has led to the result that, at the mid of the year 2005, the aggregated situation in EU was as follows (Voinea, 2006):

- 6 countries have had a national strategy for Lisbon;

- 24 countries have had a national strategy for research and development;

- 4 countries have had a distinct ministry for research-development-innovation;

- 21 countries have had National Councils for research and development with public stakeholders; 6 of these councils have also had private stakeholders; 1 country has had a National Council for research and development with private stakeholders only;

- 23 countries have had an inter-ministerial structure which coordinates the research and development activity; 10 of these are coordinated by the Prime Minister, and the remaining 13 by a line minister;

- all 27 countries have had consultative commissions for research and development; in 21 of these countries, the commission subordinated to a ministry; 12 of them also have independent commissions which function in parallel; 6 countries have had only independent consultative commissions;

- all 27 countries have public implementation agencies; 12 countries also have mixed or private agencies for the implementation of the research and development policy.

Table 4.1. The national innovation structure in Romania

ROMANIA		1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
National strategy	for Lisbon	-	-	-	-	-	-	-	-	-	x
	for R&D	-	x	x	x	x	x	x	x	x	x
National target for R&D		-	-	-	-	-	-	-	-	x	x
Administrative structure	Coordinated by PM	-	-	-	-	-	-	-	-	x	x
	Coordinated by line ministry	-	-	-	-	x	x	x	x	-	-
Distinct R&D ministry		-	-	-	-	-	-	-	-	-	
National Council	Public stakeholders	-	-	-	-	-	-	x	x	x	x
	Private stakeholders	-	-	-	-	-	-	-	-	-	-
Advisory Commissions	Ministry	-	-	-	-	x	x	x	x	x	x
	Business associations	-	-	-	-	-	-	-	-	-	-
	Academic/NGOs	-	-	-	-	-	-	-	-	-	-
EU funds administration	Public structure	-	-	-	-	-	x	x	x	x	x
	Private structure	-	-	-	-	-	-	-	-	-	-
Implementing agencies	Public	-	x	x	x	x	x	x	x	X	x
	Mixed	-	-	-	-	-	-	-	-	-	-
	Private	-	-	-	-	-	-	-	-	-	-

Source: Voinea (2005), authors' analysis for 2006

One can observe that all levels – strategy, advisory, decision-making and implementation, there is an overwhelming presence of public stakeholders alone.

Voinea (2005) undertook a cross-country (at the level of EU-27) and longitudinal (period 1997-2005) econometrical exercise to determine whether the institutional design could be an explanatory variable for the fulfilment of structural indicators in various countries. Institutional design was found strongly and positively correlated with the Lisbon Agenda performance. The main results of the model can be summarized as follows:

• There is a positive correlation between the existence of a national strategy for research and development (different from the National Development Plan) and the total expenditures on research and development;

• The same is not valid as regards the existence of a national strategy for Lisbon or the existence of specific national targets for Lisbon. However, this could be explained both by the limited number of observations post-2002 (after the Barcelona Council, which actually set the European targets for the Lisbon Agenda), and by a path dependency effect;

• It seems better to have a National Council for Research and Development as an independent structure, including business and academic representatives;

• Private institutions are more associated with higher research and development expenditures (both private and total expenditures);

• Venture capital funds are correlated with higher research and development expenditures.

Of course, these conclusions must be considered with caution, while keeping in mind that each country has its own characteristics, other than those of an institutional nature, which influence the efficiency of the institutional mechanism in general and the institutional framework for research and development in particular. Nevertheless, econometric analysis indicates that there are a series of common institutional aspects which facilitate the increase in research and development spending.

We are not saying that the institutional framework in Romania is wrong or ineffective ab initio, yet we submit the idea that, at European level, over an 8 years period, an institutional model has emerged which better responds to the needs of the Lisbon Agenda.

Public policy and the regulatory framework

As mentioned in both Sapir and Kok reports, consolidating the Internal Market is crucial for improving Europe-wide growth performance. Ensuring the free movement of products, services, capital and labour, and the smooth functioning of each of the national markets is a precondition

for enhancing competitiveness. However, the transposition rate of Internal Market directives still remains very low. Furthermore, directives still have major problems as regards national implementation.
The September 2006 Monitoring Report stated that Romania is on track to meet the accession criterion on the ability to cope with market pressures within the Union[49]. On the other hand, several surveys suggested that the majority of Romanian companies fear that accession would be detrimental to their business, to the extent of going bankrupt.

A large majority of entrepreneurs are still ignorant vis-à-vis the information about EU accession, and bear the risk of being caught off-guard. At the other extreme, a small number of companies are already 100% harmonised with the EU standards and regulations, as they already pursue export activity on the Internal Market.

The ability of Romanian producers to compete and survive in the Internal Market is key to their competitive strength in world markets. From a strictly business point of view, complying with the European Union's acquis will incur considerable additional investments, increases in direct and indirect charges for public services, and it might 'crowd out' other investments. For most sectors the additional costs will be dominated by the costs of implementing the EU's environmental regulations, both through initial upgrading of production facilities and through increased charges for waste management.

Other kinds of horizontal legislation that are likely to affect future investment requirements of individual firms are occupational health and safety requirements, and employment legislation. In addition, many companies will be affected by single market standards covering individual product specifications. For some sectors, the application of the EU's competition legislation may reshape market structure.

However, many companies in Romania, especially from the manufacturing sector, have recently undergone restructuring and modernization programmes and are more or less prepared for these legal requirements. In the medium and long run, the investments made to comply with the acquis will lead to improved competitiveness as the positive effects associated with the introduction of the single market already observed in the EU will become more and more visible in Romania as well.[50]

This section explores ways in which public policy may improve the competitiveness of Romanian companies within the Internal market. The approach will cover both institutional aspects and the debate on the content of such policy. In the last years Romania has initiated an ambitious

[49] Part of the accession criteria set by the Copenhagen Council in 1993;

[50] These include the creation of more jobs, generation of higher income, lower inflation, expansion of trade, growing competition, accelerated pace of industrial restructuring, a wider choice of products available at lower prices and greater attractiveness for investment – see European Commission (1996);

regulatory reform process, with at least three main objectives. First, to fully transpose the acquis communautaire in order to be ready for membership. Second to tackle legislative instability by improving the quality and expertise of the legislative process. Third, to bring more coherence and transparency by codifying and republishing the main regulations with an impact on socio-economic development.

Encouraging assessments also came from the World Bank, as the Doing Business 2007 report highlighted Romania as the top reformer in Europe from the viewpoint of improving the business regulatory framework. This dynamics is also validated by the record-high of foreign direct investment in the first half of 2006 (EUR 3.2 bn). Unicredit banking group estimates suggest that Romania could attract FDIs worth up to EUR 7.5 bn by the end of the year.

However, according to the Global Competitiveness Report 2006-2007, Romania's ranking for the quality of the business environment[51] suggested a slightly negative evolution (from place 71 in 2005 to place 73[52] in 2006). The explanation resides in the assessment methodology used. The World Bank is evaluating the quality of regulations and not their implementation or perceived impact. Thus, the moment Romania adopted better regulation on building permits, on credit procedure, on protecting investors, or on insolvency procedures, immediately it was credited for a successful reform. In contrast, the evaluation of the World Economic Forum is based to a large extent on the business' perception of the reform process. Therefore, such evaluation takes more into account the subjective views of entrepreneurs. The lack of ranking improvement may be explained by either the gap between adopting legislation and implementing it effectively, or the lag between actual change and its perceived business impact.

Overall, the quality of public policy formulation has improved. In 2005 Public Policy Units (PPU) were created at the level of each of the Romanian ministries, under the coordination of a specific Department within the General Secretariat of the Government. All new proposed policies must fulfill a series of minimal formal standards, among which the necessity to provide three alternative scenarios for the implementation of the envisaged policy.

The GSG is also responsible for preparing the implementation of a major reform based on the introduction of the regulatory impact assessment (RIA) procedure and on a comprehensive methodology for strategic planning at the level of line ministries. The latter includes measures to provide authorities with a clear and broad framework for the elaboration and coordination of public policies, with an active involvement of civil society[53].

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[51] composite indicator based on both hard (statistics) and soft (survey) data;

[52] or 72, if Barbados, which was not ranked in 2005, is excluded from ranking for a more accurate comparison;

[53] Monitoring report on the state of preparedness for EU membership of Bulgaria and Romania, COM (2006), Brussels, 26/09/2006;

Competing in the Internal Market – what kind of national public policy?

Regardless the debate on the degree of state intervention, the Romanian Government needs to acknowledge its role as provider of the right framework for competitive growth.
On one hand, the revised Lisbon Agenda calls for better regulation and even de-regulation, at both community and member state levels, given the negative impact of red tape on business growth and performance. On the other hand, there is an entire array of multi-level government entities with a stake in economic development. The question is not whether the government needs to be involved, but what role should assume in order to ensure the optimal set of incentive and policy coordination.

In Romania, there was little debate on the content of a possible enterprise/industrial policy over the last years. Generally everyone has agreed that structural reforms were needed in order to have a more efficient economy.

Privatisation and industrial restructuring were gradually implemented during the 1990s with a clear goal of limiting state control and intervention. The process was not linear, and to a large extent was reactive to external conditionality. State aid legislation was formally imported from the EU acquis in 1999. However, state aid rules started to be thoroughly observed only after 2003, when the Competition chapter became a worrying hindrance in closing the accession negotiations.

Currently, in the EU and to some extent even in Romania there is a debate on three policy alternatives related to state intervention in the enterprise/industrial sector.

The first alternative is the pro-market approach. According to this view, the market, provided there are no obstacles, has in-built mechanisms which allow enterprises to restructure, grow and increase their efficiency. The more competition on the market, the better in terms of allocating available resources. There should be no concern about the faith of Romanian companies after accession as the Internal market will provide more opportunities for sound corporate development. The least prepared will exit the market, being replaced by more efficient competition or better prepared start-ups. This view has been supported by the EU as the main objective of the Single market in the 1990s: to create an efficient and vast market that would allow European firms to compete in the global economy. Such approach leaves little room for state intervention, in fields such as SME support, R&D or environmental protection.

The second alternative is that of explicit public support of individual companies on sectors that are considered strategic for international competitiveness. This policy can be subsequently divided in a number of interventions different in their nature and effects, as follows[54]:

[54] Maincent E. and Navarro L (Ibid.)

• Support for infant and developing industries may be aimed at increasing domestic welfare by promoting a stronger position for selected national industries at the expense of foreign competitors. In Romania this might be the case for supporting the IT sector, as seen with the current fiscal incentives[55] unique to this sector. At the same time, such support might be provided to other industries for shifting from a factor-based approach (low labour costs) to an innovation-driven business model;

• Support for domestic "champions" in order to make them more fit to compete at the global level. The notion of industrial champions is not rigorously defined in the literature, but it usually refers to successful companies with a competitive edge based on their economies of scale and scope. This type of intervention is backed by the theory suggesting the existence of market failures/gaps in a knowledge economy, especially regarding investment in intangible assets such as R&D and innovation. In Romania, there was no debate on the opportunity to provide such support. Obviously, there are few Romanian potential champions, which are still owned by domestic capital, thus narrowing the scope for a possible intervention;

• Support for competitive industrial agglomerations – clusters – in order to benefit from positive externalities and spillovers. Clusters encompass a high density of producers, customers and suppliers with strong links to regional universities and research institutes. While collaboration is necessary due to the need of sharing knowledge-intensive investments, competition stimulates rivalry and a continuous search for innovation. In the cluster case, public intervention is horizontal, based more on indirect rather than on direct involvement in the economic activity. The role of the state policy is to promote learning processes throughout the economy, stimulating interactions amongst the enterprise sector and knowledge producers. This type of intervention is non-distortive and closest to the pro-market approach;

The third option, involving public intervention, is that of supporting large ailing companies, or declining industries in order to avoid the social consequences of large industrial bankruptcies or major restructuring. From an economic viewpoint, this type of state involvement has little, if any, economic justification. Overall, the socio-political difficulties in addressing the true nature of the problems associated with restructuring have led politicians to subsidise and protect ailing companies or industries. In Romania, this policy, although less and less pervasive, has deprived the economy of important resources, which might have been used alternatively for developing emerging companies and/or sectors.

All the above should not be interpreted as a plea for a mandatory choice of a specific intervention policy. Moreover, if several experts point to the possible existence of market failures, there

[55] software developers are subject to preferential rates of taxation, according to the Fiscal Code (Law 571/2003 with subsequent ammendments);

are plenty of other economists highlighting the existence of government failures as well. Both theory and empirical evidence underline the limits of promoting economic welfare through political involvement. Actions related to promotion of self interest or regulatory capture may distort the interventionist policies. In Romania, rent-seeking behaviour is quite present and needs to be well monitored and contained during the process of defining specific policies.

These are some of the lines of a required debate for shaping Romania's enterprise policy in the future years. There is no time, no purpose in waiting to see what the EU or other member states suggest. As part of the EU, Romania should be able to articulate its own view on the content of an enterprise policy, both at Community, national and even local levels, based not only on the principles of the Internal market, but also on the needs and realities of the domestic economy.

Cluster development and the process of competitive upgrading

As mentioned above, supporting industrial agglomerations is one of the possible instruments of a new enterprise policy. Given the relative novelty of such a policy, a few additional considerations will be presented below.

Successful economic development is a process of successive upgrading. As nations develop, they progress in terms of their characteristic competitive advantage and modes of competing. Following the Porterian model[56], there are three stages of economic competitiveness: the factor-driven economy, the investment-driven economy and the innovation-driven economy. Most of the Romanian economy of today is to a large extent factor-driven, still based on the low labour cost.

The logical way to increase Romania's economic competitiveness is to enhance innovative activities, while reducing the dependency on factor prices. In time, it is relatively certain that the factor-driven model of economic growth will eventually be upgraded, but the process is a lengthy one, involving numerous adjustments of the national economy.

In addition, regardless of the ability to create an innovation-driven economy, it is obvious that losing the factor-driven competitiveness is not subject to choice: as real wages go up, the cost of labour in Romania becomes less and less attractive compared with other sites. Thus, the case can be made that by stimulating the development of clusters, a form of spontaneous organization widely recognised as being an engine of innovation-based growth, Romania can 'burn stages' on the path to a more sustainable competitive profile.

In different studies and research projects[57], several potential or emerging clusters have been

[56] Building the Microeconomic Foundations of Prosperity: Findings form the Microeconomic Competitiveness Index, Michael Porter in Global Competitiveness Report 2002-2003, World Economic Forum, Geneva 2003;

[57] see a review of studies in Pislaru D. and Aristide O. (2004);

identified in Romania in various sectors, such as textile, wood processing, pottery, automotive, software etc. While it is not certain that the described agglomerations of companies will grow to become full-fledged, dynamic, innovating, clusters, it is equally uncertain that they will resist the competition and remain at their present level of development.

Several of the emerging clusters are operating mainly under the lohn regime, and this is a notoriously short-term solution for realizing the desired level of exports. The markets are completely beyond the ‘control’ of the domestic companies (lack of domestic brand recognition, of contacts with the final clients) and at the same time the local companies are dependent on the foreign orders.

In addition to these unfavourable demand conditions, there is always the spectre of lower-costs sites and relocation of factories. Establishing stronger linkages between industries such as wood-processing and furniture or textiles and clothing should contribute to consolidating the value chain and raise the efficiency of these menaced sectors (in Romania, there is anecdotal evidence that we are witnessing the phenomenon of export of minimally processed wood and its subsequent import as furniture). Thus, unless the local companies manage both to lock-in investors by securing the superior working conditions typical of a functioning cluster and to profit themselves from the local pool of know-how, we could very well be faced with the situation in which a great opportunity to upgrade the economy was missed.

In the introduction of this section, an evaluation statement suggested that most of the Romanian economy is still factor-driven. However, there are emerging industries which are truly competitive, and are more and more innovation-driven. The classical example is the software industry, already mentioned in the ICT section as a proof of economic convergence with the global market. Another relevant example is the automotive industry, which can serve as a short case study for how the economy is responding to competitive challenges.

Case study: the automotive industry in Romania – towards a competitive transformation

Throughout the 1990s, the Romanian automotive industry operated as a non-restructured, stagnant and state-owned. However, in early 2000, based on important FDI and decisive restructuring, the automotive sector re-emerged as a new global low cost production location.

FDI has led in recent years to increased capital intensity of the assembly sub-sector, improved management practices and has initiated the process of building a local supply base. Moreover, FDI positive spillovers were reflected in investments in human capital (vocational training). For instance, the most important investor, Renault, after the acquisition of the Dacia Pitesti plant has retrained 40% of the total number of 13000 workers of the plant in a half year training programme. More than 450 Dacia employees received training abroad at courses lasting several weeks*. Several other foreign investors, such as Continental or Michelin in the tires production sector, or Siemens and Bosch in the electrical components sub-sectors, had similar positive spillovers on the Romanian automotive sector.

Local suppliers have started to restructure aggressively since 2000. Initially, local suppliers had problems in terms of quality and ability to provide more complex sub-assemblies. High tech and high value added components have originated from western firms. This trend changed dramatically in the last years. More and more suppliers have understood the stake of providing components for international players. The automotive industry is largely based on networks, and the advantage of a local supplier is that once it could meet the requirements of price and quality, it might be selected to supply global networks.

Another advantage of Romanian local suppliers is the fact that often international orders of car parts are very small, given the customization tendency in the industry. Therefore, a capital-intensive, fully automatized production line is less efficient than a labour-intensive, manual one. This paradox is reversing the competitiveness stages described in theory, provided that top-skilled labour force is available. The case of the RAAL, a provider of aluminium-brazed heat exchangers and radiators, which entered the global production networks a few years ago, is illustrative to show that the competitive edge can be ensured by adequate investment in human capital**.

However, the value creation potential of Romania as a global automotive location has not yet been fully exploited. While great changes have been made in assembly sub-sector, further changes are expected in terms of deepening the local supply base, especially for the car parts suppliers. From a policy perspective, it is crucial to ensure that the local content is growing. In the Czech Republic and in Hungary, public policy has already started to focus on deepening value chains and developing inter-firm linkages***. The upgrading process should be based on technology, skills and national innovation systems rather than supporting direct production chains. Government capability of coordinating multi-level policies supporting industrial networks and clustering is vital for the successful transformation of the automotive industry.

References:
*Dacia Group Renault Logan: conquering new world markets and boosting the Renault group's profitable growth, Press Release, June 2, 2004;
** www.raal.ro;
*** Foreign Direct Investment and Restructuring in the Automotive Industry in Central and Eastern Europe, Radosevic S. and Rozeik A., Working Paper no.53, Centre for the Study of Economic & Social Change in Europe, SSEES, University College London, London, 2005.

The above case study shows that transformation is possible, and suggests that clustering can be an efficient instrument to enhance the competitive potential of emerging or transforming industries.

The Lisbon Agenda does not oblige Romania to develop clusters. This should be part of a national policy, and not an extension of a community one. Although clusters are recognized as best practices all over the world, their development remains closely linked with the country/region of origin. This might be the competitive edge for Romania in promoting its industry in the next decade.

4.3. Growth, competitiveness and the structural funds

For the period 2007-2013, the EU will allocate to Romania EUR 17bn. as part of the Cohesion Policy. Another EUR 11bn. will be available through the Common Agriculture Policy, out of which EUR 7bn. for rural development.

The vision and strategic goals for investing the EU funds are set in the National Strategic Reference Framework (NSRF), as follows:

Vision: To create a competitive, dynamic and prosperous Romania
Objectives: To reduce the disparities with the EU by generating an additional 10% increase in Romania's GDP by 2015

The NSRF[58] provides the most comprehensive development strategy currently available. However, the backbone of the document is rather technical, in the sense that all the content is meant to support the intervention mechanisms already pre-negotiated with the European Commission. More bluntly, the Romanian Government acknowledged the funding opportunities and eligibility within the framework of the Cohesion Policy and then has structured the NSRF to justify the investment. Therefore, the NSRF is not a genuine strategic document, as it did not stirred up a true debate on the very principles of Romania's economic development as a new member state.

On the positive side, the NSRF is an accurate document, in line with the Lisbon Strategy and in line with the Cohesion Guidelines of the EC. The Government has committed, through the NSRF, to use more than 50% of the structural funds to directly support Lisbon objectives. All proposed priority interventions, taken individually, are of common sense, and have feasible goals. Nevertheless, the NSRF does not investigate global challenges, does not show in detail the connection and complementarity between the various intervention mechanisms, and last but not least, does not aim at providing a coherent and unitary view on how Romania will/should look like after 7 years of investment.

In terms of institutional setting, the EU structural instruments will be disbursed through several operational programmes (OP). All programmes are vital for ensuring sustainable growth, and one of them is directly targeting the need for enhancing competitiveness. The Competitiveness SOP provides resources for productive investment, SME development, RDI support, IT and energy infrastructure. Out of the other OPs, the Infrastructure SOP is important for providing

[58] The NSRF is based on the National Development Plan, elaborated in 2005. In theory, the NDP should have wider objectives than the NSRF, as the latter only relates to EU funding and national co-financing. In addition to the NSRF, the NDP should also detail priorities funded solely from the national budget, mostly due to their ineligibility for EU funding (ex: Cernavoda nuclear plant, Brasov-Bors highway, etc.). In practice, Romania is barely able to provide co-financing for the EU funding, so the NDP and the NSRF coincide almost totally.

an adequate transportation platform for doing business, while the Regional OP provides support for local business development.

There are two critical questions related to the structural funds. The first question is how to ensure the proper absorption of the structural funds, in order to provide the right push for the Romanian economy. This task is no easy game, as other EU member states have shown little absorption capacity in their first years after accession.

The last GEA Lisbon Report (3rd report) outlined the need for an efficient institutional framework dedicated at implementing large infrastructure projects. Everyone agrees that preparing and managing a large number of small-scale investment projects is time consuming. This is exactly why it may be advisable to focus more, at least in the first years of accession, on the proper implementation of large-scale infrastructure projects.

There will be a learning curve regarding the capacity of the applicants to come up with well-prepared projects. The same applies to Managing Authorities and Intermediate Bodies, who will progressively become more professional in coordinating the application and disbursement of structural funds.

However, a sense of urgency is required, because Romania does not have the privilege of being excused as a newcomer in the EU. Several interest groups, who manifested overtly against Romania's accession in 2007, cannot wait to voice their criticism related to our country's capacity of using the EU support.

The second question is even more difficult, and it relates to the efficiency of spending the available funds. The answer to this question is directly related to policy design and also to programming/managing/monitoring the implementation of the structural instruments. The programming phase is almost finished, as all Operational Programmes (OPs) have been more or less finalised. Only minor changes can now be brought, and only with the express agreement of the European Commission (especially DG Regio). Ideally, by January 1st Romania should have a clear informal agreement with the EC on all OPs. Therefore, it is rather late for significant strategic changes in the programmes. However, last minute overlapping may be avoided, or better complementarity may be reached between programmes with similar goals.

The management phase will be tremendously important in selecting the best investment projects for improving competitiveness. Projects need not to be accepted just for the sake of absorption. The economic impact of the proposed investment on increased productivity, on competitiveness, should be the most important selection criterion. Obviously, the selection process will be painful. On one hand, good investment ideas may be lost because of the lack of skill in preparing applications. On the other hand, replication of projects in the same industry may decrease the profitability of the industry if resources and demand are not available. SAPARD projects focused on growing ostriches, snails or mushrooms were profitable at the beginning, but due to mimetic behaviour of applicants have started to loose their lucrative status due to market saturation.

Monitoring the projects in order to ensure proper implementation and rescue the projects, which may be endangered temporarily by minor setbacks, is very important in order to reach the expected impact. Otherwise, the rules of the game are very clear and ruthless – all disbursed funding will be recuperated and Romania as a state will be severely penalized.

4.4. Conclusions and recommendations

The Lisbon strategy postulates competitive growth as an imperative priority for the EU in a globalised world. It also tries to provide a vision on how the EU should develop in the coming years. At the operational level, member states are pushed, mostly by peer pressure, to deliver the right set of policies in order to reach several thresholds on a number of development indicators. A number of best practices are suggested in order to reap the benefits of applying success stories. Financial instruments at the community level are also available to give an additional impulse for fulfilling the planned objectives.

What the Lisbon Agenda lacks is a differentiated approach for the member states, according to their level of development. The one-size fits all approach of the EU as regards stimulating sustainable growth does not take into account the particularities of each country and the different stages of competitive development. Labour intensive industries were extremely useful in absorbing the shocks of structural reforms, but they may not be that competitive in the current investment-driven stage of economic development. Similarly, technology licensing and importing is crucial for powering-up the industrial investment base, but the process should be gradually abandoned to give way to indigenous technology development.

The Lisbon Agenda strategic goals are generally good for improving the health of the Romanian economy, but they are not a substitute for a true national economic strategy. Romania should strive to meet the thresholds set through the structural indicators, as this is a necessary process. However, this is not sufficient to compete globally. Redressing current economic weaknesses is one thing, and providing a unique mix of strengths in terms of micro-economic climate is something else. In addition to the Lisbon guidelines Romania needs to seek the way to make its economy distinctive. The success stories in terms of competitive economic development – Finland, Singapore, China, part of India, South Korea – offer a unique value proposition in some set of fields, beyond an impeccable business climate[59]. Romania needs to define its unique value proposition, and this process should be both bottom-up and top-down. Gently growing the emerging clusters, without excessive public intervention, but with goodwill and genuine concern for a mutually rewarding partnership from the different levels of Government might be the right solution. In addition, there is a clear need for an integrated enterprise policy at the

[59] Porter et al. (2006);

national level that may provide guidance and coherence to the micro level of the economy.

A series of public policy actions, regarding the institutional framework, the governance mechanism and support measures might help increase the research and development expenditures in Romania (both public and private).

The overlaps between the Ministry of Education and Research and the Ministry of Economy and Commerce need to be eliminated. There should be only one institution to coordinate the research activity, and this institution should be run by a line ministry. If one wishes to build this institutional capacity on the basis of the recently established National Authority for Scientific Research, then the latter should incorporate the research activity domiciliated at other ministries and it should also represent the interface between fundamental research and industrial research. The existent Inter-Ministerial Council for Science, Technology and Innovation is only quasi-functional as long as it does not have decision making attributes.

A valuable policy decision would be to set up an independent National Council for Research and Development, which should include business and academic representatives. Its role would be to advise the R&D responsible public authority, to monitor the general research and development activity in Romania and to publish regular reports on the performce indicators mentioned in the national strategy. It would be good that the Council finance its activity not only from public funds, but also from private contributions.

Venture capital funding for R&D projects and technology transfer should be encouraged, through pooling together domestic resources and structural funds (ERDF). Moreover, there is a need to introduce indirect financial support measures for research, development and innovation, similar to those applied in EU countries, such as deduction of R&D spending from the tax base and fiscal credit for R&D investment reserves.

A permanent ex-ante, on-going and ex-post evaluation mechanism should be put in place for the projects financed from public funds, in order to improve the efficiency of public spending on R&D and to enhance the spreading-out effect.

Last but not least, how can we use the structural funds in the best way for the competitive upgrading of Romania? Absorption is important, but not more important than the usefulness and positive impact of the intervention. There is no optimal solution, but there is a need for sequential coordination, so that the process will not enter on some sort of automated pilot, fuelled by the institutional inertia. Political interests will also be high, and the only way to resist them is by providing transparency, permanent public debate and resources for constant monitoring. The overall process should be seen as strategic and not bureaucratic.

5. More and better jobs

In spring 2005 the EU as a result of the assessment of the progress shifted the focus of the Lisbon Strategy towards employment and growth where the emphasis was on "delivering strong and lasting growth and more and better jobs[60]". Under the new Strategy, the importance of developing a skilled, well educated and competitive labour force, better able to adapt to changes in the global environment, has increased.

An important objective of the Strategy is to create the premises for the European economy to deal with the problems that might appear with the ageing of its population, such as with the impact that this phenomenon will have on public budgets and, in particular, on the pay-as-you-go (PAYG) pension systems. The core message of the assessment is that an ageing population will translate into higher dependency ratios, as long as sustainable employment is not stimulated. Consequently, an important part of the effort for creating more and better jobs is devoted to finding ways to attract people into the workforce.

The specific goals are to achieve a rate of participation of 70% for the population aged 15 to 64 years old, of 60% for women, and of 50% for older workers by year 2010. At the same time, the Lisbon Agenda links the establishment of a skilled, well educated, flexible labour force to lifelong training and encourages people to enrol in higher education programs, and firms to train their employees. In parallel, an important objective of the Agenda is to modernize the European social protection systems, some of which risk to become unsustainable in long run and put additional pressures on public finances. The pension systems in particular have to be reformed in order to avoid deficits that drain significant resources away from other priorities such as investments in the human capital.

5.1. The specificities of the labour market in Romania

Romania's population trend has been negative since 1990, with no signs of reversing in the near future. If the trend does not reverse, Romania's population will gradually grow older, and more public resources will be dedicated to social insurance and assistance. Due to the promotion of early retirement as an alternative to labour shedding, especially in the early years of transition, the ratio of the beneficiaries to the contributors to the PAYG pensions system is well over one, one of the highest in Europe. There is no surprise therefore that the pension system runs a large and endemic deficit fluctuating around 0.5 - 1% of GDP per year. This has the potential to further increase due to the ageing of the population, if no measures to attract people back into employment are taken.

A second element contributing towards the aggravation of the population problem is the

[60] Common Actions for Growth and Employment. The Community Lisbon Program, Brussels, 20.7.2005;

phenomenon of migration, which affects asymmetrically different age groups. Young persons have higher mobility and migration probabilities. Consequently, possibly due to migration, the ratio between the number of contributors and beneficiaries could further worsen. In addition, once Romanian workers are less restricted to move abroad, in some cases possibly as early as January 2007 if EU accession occurs on time, migration might increase, affecting the number of contributors to the social security and pension systems even further. As the number of beneficiaries will practically remain unaffected by EU accession, the pressure on the two respective budgets will further accumulate.

Year 2005 did not bring to Romania the long awaited employment rate growth that is long overdue. Romania's employment rate for the population aged between 15 and 64 years old was 57.7% in 2004, and in 2006 it stagnated at 57.6. The negative trend established after the collapse of the communism was stopped in 2002 but the economy seems to lack the incentives necessary to attract people back to employment. One possible factor is migration. The phenomenon of migration is largely illegal due to the restrictions that workers from Romania face in obtaining jobs in the EU countries. Statistically, this means that the migrants are still residents of Romania and counted in the working age population group, which is the denominator of the employment rate. On the other hand, they are formally not employed in Romania, therefore pushing the employment rate downwards. While in 2000, with the exception of the Czech Republic, Romania had the highest employment figure among the Central and Eastern European countries, in 2005 the picture has changed significantly. Romania is now among the low performers in terms of employment figures. While in most CEE countries, with the exception of Poland, employment stabilized or even returned to growth by 2000, the shrinking of employment continued in Romania up to 2002[61]. Observers attribute the slow reversal of the trend in employment to the protracted enterprise restructuring process and the sluggish structural reforms in the public sector. Some of the reverse in the employment trend in 2004 might be attributable to the cycle of high economic growth rates that Romania has experienced after 2001. The fiscal stimulus introduced in early 2005, through the adoption of a flat 16% corporate profit and income tax, appears not to have been successful enough in encouraging formal employment expansion. The still high social contributions might have offset its positive effect.

Table 5.1. Employment rate of population aged 15-64 in NMS and candidate countries

Employment rates	2002	2003	2004	2005
EU (25 countries)	62.8	62.9	63.3	63.8
EU (15 countries)	64.2	64.3	64.7	65.2
Euro-zone	62.4	62.6	63	63.5
Euro-zone (12 countries)	62.4	62.6	63	63.5

[61] The large employment rate drop that appears in 2002 can partially be attributed to a change in the definition of employment;

Czech Republic	65.4	64.7	64.2	64.8
Estonia	62	62.9	63	64.4
Latvia	60.4	61.8	62.3	63.3
Lithuania	59.9	61.1	61.2	62.6
Hungary	56.2	57	56.8	56.9
Poland	51.5	51.2	51.7	52.8
Slovenia	63.4	62.6	65.3	66
Slovakia	56.8	57.7	57	57.7
Bulgaria	50.6	52.5	54.2	55.8
Croatia	:	53.4	54.7	55
Romania	**57.6**	**57.6**	**57.7**	**57.6**

Source: Eurostat

An important objective set by the Lisbon summit is to increase the participation of women and older workers, aged between 55 to 64 years. Romania's women employment rate is low compared to the EU-15 and EU-25 average, at less than 52% in 2005 down from 58% in 2000, and it is sensibly smaller than that of the males, of around 58%. The decline in female employment in 2005 was larger than the fall in the total employment rate, indicating that the male employment rate has, at the same time, increased. The figure is a long way out from the Lisbon target. In 2001, older workers, aged between 55 and 64, had an employment rate of 48.2%. This did not depart significantly from the EU target of 50% participation rate by 2010. Unfortunately, after 2001 there has been a significant drop in the employment of older workers, which shrunk to around 40%.

One has to be cautious in interpreting the employment rates of women and older workers. First, the two rates have been decreasing since the beginning of transition. Romania, unlike most of the EU countries, had a tradition of high women participation rates. The drop in the activity of women was largely involuntary, attributable to the decline in output and employment opportunities following the collapse of communism, and the concomitant severe deterioration in living standards and increase in long-term unemployment. We expect therefore a large percentage of inactive women to return to work when labour market conditions start to improve. Labour market transition probabilities[62] from out of the labour force into employment show an important female added worker effect, where women enter the labour market to compensate for the withdrawal of men. At the same time, the participation of women and older workers in the subsistence agricultural sector is even larger than in the case of men. The correlation between the decrease in agricultural employment on one hand, and the decrease in female and

[62] Romania Country Economic Memorandum, World Bank, 2004;

older worker participation, on the other hand can not be coincidental[63]. This suggests that the employment figures in the two cases hide bigger imbalances than at a first glance.

Table 5.2. Female employment rates for NMS and candidate countries

Female employment rates	2002	2003	2004	2005
EU (25 countries)	54.7	55	55.7	56.3
EU (15 countries)	55.6	56	56.8	57.4
Euro-zone	53.1	53.6	54.5	55.2
Euro-zone (12 countries)	53.1	53.6	54.5	55.2
Czech Republic	57	56.3	56	56.3
Estonia	57.9	59	60	62.1
Latvia	56.8	57.9	58.5	59.3
Lithuania	57.2	58.4	57.8	59.4
Hungary	49.8	50.9	50.7	51
Poland	46.2	46	46.2	46.8
Slovenia	58.6	57.6	60.5	61.3
Slovakia	51.4	52.2	50.9	50.9
Bulgaria	47.5	49	50.6	51.7
Croatia	:	46.7	47.8	48.6
Romania	**51.8**	**51.5**	**52.1**	**51.5**

Source: Eurostat.

The dynamics of unemployment affects the overall labour market participation. Although in Romania open unemployment emerged inevitably as a consequence of enterprise restructuring and output contraction, in recent years it appears to have stabilized at around 7-8% of the labour force. This is less than the EU average figure. This relatively low registered and Labour Force Survey (LFS)[64] unemployment levels can be partially attributed to the limited restructuring that took place in the enterprise sector. At the same time, the decline in employment has not been matched by a proportional rise in unemployment, as long unemployment spells discourage people from actively looking for jobs, and pushes them out of the labour force or into subsistence agriculture. The large informal economic sector, estimated at least 20% of GDP, may also explain the low formal employment figures and the low unemployment paradox. The grey economy appears to provide a large number of low paid jobs to mostly unskilled individuals who cannot find formal employment. External migration and the high economic growth rates achieved in

[63] See the next sub-chapter for a detailed analysis of sectoral employment composition;

[64] According to the Romanian National Institute of Statistics (NIS) methodology;

the last years are other factors that explain the low unemployment figures. At the same time, more than 50% of the unemployed are long term, with unemployment spells of more than one year, indicating a profound mismatch between skills and labour demand.

According to the World Bank CEM[65], the transition probabilities of moving from one state of the labour market to another, in one-year time, are relatively high. An unemployed person had in 1999 a 32.3% probability of finding a job, a 52.5% probability of staying unemployed, and a 15.5% probability of moving out of the labour force. This indicates that a large percentage of the unemployed is long-term. Unemployment cannot be avoided, especially in an economy that requires substantial labour reallocation across sectors, as is the case of Romania. However, long-term unemployment is detrimental to an economy and its workers, from a number of reasons: it contributes to an erosion of skills; employers associate long term unemployment to unproductive workers, and therefore are reluctant to hire them; long term unemployment spells have an effect of discouragement of the unemployed, and push them out of the labour force or into the informal sector. Long-term unemployment affects asymmetrically different age categories. It is very high among new graduates and low level educated youth, indicating a mismatch between skills that the education system provides and labour market demand.

Analyses show that the Romanian labour markets still require significant restructuring. If the reform process is to be successful, measures stimulating durable job creation and higher participation have to be taken. Bringing back into the labour force the categories affected severely by the transition is also a challenge. The present economic climate is beneficial, as Romania's economy has been growing robustly for six consecutive years, making the task of encouraging job creation easier and financially more affordable. There are some steps that could be taken in order to help a sustainable creation of jobs.

First, the establishment of new business should be encouraged. In 2004, Romania has taken additional steps to reduce the period of time necessary for the registration of new business, and has adopted an action plan to improve the business environment. The new legislation reduces the period of time in which a business can become operative to three working days, provided that it carries on with the registration procedures. This is a step in the right direction, although there are some voices arguing that the process is more expensive, and more complicated than before. In 2006 The World Bank Doing Business report ranks Romania as on of the top ten reformers in the world in terms of simplifying and expediting business start-up procedures. The same publication in 2007 considered Romania the second country, after Georgia, with respect to reforms aimed at easing businesses. Romania simplified procedures in the area of construction, international trade, managing to reduce dramatically the time necessary in order to comply with the legislation in the fields listed above.

[65] Country Economic Memorandum, see before;

Improving registration conditions is not enough to create new sustainable jobs, if the competitive environment in which firms operate is not conducive to performance. Enhancing fiscal and financial discipline and eliminating the treatment of granting soft budget constrains to selected companies is a crucial ingredient to achieving a competitive environment based on a level playing field for all market participants. According to a recent study[66], which analyses company behaviour between 1995 and 2002, the top 20% companies, totalling around 80% of the sectoral turnover, also accumulated almost 80% of the total debt. The finding was consistent throughout the analyses period. This indicates that there are distortions in the economic environment and that some large companies are given an unfair advantage over the rest of the firms, discouraging otherwise profitable firms from setting up, or from growing, and preventing new job creation. Evidence shows that SMEs constitute a major employer, generating more than 40% of total employment in Europe. Most of employment growth, in general temporary and part-time, takes also place in the SME sector.

There are various ways to encourage companies to create more jobs without distorting the market environment. This could be done by reducing the non-wage costs faced by the employer, or by enhancing the flexibility and competitiveness of the labour markets through a more favourable legislative framework. In recent years, Romania has taken steps to reduce the non-wage labour costs. Since 2003 the social contribution levels have been reduced gradually. Further cuts are envisaged, but the non-wage costs of employers and employees added together still amount to over 45% of the gross wage. As table 5.3. shows, Romania has one of the highest non-wage component of the labour costs when compared to other European countries.

Table 5.3. Social security contribution in European countries

	Old Age, Disability, Survivors				All Social Security Programs		
	Insured Person	Employer	Total		Insured Person	Employer	Total
Netherlands	19.15	8.9	28.05		39.45	17.2	56.65
Czech Rep.	6.5	21.5	28		12.5	37	49.5
France	6.65	9.8	16.45		15.45	33.86	49.31
Albania	9.5	29.9	39.4		9.5	39.5	49
Poland	16.26	16.26	32.52		26.96	19.68	46.64
Romania	**9.5**	**19.75**	**29.25**[a)]		**17**	**29.25**	**46.25**[b)]
Hungary	8.5	18	26.5		13.5	32	45.5
Bulgaria	21.75	7.25	29		25	17.7	42.7
Austria	10.25	12.55	22.8		17.15	24.95	42.1

[66] Mereuta, C. Analiza nodala a sistemelor de companii, Editura Economica (2004);

Germany	9.75	9.75	19.5		20	21.33	41.33
Italy	8.89	23.81	32.7		8.89	30.9	39.79
Average	9.53	16.44	25.98		14.11	25.05	38.57
Slovenia	15.5	8.85	24.35		22.1	15.9	38
Spain	4.7	23.6	28.3		6.25	31.58	37.83
Croatia	20	0	20		20	17.2	37.2
Greece	6.67	13.33	20		11.55	24.1	35.65
Slovakia	7	19	26		9.4	25.6	35
Estonia	2	33	35		2	33	35
Portugal	11	23.75	34.75		11	23.75	34.75
Sweden	7	11.91	18.91		7	25.87	32.87
Finland	4.6	22.75	27.35		6.1	25.36	31.46
Lithuania	2.5	23.4	25.9		3	28	31
Belgium	7.5	8.86	16.36		13.07	17.92	30.99
Latvia	2	18	20		..	..	24.32
United Kingdom	11	12.8	23.8		11	12.8	23.8
Ireland	8	10.75	18.75		8	10.75	18.75

Note: a) For normal working conditions. Contributions are higher for exceptional and special working conditions (Law 380/2005); b) Refers only to social insurance, health fund and unemployment fund contributions. Employers also contribute to the social solidarity fund for the handicapped, the fund for work accidents and occupational illnesses, etc., which adds another few percentage points to the burden.

Source: World Bank (2006).

The high social security contributions create a distortion affecting both the supply and the demand of the labour market and increasing transaction costs for companies. Labour force participation rates are correspondingly low, as a result. The authorities also recognize that the high contribution rates encourage migration into the informal sector in a manner that undercuts collections and complicates tax administration. The government has introduced a series of reductions in payroll taxes and plans additional cuts to align them with the regional standards. However, in the short-run, the scope for further social tax rate reductions has been limited by the introduction of flat tax.

In March 2003 a new labour code governing the functioning of the labour markets came into force. The code has been widely criticised by investors for introducing significant rigidities in the labour market, which adversely affect job creation and labour costs. Several provisions of the code feature prominently among those criticised.
First, the use of term contracts is restrictive; as they can only be used in exceptional circumstances.

This is partly offset by the introduction of the institution of temporary work agency. However, most of the growth in employment in the EU in the last decade is based on term contracts, and has led sometimes to significant declines in unemployment, such as in Spain.

Second, the employer's rights to labour retrenchment for economic reasons are severely restricted. Valid reasons for dismissals are economic hardship, but firms may need to shed labour in order to improve their competitiveness as well. The flexibility in the area of labour and labour relations includes the possibility to employ, adjust, distribute and dismiss workers based on job requirements, to ensure the ability to adjust to the external market criteria like changes in the economic environment, to maintain competitiveness by means of cost control. Economic reasons should be added on the list of valid reasons for dismissal, because preventing firms from adjusting their workforce hampers efficiency and the external competitiveness of the economy.

Third, the automatic application of branch contract agreements to all contracts in the sector should be revised. Mandatory extension of industry – wide collective labour agreements to non-participating employers should be discouraged, or there should be an "opt-out" option for employers for whom complying with the industry level agreement is too costly. Small firms are forced to comply with industry level agreements that are negotiated above their heads. The negotiated salaries and benefits may be too high for firms to afford, pushing them out of business. Overall, although the labour code has introduced some positive changes which simplify recording procedures and limit the opportunities for abuse and corruption, it has not been promoting a flexible environment in which labour market need to operate. Several chances in the code have been made in 2005 to correct some of the imbalances, but the fundamental rigidities have not been removed. It is expected that workers be protected by a proper legislation from abuse by employers.

At the same time, a rigid labour market is not conducive to job creation and sustainable economic development. In 2005 the labour code was amended slightly in several areas. The duration of the term contracts was increased from 18 to 24 months. In addition some incentives for businesses to hire first time workers were introduced.

While the creation of new jobs per se is important, the quality of the human capital they embody is equally central. The distribution by levels of education of the labour force is positively correlated with value added, and hence with the overall competitiveness of an economy. According to a recent survey, Romania has the highest percentage of early school leavers in the region, with 23% of the population between 18 and 24 leaving all forms of education, and the lowest percentage of life-long training.

In 2003, only 1.3% of the population aged between 25 and 64 was participating in training or education. Expenditure on education is one of the lowest among CEEs countries, at around 3.4% of GDP. Long-term unemployment among recent graduates indicates a mismatch between the skills the education system provides and the labour market demand. To address this challenge, the education system is undergoing a comprehensive reform, which has already produced significant changes, especially in compulsory educations. Reform measures were piloted in the vocational education and training system. An important issue that needs to be addressed is the quality of education. The scores of the Romanian students at TIMSS[67] have been consistently among the lowest compared to the eight EU countries which participated in the study.

5.2. An analysis of sectoral employment in Romania vis-a-vis the European Union.

The World Bank Country Economic Memorandum (CEM) analyses sectoral employment distribution in Romania at the beginning of the transition, in 1989, and 2001, and compares it to the sectoral employment of the acceding countries and current EU members. An index of structural imbalances of labour markets has been defined as a means of quantifying the labour reallocation requirements. The index was defined as the overall excess employment in sectors where employment in the country exceeds mean employment in the corresponding sector from the EU.

According to this measure, Romania needed the largest reallocation of labour both in 1989 and 2001. In 1989, around 30% of the labour force would have been required to change occupations and sectors in order for Romania to reach a sectoral employment comparable to that of the EU. The index, instead of decreasing, which would have indicated an adjustment towards the EU levels, had deteriorated further and, in 2001, more than 40% of the work force would have needed to change occupations. With the exception of Bulgaria, the rest of the CEE countries under investigation have made significant progress in convergence towards EU employment structures. This finding provides evidence in support of the fact the Romania's aggregate employment figures present a picture rosier than the reality may be. It suggests that the present employment structure will not help Romania to withstand the competitive pressures that a single market will bring, without a large degree of reallocation across sectors. The large migration of Romanian workers to EU member countries is a facet of the needed labour reallocation.

In Romania, agriculture has played throughout the transition the role of the "employer of the last resort". In countries with high agricultural employment, when the process of job destruction in the industrial sector has not been accompanied by job creation elsewhere, laid-off workers have turned to small scale farming as an alternative to open unemployment. This is the case of Romania, where employment in agriculture has risen from 28% in 1989 to 42%[68] of the total in 2001. Since 2001, employment in agriculture has decreased significantly, from 42% to 32% in 2004. The decrease is an anticipated move in the right direction.
Among the NMS, Poland is the only country with a large share of agricultural employment, although significantly lower than Romania's, at around 18%.
Scattered evidence shows that the decrease in agricultural employment was attributable not only to labour reallocation across sectors, pushed by the need to compensate productivity gaps,

[67] TIMSS is an international mathematics and science study that provides an assessment of students from different countries. The study was run in 1995, 1999, and 2003;

[68] Labour Force Survey figures;

but also to external migration, as Romania has a large outflow of migrant workers. Part of the decrease can be attributed to some classification changes, as well.

Manufacturing is one of the sectors that has expanded between 2001 and 2004, when employment increased from 19% to 22%. This can be related to industrial relocation to lower wage countries which has been taking place in Europe during the last decade following the pressure of globalization. Trade, financial services and the public sector have also expanded during the last 3 years, gaining around 2% each in net new job creation.
These reallocations and job expansion, although small in comparison to what is needed to reach comparable EU employment structures, are in the right direction, and indicate that the restructuring process has started to gain momentum.

Table 5.4. Sectoral employment composition for the EU member states and candidate countries (2001-04)

	Agriculture				Manufacturing, Mining, Energy				Construction				Trade				Transport				Financial				Administration.			
	01	02	03	04	01	02	03	04	01	02	03	04	01	02	03	04	01	02	03	04	01	02	03	04	01	02	03	04
Belgium	1.6	1.7	1.9	..	19.6	19.0	18.5	..	6.4	6.4	6.4	..	16.9	17.7	17.0	..	8.0	7.7	7.6	..	12.8	12.9	13.2	..	34.6	34.5	35.5	..
Czech Republic	4.8	4.8	4.5	4.3	31.0	30.7	30.1	29.9	9.1	8.9	9.3	9.3	16.2	16.6	16.9	17.1	7.7	7.7	7.6	7.7	7.6	7.6	8.1	8.0	23.8	23.6	23.6	23.7
Denmark	3.3	3.2	3.0	3.1	18.5	17.6	17.1	16.7	6.7	6.7	6.7	6.8	16.2	16.8	17.2	17.5	6.7	6.8	7.0	6.8	12.5	12.4	12.3	12.1	36.1	36.4	36.7	37.0
Germany	2.6	2.5	2.5	2.3	24.5	24.4	23.9	24.0	7.9	7.5	7.2	6.8	17.6	17.3	17.4	17.4	5.6	5.6	5.5	5.5	11.8	12.2	12.6	12.8	30.0	30.5	30.8	31.1
Estonia	6.9	7.0	6.2	5.9	26.2	24.7	25.2	27.0	6.8	6.6	7.2	7.9	17.5	17.8	16.5	16.2	9.3	9.3	9.5	8.6	7.9	8.9	8.8	7.9	25.5	25.7	26.6	26.5
Greece	16.0	15.8	..	..	15.6	15.0	..	..	7.3	7.4	..	..	23.7	24.0	..	..	6.4	6.2	..	..	8.2	8.2	..	..	22.9	23.4	..	..
Spain	6.4	5.9	5.6	..	19.9	19.4	18.7	..	11.6	11.8	11.9	..	22.1	22.0	22.1	..	6.1	6.1	6.2	..	10.2	10.4	10.6	..	23.7	24.4	25.0	..
France	..	..	4.3	4.0	..	..	18.2	17.9	..	..	6.7	6.7	..	..	16.6	16.9	..	..	6.4	6.4	..	..	12.8	12.8	..	..	34.9	35.3
Ireland	7.0	6.9	6.5	6.4	18.5	17.3	17.1	16.4	10.5	10.3	10.7	11.2	20.5	20.0	20.4	20.1	6.4	6.3	6.3	6.2	12.7	13.1	12.7	12.9	24.3	26.0	26.4	26.9
Italy	5.2	5.0	4.9	..	23.7	23.6	23.5	..	7.9	8.0	8.2	..	19.9	19.9	20.3	..	5.5	5.3	5.3	..	10.2	10.7	10.8	..	27.6	27.5	27.1	..
Latvia	15.0	15.4	13.8	..	19.5	19.5	19.6	..	7.0	6.1	7.4	..	17.9	17.4	17.6	..	8.1	8.7	9.4	..	5.7	5.2	5.7	..	26.7	27.7	26.5	..
Lithuania	17.3	17.8	17.9	15.8	20.8	20.9	20.7	20.1	6.3	6.6	7.4	8.1	17.1	17.0	17.0	18.2	6.4	6.2	6.4	6.5	3.8	4.9	4.9	4.9	28.3	26.6	25.7	26.3
Luxembourg	1.4	1.4	1.3	..	12.7	12.2	11.8	..	9.7	9.8	9.7	..	18.8	18.8	18.7	..	8.1	8.2	8.3	..	27.6	27.9	27.8	..	21.7	21.8	22.3	..
Hungary	6.2	6.2	5.5	..	27.2	27.1	25.7	..	7.1	7.0	7.6	..	17.9	17.8	17.7	..	8.1	8.0	7.7	..	7.7	8.0	8.6	..	25.9	26.0	27.2	..
Netherlands	2.8	2.9	..	..	14.7	14.3	..	..	6.5	6.1	..	..	19.6	19.9	..	..	6.2	5.8	..	..	15.9	15.9	..	..	34.2	35.1	..	..
Austria	5.7	5.6	5.6	5.0	20.7	20.6	20.4	19.6	8.9	8.8	8.9	8.1	21.3	21.3	21.4	21.9	6.7	6.6	6.3	6.4	11.2	11.4	11.6	12.5	25.4	25.7	25.9	26.5
Poland	19.1	19.3	18.4	18.0	23.7	22.5	22.7	23.1	6.7	6.2	5.9	5.7	15.9	16.0	16.1	16.2	6.0	6.0	6.0	6.0	6.8	7.2	7.2	7.8	21.7	22.8	23.7	23.2
Portugal	12.7	12.4	12.5	..	22.5	21.6	20.9	..	11.3	12.0	11.4	..	20.1	20.3	20.2	..	4.0	4.0	4.2	..	6.3	6.4	6.8	..	23.1	23.5	24.1	..
Slovenia	9.9	9.6	8.4	9.6	32.1	32.7	31.1	30.3	6.0	5.8	5.8	5.7	16.1	16.9	17.2	16.7	6.3	6.0	6.6	5.9	7.6	7.3	8.4	8.5	22.0	21.8	22.5	23.2
Slovakia	6.1	6.2	5.8	5.1	29.6	30.1	29.3	29.5	8.0	8.3	9.0	9.5	15.4	16.0	16.1	15.9	7.6	7.3	6.9	6.5	6.7	6.7	7.0	7.7	26.5	25.5	25.8	25.9
Finland	5.7	5.3	5.0	4.9	20.8	20.6	19.7	19.2	6.1	6.2	6.3	6.2	15.0	15.2	15.2	15.4	7.3	7.1	7.3	7.2	12.6	12.9	13.1	13.2	32.6	32.8	33.3	33.9
Sweden	2.3	2.1	2.1	2.1	18.3	17.6	17.1	16.9	5.5	5.5	5.6	5.7	15.1	14.8	15.3	15.5	6.7	6.7	6.5	6.3	15.1	15.4	15.1	15.0	37.2	37.8	38.4	38.4
United Kingdom	1.4	1.4	1.3	..	17.5	16.8	15.8	..	7.3	7.3	7.5	..	19.3	19.5	19.9	..	7.1	7.1	7.0	..	15.7	16.0	15.5	..	31.7	31.9	33.2	..
Bulgaria	25.8	25.8	25.5	25.0	23.8	23.8	23.0	23.1	4.2	4.1	4.2	4.5	15.0	15.4	16.2	16.5	7.5	7.3	6.7	6.5	5.7	5.6	5.9	6.0	17.9	18.0	18.5	18.5
Croatia	15.6	15.2	16.9	16.4	23.4	22.8	21.6	21.7	6.6	6.9	8.2	8.2	19.7	19.6	19.4	19.3	7.0	6.9	6.6	6.6	6.0	6.3	6.3	6.0	21.7	22.2	21.1	21.8
Romania	42.3	36.4	35.7	31.6	22.2	25.0	25.2	26.0	4.0	4.5	4.6	5.2	10.1	10.5	10.6	11.9	4.9	5.0	5.0	5.0	1.9	2.3	2.5	3.5	14.6	16.3	16.3	16.8

Source: ILO

5.3. Labour productivity

One of the comparative advantages that Romania enjoys is the low labour costs in comparison to the EU, including NMS, as the table below indicates, even when non-wage costs are added to the picture. These levels of wages make Romania attractive in terms of relocating labour intensive productive activities from Western Europe. At the same time, one can notice the trend of increasing wage levels, expressed in Euros, which, if productivity does not keep up, might result in the deterioration of the unit labour costs. With the severe appreciation of RON in 2004 and 2005 the current labour cost advantage might have been eroded in certain sectors (particularly those which are labour intensive). Enhanced competition from East Asia, and primarily from China, in labour intensive industries, such as clothing, textiles and footwear, visible in recent years, is likely to negatively affect employment in these industries in Romania. This is of some concern, as these industries continue to contribute substantially to Romania's exports. At the same time, increased external competition forces the economy to move up the ladder in terms of value added, a trend that is observed in the NMS.

Table 5.5. Hourly labour costs in selected countries and the EU (EURO)

Hourly labour costs	2000	2001	2002	2003	2004	2005*	2006**
EU (25 countries)	19.15	19.72	20.42	20.52	21.22	22.03	22.81
EU (15 countries)	21.89	22.41	23.15	23.32	24.02		
Euro-zone	21.16	21.65	22.38	22.88	23.71		
Czech Republic	3.86	4.64	5.39	5.47	5.85		
Lithuania	2.63	2.76	2.9	3.1	3.22		
Hungary	3.63	4.04	4.91	5.1	5.54		
Poland	4.48	5.3	5.27	4.7	4.74		
Slovenia	8.98	9.58	9.7	10.54	:		
Slovakia	3.07	3.26	3.59	4.02	4.41		
Bulgaria	1.23	1.29	1.32	1.39	1.45		
Romania	**1.41**	**1.55**	**1.67**	**1.6**	**1.76**	**2.29**	**2.57**
Real wage index Romania (1999=100)	**104**	**109**	**112**	**124**	**137**	**155.2**	**170.7**

Source: EUROSTAT; *) preliminary; **) projections. Hourly labor cost is total labor cost divided by the number of hours effectively worked, expressed in Euros.

Lower productivity in Romania relative to the NMS erodes part of the advantage deriving from low wages. As a result, Romania has unit labour costs only marginally lower than Latvia, Lithuania, and Slovakia. The table below presents the dynamics of the unit labour costs as a percentage of Austria's. In the case of Romania it can be noticed that unit labour costs have been influenced by the electoral cycle, and they have tended to increase in the election years and their aftermath. This is an indication that growth in unit labour costs has been triggered by real wage increases above productivity gains in the periods preceding elections, with important inertial effects manifesting subsequently.

Table 5.6. Unit labour costs, PPP adjusted, Austria = 100

	2000	2001	2002	2003	2004	2005*	2006**
Czech Republic	31.5	34.5	39.6	38.4	38.6		
Estonia	35.9	37.7	38.9	40.1	40.7		
Latvia	35.1	34.7	34.5	32	31.2		
Lithuania	32.5	30.4	31	29.9	30		
Hungary	28.1	31.9	37.8	39	39.5		
Poland	45.7	51.5	47.1	39.9	38.7		
Slovenia	67.6	69.7	69.2	67.5	73.9		
Slovakia	26.6	27.1	28.2	29.3	31.5		
Bulgaria	31.3	32.5	32.5	31.9	31.9	32.9	33.8
Romania	**27.9**	**29.8**	**32.0**	**34.0**	**36.3**	**39.2**	**40.7**

Source: WIIW Handbook of Statistics: Countries in Transition 2004
*) preliminary; **) projections. Productivity is defined as GDP at PPS per person employed relative to the EU -25 average. Source: Eurostat

The next table presents the dynamics of the unit labour costs. It can be noticed that, with the exception of 2004, an electoral year, unit labour costs have consistently decrease after 2000. It is interesting to notice that, in the last year, with the exception of Hungary and Bulgaria, most CEE countries have managed to reduce their unit labour costs, and at a higher speeds in comparison to EU 15.

Table 5.7. The growth of unit labour costs (% change).

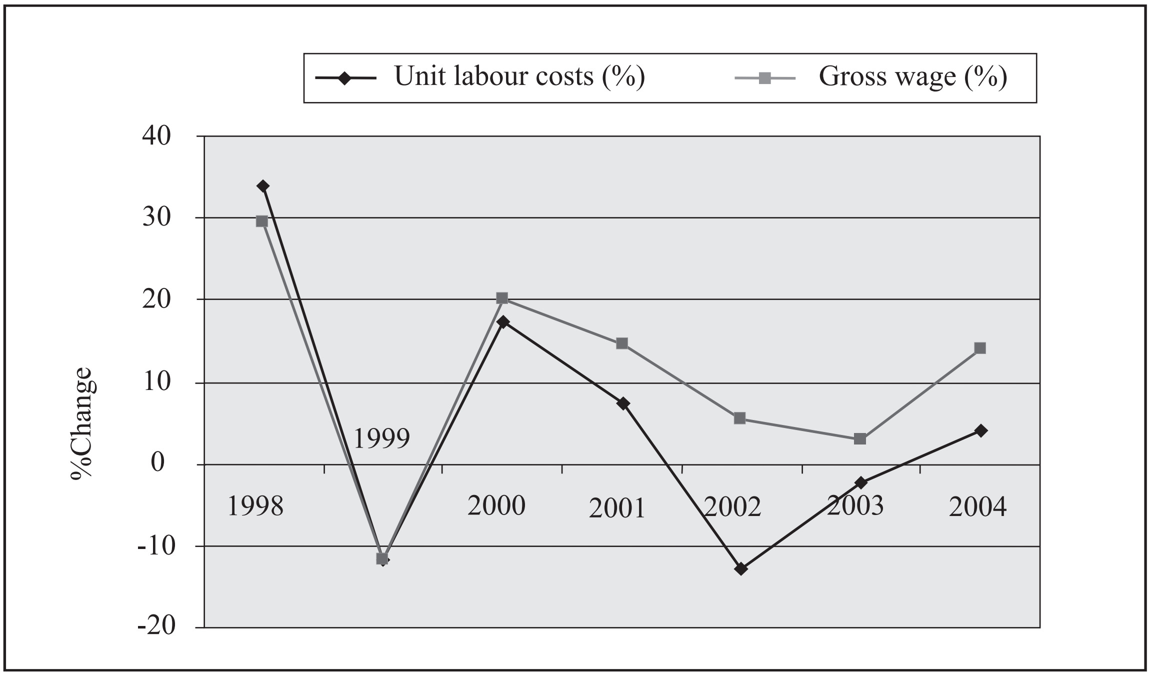
	2000	2001	2002	2003	2004	2005
EU (25 countries)	0.1	0.2	-0.5	-0.3	-1	-0.6
EU (15 countries)	0.1	0.2	-0.4	-0.2	-0.9	-0.4
Czech Republic	0.7	1	3.1	2.7	-1.5	-3.1
Estonia	-8.8	-2.4	-1.5	4.7	2.2	-3.8
Latvia	-6.9	-3.9	-4.2	1.9	-0.3	-3.1
Lithuania	-8.1	-5.3	2.2	1.9	-1.7	-2
Hungary	0.5	3.1	-0.2	0.5	1.1	2.3 (f)
Poland	-2.3	2.9	-4.3	-3.5	-5.7	-3.2
Slovenia	3.3	0.4	-1.3	-2.2	0.3	0.1

Slovakia	-1.5	-1.5	-0.3	1.1	-2.6	-1.1
Bulgaria	-5.4	0.8	-3.4	0.4	-2.6 (f)	1.7 (f)
Croatia	-3.3	-5.3	1.5	2.4	:	:
Romania	21.7	-1.1	-5.6	-2.6 (f)	2.9 (f)	-1.6 (f)

Source: Eurostat.

The following graph presents the percentage change in the gross average wage and unit labour costs in Romania during 1998-2004. The graph shows that both gross wages and unit labour costs have traditionally moved in the same direction, confirming that increases in wages have been responsible for the increases in unit labour costs. Both 2002 and 2003 are years when real wages have grown moderately and unit labour costs have decreased. At the same time, in 2004, the 15% increase in wages has again resulted in the deterioration of the unit labour cost and arguably has contributed to the big rise in the current account deficit.

Figure 5.1. Annual changes in unit labour costs and gross wages in Romania



5.4. EU accession and external migration

Labor mobility and external migration represent two of the most sensitive and controversial items on Romania's EU integration agenda. The concern expressed recently by current EU member states, including by several New Member States (NMS), regarding possible massive inflows of cheap labor from Bulgaria and Romania after January 2007 is expected to trigger the imposition of temporary labor market restrictions to labor mobility for workers coming from the two Balkan countries[69]. The character of these restrictions will probably vary from country to country, and could range from a restrictive migration regime, where Romanians (and Bulgarians) will be treated as any other non-EU members, to an unrestricted access on the national labor market and, eventually, to the social assistance system of the country of destination.

At this stage, no formal decisions have been taken by the current EU members vis-à-vis the treatment to be offered to Bulgarian and Romanian workers, probably in expectation of the confirmation by the EU of the entry of the two countries into the club. Nevertheless, public debate is picking up, both in Bulgaria and Romania and the EU. The debate has also been fuelled by the limited and sometimes contradictory information regarding the magnitude of the migration flows from the NMS to EU-15 following their entry in May 2004. The conclusion that seems to prevail more and more is that, while overall, migration inflows from NMS to EU-15 did not exceed initial expectations, countries that opened their labor markets, primarily the UK and Ireland, have registered a larger-than-expected inflow of Eastern European workers. A report published by the European Citizen Action Service (ECAS) in August 2005[70] showed, based on official figures, that the overall migration levels from the NMS towards EU-15, in the first year after accession, were below the initial estimate of 1% of the EU-15 population. The level of these inflows varied from country to country, the largest being observed in Great Britain, where the number of migrants from the East amounted, by some counts, to 0.4% of the population. Recent evidence from Great Britain shows, however, that the number of workers from the NMS might have reached 600,000 people by mid-2006, well above the initial expectations of the government, which forecasted a figure more than three times lower. The main destinations of the migrants in the first two years after enlargement were Ireland, Germany and Great Britain, and the main source of migrants was Poland.

The temporary measures aimed at restricting the access of the Bulgarian and Romania workers on the EU market are governed by the Accession Treaty of each country. The provisions of the Accession Treaty represent exceptions from the principle of free movement of labor across the borders of the EU members (Articles 1 - 6 of EEC Regulation No. 1612/68) and are seen as bilateral and voluntary agreements between EU members and Romania. The Accession Treaty underlines the temporary character of these restrictions, which vary from country to country, in terms of duration and degree of liberalization of the labor markets towards the newcomers. The main feature of these transitory measures is given by the applicability of the

[69] At the time this text has gone to print several EU member countries have announced the imposition of such restrictions;

[70] Report on the free movement of workers in EU-25 - Who's afraid of EU enlargement?, European Citizen Action Service, Brussels, August 2005;

national rules, derived from bilateral agreements, regarding work permits for the Romanian citizens. When the application of national rules terminates, meaning the end of the transition period, the member state is no longer permitted to request a work permit as condition for the Romanian citizens to enter the labor market in that country. At the same time, the state has the right to continue to issue these permits for statistical purposes, in order to monitor the dynamics on the labor market.

The transition rules are organized in a flexible form, called the “2+3+2 years“. Specifically, assuming that Romania joins the EU in 2007, the following rules will apply:

- in the interval 2007 – 2009 all member states apply individual national measures which regulate the access of the labor force from Romania on their markets. According to the bilateral accession agreements (paragraph 12 in the annex), member states may introduce, as part of the national legislation, an increased flexibility of movement, which might go as far as to fully apply EU legislation regarding the free movement of labor. However, national measures cannot be more restrictive than at the moment of the signing of the accession agreements (paragraph 14).

- at the beginning of the period 2009 – 2011, the European Commission is expected to draft, for the Council of Europe, a report which will document the functioning and the impact of the transitory measures. The results and recommendations of this report will though not be mandatory for the member states. The states that want to continue to apply national measures will have the right to do so, after the notification of the European Commission. The European rules regarding the free movement of labor will apply automatically in the absence of this notification. During these three years, until 2011, member states applying national policies can opt at any time to adopt the EU policies.

- during 2011 – 2013, as a general principle, national policies will cease to apply. Member states will still have the right to apply national legislation, by notifying the Commission, in case there are serious dysfunctions of that labor market or there are risks of substantial distortions induced by the full liberalization.

Starting with 2014, all transitory measures applied by the member states for the labor force from Romania will have to cease, and the European legislation that regulates the free movement of persons will have to be fully applied. Over the period of maximum seven years during which national measures apply, any member state who applies the European legislation has the right to use a safeguard clause (paragraph 7 in the accession treaty) which gives it the right to temporary introduce access restrictions in case there is a substantial worsening of the conditions, triggered by the labor force inflows. The European Commission has the prerogatives to allow or not the application of this clause.

At this stage, there are no comprehensive studies researching potential migration from Bulgaria and Romania and no consistent estimates for the number of Romanian workers expected to migrate in search for work to the current EU members. This number will clearly depend on the nature and the duration of the restrictions imposed by the destination countries, as well as by the economic conditions at home. The number of legal and illegal workers from Romania employed in the current EU countries is already high. Rough estimates put their number in the range 1.5-2 million people, almost double than the official figures put forward by the destination countries. According to some estimates these workers have sent back to their families more than Euro 5 bn in remittances in 2005. Romanian workers seem to be concentrated in countries experiencing both shortages of labor and tight labor market regulations, primarily in Spain and Italy. Cultural affinities clearly play a role in attracting Romanian migrants, who seem to prefer latin countries as destination.

The potential for migration after Romania's accession to the EU remains non-negligible. A recent World Bank study[71] finds that around 88% of young Romanians, aged between 15-24, would consider leaving the country in search for better job opportunities abroad. Only 20% of those, though, would consider migrating permanently. Men seem to be more prone to migrate than women.

The large and widening economic discrepancies and labor market opportunities between urban and rural areas are expected to fuel external migration, especially as 45% of Romanians and two-thirds of the poor live in the countryside. As the opportunity cost to migrating or commuting to urban localities, where most of the new jobs are expected to be created, such as in the expanding services sector, remains high, external migration seems to remain a better option for the unskilled. Furthermore, as economic growth expands and labor costs increase, migration is likely to trigger shortages at home, especially in the unskilled sectors and specialized occupations. The shortages and the increased standards of living will gradually make Romania an attractive destination country for migrants from the outside of Europe. Scattered evidence indicates that this is already happening.

The restrictions to be imposed by the current EU countries are expected to play a role in controlling migration from Bulgaria and Romania in the first years after accession. Evidence shows that the countries which opened their domestic markets to NMS workers, such as Ireland and Great Britain, experienced the largest inflows from the East. At the same time, the enlargement experience of the European Union with the Mediterranean countries Greece (1981), Portugal and Spain (1986), which display important similarities with the enlargement in Eastern Europe, shows that the periods of temporary restrictions can be reduced – from seven to six years in case of Portugal and Spain – without a major impact on the levels of migration flows. In these cases, after the elimination of the restrictions, migration remained stable, in the case of Spain, and grew slightly in the case of Portugal.

[71] World Development Report 2007, Development and the Next Generation, World Bank, 2006.

Studies show that the magnitude of the migration flows depends not only on imposing certain temporary restrictions, as migration took place informally as well. The adoption of these restrictions was a response to certain domestic political constraints in the context of high unemployment, low economic growth and uncertainties concerning the direction of the EU integration. Studies also show there are important differences between intention to migrate and the decision to apply it. At the same time, migration was not a general phenomenon, being often triggered by specific circumstances, such as traditional bilateral relationships among countries or opportunities in the border regions between EU members.

The decision to migrate depends on economic and personal factors. First, the migration of the labor force depended on the existence of excess demand for labor in the destination countries, in general, or in certain sectors and occupations. Ireland and Great Britain are countries with a liberal migration regime, generated by the dynamics of the markets, robust economic growth, numerous vacant positions and a shortage of qualified labor force in certain sectors, such as health. Thus, the two countries were capable to absorb the inflow of immigrant workers without distorting the domestic labor market and without increases in unemployment. In fact, the national policies of Ireland and Great Britain themselves encouraged migration as a response to the gap between labor demand and supply.

Evidence shows that, in many cases, migration is segmented, in response to excess demand for occupations requiring specific expertise (ex. dentists, nurses, software programmers, workers in agriculture, etc.). Wage differentials represented a major factor in the decision to emigrate. Proximity, cultural and language similarities also played a central role in the decision to search for work in the EU. Migration flows are far from negligible within NMS themselves for similar reasons, such as for example from Slovakia to Hungary and the Czech Republic, where salaries are higher, but the gap is not as high as between NMS and EU-15.

According to statistics, the representative migrant worker from NMS-8 to EU-15 is between 18-34 years old, male, single and has at least a secondary education degree. Most of the migrants intend to go back to the country of origin after at most one year of work abroad, migration from NMS being thus temporary, similarly to that from the Mediterranean countries after their accession. The opportunity cost of migration, caused by the rapid wage growth in NMS-8, as well as the administrative barriers related to registration, work permit application and financial constraints tend to contain the appetite for migration.

The relocation of industries, especially those energy and labor intensive, but, lately, also high tech industries, from Western to Eastern Europe, opens job opportunities similar to those in EU-15 at home and dissuades migrants. In spite of the evidence and of the dynamics of these processes, many EU-15 states have decided to continue to maintain labor force movement restrictions for the NMS up to 2009, and, exceptionally, beyond. These are fuelled by concerns that the newcomers will take up the cheaper jobs in the destination countries. In Germany, 75% of the population believes that EU enlargement will lead to increased unemployment.

5.5. Policy recommendations

Romania has promoted, in recent years, a series of reforms aimed at increasing participation in the labour market. This includes the introduction of a flat 16% income and corporate profit tax, one of the lowest in Europe, enhanced flexibility, though limited, of the labour market through the revision of the labour code in 2005, more emphasis on active labour market policies and the simplification of company registration. Several effects have been beneficial and have resulted in increased employment and lower unemployment. This said, one should not omit the safety valve which is represented by the massive migration of workers abroad, contributing to maintaining unemployment relatively low.

The high economic growth, which is expected over the next few years will make job creation easier, and the increase in the participation rate is likely to continue. In addition to promoting growth as a means to increasing employment, Romania needs policies targeted at the most vulnerable categories of workers. Women and older workers, in general, are less likely to find jobs. The promotion of non-discriminatory legislation, without more consideration being paid to enforcement, as it currently happens, does not make a difference yet. The practice of employers discriminating job candidates has not disappeared, although it is not pursued as openly as before.

If measures for stimulating job creation and higher employment are to be successful, several aspects have to be taken into considerations. First, they should allow for the downward adjustment of the labour costs. This can be achieved through the reduction of the non-wage components of labour costs, especially for low skilled employees.

Second, hiring and firing costs should be reduced. Employers should be allowed greater flexibility in adjusting employment to respond to opportunities for economic development.

Third, further deregulation allowing flexible labour contracts is needed, particularly to encourage temporary and part-time employment. Measures that promote part-time employment have been successful in increasing female employment rates in the EU countries, as well as for bringing parts of the informal employment into the formal sector.

Fourth, the quality and skills of the labour force should be upgraded, by encouraging people to enrol in higher education programs and lifelong learning. Education institutions should conduct studies to identify match and mismatch situations and reorient profiles, study streams, and curricula, in order to create an educated labour force with the right qualifications. The unemployed should be stimulated to undertake training in order to update or even change their skills. This requires an increase in the budget devoted to active labour market programs, towards EU levels. The current percentage is still small, though higher than in the past, especially since studies have found that training and retraining, small business consultancies and assistance, and employment and relocation programs increase the chances of the participants to find employment and reduce the likelihood of receiving unemployment benefits. At the same time, firms should be encouraged through non-distortive incentives to invest in their workers, by upgrading their skills through on the job training or lifelong education.

Fifth, the establishment of a transparent, stable and predictable business environment that encourages the formation of new entrepreneurs, the reduction of the administrative and regulatory obstacles to businesses as well as the set-up costs in registering new firms should have a major positive impact on sustainable job creation. Assistance and consultancy for the small business should be widely available.

Sixth, a competitive business environment where all actors participating play by the same rules, needs to be consolidated, which implies eliminating the practice of allowing firms to operate just because they have a large working force, or the right political connections.

Seventh, the use of early retirement policies should be made more restrictive both by gradually increasing the retirement age and by limiting the categories of workers and individual cases that qualify for special treatment.

The balance of the pension system is still not contained. The new pension system has corrected some problems, but has not managed to solve them. The introduction of alternative pension schemes should alleviate the problems that the state pensions system is currently experiencing, but not in the near future. It is important to resist the temptation to resort to populist practices (that would increase the fund's deficit) in order to gain electoral support.

6. Summing up and a series of policy recommendations

The medium term prospects for the Romanian economy are positive. The economy is expected to keep growing at a strong pace in the years to come. However, concerns over refinancing risks of the current account deficit together with the evolution of household consumption and credit growth warrant a careful monitoring of these indicators.

There is urgent need for multi-annual budget programming (MABP), which should assess future pressures on the budget thoroughly. This is increasingly asked for since inflation targeting could overburden the budget policy in case of adverse shocks.

In view of possible pressures on the budget in the years to come, income and structural reform policies will have to play a more important role in fiscal consolidation and support of disinflation. A consistent reform of the public expenditures will be needed in order to improve their prioritization and redirect them towards areas that strengthen the country's human capital, infrastructure and administrative capacity. Together with a broadening of the tax base and better tax collection this would make room for sustaining the additional EU related accession costs while avoiding the implementation of a risky pro-cyclical fiscal and budgetary policy.

The reform of the health and pension systems is crucial to counter the expenditure pressures of an aging population and to improve the sustainability of the public finances.

The development of the institutional capacity to absorb EU funds is a huge challenge; the absorption of EU funds conditions rural modernization.

Romania's successful integration into the EMU depends critically not only on the fulfilment of the Maastricht criteria (of which inflation is a crucially important one), but also on diminishing the gap in real convergence indicators.

Policies for stability and growth

- A post-accession strategy is needed. This has to look at the longer term and outline the economic geography of Romania by 2015. This strategy implies the bouquet of major (national) projects (highways, roads, ports, airports) that would connect Romania to the developed world and permit the reduction of economic gaps.

- There is urgent need for genuine multi-annual budget programming (MABP), which should assess future pressures on the budget thoroughly so that a "budget shock" be averted after accession. MABP would also cover the cluster of national infrastructure projects and other publicly funded programmes.

- A consistent reform of the public expenditures is needed in order to improve their prioritization and redirect them towards areas that strengthen the country's human capital, infrastructure and administrative capacity. Together with a broadening of the tax base and better tax collection this would make room for sustaining the additional EU related accession costs.

• Budget and monetary policies are to be better coordinated in order to continue disinflation and avoid unsustainable external deficits.

• The reform of the health and pension systems is crucial to counter the expenditure pressures of an aging population and to improve the sustainability of the public finances.

• The development of the institutional capacity to absorb EU funds is a huge challenge and the Government has to adopt urgent measures to this end. The setting up of a special vehicle to implements large (national) projects is still advocated by us.

• Romania has a low efficiency in producing and consuming energy. Having this in mind, and in particular the international context on the demand side (the economic rise of Asian economies), it will be very unwise for Romanian companies not to undertake significant investment in order to reduce primary and final energy intensity. State support should also be provided in order to help companies tap into such efficiency reserves.

• An expansion of rural credit mechanisms (that involves the efficient use of EU rural development funds) and land consolidation would be among the solutions for rural development. The fate of Romanian agriculture depends on how the Common Agricultural Policy will be shaped in the years to come and on how Romania will use the EU financial assistance oriented toward this sector.

• The impact of climate change needs to be taken into consideration as huge floods and dramatic fluctuations of temperature have produced havoc in recent years. Policymakers have to make adequate room for contingencies when they allocate state revenues; there is also need for dealing forcefully with deforestation, inadequate damming, etc. The financial implications of building up proper infrastructure can be quite large and give more salience to the need of absorbing EU funds to the utmost and most effectively.

• The privatisation of the energy sector distribution should be carefully monitored in order to avoid state monopoly to be transformed in private monopoly, without any efficiency and welfare gains. Abuse of market power has to be forcefully fought against.

• Romania should encourage investment in new equipment and technologies that are environment friendly and require reduced energy inputs.

Education and R&D

• Education should be a top public policy item; it should be supported by more public funding and measures that would stop the degradation of primary and secondary education. Engineering and technical schools, science in general should be promoted.

• it is good that R&D public expenditure has been raised and that it is planned to reach 0.7% of GDP in 2007; business R&D expenditure needs to be supported by indirect financial measures, which are allowed by EU regulations;

• Romania needs to further develop the ICT networks. Particular care should be given to reduce the digital divide in between the users and non-users of ICT, possible with the use of structural funds.

• Romania should increase its R&D expenditure by using a series of fiscal and non-fiscal incentives, especially given the proposal for more lenient state aid regulations. Additional support should be given to applied research, which has more impact on economic efficiency. A system of periodic review should be introduced for assessing the efficiency of public expenditures.

• Romania should concentrate all efforts in disseminating knowledge and supporting technology transfer. From an institutional viewpoint, the promotion of networks, clusters and cooperation between universities, research and industry should be prioritised.

• there is need for a coherent "enterprise policy", that should foster innovation.

• Labour intensive industries were extremely useful in absorbing the shocks of structural reforms, but they may not be that competitive in the current investment-driven stage of economic development.

• The Lisbon Agenda strategic goals are generally good for improving the health of the Romanian economy, but they are not a substitute for a true national economic strategy. Romania needs to define its unique value proposition, and this process should be both bottom-up and top-down. Gently growing the emerging clusters, without excessive public intervention, but with goodwill and genuine concern for a mutually rewarding partnership from the different levels of Government

• there is a clear need for an integrated enterprise policy at the national level that may provide guidance and coherence to the micro level of the economy.

• Designing a national strategy for research and development, other (more detailed, with clearer responsibilities and benchmarks) than the one included in the National Development

Plan. This strategy should identify not only the targets, but also the means to reach those targets. The strategy should clarify the position of public research institutes, many of which waste public money (in terms of their efficiency).

• Eliminating the overlaps between the Ministry of Education and Research and the Ministry of Economy and Commerce. There should be only one organism, inter-ministerial, too coordinate de research activity, and this organism should be run by on eline ministry.

• Setting up an independent National Council for Research and Development, which should include business and academic representatives. Its role would be that of supervising the activity of the R&D responsible public authority, monitoring the general research and development activity in Romania and publishing regular reports on the performce indicators mentioned in the national strategy.

• Setting up an independent consultative commission at the strategy level. Its role would be that of reconciling the strategic vision and the funds allocation. It is essential that both the council and the commission finance their activity not only from public funds, but also from private contributions, so that they could secure their independence.

• Setting up a large venture capital fund for R&D projects, initially supported 100% by the state, while having the goal to attract up to 50% private financing in the first 2-3 years. It is important that the initial capital provided by the state be large enough. This fund could bear most of the difference between the current public R&D expenditures representing 0.4% of GDP and the 1% of GDP level to which Romania has commited itself by 2007.

• Introducing indirect financial support measures for research, development and innovation, similar to those applied in EU countries, such as deduction of R&D spending from the tax base and fiscal credit for R&D investment reserves.

• Introducing a permanent ex-ante, on-going and ex-post evaluation mechanism for the projects financed from public funds, in order to improve the efficiency of public spending on R&D and to enhance the spreading-out effect.

• The absorption of EU funds is important, but not more important than the usefulness and positive impact of public intervention. There is no optimal solution, but there is a need for sequential coordination, so that the process will not enter on some sort of automated pilot, fuelled by the institutional inertia. Political interests will also be high, and the only way to resist them is by providing transparency, permanent public debate and resources for constant monitoring. The overall process should be seen as strategic and not bureaucratic.

More and better jobs

- there is need for a vigorous public policy demarche that should encourage young people to acquire skills and enter the job market. Public education has to play a major role in this regard; the policy has to target the youth from the rural area.

- If measures for stimulating job creation and higher employment are to be successful, they should allow for the downward adjustment of the labour costs. This can be achieved through the reduction of the non-wage components of labour costs, especially for low skilled employees.

- Hiring and firing costs should be reduced. Employers should be allowed greater flexibility in adjusting employment to respond to opportunities for economic development.

- Further deregulation allowing flexible labour contracts is needed, particularly to encourage temporary and part-time employment. Measures that promote part-time employment have been successful in increasing female employment rates in the EU countries, as well as for bringing parts of the informal employment into the formal sector.

- The quality and skills of the labour force should be upgraded, by encouraging people to enrol in higher education programs and lifelong learning. Education institutions should conduct studies to identify match and mismatch situations and reorient profiles, study streams, and curricula, in order to create an educated labour force with the right qualifications. The unemployed should be stimulated to undertake training in order to update or even change their skills. This requires an increase in the budget devoted to active labour market programs, towards EU levels. At the same time, firms should be encouraged through non-distortive incentives to invest in their workers, by upgrading their skills through on the job training or lifelong education.

- Assistance and consultancy for the small business should be widely available.

- The use of early retirement policies should be made more restrictive both by gradually increasing the retirement age and by limiting the categories of workers and individual cases that qualify for special treatment.

- Internal labor movements should be encouraged in view of the large unemployment differentials.

- The balance of the pension system is still not assumed. The new pension system has corrected some problems, but has not managed to solve them. The introduction of alternative pension schemes should alleviate the problems that the state pensions system is currently experiencing, but not in the near future. It is important to resist the temptation to resort to populist practices (that would increase the fund's deficit) in order to gain electoral support.

APPENDIX: **The Lisbon Agenda and the problem of competitiveness**

At first sight, it would appear nonsensical to question the decision of the 2000 European Council in Lisbon to make Europe an exemplar of competitive performance. This strategy, since then known as the "Lisbon Agenda" of a ten-year program of economic reform, was thought to bring about an average annual economic growth of 3 per cent and create 20 million jobs by 2010. At mid-term, the 2005 European Council in Brussels judged the results as "mixed" and decided to have both SGP and LA revised. The non-official evaluations are however more drastic: the Lisbon strategy exhibits "general lack of progress" (Hodson, 2005), "failure" (Pisani-Ferry and Sapir, 2006; Wanlin, 2006b), "disappointing delivery" (Kok, 2004), and, according to Wanlin (2006a), some commentators even speak of a "ludicrously ambitious overall objective".

With the benefit of hindsight, it might be acknowledged that lucidity about lacklustre economic performance of the whole area should have left no room for mercy. Data summed up in Wanlin (2006) are suggestive: in 2005, average GDP per head in the EU-15 was 27 per cent below the US average, unchanged compared with 2000, while the EU-15 productivity growth averaged 1.4 per cent between 1995 and 2005, compared with 2.4 per cent in the US.

The launch of the LA was preceded by an upsetting revelation: the decline of the EU competitive position vis-à-vis the US, had been a fact that overshadowed the accomplishments of the European integration for decades. Bannerman (2002) provides a series of data of irrefutable evidence: from 1990 to 2000, the EU achieved only one year of economic growth above 3 per cent, whereas, in contrast, the US economy experienced just one year in which its economy grew by less than 3 per cent; data on GDP per capita put the EU level at less than two-thirds that of the US, the widest gap since the 1960s. The fear of losing standards of living and technological supremacy certainly played the key role in devising the LA. It is even suggested (e.g. Bannerman, 2001) that emotional reasons like envy of the American and Japanese miracles and Schadenfreude at their deadlocks undoubtedly count much for the idea of what LA actually means. The level of performance of the main competitors, especially the US and Japan, thus provided a benchmark for the level of competitiveness that the EU would need to achieve if it is to become the most competitive economy in the world.

This sense of discomfort unintentionally strengthens Paul Krugman's argument in describing competitiveness as a "dangerous obsession". One of its tangible effects appears in the way the LA target areas have come to be recognized. The initial formulation was one of great ambitions: the strategy commits Member States to the goal of making the EU "the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion" by 2010 (European Council, 2000: para. 5). There were thus defined four pillars of the strategy – "growth", "innovation", "employment" and "social cohesion", and if one translates "sustainable economic growth" into an "environmental dimension" – a decision in fact explicitly made at the 2001 European Council in Göteborg – the LA set the EU on a five-pronged competitive track.

The LA mid-term review in 2005 apparently refocused the target on a much narrower objective, the strategic goals of "growth" and "employment", but they multiplied at the Community and national levels in ten and three, respectively, distinct dimensions considered to be critical for competitiveness. The "obsessive" character of this quest for competitiveness determinants engendered a continuous redefinition of what is "critical" and resulted in loose interpretations of what LA actually means. Table 1 gathers representations about LA targets of some of the most authoritative texts on the subject. These certainly can not be viewed as many different views on LA, but one can hardly make up a unitary programmatic vision either.

Table A.1. Target Areas of the Lisbon Agenda

Growth ♦ Innovation ♦ Employment ♦ Social cohesion ♦ Environment
Document: European Council, 2000
Growth ♦ Jobs
Document: European Council, 2005
Single Market ♦ Open and competitive markets inside and outside Europe ♦ European and national regulation ♦ European infrastructure ♦ Research and Development ♦ Innovation and sustainable use of resources ♦ European industrial base ♦ Employment and social protection systems ♦ Adaptability of workers and enterprises and the flexibility of labour ♦ Human capital through better education and skills
Document: The Community programme
Macroeconomic ♦ Microeconomic ♦ Employment
Document: National level integrated guidelines
Innovation ♦ Liberalisation ♦ Enterprise ♦ Social inclusion ♦ Sustainable development
Document: Centre for European Reform (Bannerman 2002)
Knowledge society ♦ Internal market ♦ Business climate ♦ Labour market ♦ Environmental sustainability
Document: Kok Report (Kok, 2004)
Information society ♦ An European area for innovation, research and development ♦ Liberalisation ♦ Building network industries (telecommunications, utilities and transportation) ♦ Efficient and integrated financial services ♦ Improving the enterprise environment ♦ Increasing social inclusion ♦ Enhancing sustainable development
Document: WEF (2004)
Internal market for services ♦ Reduction of administrative burdens ♦ Goals on improving human capital ♦ 3% target on research and development expenditures ♦ 70% target on the employment rate.
Document: Gelauff and Lejour (2006)*

* These authors' option was constrained by data availability for their use of quantitative techniques in assessing the LA impact.

The range of possible interpretations of LA targets raises a legitimate question: Does the LA really stand for a guideline to achieve a coherent strategy for competitiveness? Commissioned to deliver a verdict on the ongoing process, the Kok Report (Kok, 2004) fingers the main vulnerabilities of the LA when says that "Lisbon is about everything and thus about nothing. Everybody is responsible and thus no one." From good intentions to lamentable achievements, the Lisbon process rests on disputable rationales and conveys a sense of intellectually deceptive "one-size-fits-all" prescriptions which are irreconcilable with explicit accountability. The following paragraphs discuss these two explanations which prefigure theoretical and practical confusions as *structural weaknesses* of the LA that seem to validate Krugman's fears about an "obsessive" and, for that matter, elusive quest for competitive upgrading of whole economies.

(1) The Lisbon strategy exhibits the perennial economics problem of identifying the "right" structural reforms.

The EU administration picked up the goal of creating a "knowledge economy" amidst a world-wide euphoria about the benefits of the "new economy" which was by that time epitomized by the .com boom. The tone watered down since and more recent documents (e.g. Commission, 2005) praise the importance of traditional manufacturing industries. Discussions with Commission officials, as they are reported by Pisany-Ferry and Sapir (2006), in fact revealed that the initial theoretical underpinning had to rely on common sense and on consensus prescriptions from international organisations, rather than on a set of ex ante priorities and a methodology for dealing with the complex nature of competitiveness of an economic zone. In confirmation, the Sapir Report (Sapir, 2003: p. 86) calls for "a more sustained investment in developing effective methodologies" in order to deliver a successful Lisbon strategy. Two implications become obvious: one refers to the analytical ambiguity associated with evaluating the "success stories" of countries of commending competitive performance; the other results from the difficulties in achieving an effective policy coordination required to make the EU emerge as the highest ranking bloc in international competition.

The analytical issue could certainly be avoided if the EU attempt to deal with structural economic liabilities of its member countries paid due attention to parallel international efforts. The practice of multilateral evaluation and coordination may be found in the IMF assessments on Article IV of its Agreement on judgments about structural reform of its constituents; in the OECD cross-country comparisons and country-by-country evaluation of structural reforms (e.g. OECD, 2006); and in the WTO regular Trade Policy Reviews which dedicate a substantial section on "structural" economic policies of its members.
Given that all EU countries belong to those institutional arrangements, one may reasonably ask to what extent the LA should not be regarded just as an undertaking in duplicate. What makes indeed the EU Lisbon process different from all those analytical evaluations consists of its goal of embarking at the same time on the misleading task of indicating *the right venue towards competitive upgrading* as well. From an analytical standpoint, this strategy fails on the ground that it gets the observer confused about the existence of any critical determinant

of competitiveness, be it “information technology”, “employment” or whatever. If one follows two assessments (WIFO, 1999; Murray, 2003) of competitive standing of Sweden and Finland between 1999 and 2003, it is disconcerting to find out that their march from bottom to top in the competitive hierarchy of European countries in such a short period of time is explained by the mere refutation of the “ultra liberal Anglo American” economic model, that is the very one whose success the AL was supposedly conceived to emulate.
This misapprehension of competitiveness analytics notwithstanding, the EU claim that synergy is urgently needed to make competitive upgrading possible should not be dismissed. One recent account of the LA (Commission, 2006) says that Member States can not identify themselves the priorities for structural reform and is right in one sense. As usually reported in the literature (e.g. Pisany-Ferry and Sapir, 2006), the legitimacy of a supra-national stricture rests on the existence of two types of reasons to embark on policy coordination. First, *interdependence* make EU policies and national policies complement each other because of spillover effects. One of the most cited domains is “research and development”, whose benefits are compounded by trans-national joint ventures, but “environment”, “free movement of goods and services” or “criminal prosecution” are other typical examples. A second reason for coordination consists of the *learning effect* from which governments and civil societies benefit as a result of comparing and benchmarking their experiences against that of others. It is for that reason that the transparency and the wealth of information which are justly associated with the LA initiatives render a remarkable service to its objectives.

In a different sense, the argument of centralizing decision at the EU level fails on two premises. First, the results of scholarly work point to divergent solutions as to the suitability of all-encompassing prescriptions. The large degree of diversity among member states ranks differently the priorities relative to, for example, increasing the pension age, improving education or taxing energy consumption. The OECD experience (OECD, 2006) with assessing structural reforms reveals that countries’ needs vary most significantly with their general level of development. Insofar as this logic holds, it would be for example advisable to choose different levels of R&D spending so as to maximise the *overall* EU innovation capacity and growth potential.

Second, the LA falls short of an integrative solution responding to the needs of a monetary area in its infancy. Direct confirmation comes from the separate treatment of the SGP and the LA which would normally command a unitary coordination. When large member states (France and Germany) or smaller ones (Portugal, Greece, Ireland) proved incapable to observe the SGP provisions, the 2005 revision of the pact loosened up the excessive deficit procedure for member-states which have reformed their social protection systems or invested in research and development (R&D), both key Lisbon goals. Conversely, there is no indication in the LA that its prescriptions are deemed to also serve the foreseeable imbalances of an ever greater integrated space. For example, the “Single Market” prescriptions remain ineffective as long as member countries stubbornly stick to ineffectual cultural symbols. A case in point reported by Wanlin (2006) is the patent protection for which the US companies spend \$10,000 on average; by contrast, an EU-wide patent costs \$50,000, since companies have to hire lawyers and translators to file with the various national patent offices.

(2) The Lisbon process exhibits cumulative complexity and ambiguous accountability.

As it seems, the analytical foundation of the LA translates into a continuous process of additions to what appears to make up the set of critical factors for competitive upgrading and hence makes increasingly obscure the role a member country should play in the process. The wide scope of the LA contributed to a sharp increase in the number of priorities for the EU economic policy. As Deroose, Hodson and Kuhlmann (2005) document, a preceding set of guidelines – the Broad Economic Policy Guidelines (BEPGs) from 1993 – contained just three general guidelines; by 2003, there were twenty-three general guidelines, four euro area specific ones and ninety-four country-specific recommendations for the period 2003-05.

It became so visible that the LA expanding complexity would lead to dispersed accountability. The problem of assigning responsibilities in the process between the Community and its Member States looks like unfinished business. Article 99 of the Treaty (of Amsterdam) calls on Member States to regard their economic policies as a matter of common concern and to coordinate them within the Council, but it falls to the individual Member State to implement these policies. The distinction is consistent with Article 98 of the Treaty, which calls on national economic policies to contribute towards "the achievement of the objectives of the Community", while at the same time recognising the right of Member States to conduct these economic policies.

At the decisional level, these legal provisions have been transposed in a so-called "open method of coordination" (OMC) whose central elements are information exchange, peer pressure and benchmarking by delivering "in the most public manner possible" an annual league table of member state progress towards key targets. Stronger reliance on "naming, shaming and faming" was accordingly advocated (Kok, 2004). In contrast to the usual approach to decision-making, the European Commission (EC) has no legislative role in this model, and confines its role to developing a number of 'structural indicators', which benchmark EU member states against each other and against other leading economies, in order to aid the exchange of best practice.

At the policy level, the Council adopted in 2005 *The Integrated Guidelines for Growth and Jobs (2005-08)* by which it invites Member States to draw up their National Reform Programmes (NRPs) "on their own responsibility" and "geared to their own needs and specific situation." (European Council, 2005: p. 13) The integrated guidelines are defined as "a checklist of national commitments and benchmarks to monitor progress in the months and years ahead." (Commission, 2006: p. 9) They set out objectives to which all member states are expected to adhere and which should provide a basis for evaluating national programmes.

For the time being, the *Guidelines* resemble an à la carte menu with no constraint on the part of Member Countries to choose or leave the recommendations in a way that suits them at best. In one of the suggestive cases, the European Parliament has twice voted against Commission proposals to open port services to greater competition, in 2003 and again in January 2006 following violent protests in Strasbourg by dockers from across the EU (Wanlin 2006). In general, the governments seem to have largely ignored the Guidelines when drafting their NRPs. An examination of these documents (Pisany-Ferry and Sapir, 2006) shows that they usually refer only vaguely – if at all – to them, raising the suspicion that in several cases NRPs consist simply of a repackaging of existing measures.

What are the lessons of this package of good intentions and questionable execution? What could all this mean for competitive development of the Member States? It is without doubt that the LA stands for a sort of reaction, kind of attitude against ever fiercer competitive confrontations in the international marketplace. It nevertheless delivers no recipe for reaching higher stages of competitive competence in whatsoever industry. It is about awareness rather than recipe. Following its lines prove instead useful in pointing an outline for devising policies for competitive development on two coordinates.

First, *define your priority and then benchmark the results within the framework provided by the LA*. It should be noted that the recourse to the LA should come as a consequence of the national initiatives and definition of priorities and the other way around. The very nature of the Lisbon process implies EU involvement in policy domains that primarily belong to the responsibility of member states. A thoughtful example is provided by Bannerman (2002). He compares one initial LA target to connect all schools to the internet by 2001 with the revised target of one computer for every 15 pupils by the end of 2003 and comments: “Even when all schools are ‘wired up’, it will remain a challenge to ensure that every pupil in Europe is taught how to make use of new technology. A solitary PC gathering dust in the headmaster’s office does nothing to create an information society.”

Benchmarking should come only after defining priorities and implementing policies because understanding what happens within large economic spaces like EU, the US or Japan is not primarily linked to whatever bunch of indicators, but to a familiarity of that environment’s competitive needs. In this regard, the apparent disregard for a unitary analytical treatment of competitive issues and economic imbalances of the euro zone needs revisiting in due time, especially because both the US, and Japan form more homogenous economic areas and represent for that reason sensibly less relevance in comparative perspective. The fragmented nature of EU markets whether for financial services, intellectual property, labour market or telecommunications is symptomatic for the diligence required in assessing competitive capabilities on an international scale.

Second, *define the economic rationale for reform and then find opportunities for joint ventures in the integrated space*. The governments should be aware that their LA-related reform is about programs and priorities which should not take anyway the course suggested by the LA. A case in point is the liberalisation of the energy sector. Stimulated or not by the American example, the Commission has been struggling to increase competition in energy markets with

no significant results to date. Meanwhile, an effervescent process takes place in the Northern part of the continent where two national grid companies, Statnett SF in Norway (50%) and Affärsverket Svenska Kraftnät in Sweden (50%), have taken the lead in establishing Nord Pool ASA - The Nordic Power Exchange – which, according to its own information, is the world's only multinational exchange for trading electric power.
If a proper rationale is to be found, the Member Countries should take then benefit from similar initiatives across the EU area. For instance, it is quite awkward to see why the full liberalisation of postal services is deemed so critical for the competitive process, whereas many barriers to the free movement of goods, services, people and capital remain still intact.

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