

# **EARLY WARNING REPORT ROMANIA**

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## **UNDP - ROMANIAN ACADEMIC SOCIETY (SAR)**

*Issue: Dec 2001 – Jan 2002*

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**EVOLUTION OF SELECTED INDICATORS**

INDICATORS	General Trend	Latest evol.	Year 2001	Dec 2001	Nov 2001	Oct 2001	Sep 2001	Aug 2001	Jul 2001	Jun 2001	May 2001	Apr 2001	Mar 2001	Feb 2001	Jan 2001
GDP growth (quarterly, annualized), %	↗		5.1				5.1			5.1			4.8		
Devaluation of the Leu, %	↘	↘	21.8	0.2	1.67	1.81	1.40	1.42	1.59	1.41	1.91	2.35	1.87	2.06	2.26
Inflation, %	↘	↘	30.3	2.2	2.7	2.4	1.9	2.2	1.3	1.6	1.7	2.7	2	2.3	3.7
Industrial output, % change	↗	↗			1.8	5.6	-0.5	-1.7	0.2	-5.3	7.6	-3.4	11.4	4.1	4.9
Trade deficit, FOB/CIF (million USD)	↗	-		412.5	508.5	145.4	198.1		272	294	484	447	228	334	260
Unemployment rate, %	↘	↗		8.0	7.7	7.8	8.1	8.4	8.4	8.8	9.3	9.9	10.4	10.8	10.8
Employed (,000)	↗	↘		4,507	4,545	4,551.7	4,546	4,542	4,542	4,530	4,521	4,485	4,467	4,448	4,414
Net salary, % change (Jan 2001 = 104 USD)	↗	↗		3.2	2.7	-0.3	0.4	2.6	2.6	0.6	-5.7	5.1	6.7	-7.2	
Foreign companies increasing their business in Romania (KPMG quarterly poll), %	-	↗		50*			48			60			55		
The current Government can improve things (CURS poll), %	↘	↘		42.3	49.1	47.4		48**		46			57		
Pessimism, % (Country heading in the wrong direction)	-	-		63.3***	48	42.8		44**	54		52			54	53
Subjective welfare, % (Better off than last year)	-	↗		22.5			18.7**			19	16			18	17

\* prediction

\*\* urban population only

\*\*\*BOP-IMAS, variables "Things are not changing", and "things are going in the wrong direction" - added

**ABSTRACT**

This issue of the Early Warning Report reviews the main outstanding problems on the public agenda and weighs last year's good economic performance by such unfinished businesses.

The **Social** section analyzes the flagship initiative of the social democratic government of Adrian Nastase, namely the guaranteed minimum income policy. The policy rightfully includes safeguard measures to mitigate the disincentives to work commonly associated with means-tested benefits. However, the financial feasibility of the scheme, aimed at covering more than 10% of the population, is a real issue. Should the central government fail to provide adequate funding, the initiative will be just an empty promise of the national government, thrown on the shoulders of an overburdened local administration.

The **Economic** section assesses the risks for economic growth in 2002. Many fiscal exemptions and tax holidays were granted during the past year. The price of the energy was maintained under the cost-recovery level and represented an important hidden subsidy. Notwithstanding such soft policies, however, the companies did not begin to pay their taxes, and the stock of fiscal arrears increased substantially. Most probably, the arrears also contributed to GDP growth last year, but this should not happen again in 2002 if the government is to preserve its credibility. Agriculture, to which a special section of this issue is dedicated, will not be able to grow as impressively as in 2001.

Even though it has proven to be relatively resilient to the world downturn so far, it is likely that the Romanian economy will eventually be affected by the European recession. Equally, domestic demand, the most important source of growth in 2001, will also have to adjust to the austerity measures that the Government must take to reduce subsidies, decrease public spending and exert a much tighter control over the salaries in the public companies. The GDP growth rate in 2002, therefore, is likely to be lower than in 2001 – which conflicts with the Government's official forecast.

The **politics** section discusses the call for reforming the state along federal lines and concludes that better solutions are at hand to address the Romanian low administrative capacity and corruption, which are the actual factors that threaten any reform and seriously cripple the Government's ability to implement its policies, regardless of their adequacy. This warning is echoed in the **Social** section, which warns on the low implementing capacity of local Governments. A more effective and accountable administration is certainly needed, but the report finds no evidence that creating regional Parliaments and a new level of government would solve this problem.

# SOCIAL

## STRIVING TO DELIVER

### **The minimum income guarantee policy is put at risk by the low capacity of the administration**

The flagship initiative of the social democratic government of Adrian Nastase, the minimum income guarantee policy, is meant to tidy up the Romanian welfare support system. Moreover, the law introduces safeguard measures to mitigate the disincentive to work commonly associated with means-tested benefits. The financial feasibility of the scheme, aimed at covering more than 10% of the population, is however in doubt. Should the central government fail to provide adequate funding, the initiative will prove again an empty promise of the national government thrown on the shoulders of an overburdened local administration.

### **Poverty in Romania**

The poverty rate has substantially increased over the transition period. Fig.1 shows that both poverty rate and the extreme poverty rate have doubled since 1995. Romania is also a laggard in regional comparison tables, registering the fourth worst poverty rate in Central and Eastern Europe. Only Albania and the former Soviet Republics of Moldova and Russia have a worse situation in this respect (Fig.2).

**Fig. 1. Poverty in Romania, 1995 – 2000, % of the population**

	Poverty rate	Extreme poverty rate
1995	25.3	8.0
1996	19.9	5.1
1997	30.1	9.5
1998	33.8	11.7
1999	41.2	16.6
2000	44.0	N/A

*Source: Tesliuc, Pop, Tesliuc, 2001*

**Fig. 2: Poverty in Central and Eastern Europe, 1995 – 1999, % of the population**

	Year	Poverty rate	
		2 USD PPP*/day	4 USD PPP/day
Moldova	1999	55.4	84.6
Russia	1998	18.8	50.3
Albania	1996	11.5	58.6
Romania	1998	6.8	44.5
Macedonia	1996	6.7	43.9
Latvia	1998	6.6	34.8
Bulgaria	1995	3.1	18.2
Lithuania	1999	3.1	22.5
Ukraine	1999	3.0	29.4
Slovakia	1997	2.6	8.6
Estonia	1998	2.1	19.3
Hungary	1997	1.3	15.4
Poland	1998	1.2	18.4
Belarus	1999	1.0	10.4
Croatia	1998	0.2	4.0
Czech Republic	1996	0.0	0.8
Slovenia	1997/98	0.0	0.7

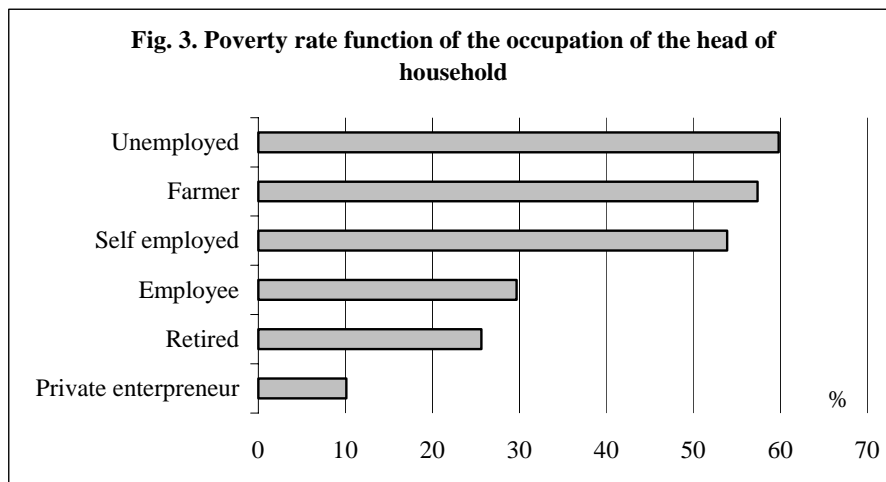
*Source: World Bank, 2000*

Note: The poverty estimates use thresholds in USD/day/adult at 1996 PPP (purchasing power parity) equivalent

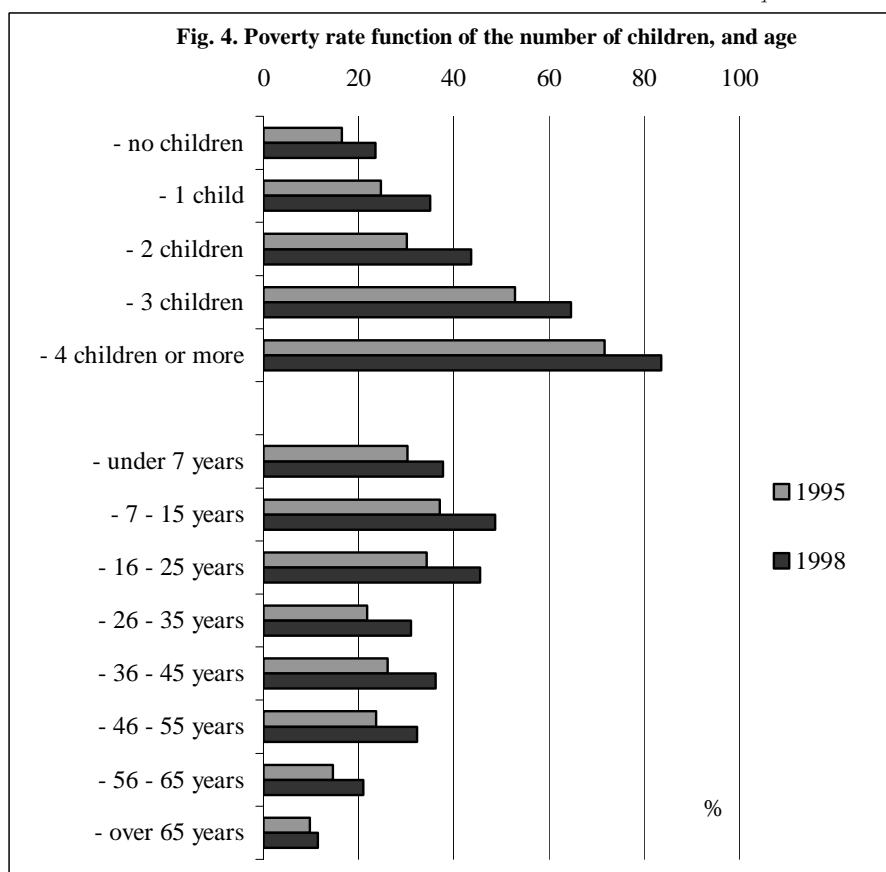
## Sources of poverty

Fig.3 shows the breakdown of poverty amongst the Romanian population. Contrary to common wisdom, poverty is most prevalent not amongst pensioners, but amongst young families with many children, unemployed and even self-employed people. Over 80% of the families with 4 or more children

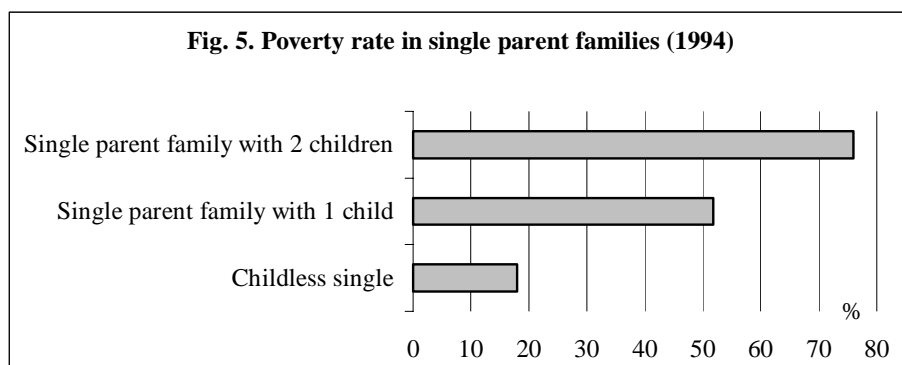
live in poverty (Fig. 4). Single parent families are also prone to living in poverty (Fig.5).



Source: Tesliuc, Pop, Tesliuc, 2001.

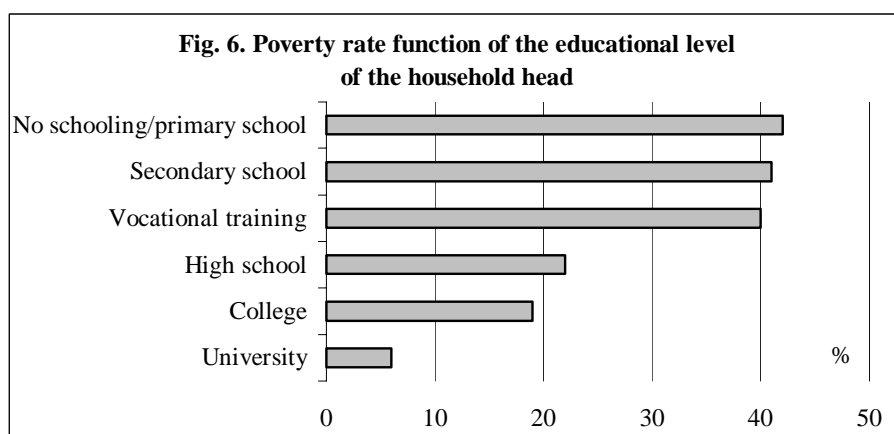


Source: Tesliuc, Pop, Tesliuc, 2001.



Source: C. Zamfir (ed.), 1995.

Poverty also correlates strongly with low education. A household whose head did not attend secondary school is 7 times more likely to live below poverty line, than a household headed by a university graduate (Fig. 6).



Source: Tesliuc, Pop, Tesliuc, 2001.

## Poverty alleviation

The Romanian government has employed a wide array of instruments in fighting poverty. Most of social expenditures are now accounted for by the employment related contributory benefits - the most important of these being healthcare and pensions. Only the access to education services, an important poverty prevention tool, is totally free for its beneficiaries.

The non-contributory benefits have witnessed a shift from universal coverage to means testing. The only large universal benefit is the child allowance. The means-tested income support was introduced in 1995. Having said this, the value of social benefits has decreased dramatically, during the transition years, in both real and relative terms (Fig.7).

**Fig. 7. Social benefits, % of average wage**

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
The average public social insurance pension	46.4	44.7	45.1	43.6	45.2	42.6	40.8	38.6	40.3	37.2	35.9	34.3
Child allowance	10.5	9.7	7.2	5.4	4.9	4.2	4.3	3.9	7.4	6.2	4.3	3.2
Supplementary allowance for the 2nd child*	-	-	-	-	-	-	-	-	13.7	10.1	7.0	5.5
Income support	-	-	-	-	-	-	21.3	14.0	15.6	13.2	10.6	7.7
Support allowance (post unemployment benefit)	-	-	20.0	16.1	14.4	18.6	15.7	15.4	14.7	16.8	12.9	
Employment subsidy	-	-	-	-	-	24.7	20.1	17.0	18.8	17.9	21.9	17.4

*Source: ICCV*

\*Since 1997, a supplementary allowance for families with 2 or more children was introduced

## Guaranteed minimum income

The guaranteed minimum income has been one of the key campaign pledges of the new administration of Adrian Nastase. The Parliament has swiftly enacted it through the Law 416/18 July 2001. Starting with 2002, income support will bridge the gap between the guaranteed minimum and the actual income of the family, other social benefits included. There is a supplementary heating allowance for income support recipients, and the universal child allowance is substantially increased.

The guaranteed minimum income integrates a number of social benefits:

- income support, burial support and emergency relief, funded from the local budgets.
- child allowance, and the allowance for the wives of conscripts, funded from the central budget.

Income support will continue to be provided by the local governments, but overall 80% of funds are expected to come from the central government, through earmarked transfers. Apart from cash transfers, the income support can include goods or services.

## Poverty-trap

The problem commonly associated with means-tested benefits is the disincentive to work. Since any increase in income is offset by the decrease in the amount of the social benefit, the marginal utility of labor is very low. The result is the so-called 'poverty trap': people do not find it worthwhile to take

the pain of a regular job, and therefore do not acquire the experience needed for advancing to better paid positions.

The field research<sup>1</sup> has found little evidence that this theory applies in Romania. Due to their low administrative capacity, the Romanian authorities are hardly able to check on the income statements of the applicants for social benefits. The most likely outcome in Romania is driving the recipients of social assistance towards the black market, rather than just making them idle.

However, the law also includes safeguards. Able recipients are required to perform up to 72 hours per month of community work, and those legally employed receive a 15% higher income support.

## Implementation problems

The Achilles' heel of the Romanian income support system has been its reliance on local administration. Fig.8 and 9 paint a dramatic picture of the ability of the local governments to implement means-tested benefits. In 1995, the distribution was dealt with by the central government. Since 1996, it has been taken over by the local administration. Facing such a big administrative and financial challenge, the local governments by and large failed to implement the measure properly. In 2000, the number of families receiving income support represented only 6% of the number of 1995 – see Fig.8 and 9.

**Fig. 8. The number of families receiving income support (End of 1995 = 100)**

Year	1996	1997	1998	1999	2000
	49	26	22	15	6

*Source: Ministry of Labor and Social Solidarity*

**Fig. 9. The dynamic of the real expenditure for social benefits (End of 1995 = 100)**

Year	1996	1997	1998	1999	2000
	144.2	47.6	30	14.8	-

*Source: Ministry of Labor and Social Solidarity*

Note: The 1995 expenditure covered only the last 3 months of the year.

In 1994, the number of households qualifying for income support was estimated at 659,000, or about 12% of the population. By 1998, only 50,000 households, that is to say, 0.5% of the population, were actually receiving income support.

The guaranteed minimum income policy could have the same fate. The Ministry of Labor and Social Solidarity (MMSS) estimates at 600,000 –

<sup>1</sup> The Romanian Institute for the Quality of Life (ICCV), a report by Luana Pop.

750,000 the number of those to be covered, which is a number comparable to those who were entitled to receive income support in 1995. Under a comparable administrative and budgetary burden, the local administration might crack again.

By 2000, most of local authorities, especially in rural areas, had practically stopped distributing income support. Under the present provisions of the law, a large share of beneficiaries of the minimum income guarantee will come from rural areas (e.g. pensioners from the former socialist farming system). This will create a huge pressure on the local governments from rural communities, which have in many cases already lost from the financial decentralization reform introduced by the previous government.

### **Financial feasibility**

In 1994, income support covered 87% of the extreme poverty threshold, and 58% of the poverty one. By 1998, its real value had eroded to only 48% of the extreme poverty threshold, and 32% of the poverty one.

In 1997, income support amounted to only 0.05% of GDP. Now, the government expects the guaranteed minimum income to increase this amount to 0.4% of GDP, which is an eightfold increase.

### **Conclusions**

- The guaranteed minimum income policy confirms the Romanian Government's orientation towards means testing, and away from universal benefits. This option is consistent with the financial situation of the country.
- The guaranteed minimum income includes measures to mitigate the disincentive to work associated with means-testing.
- The guaranteed minimum income is part of a complex approach to poverty alleviation. It combines cash benefits with in-kind provisions (e.g. school allowance for pupils), and special measures for vulnerable social groups (e.g. Roma). This approach should be furthered by developing social assistance programs, as an alternative to cash benefits.
- The government is right in identifying the link between children and poverty. The substantial raise in child allowance is welcome from this perspective.
- The Romanian welfare support system is now well targeted to reach the poor, at least in theory. Its main problem continues to be the lack of resources.

- Abolishing the child allowance as a universal benefit, and instead transforming it in a means-tested aid, would be consistent with recent reforms. Large sums of money are currently spent on families that are relatively well-off, where they make an irrelevant addition to the household's income.
- Another option is to take into account, when establishing guaranteed minimum income, the difference in the cost of living between rural and urban areas, and use different thresholds. This would lead to an equalization of the real – not nominal – value of aid, whilst at the same time it would ease the burden on local authorities from rural communities.
- Based on the experience accumulated since 1995, if the central government fails to provide the resources for income support, the local administration will just be unable to cope with the burden, and the whole policy will become an empty promise that will foster frustration. Should the situation of public finances worsen, the government would be better advised to narrow down the scope of the policy, from over 10% of the population at present, to a more manageable number.

# ECONOMY

## ROMANIA'S FINANCIAL OPENING

*By Daniel Daianu*

Recently, The National Bank of Romania has initiated a series of limited measures in regards to its capital account and the consequent capital inflows and outflows (see Fig.1). These measures can be examined in the context of the role that foreign capital has played in the Romanian economy during the last decade. Likewise, they can be judged through the lenses of Romania's commitment (vis-à-vis the European Union) to open its capital account, by and large, by 2004.

### **The need for capital inflows**

There are several features of the Romanian economy, which point to the need for external resources. One feature is linked with the "shock therapy" of the eighties, during which Romania paid back, entirely, an external debt of over US\$10 billion. That policy entailed a drastic reduction of domestic absorption (and of domestic consumption in particular), which aggravated shortages of all kinds; one effect of this situation was a massive decompression of consumption and imports after 1989, which depleted rapidly the reserves of the Central Bank.

A second feature is the magnitude of the required resource reallocation following price liberalization, against the backdrop of structural rigidities, institutional disarray, and scarce domestic resources; these circumstances pointed to the need for substantial capital inflows.

Thirdly, the implosion of the economy in the early nineties, and again in the late 90's, led to lower saving ratios than anticipated. This large drop in savings further increased the need for capital inflows to finance domestic investment and consumption.

And last but not least, the uncertainty and fuzziness of the domestic environment enhanced capital outflows, particularly in the early years of transition, which aggravated an already precarious situation.

The circumstances highlighted above would, *prima facie*, consolidate the thesis that financial opening is a must in order to create channels for capital to flow into Romania. Financial inflows are also to be related to the functional opening of the economy, which was one of the main features of the reforms after 1989. However, this judgement fails to address a crucial issue, namely the speed and the nature of financial integration with the outer world. Should domestic financial markets be developed at full speed, and be integrated with external ones as quickly as possible for the sake of attracting foreign capital? How feasible is this, in view of both institutional and structural constraints that currently exist?

### **The speed of financial opening**

Financial opening helps attracting external funds. It can be argued that the more advanced in reforms and restructuring an economy is, the more likely it is that financial opening will entail considerable benefits. But, on the other hand, it can also be argued that, where rigidities are considerable and institutional fragility is high, less sophisticated and less (externally) integrated financial markets are probably better suited in fending off external shocks<sup>2</sup>. Clearly, the effects of liberalizing capital flows hinge on the soundness of the financial system.<sup>3</sup> When lending by official creditors is available, the pressure to resort to external private capital markets is lessened.

Romania's experience seems to vindicate the view underlined above. On the one hand, a certain financial opening of the economy brought benefits and helped develop internal financial markets. This opening occurred against the background of a gradual liberalization of domestic financial markets; caps on interest rates were lifted at the end of 1993, rationing on the official foreign exchange market was terminated in the early 1997, and full convertibility of the ROL (Romanian leu) was achieved in 1998. Likewise, the Stock Exchange started to operate in late 1996 and bank privatization got under way afterwards. Given this situation, Romania was only able to avoid external default, in 1999, owing to an exceptional balance of payments adjustment program, which halved the current account deficit, at that time. Arguably, this was also warded off, due to a lesser integration with external financial markets and to less developed domestic financial markets – which prevented speculative capital to cause havoc. Although Romania returned to private

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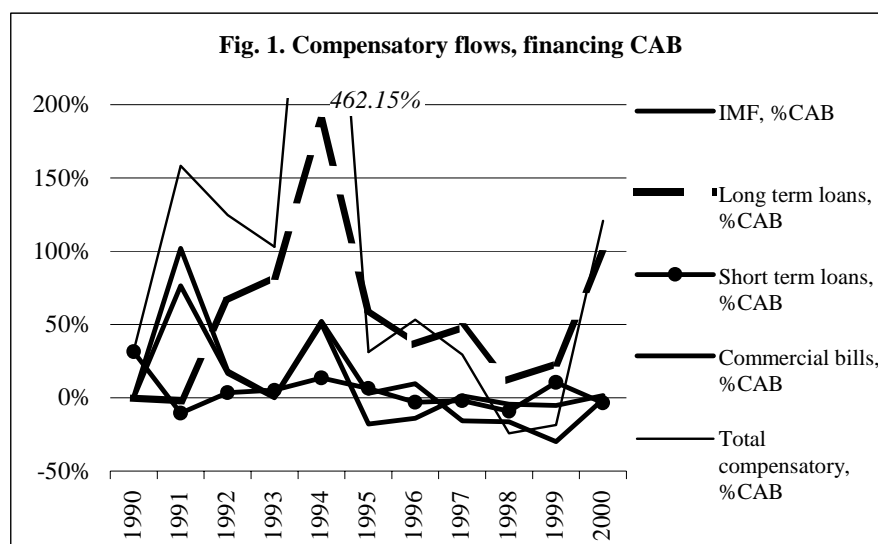
<sup>2</sup> See also Christian Weller and Bernard Morzuch, "International Financial Contagion: Why are Eastern Europe's banks not failing when everybody's else's are?", *Economics of Transition*, vol.8(3) 2000, pp.639-663

<sup>3</sup> James A. Hanson, "Opening the capital account: costs, benefits, and sequencing", in S.Edwards (ed.), "Capital Controls, Exchange Rates and Monetary Policy in the World Economy", Cambridge, Cambridge University Press, 1995, pp.383-429

capital markets in late 1995 (after a lapse of more than twenty years) and borrowed heavily in 1996, it kept its domestic capital markets officially closed to foreign investors. This actually proved not to be an unwise measure, in view of what happened in Russia in 1998 and in other emerging economies, which succumbed to the temptation to open widely their domestic capital markets capital accounts. This is an episode which deserves particular attention, taking into account the quasi-unanimous opinion of rating agencies (and not only theirs) on Romania's chances to avert external default in 1999.

The Romanian experience, therefore, supports the conclusion that, in transition economies, which are less integrated with the world economy, banking crises have, essentially, an internal origin. This is linked with a low ability of local banks to lend properly, or to extricate themselves from a hostage relationship (specially in the early years of transition), and with mistaken policies.

The pains of reforms made Romania rely extensively on funding from the international financial organizations and other official lenders, and compensatory flows played a major role in bridging the financial gap in the balance of payments, especially in the first half of the past decade (see Fig.1). This pattern of financing underwent substantial changes following the Asian and the Russian crises and the increasing role of remittances in the current account balance (CAB)<sup>4</sup>.



Source: Daniel Daianu, Liviu Voinea, *Foreign Capital Flows in Romania*, ICEG, forthcoming Occasional Paper.

<sup>4</sup> Remittances accounted for more than US\$1 billion in recent years.

## Looking forward: the opening of the capital account

Policy does make a difference. But it can be also argued that there is a certain “natural” speed of development of domestic financial markets; this speed hinges on the local institutional culture and on the mental readiness of local agents to use new financial instruments. The infrequent use by Romanian individuals and firms of new, market-based, financial instruments, as well as the almost “frozen” Stock Exchange in recent years (in spite of tremors around the world) indicate limits to speeding up the development of domestic financial markets. Only during 1997, shortly after the Stock Exchange started to operate, and when there was a lot of euphoria linked to “the new policies”, had the Romanian Central Bank a hard time in managing capital inflows. Otherwise, much of the pains of controlling liquidity is to be assigned to the persistence of the National Bank’s substantial quasi-fiscal operations in the late 90’s, which are linked essentially with the attempted rescue packages for several banks.

The development of domestic financial markets has to be seen in conjunction with the financial opening of capital flows. Whereas the latter process can bring great benefits, it poses high risks as well; these risks are magnified when domestic policies are not sound and institutions are frail. In addition, the risks are heightened in a world economy, which is increasingly uncertain and volatile.

Actually, the recurrent financial crises around the world force countries to seek *shelters*. In this context, the support of the EU to transition countries in Europe would really be most welcome – under the understanding, of course, that they should comply with the requirements of the *acquis communautaire*. Romania, however, is less connected financially with the EU and seems to have relied less on it as an anchor – as has been the case with some front-runner candidate countries. But this situation will very likely change, should the country move closer to the Union. A clear indicator of such a development would be when the economic cycle in Romania will move, more or less, in tandem with the cycle in the EU; at that time external shocks will be felt similarly and policy responses will, presumably, become alike.

Romania’s quest to join the EU involves the pledge to open the capital account, basically, by 2004. This is a time which will, very likely, precede the accession into the EU. As it is widely accepted by economists and amply proven by worldwide experience, the opening of the capital account needs to rely on solid institutions (including the financial and the banking system) and good economic performance – which, for Romania, implies convergence towards the EU benchmarks. Inflation should be in the range of the one digit level, interest rate differentials should be low, and external debt should grow at a lesser pace than the rate of GDP growth. Likewise, the economy would have to be able to cope with sudden reversals of capital flows without unbearable trouble. In general, hard budget constraints (financial discipline)

would have to become the rule of the game and fiscal prudence would be a must for public policy conduct.

There are some premises for thinking about opening the capital account in Romania, according to the pledged timetable: disinflation is underway, albeit, it should be said, the battles ahead will be very painful; the banking system is more solid, as compared to its situation in the late nineties; domestic nominal and real interest rates have been declining considerably lately; the public debt seems to have flattened out; external debt is relatively low, and only a small part of it is short term debt. Accordingly, the credit rating of the country improved at the end of 2001<sup>5</sup>. However, inflation is still too high; arrears have grown by 6% of the GDP in 2001; the trade deficit rose sharply last year; economic growth is likely to slow down in 2002 because of the worsening international conditions and of the need to reduce the budget deficit, and foreign direct investment is below expectations. Equally, there are other characteristics of the domestic financial and monetary environment which should provide food for thought: financial markets are relatively thin (see Fig.2), which increases the likeliness for capital flows (in and out) to produce disturbances; the ability of the National Bank to sterilize money supply can easily be overstretched, and wide fluctuations of the exchange rate could have negative effects on trade flows and price stability.

**The bottom line is: the Romanian economy is still fragile, in spite of positive developments that have occurred in the last couple of years. This is why there is a clear need to have a discussion about the ways and means regarding the opening of the capital account. Such a discussion should not be put aside just because there is a policy commitment towards the EU to carry out such an opening.**

**Fig. 2. Broad money (M2) % of GDP (international comparison, as of 1999)**

Country	M2 / GDP
Czech Republic	76%
Slovak Republic	51%
Hungary	46%
Albania	45%
Poland	42%
Croatia	39%
Bulgaria	32%
Romania	25%

*Source: IMF statistics, WIIW database*

The opening of the capital account is actually an issue of utmost importance for policymakers, for two reasons at least. One is linked with policy formulation in the next few years. Can economic policy be geared in such a

<sup>5</sup> In December 2001, Moody's upgraded the country's rating for Government bonds in both foreign currency and domestic currency, to B2 (from B3 and Caa1 respectively).

way so that the requirements of opening of the capital account be met according to the timetable? In this respect, one has to provide answers to a series of problems, which have proved quite intractable during Romania's transition. One such problem is the degree of financial indiscipline, another problem is the import dependency of the Romanian economy. At the same time, can financial markets become sufficiently strong and can the Central Bank improve its effectiveness sufficiently in dealing with possible massive flows of capital in and out of the country? Or, how can a steady policy course be maintained, which should achieve a substantial amount of nominal and real convergence, in a relatively short span of time; and is this convergence possible? Certainly, the more the EU opens its labor markets to Romanian workers and the more EU direct investments flow into Romania, the easier it is to advance with financial opening – however, the questions raised above remain valid. The second reason for caution concerns the pitfalls of opening totally the capital account without a proper preparation of the institutional setup and some substantial improvement in economic performance. Therefore, aside from an optimistic scenario, one has to consider the case that, by 2004, the concrete circumstances would not warrant the complete opening of the capital account, and imagine alternative measures.

Romania needs to honor its commitments and policy planning is a must in the quest to join the EU. But on the other hand, the opening of the capital account should take place in accordance with the actual performance of the economy and not as if it is a god dictated event.

**EARLY WARNING REPORT – ROMANIA 1 / 2002**

**Fig.3. Romania's capital account opening: stages and timeframe**

	1 <sup>st</sup> stage (under way)	2 <sup>nd</sup> stage (January 1 <sup>st</sup> , 2003)	3 <sup>rd</sup> stage (January 1 <sup>st</sup> , 2004)	4 <sup>th</sup> stage (no later than EU accession)
Shares or other securities of a participating nature	Sale or issue abroad by residents	Purchase abroad by residents	Sale or issue locally by nonresidents	Purchase locally by nonresidents
Bonds or other debt securities	Sale or issue abroad by residents	Purchase abroad by residents	Sale or issue locally by nonresidents	Purchase locally by nonresidents
Money market instruments			- Purchase locally by nonresidents - Sale or issue locally by nonresidents - Sale or issue abroad by residents - Purchase abroad by residents	
Collective investment securities	- Purchase locally by nonresidents - Sale or issue abroad by residents		- Sale or issue locally by nonresidents - Purchase abroad by residents	
Derivatives and other instruments			- Purchase locally by nonresidents - Sale or issue locally by nonresidents - Sale or issue abroad by residents - Purchase abroad by residents	
Credits		To residents from nonresidents	By residents to nonresidents	
Guaranties, sureties, and financial back up facilities	By residents to nonresidents (EU only)	- By residents to nonresidents - To residents from nonresidents (EU only)	To residents from nonresidents	
Direct investment	- Inward direct investment - Controls on liquidation of direct investment - Outward direct investment			
Real estate transactions	- Sale locally by nonresidents - Purchase locally by nonresidents (except land by private nonresidents) - Purchase abroad by residents			
Provisions specific to commercial banks	- Borrowing abroad - Foreign loans (EU only)	Nonresidents deposits	Foreign loans	Deposits overseas
Personal capital movements	- To residents from nonresidents - Debt transfer by immigrants	By residents to nonresidents		

## **TREND: ARREARS ARE STILL AN UNSOLVED PROBLEM**

After 1989, as the role of the Romanian state in the economy diminished, the direct budget subsidies toward enterprises were drastically reduced. The number of centers performing the corporate governance of firms increased from one (the government) to four (the government, the banks, the utilities and “the other enterprises”). Cutting off investment funds received from the state budget, abolishing the automatic access to bank financing, and the price liberalization forced enterprises to look elsewhere to find ways to overcome the tighter budgetary constraints. The main channels available to the firms in order to reduce the pressure exerted on them, have been the state budget, commercial banks, utilities and the other commercial partners.

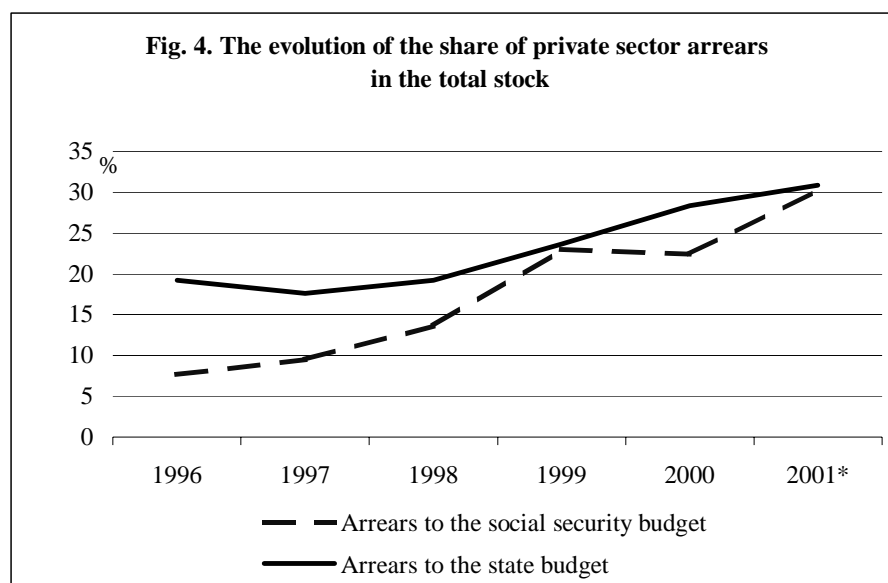
During the transition period, “the other enterprises” have been the only ones performing adequate corporate governance. Irrespective of their property form, they have learned very rapidly the importance of commercial credit controls, exerted through standard market economy procedures.

The delay in the privatization of the banks led, in the mid nineties, to the accumulation of a huge stock of bad loans in the banking sector. Thus, the large loss-making state owned enterprises were allowed to survive financially by borrowing great amounts of money from banks and not paying back. However, the liquidation of Bancorex, the collapse of a few well-known private banks and the privatization of some of the state-owned banks (Agricola, Bancpost, BRD), led to a gradual hardening of the borrowing conditionality. The stock of bad loans decreased substantially and the banking system moved towards adequate corporate governance.

By contrast, utilities and the state budget have remained major sources of financial indiscipline. The utilities – the energy sector first of all – are a permanent source of soft loans on the one hand, and a reckless commercial creditor on the other. First, the cash collection rate of the energy bills has always been low. Second, because of social protection reasons, the energy price was maintained at a level below the cost-recovery level. In order to survive financially, the utilities accumulated a substantial stock of fiscal arrears toward the state budget. The government’s tolerance of such behavior actually represented a disincentive for restructuring the utility sector and perpetuated lax budgetary constraints on firms with political connections from the sector of the “other enterprises”. Thus, a dual financial regime emerged.

The budget, as the fourth center of corporate governance, stands out as a consistent source of soft budgetary constraints in the economy. The large state-owned enterprises have been allowed to preserve their structural inefficiency by not paying their tax liabilities. This behavior was encouraged through frequent roll-overs and unconditional tax cancellations granted by the fiscal authorities. Such measures created an image of soft creditor for the government, diminished the fiscal authorities' credibility and led to the extension of such a behavior to the profitable private companies.

After 1990, the overall level of arrears has increased steadily, reflecting both the incapacity of successive governments to act on this issue and the inherited distortions in the Romanian economy. From 33.6% of GDP in 1997, the level of arrears climbed to 40.67% in 2000. However, such data do not reflect the reality entirely, as the amounts of tax debts cancelled or rolled-over by administrative decisions were not included. If these are included, the total stock of arrears would be substantially higher. What is worrying is that lately the growth of arrears accelerated. In the first semester of 2001, arrears increased by 39% compared to the same period of 2000. The debt to the social security budget increased by 57%, while the debt to the state budget went up by 36%.



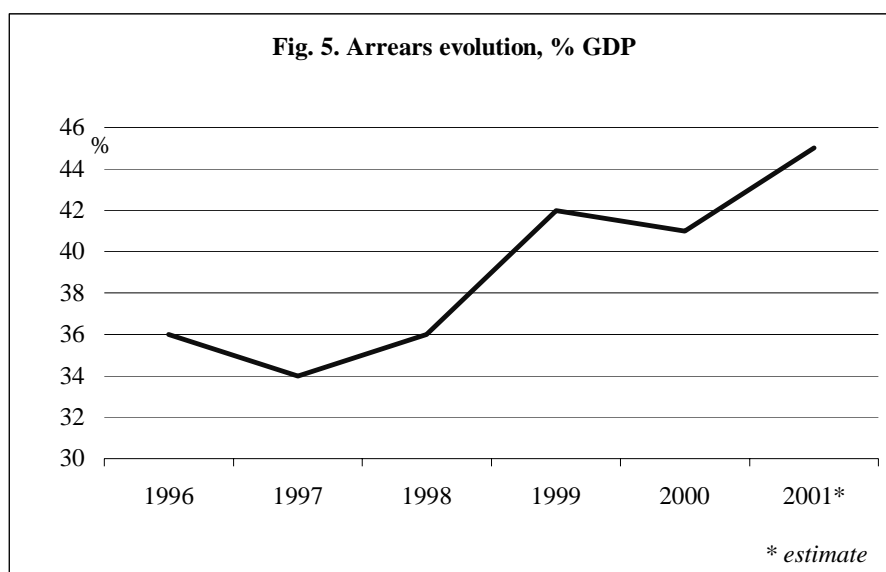
\* first semester

The bulk of the problem seems to be concentrated in a limited number of firms. The arrears of the largest 200 tax debtors toward the consolidated state budget increased by 32% in the first semester of 2001 compared to the first semester of 2000. In fact, it is the state budget that bears most of the burden: the share of the state budget arrears in the total structure of the fiscal arrears increased from 47.4% in the first semester of 2000 to 61.4% in the first semester of 2001. But the situation worsened in the social security budget as well.

The bad demonstration effects of the government's incapacity to collect taxes have become apparent over time. The private sector has learned that there is no punishment for not paying the taxes and contributions due, and as a consequence the share of the private sector in the total stock of fiscal arrears to the social security budget increased from 7.6% in 1996 to 22.4% in 2000. The trend continued in the first semester of 2001, when this figure reached 30% (Fig. 4).

The situation is not different with the special funds, where the share of the private sector arrears increased from only 10% in 1996 to 33% in 2000.

The total fiscal arrears of the companies that have a gross profit greater than 1 billion ROL and a fiscal debt greater than 10 billion ROL, was of about 20,000 billion ROL at the end of the first semester of 2001, which amounts to 4.5% of the GDP for the period considered. As a proportion of the GDP, the total stock of arrears was 40.7% in 2000. Extrapolating the average rate of growth of the arrears in the last three years, one can estimate a total stock of arrears at the end of 2001 of around 45% of GDP.



## Conclusions

**Many fiscal exemptions and tax holidays were granted during the past year. The price of the energy was maintained under the cost-recovery level and represented an important hidden subsidy. However, even in this environment, the enterprises did not begin to pay their taxes and the stock of fiscal arrears increased substantially.**

The *recommended strategy* to deal with the tax arrears is twofold – and is meant to address the problems on the short term, and on the medium term.

The essence of the **short-term strategy** is to limit the tax arrears problem by putting a high priority on restoring and maintaining the position of the government as a tough creditor. The fact that loss-making firms accumulate large tax arrears even in leading transition economies suggests that in Romania, as elsewhere, some tax arrears are difficult to avoid. The serious danger appears when tax arrears spread beyond loss-making firms, since the stability of the fiscal system itself can be put at risk under such circumstances.

- The Government should attempt to contain the problem only to the loss-making and financially distressed firms. This means that the Ministry of Public Finance should maintain the pressure on companies and try to collect tax revenues, considering the use of the forced execution procedures by asset seizures and bank accounts seal-offs. On the short term, the liquidation and closure of the large loss-making state-owned enterprises would face political and social obstacles that may be difficult to overcome. However, while they are still operating, government can put pressure on these firms in order to contain the magnitude of the problem.
- Tax discipline should be restored in the profitable firms. If the current situation of moral hazard (when it pays to be a debtor to the state budget) is terminated, these firms will have to hold down their wage bill or borrow from banks rather than accumulate tax arrears.
- In the case of energy suppliers, it is essential to align energy prices to cost-recovery level and allow these energy suppliers much greater freedom in cutting off supply to non-paying customers. In order to reach a long-lasting solution, the production and the distribution of energy should be privatized and opened to competition. Some steps were taken already, but the process must be speeded up. In terms of priorities, it is important that a sound regulatory framework be in place prior to privatization. Equally, since the main problem is the energy bill collection, the privatization of distribution companies should be initiated before the privatization of the production companies.
- The Government should avoid measures to write off or reschedule tax arrears for different categories of firms – like the ones granted at the beginning of 2002. Such programs are extremely dangerous: they only aggravate the moral hazard behavior and create perverse expectations for future unconditional tax forgiveness, thus increasing the marginal propensity of companies to accumulate tax liabilities. Furthermore, the social utility of such measures is often questionable (for example, when the Government reschedules or cancels debts of private tobacco and beer producers), and they represent incentives for corruption.

The **medium-term strategy** used by the leading transition economies has been to deal with the problem companies by privatization or selling of assets, whenever this was possible.

When the above is not possible, because the political or social concerns prevent the sale or closure, the problem of the tax arrears should be gradually reduced through the sustained application of hard budget constraints. Faced with tougher rules of the game, the loss-making firms will eventually shed large amounts of labor out of necessity. Thus, the scale of the problem would decrease in time, and it would become easier to deal with individual firms in a variety of ways depending on the situation: restructuring, privatization or closure of the firm. Such a strategy also proved effective in other transition economies.

## **AGRICULTURE: RIGHT ENDS, WRONG MEANS**

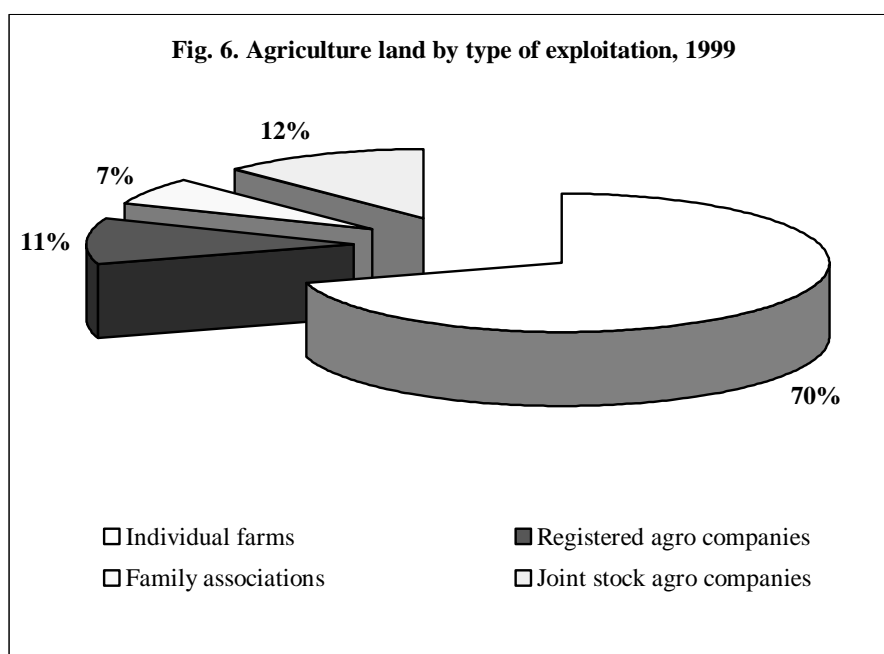
### **The current attempts to encourage consolidation of farms are unlikely to make an impact**

Due to its current structure, the Romanian agriculture is not able to fully realize its competitive advantage in the agro-food sector. A large number of tiny, traditional family farms producing largely for their own consumption (there are over 4 million such small exploitations at present) coexist with a small number of large industrial farms that inherited the assets and management of the former communist state farms (IAS). The vast majority of the agricultural land is, however, still owned by small holders (Fig.3): the average area of an individual household exploitation has been of about 2.3 ha over the past five years. Agro companies (most of them former communist cooperatives – CAP) exploit little over 400 ha on average, and a family association around 100 ha. The former IAS dominate the sector by their size, with an average of 3,300 ha in 1999. Once the second wave of restitution and concession of state owned land began in 2000, the participation of the state sector in agriculture has further diminished; but more than half of the IAS have yet to be privatized.

The polarization of exploitations, increasingly visible in the Romanian agriculture, is taking place everywhere in Central and Eastern Europe. However, the situation is so dramatic in Romania, that it has to implement radical measures in order to change this situation. What are the chances for

the current policies of the Năstase government to achieve their intended results? Not very high, as it will be argued below.

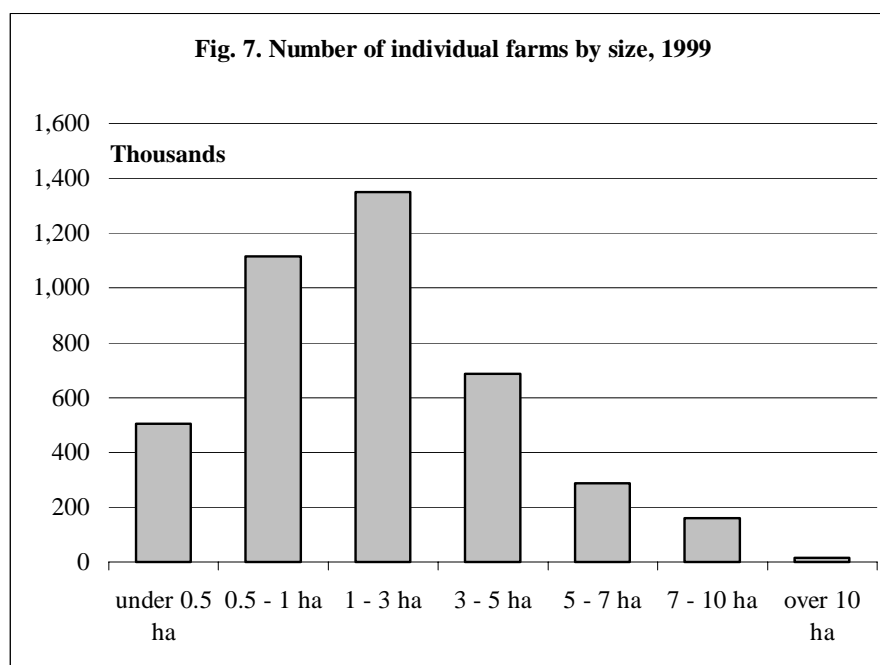
The Ministry of Agriculture tried to tackle the problem of agriculture land fragmentation by issuing Emergency Ordinance 108/2001. This legislation defines the agro exploitation by type, in a very peculiar way: in the areas where cereals are grown, only farms with more than 110 ha qualify as such; dairy farms should have more than 15 animals; etc. The ordinance specifies the minimal dimension for every culture or type of livestock – and only the exploitations that meet the criteria will have access to "state support similar to that practiced in the EU". The units that fail the test are considered "family farms" and do not qualify for support.



The data in Fig. 7 show that the 4 million individual farms are practically excluded. As a consequence, the households who rely on these agro activities for subsistence will see their living standards declining even further. At present, the state provides little support for smallholders and they do not sell much of their products on the market. However, the new policy will isolate them even more from the official economy. The Government's argument is that the farmers will, in this way, be stimulated to consolidate their lands into agricultural associations of viable size; and that such forms of co-operation are widespread in the European Union. However, what the authorities do not mention, is that in the EU the co-operatives have other purposes than production (with the exception of the Eastern German lands), which is almost always realized on an individual basis.

It is unlikely that the policy promoted through the Ordinance 108/2001 will have a significant impact on the number of the legally registered associations,

the only ones eligible for support. Moreover, their overall economic performance over the last years has been modest, with slightly better performance in the plain areas with cereal crops. Their number and size have not changed much for the better – indeed, there was a slight decline in the last three years.

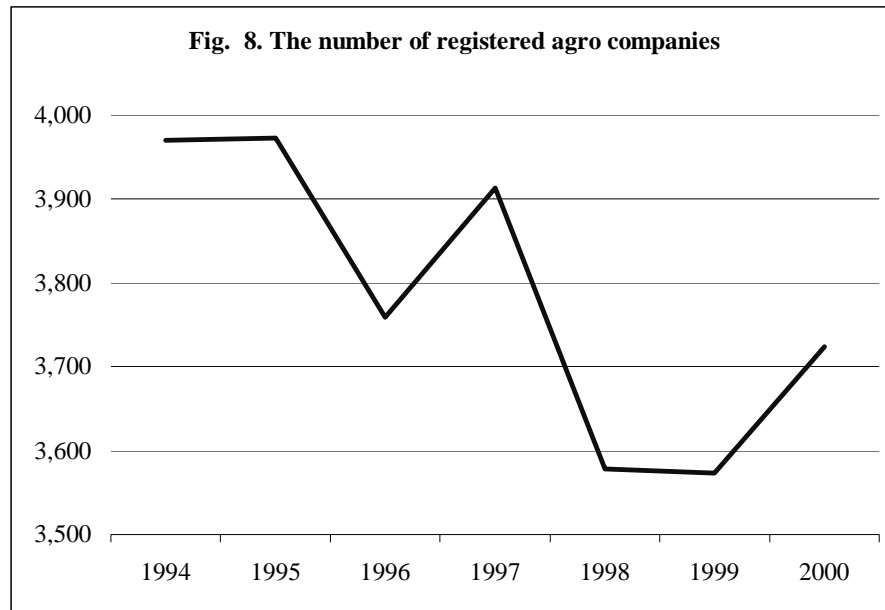


The significance of the new policy is twofold. First, it reveals the Government's nostalgia for the old forms of associative production, based on massive social engineering and selective assimilation of Western models (real or imagined). Only the old instruments of political coercion are replaced by new economic incentives. But nobody can guarantee that associations will be set up voluntarily by private agents when they do not appear to be very enthusiastic in this respect in the first place. On the contrary, the analyses available so far demonstrate that the profitability of existing associations can hardly be a reason for promoting them.

Second, the way the ordinance was drafted and debated in the Parliament – with little concern for the rural votes that might be lost – shows that the interests of the large farm owners prevailed. Who are, in fact, these people, the winners of the battle for agricultural aid? The scarce public resources will go mostly to:

- the agro associations, whose managers are able in most of the cases to extract personal benefits at the expense of the members,
- the former IAS, still state-owned, which are hugely indebted and managed by directors appointed by the Ministry of Agriculture,

- the new private administrators of lands on lease from the Agency of State Domains (subordinated to the Ministry of Agriculture), typically over-diversified commercial holdings, and
- the few real farmers who qualify for support according to the ordinance.

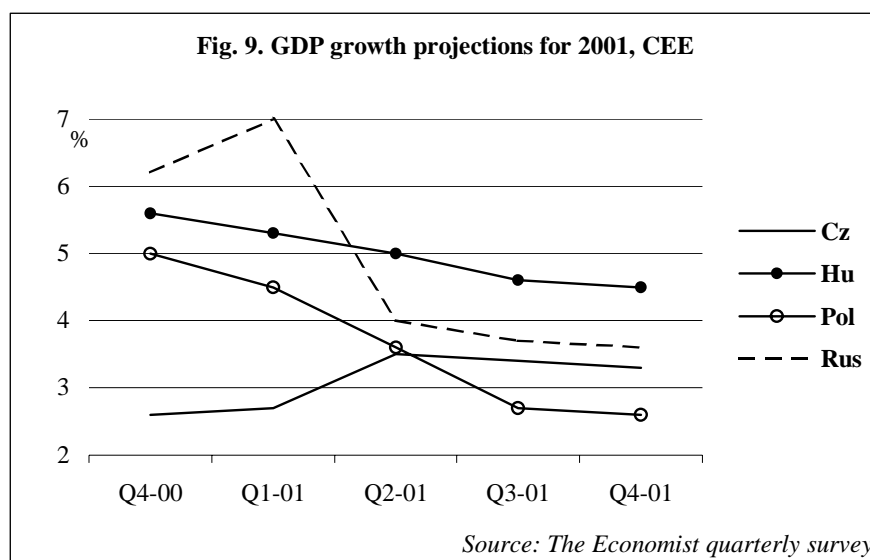


The number of all these beneficiaries revolves around 10,000, and they hold about 30% of the agricultural land of Romania. Although the Senate has amended the Ordinance, including amongst its beneficiaries the mixed farms, the principle of discrimination according to size was preserved in spite of its foreseeable social and economic consequences. The lower Chamber has still the chance to amend a piece of legislation that was rushed through the Senate in 2001.

The official position of the Government is that the policy will speed up Romania's European integration. The problem is, such policies that discriminate among farmers do not exist in the EU, and the average farm size is no bigger than 18.4 ha (1997 data). Most European farmers would have a hard time meeting the strict criteria imposed by the Romanian Government. A real harmonization policy would require that Romania stimulate the consolidation of farms within the size bracket of 20-50 ha, all the more so, since the economies of scale, mentioned by the initiators of the ordinance, have limited effect in agriculture. The increase in productivity and profitability of the Romanian agro-food sector, together with the actual realization of the competitive advantage of our country (if indeed there is one) in this respect, are legitimate goals – but they must be pursued through different means than those envisaged in Ordinance 108/2001.

## GROWTH PROSPECTS AND THE DOMESTIC BUSINESS ENVIRONMENT

Romania goes against the trend, for good and for bad. In 2001 it was mainly for the good, but it may not happen again this year.



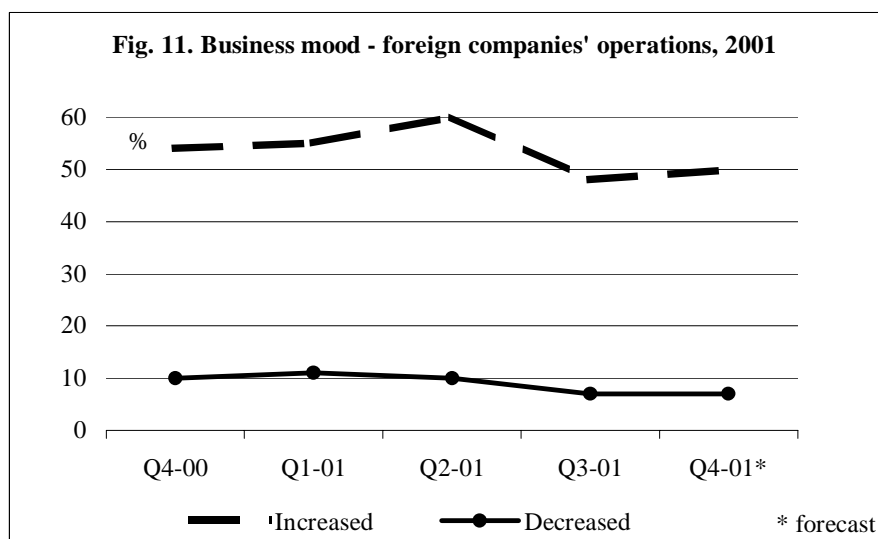
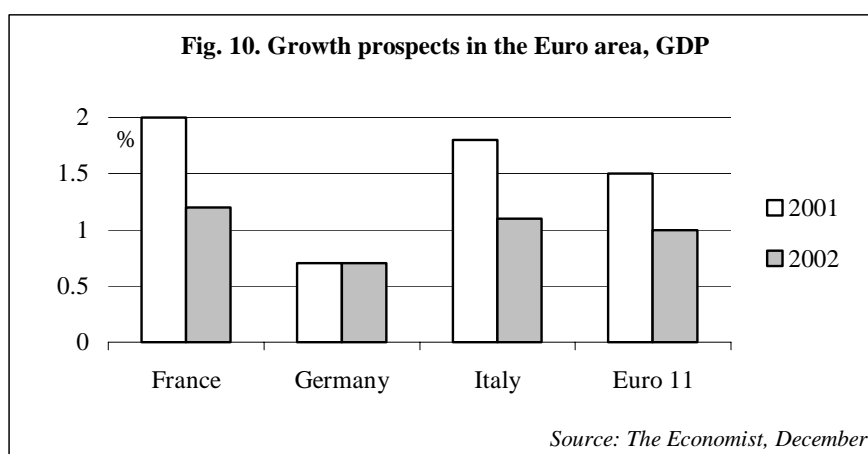
The world seems always willing to forgive you for other things if you are able to deliver growth – especially when you are a Romanian government at a time when the whole Central and Eastern Europe has become gloomier, following the general trend of the world economy (Fig. 9). With an expected growth rate close to 5% in 2001 (see the table of indicators in page 2), Romania will most likely outperform its more advanced neighbors. The downturn of our main EU trading partners did not seem to have a substantial influence either. This surprising results allowed the Romanian government to gain credibility, domestically and abroad. The question is, will the same thing happen again in 2002?

Most probably, the growth rate in 2002 will be lower than in 2001, because:

- The agriculture will not be able to grow as impressively as in 2001 in relative terms (2000 was a bad year for crops, which explains the push ahead in this sector last year).
- Romania's main trading partners – and the whole Euro area – will slow down even more in 2002 before their economies will recover (Fig.10). Even though it proved to be quite disconnected from the

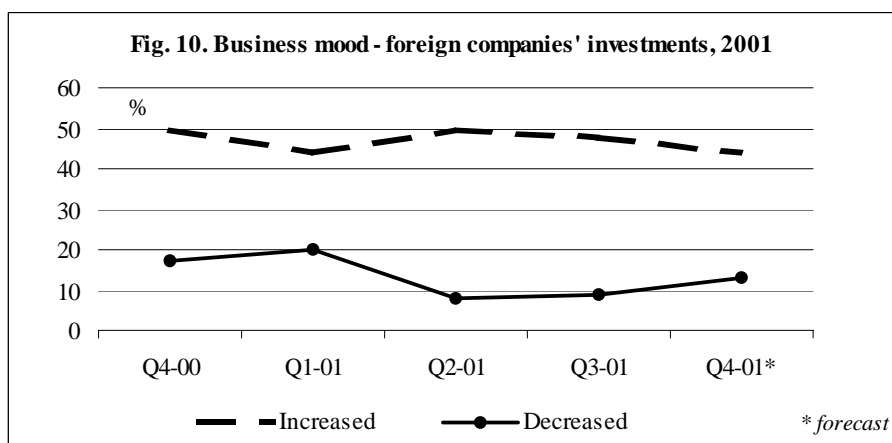
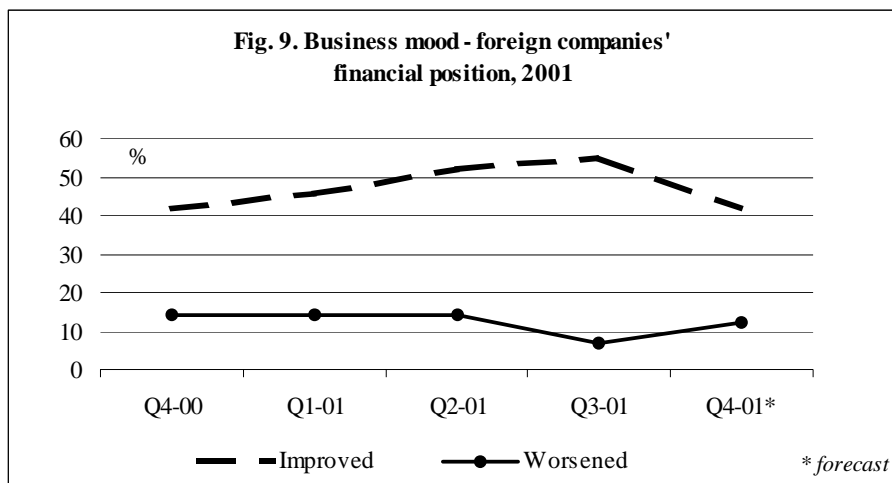
world trends so far, it is unlikely that the Romanian economy will not be affected eventually.

- Domestic demand, the most important source of growth in 2001, will have to adjust to the austerity measures that the government must take, namely: reduce subsidies, decrease public spending and exert a much tighter control over the salaries in the public companies.
- Arrears represent a serious problem that no government has been able to tackle so far, which only got worse in 2001 (see the analysis in this report). Most probably, the arrears also contributed to the GDP growth last year, but this should not happen again in 2002 if the government is to preserve its credibility.



The Government would be well advised to pay attention to the activity of the foreign companies, since they are the ones who bet with their money on the Romanian economy. The KPMG quarterly survey of the foreign investors

shows them in stationary mood (Fig.8,9,10). The deterioration of their financial position and business activity towards the end of 2001 may be attributable to the ups and (mostly) downs of the world economy. However, the very fact that they felt that they were worse off in the fourth quarter than in the first should be a matter of concern. The government should remember such market signals as it plans ahead for the new year.



# POLITICS

## THE PUBLIC DEBATE ON REGIONALISM

### Capacity building, not new forms, is what the Romanian administration badly needs

A recent event stirred public debate, due more to the sensitivity of the Romanian public opinion to the issue than to the challenge itself. A small group of intellectuals based in large Transylvanian cities, headed by a Transylvanian-born, Budapest foreign policy analyst, Gusztav Molnar, launched on December 8 a manifesto. The manifesto denounced the centralism of Romanian administrative structures, claiming that these structures had actually endured from the Ceausescu era without change, and calling for the creation of fully devolved regions, with regional Parliaments and an adjacent public awareness campaign to promote the advantages of federalism. The document was sent to the Romanian Parliament, the European parliament, the Committee for Regions, and to various political parties. Concrete demands ranged from full autonomy of public television regional stations to essential changes of the Romanian Constitution, in order to create a new level of government, the *meso-government*, in line with 'the new European Constitution'. Besides a couple of errors – such as the reliance on a still unwritten European Constitutions as a binding document calling for a specific form of government, or the verdict on the current administrative system, reshaped by successive laws of local government and especially by the 1998 fiscal decentralization act (the law on local budgets) – as being 'unchanged' from Communist times – the document reflects a growing trend amongst the Romanian provincial elites. Over the last ten years, in Transylvania and Banat especially, opinion leaders have been constantly attributing every ill of the transition to the central government and to the rest of the country, which are perceived as being less developed and benefiting more from revenue transfers via Bucharest. Consequently, emancipation from Bucharest is sought as a way to improve economic standards as well as the

self-esteem of these regions, which consider themselves unfairly patronized by the Capital. Until 2000, both Transylvania and Banat have blamed the rest of the country for being more ‘communist’ and have taken pride for having voted for the center-right coalition, the Democratic Convention of Romania, allied with the Hungarian Party (UDMR) between 1996 and 2000. However, after 2000, two events shook this pride: first, citizens from these regions voted massively for the ‘third’ option – radical extremist candidate Corneliu Vadim Tudor in the November 2000 presidential elections. Second, UDMR allied itself with the new government party, PSD, a traditional enemy, which it had often accused of nationalism, centralism and anti-Hungarian attitudes.

Similar manifestos, originating basically with the same group of people, have been launched before. However, there never was any serious discussion on the focal assumptions behind the call for a radical change of the Romanian state, such as the passage from a unitary form to a federal one. While the need for further decentralization is obvious and various programs and agencies strive to address it, the need for radically redesigning the state is less clear. The following analysis tries to assess whether the federalists’ argument can be substantiated, and it does so, by reviewing some of the doubtful pre-assumptions that the manifesto draws upon.

**Doubtful assumption number one: there is a popular drive against the unitary state, creating a need for a radical reorganization of the state along federal lines.**

The preference of Romanians for various forms of government was investigated several times. In a 2000 poll of SAR with CURS, the question ‘what kind of government?’ was the main focus. The answers are in line with other more recent polls, all showing a similar trend. Romanians favor the unitary state strongly, with only 2% expressing their preference for federalism or a canton-type arrangement (Fig. 1). They dislike the Parliament, which they perceive as corrupt, and favor a reduction in the number of MPs and the shift to only one Chamber of Parliament (71 % agree that ‘We should cut one Chamber in order to have fewer MPs’, versus only 14% against<sup>6</sup>). The general picture favors the executive and the technocrats against the representatives, which may well be a problem for the Romanian democracy unless representatives decide to improve their own image. Nobody can claim, however, that the public wants regional representative assemblies or more representatives – rather the contrary is true. Creating regional Parliaments, besides overburdening a public budget which is already under serious strain, would not improve the popularity of MPs. This poses a serious obstacle for the advocates of federalism, since any constitutional reform of the kind envisaged by them needs a qualified majority and a referendum, and it is unlikely that the public would vote for more MPs. Instead of focusing on such far-fetched, unrealistic options, the Romanian opinion leaders should

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<sup>6</sup> CURS, 2000.

rather seek realistic solutions to improve the legitimacy of the political class, a real and ever-increasing problem.

**Fig. 1. Preferred solution for accommodating minorities**

Choice	%
Proportional representation plus minority quotas	16.1
Covasna-Harghita as a canton	0.6
Federal Romania with Transylvania federal unit	1.1
Things should stay as they are	69.3
Other	2.4
No answer	10.4

**Doubtful assumption number two: there is a strong, post-modern regional identity of the type seen in Northern Italy, which demands a lesser presence of the central government.**

The New Democracies Barometer (NDB) revealed a weak national identification in post-communist Europe (Fig.2).

*'Even though most states are nation-states, most Central and East Europeans continue to have multiple and diverse identities. A total of 30 percent in CEE countries put their nation-state identity first and a local or regional identity second, and 21% order identities in the opposite way. But another fifth are localists or even parochial, identifying only with their town or region.'*

*(Rose and Haerpfer 1998: 227)*

**Fig. 2. The multiple identities of Romanian citizens (first choice; then first and second cumulated)**

	Romania		NDB regional mean Eastern Europe	
Close to country	27	56	39	64
Close to neighborhood (town, region)	42, 14	62,44	32,8	57,28
Close to Europe	8	18	8	19

*New Democracies Barometer, 1998*

At a first glance very few Romanians (27%) declare their national identity as their first option, that is to say, less than the CEE average, and about half of the Western European average, according to the NDB. However, when trying to find out whether 'close to neighborhood' is actually a regional identification, one discovers that the local identity overrides the regional identity, as well as the national identity (Fig.3). Only 11% of the Romanians have what can be considered a 'regional identity'.

<sup>7</sup> New Democracies Barometer Y, Glasgow: Center for Policy Studies

**Fig. 3. Local versus national identity<sup>8</sup>**

	1st choice %	2nd choice %
Close to town or village	64.0	15.4
Close to region	11.5	21.7
Close to country	21.1	47.7
Close to Europe	1.2	7.1
Other	1.1	1.0
No answer	1.1	7.2

**Fig. 4. Last month household income by identity**

	Average revenue per household (ROL) <sup>9</sup>
Close to town or village	3,316,935
Close to region	3,885,545
Close to country	4,287,355
Close to Europe	4,666,666
No answer	2,369,000
Another place.	4,920,000

This local identity, however, is not similar to the one of Northern Italy. Contrary to what we would expect in such a situation, the 'localists' are the poorest, and the 'nationalists' the richer. The 'regionalists' fall in between, however closer to the well off part of the scale. National identity is only a form of modernity, being correlated with better education and superior status. In explanatory models of nationalism, it does not even turn out as a predictor, nationalism drawing to similar extents on people who identify with the region, the town or the country<sup>10</sup>.

**Doubtful assumption number three: Transylvania and Banat are richer than the rest of the country and their development is crippled by redistribution to poorer regions of Romania.**

While Transylvania and Banat are historically more developed, in accordance to the overall regional pattern of former Habsburg provinces versus Ottoman-dominated ones, one cannot safely identify a pattern of redistribution from Transylvania towards the rest of the country, based on current statistical data. The most developed counties are those including large cities, which act as engines of development, Cluj and Iasi being similar in this respect, and doing worse than, say, Bucharest or Ploiesti. The pattern of redistribution is seemingly erratic, shaped by local needs regardless the

<sup>8</sup> CURS poll, October 2001

<sup>9</sup> 30 000 ROL make one US\$, i.e. revenues vary around 100 USD. However, even if small in dollars, differences are significant among categories.

<sup>10</sup> see Mungiu-Pippidi, A. "Lungul drum spre identitatea europeana", Sfera Politicii, no 99, Bucuresti.

geography, but in no way does a pattern emerge with Transylvania being disfavored compared to other regions.

**Fig 5. Regional gross domestic product (ROL)**

	Regional GDP/capita	Regional GDP <sup>11</sup>	Regional subsidies/product	Taxes / product <sup>12</sup>
North-East	12,563,993	47,766	322.3	4,244
South-East	16,555,113	48,751	243.7	4,322
South	14,199,851	49,516	243.0	4,392
South-West	14,803,014	35,742	174.8	3,170
West	17,294,919	35,471	247.6	3153
North-West	15,630,360	44,664	260.2	3,965
Center	17,768,983	47,173	281.1	4,189
Bucharest	26,896,839	61,672	333.2	5,473

**Fig. 6. Revenues of selected counties in 1999**

Selected counties	1999 Revenues – total <sup>13</sup>
Botoşani	394,547
Iasi	814,733
Vaslui	313,550
Giurgiu	162,609
Teleorman	277,414
Mehedinti	214,400
Cluj	823,045
Brasov	697,780
Covasna	206,453
Harghita	291,711
Bucharest	4,993,843

*Source: INSSE*

**Doubtful assumption number four: federal states are better suited for multi-ethnic societies than unitary states, preventing violence and ethnic conflict.**

According to a reliable estimate, 8,000 miles of new state borders have been created in Central and Eastern Europe since 1989. The sudden – be it peaceful (Czechoslovakia) or not (Yugoslavia) – redrawing of frontiers within Eastern Europe frightened the Western world: but it was a mere revenge on a

<sup>11</sup> 1998, billion ROL current prices.

<sup>12</sup> Including VAT.

<sup>13</sup> 1999, million ROL

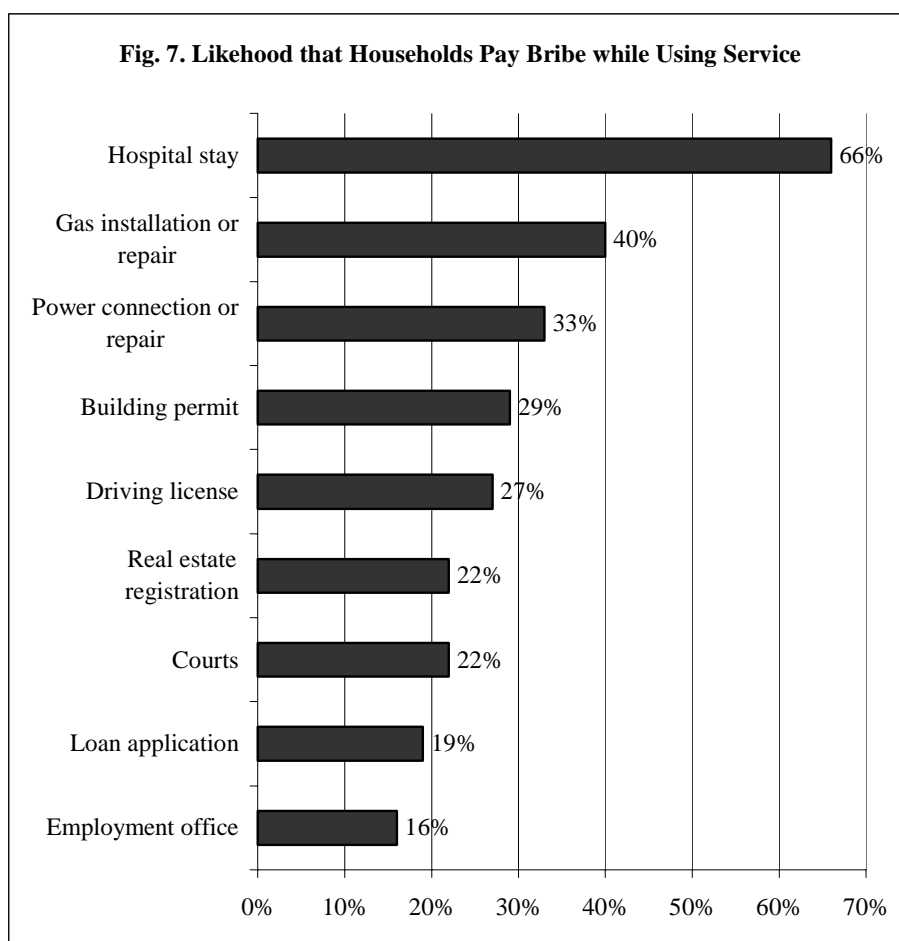
century of frustration over the inability to find the 'right' borders, hence the expression of 'unfinished national revolutions'<sup>13</sup>. Explanatory models using the influence of the state structure (federal or unitary) in post-communist Europe as the main explanatory variable led to the conclusion that **federalism increases the likelihood of both constitutional conflict and ethnic violence**<sup>14</sup>. Such analyses only confirm the common observation that all the federations in post-Communist Europe have vanished during the past decade, regardless of whether they were created by the Communist régime, or by pre-Communist ones. While protecting minorities is a must, one has to be extremely careful not to create new problems when trying to solve the old ones.

**Doubtful assumption number five: corruption is determined by centralism; the more you descend in the hierarchical structure, the less corruption you encounter.**

This assumption is equally wrong. Repeated studies show that corruption correlates with freedom and accountability, but these are not dependent on the structure of the state (i.e. unitary or federal). A provincial local government can restrict freedom of business, therefore fostering bribing and corruption at least as effectively as a central government (actually most of the corruption in Romania is to be found in decentralized local governments or autonomous government agencies). A rapid glance at the frequency of bribing shows in the top the local governments (mainly in relation to building permits). A similar assessment of business corruption in a World Bank Romania Survey shows the customs office on top. Most of the permits that a businessman or an ordinary citizen need depend on local, not national authorities. Accountability mechanisms at both central and local level need considerable improvement, but this is a different matter altogether.

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<sup>14</sup> Philip Roeder, 'Unfinished National Revolutions?', *Slavic Review*, 1999 (Vol. 58, No. 4).



## Conclusion

The theme of regionalism will remain on the public agenda to the detriment of substantive issues such as fiscal decentralization, the need for capacity building of local governments, as well as the shameful politicization and opportunistic practices of the local administration. Whenever local elites will feel that they need a greater share of power and prestige, they will push the button of 'regionalism' as a solve-all solution. Were Transylvania to have already a regional federal Parliament in 2000, it would be now shared mostly between *Greater Romania Party* and the Hungarian alliance. In Cluj, the capital of Transylvania, Gheorghe Funar, a radical nationalist, has managed so far to win three successive elections. There is no evidence that Transylvania on its own would be a more tolerant political society, but rather the contrary. While decentralization must progress further, accompanied by the development of reliable accountability mechanisms, both the government and the civil society should do more to publicize the steps already taken and the need for citizens' participation, so that more devolution does not imply more corruption.

*This report, as well as past issues can be downloaded from the UNDP Romania's website,*

<http://www.undp.ro/>

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