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**EARLY WARNING REPORT**

# **Early Warning Report**

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# EARLY WARNING REPORT ROMANIA

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## UNDP - ROMANIAN ACADEMIC SOCIETY (SAR)

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### SELECTED INDICATORS

	Q1-2001	Q2-2001	Q3-2001	Q4-2001	Jan-2002	Feb-2002	Mar-2002	Trend
GDP growth (quarterly, annualized), %	4.8	5.1	5.1	5.4				↗
Devaluation of the Leu, monthly average, %	2.1	1.9	1.5	1.2	1.9	1.3	0.9	↘
Inflation, monthly average, %	2.7	2	1.8	2.4	2.3	1.2	<u>0.4</u>	↘
Interest rate (BUBOR, one week) %	3.4	3.2	2.6	2.6	2.7	2.5		↘
Industrial output, % change	6.8	-0.3	-0.6	-3.0	4.6	3.8		-
Trade deficit, monthly average FOB/CIF (mil USD)	274	408	205	504	257	239		↘
Unemployment rate, %	10.7	9.3	8.1	8.1	12.4	13.2		↗
Average net monthly salary, USD	99.2	96.3	92.9	96.4	114.1	106.3		-
State pensioners / employees	0.97	0.97	0.98	1			1.01*	↗
Trust in Government, %	57	46	48**	42	45		38	↘
(The current Government can improve things)								
Pessimism, %	54	52	44**	48	51		57	↗
(Country heading in the wrong direction)								
Subjective welfare, %	18	19	19**	22	11		12	-
(Better off than last year)								

\* projection;

\*\* urban population only

# REGIONAL

## **WARNING: THE BANKRUPTCY OF THE MOLDOVAN STATE SPILLS ~~OVER~~ REGIONAL INSTABILITY**

By Alina Mungiu-Pippidi

### **The trigger**

The beginning of year 2002 has brought a significant deterioration of the situation in the Republic of Moldova<sup>1</sup>, and a simultaneous deterioration of its bilateral relations with Romania. This latter process was already noticeable last year, when Moldovan diplomacy started to use every international opportunity in order to blame the alleged Romanian interventionism in Moldova's internal affairs.

Two sets of problems, political and economic, have challenged the Government of the Moldovan Communist Party (PCM), which arguably originated in the PCM Government program itself. ~~This program,~~ made public on June 4, 2001, and which contained a set of political measures, meant to boost the status of the Russian language and to roll back privileged cultural ties with Romania. This program, which materialized in an attempt to reinstate Russian as second official

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<sup>1</sup> This report has also used sources such as *East European Constitutional Review* updates on Moldova; Freedom House 1997-2000 reports included in the 'Nations in Transit' final report (signed by Charles King); the paper 'Regional Political Cleavages in Ukraine and Moldova' by Ivan Katchanowski, George Mason University, as reported in the 21 Annual Meeting of the American Political Science Association ([www.pro.harvard.edu](http://www.pro.harvard.edu)); policy reports of the *Institute for Public Policy* Chisinau; and press reports from the Moldovan Agency *Basa*.

language, and making it *compulsory* in administration and education for non-Russian and Russian speakers alike, is unusual by every standard related to minority rights. Measures against cultural identification with Romania included making Romanian a ‘minority language’ (thus politically enforcing its alleged difference from Moldovan) and replacing the ‘History of Romanians’ taught so far in the education system, with a ‘History of Moldova’. The latter initiative is officially justified by the objective of making minorities feel more that they belong to the Moldovan state. Whilst this reasoning may seem a sensible approach under normal circumstances, it is, however, worth mentioning that the Moldovan media, including public media, has been already broadcasting numerous Russian language programs, which match and even surpass the Romanian language programs in some categories. ***However, this specific Moldovan situation, which is very different from the situation in the Baltic States (where the newly independent states have consistently pursued a cultural policy of promoting national languages versus Russian), has not helped Moldova gain more legitimacy with its minorities over the last decade.*** On the contrary, neither the Russian-speaking population of the self-proclaimed Dniestr Republic, nor the Gagauz or the Bulgarian, acknowledge the status of Moldovan (Romanian), whilst they endorse Russian more than any minority language. Furthermore, developments over the last year show that even with a Communist Government in Chisinau, minorities do not really settle with the Moldovan state.

~~Another category of~~ Further political problems, generated by the Government program, concerns the re-centralization of power in the hands of the Government. This included, via an administrative reorganization, depriving Moldovans of their right to elect directly their own mayors, and making every influential local executive an appointee of the central Government. Following a Constitutional Reform carried out two years ago, which made the Parliament, not the voters, the sole electors of the President (thus transforming Moldova into a full parliamentary democracy), this administrative reorganization further reduced the possibility for expressing popular will. Moldova currently has a proportional electoral system, which can be characterized as ‘extreme proportionalism’, with the entire country as an electoral unit. Most of the power, therefore, is entrusted to political parties, which run electoral lists, and to party leaders, who pick candidates on the list<sup>2</sup>. These features of the political system combine to burden the newly created political parties – the weak spot in all post-Soviet emerging democracies – with the heaviest tasks. No wonder, therefore, that the public has become increasingly alienated and dissatisfied with politics and politicians, and that the oldest and largest party on the premises, namely the Communist party, which owns the best network and grass-root structures, performs

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<sup>2</sup> The electoral threshold was raised from four to six percent recently. Classification of ‘extreme proportionalism’ on basis on Arendt Lijphart’s classification.

the best. The growing civil unrest is an indicator that the public resents being deprived of other traditional channels to express its opposition towards the Government.

The second set of problems, faced by the PCM Government, are economic problems. Whilst these are undeniably rooted in the legacy of previous Governments, the PCM program did its best to worsen the situation. Last year, Moldova joined the Russia-Belarus Union and applied to join a newly created common market (CEEA), made precisely of those post-Soviet states, which didn't really succeed in their attempt to reform their economies, and which remained close to, and dependent on, Russia. The Moldovan Government also moved towards creating a department for price control, stalled privatization, increased wages in the public sector and announced its intention to create worker-owned 'people's enterprises'. As a result of such policies, the IMF assistance was put on hold, whilst this year the Government has to pay external debt amounting to 75% of its total annual revenues. Following three years of quasi-insolvency, when money to repay loans was found, as a rule, in the last moment, Moldova is now heading towards bankruptcy. Its total foreign debt of US\$1.9 billion amounts to 154% of GDP, several times higher than the average 35% of developing countries.

**Fig.1. The spiral of foreign debt**

Year	Foreign debt, % of GDP
1993	> 10
1995	20
1996	43
1999	97
2001	120
2002 (forecast)	154

*Source: IPP, [www.ipp.md](http://www.ipp.md)*

Romania's policies towards Moldova have recently gained in discipline and restraint. However, even in January and February of this year, important Romanian officials, invoking their 'private' opinions, publicly endorsed pro-Romanian factions in the Moldovan Parliament. Whilst Romania succeeded in its advocacy efforts within European assemblies (from the EU to the OSCE) to protect the democratic forces in Chisinau, and managed to obtain a range of critical statements by these organizations towards the Moldovan Government, these are too recent to really make a difference for a Moldovan public used, through official propaganda, to lay the blame for Moldova's problems on Romania's patronizing attitudes, all the more so, since the Moldovan Government seems determined to use Romania as a scapegoat. At a moment when Romania is making efforts to obtain an invitation for joining NATO later this year, the imminent bankruptcy of the Moldovan state, which poses a threat to regional stability, could not have been timed worse.

## A failed state?

Many new states have emerged in Europe after 1989. It is, however, difficult to decide what is an acceptable time frame of reference for analyzing the success or failure of these new states. Either for reasons of political correctness, or out of caution, analysts, unlike journalists, have so far refrained to pass judgment on the sustainability of some of these new states. Moldova, however, was less spared: both journalists and analysts seem to have abandoned restraint in pointing at it as a failure of state-building.

There are two basic research questions, which are relevant for policymaking, the obvious first being *whether evidence supports the state failure hypothesis*. The second question is broader, and tries to identify *the reasons for such a failure*. Is it linked with a nation-building policy failure? To what extent is it determined by domestic factors, such as poor governance, and to what extent by external factors, such as Russian or Romanian interventionism? The answers to these questions may help propose a solution for Moldova, as it may turn out that pulling the curtain on the Moldovan state and declaring it a failed attempt doesn't solve anything, but instead creates further regional problems.

As Fig. 2 shows, Moldova's GDP per capita is the lowest amongst the countries surveyed. Not only is it lowest in absolute terms, but it has also had the slowest progress, as compared to the other countries. Georgia, a country which faces considerable constraints and has a comparable situation, in many respects, ~~with-to~~ Moldova, had a lower GDP per capita in 1994, but subsequently managed to overpass Moldova. Equally, alongside Belarus and Georgia, Moldova has received the least foreign direct investment in 2000. When compared to the successful Baltic States, its score of economic freedom is significantly lower, although they have other things in common, such as the high percentage of Russian-speaking minorities.

Fig.2. Performance of post-Communist countries compared

Country	GDP per capita – 2000	GDP 1994	FDI in 2000	% minorities	State type	Unemployment rate-average 1994-2000	Inflation average 1994-2000	Economic liberalization index – Freedom House	Economic liberalization index – Heritage
Romania	1596	1323	1000	9	unitary	9.48	73.31	4.71	3.30
Moldova	326	268	100	36.	unitary	1.67	67.64	4.00	3.20
Ukraine	640	727	594	27	unitary	2.37	203.61	4.58	3.60
Belarus	1104	472	90	22	unitary	2.58	511.81	6.25	4.10
Estonia	3409	1530	241	35	unitary	10.42	18.07	1.92	2.20
Lithuania	3045	1143	355	20	unitary	13.51	21.72	2.83	2.90
Latvia	3019	1442	399	44	unitary	15.02	13.82	2.50	2.65
Poland	4108	2399	9299	3	unitary	13.01	17.71	1.67	2.80
Bulgaria	1484	1152	957	14.	unitary	13.74	199.44	3.75	3.40
Georgia	555	232	101	30	unitary	8.81	2263.30	3.67	3.65
Russia	1697	1867	2000	19	federal	10.37	100.87	4.33	3.70
Macedonia	1685	1742	169	33	unitary	33.72	22.20	4.58	not available
Yugoslavia	1225	1392	50	37	federal	28.01	46.35	5.33	not available

Source: Freedom House Nations in Transit, 2001; Heritage Foundation. Items measured as: GDP per capita (US\$); FDI (US\$ million); Index of economic liberalization FH, scale from 1 to 10; Index Heritage of Economic Freedom, scale from 1 to 5; 1=maximum of freedom.

Based on the above data, we built a model to measure the correlation between economic performance (GDP per capita) and other variables (Fig. 3). The results suggest that a combination of structural (historical) factors, and of policies during the transition period, are correlated with economic performance. Amongst the ‘historical’ legacies, the development legacy (GDP per capita after the split from the Soviet Union) turns out to be a significant predictor for economic performance at the end of the last decade, whilst the percentage of minorities in the total population, which is another structural/historical factor, did not turn out to be a predictor. However, when minority problems resulted in civil war, this affected economic performance.

If we consider the index of economic liberalization as a proxy for economic policies during the transition period, we find, not surprisingly, that this index is a predictor for economic performance in 2000. In other words, Moldova suffered both from a heavy economic legacy at the beginning of its transition, as well as from inconsistent policies of successive governments thereafter. Furthermore, it also suffered from civil war, and from a *de facto* separation of the self-proclaimed Dniestr Republic, which was the most industrialized area of socialist times Moldova, and powerful enough to disconnect all Moldova from its main gas pipe throughout the war.

**Fig. 3. Determinants of economic performance in post-Communist societies**

Predictor	Association and Significance
Development legacy <sup>1</sup>	+ ***
Economic liberalization policy <sup>3</sup>	- **
% Minorities	N/S
War	+ *
R <sup>2</sup>	0.89

Source: Fig. 2 data; + signifies a positive correlation, - a negative correlation; \* predictor significant at \* p≤0.05, \*\* p≤0.01, \*\*\* p≤0.001 (\*\*\*=strongest association). Notes: 1- proxy used: 1994 GDP per capita; 2- according to Fig. 2; 3- proxy used: Freedom House index of economic liberalization; (\*\*\* p≤0.001, \*\* p≤0.01, \* p≤0.05). OLS regression model with GDP 2000 as proxy for economic performance. ‘War’ is a dummy variable (dichotomous) measuring if the country was involved in a war, civil or with another country over the last decade.

Therefore, **civil war in recent history, the development legacy and the lack of liberalization of Moldova’s economy are causes of its poor economic performance.** This also means that the only room for Government intervention is

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at the level of economic policies, and it is precisely in this field that the Communist administration continues to make mistakes, alienating both international donors and private investors.

It may be argued that we are not dealing with state failure even if the economic performance is poor and bankruptcy knocks at the door. Economic welfare matters, but it is not the only public good that a state must deliver to taxpayers, even if it takes a heavy toll on all the others. Let us examine Moldova's state performance taking into account other factors as well. A 'weak state' is usually defined from three perspectives, namely of the state as 'collector' (does tax collection succeed in feeding the spending budget?), of the state as 'deliverer' of public goods (do consumers experience satisfaction with the state's services such as health, education and personal security?), and finally of the state as 'captured' by private interests, such as those of 'predatory' elites.

The Moldovan state is an extremely poor collector. The revenues of the state budget come mostly from customs taxes. An alleged 500,000 people, that is to say roughly a third of Moldova's workforce, are currently working abroad, and although they may contribute to supporting their families back home, they do not pay any taxes. The Moldovan state also performs poorly in delivering security, law and order, starting with customs (58% of Moldovans declare to have bribed a customs officer over the past year<sup>3</sup>, 62% declare that they do not feel that their personal security is ensured by the state, 57% complain of economic security and 48% of health services). In terms of UNDP's Human Development Index, Moldova ranks at the bottom, at the same level with Tajikistan and slightly ahead of Mongolia. Wages in the public sector, which are on average around US\$20 net per month, are paid with considerable delays and seldom in the full amount. Categories that experience chronic payment delays are the police, the border guards, and civil servants in general. Salary arrears in the national economy amounted to US\$28 million in February 2002, according to Moldovan official statistics. Corruption plagues the administration and the judiciary, and anecdotal evidence claims that every felony has a price tag attached, so even convicted felons are able to buy their freedom. Efforts have been made constantly to address this situation, and with some effect, but still it is clear that people live from informal activities, and that they usually do not have any other choice for surviving. The large informal sector (estimated at 65% of GDP) is blamed on the lack of

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<sup>3</sup> According to the Barometrul de Opinie Publica 2001, Institutul de Politici Publice, [www.ipp.md](http://www.ipp.md)

resources of the state, but it also provides a backup for the poor and the unemployed, which the state is unable to provide. Equally, Moldova scores high in terms of corruption (6 as compared to 4 for Romania in the Freedom House rankings –scale ranges from 01 the least corrupt to 107 the most corrupt; ~~3.2 as compared to Romania's 2.8 in the Transparency International Index, which also grants a 2.3 to Russia and a 2.1 to Ukraine~~).

### The impact of foreign actors

It is undeniable that Moldova's situation was made worse by her being caught ~~among~~ between more powerful state actors, most notably Russia, but also Romania to some extent. Moldova was not the only post-Soviet state to have kept a Russian army on its territory, but the difference between Lithuania on the one hand and Moldova or Georgia on the other is that between an idle army and an army supporting secessionist regions, such as the Dniestr Republic or Ossetia. In what Romania is concerned, its impact has been more in the form of fear by Moldovans that they would be discriminated in a reunified Romania, which also made many of them more likely to be influenced by anti-Romanian propaganda, abundant in Chisinau over the last years. The 'pro-Moldovan' discourse as a separate identity from the Romanian, and the pro-Romanian discourse, have polarized the Moldovan society over the last decade. As shown in a previous Report<sup>4</sup>, there is a significant correlation, amongst the Moldovan public, between pro-Communist attitudes and anti-Romanian (and anti-Western) ones.

Possible explanations for the pro-Russian and pro-Communist attitudes are mostly historical. The more a region has a history of independence in its last hundred years, the less its inhabitants display nowadays a pro-Russian and pro-Communist attitude. There is a significant difference in attitudes towards Russia in regions such as Bukovine, Moldova or Galicia, as compared to regions of Eastern Ukraine or Dniestr, with no tradition of independence prior to 1989 (see Fig. 4). When replicating the same model for explaining voting preferences, historical experience turns out as a powerful predictor. Another factor, which contributes significantly to the vote for Communist and pro-Russian parties, is belonging to the Russian ethnic group or another minority group (as minorities in this part of the world use mostly Russian, not their vernacular languages).

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<sup>4</sup> Annual Early Warning Report for 2001, issued in March, 2002.

**Fig. 4. Determinants of regional pro-Communist/pro-Russian vote in Ukraine and Moldova, 1991-1999.**

Predictors	Association and Significance
Historical legacy	- ***
Catholic	N/S
Ethnic Ukrainian/Moldovan	- **
Urbanization rate	N/S
R <sup>2</sup>	0.68

Legend: + signifies a positive correlation, - a negative correlation; \* predictor significant at  $p < 0.1$ ; \*\* $p < 0.05$ ; \*\*\* $p < 0.001$  (\*\*\*=strongest association). N/S means that the variable did not turn out as a predictor. Source: Katchanovski 2001. Proxy for historical legacy: years of the region surveyed outside Russia or Soviet Union in the 20<sup>th</sup> Century

**Fig 5. Determinants of the index of pro-CommunistSoviet/pro-Russian attitudes in Moldova**

Predictor	Association and Significance
Historical experience	- ***
Ethnic Russian	+ ***
Other ethnic minority	+ ***
Occupation rank	- ***
Education	N/S
Born in a rural area	- *
Age	+ ***
Male	N/S
R <sup>2</sup>	0.21

Legend: + signifies a positive correlation, - a negative correlation; \* predictor significant at  $p < 0.1$ ; \*\* $p < 0.05$ ; \*\*\* $p < 0.001$  (\*\*\*=strongest association); N/S means that the variable did not turn out as a predictor. Source: 1998 Latin/Hough Survey apud Katchanovski 2001. Historical experience- dummy based on the regional experience outside Russia or the Soviet Union in the 20<sup>th</sup> century.

The past within dictatorial Russia or totalitarian Communist regimes is a heavy burden, which still and shapes still the political life of these post-Soviet societies in more than one way. These models show the past as the strongest determinant of current political attitudes. But However, one should also consider the extent to which the elites of these regions were simply annihilated by decades of Soviet repression. Intellectuals and better off peasants were deported in the Stalinist years and, despite asome formal rehabilitation later, few have ever returned from Siberia. The current elites are mostly sponsored and socialized by the Communist regime. Romania has offered some counter-socialization in the last decade

through a program of fellowships in Romanian high schools and universities, but this affects only the youngest, who are anyway more Western-oriented and less Communist. Moldovans work indiscriminately in Romania, Russia and Ukraine from neighboring countries, and they also apply for second citizenship in these three countries, with Romania allegedly leading the top. Double citizenship was formally forbidden in Moldova until recently, and even now its status is not cleared altogether. Romania's granting of Romanian citizenship to Moldovans born before the war when Moldova was part of Romania or their descendants was a constant source of irritation for Chisinau, despite formalities being lengthy and tedious and few Moldovans taking advantage of it<sup>4</sup>. Since December 14, 2001, Romania put on hold this policy altogether, frightened by an increase in the number of requests due to Romania's new visa-free status in the Schengen area.

In its relations with Moldova, Romania is increasingly constrained by its application to become a NATO and EU member ~~in the relations with Moldova~~. The current interest of the country is clearly ~~in the direction of~~ giving up the privileged relationship with Moldova, which has become an increasingly embarrassing more and more an embarrassing neighbor. In 2001 and 2002 alone, the Moldovan Communist leaders, ~~followed by the State Duma of Russia prompted by them~~, have blamed Romania ~~on for~~ the fight between two branches of the Orthodox Church<sup>5</sup>, for the emergence of a 'new wall' at the border between Romania and Moldova due to Schengen arrangements ~~at the border between Romania and Moldova~~, and for the opposition resistance that the Moldovan Government met when trying to reintroduce Russian as a compulsory object of study in ~~the~~ primary cycle of education. The long term support ~~of by~~ Romania ~~to help for~~ Moldova in developing some autonomy in the field of energy production was recently labeled as 'interventionism' by officials in Chisinau<sup>6</sup>, ~~despite former President's Lucinschi acknowledgment that Moldova's dependency on Russia for energy and its huge debt towards the latter is the most serious threat to the independence of the country and its viability as an independent state.~~

<sup>5</sup> See Yearly Annual Early Warning Report 2002, Regional Section 'When Special Care Creates Special Problems'. The attempt to forbid the Romanian Orthodox Church in Moldova to exist alongside the Russian one was supported by the Moldovan government through all the Moldovan Courts, but ~~they it~~ lost ~~theits~~ case in the European Court of Human Rights in Strasbourg last fall.

<sup>6</sup> This, despite former President's Lucinschi acknowledgment that Moldova's dependency on Russia for energy and its huge debt to Russia is the most serious threat to the independence of the country and to its viability as an independent state.

~~While/Whilst~~ Romania's attitude towards Moldova is likely to ~~change and~~ become more restrained in the foreseeable future, Russia's attitude is unlikely to stay the same/change. Despite repeated vows to pull out/retreat the XIV Army from Dniestr, the process was has been slow and ineffective so far. ~~There is also doubt that such a belated retreat can change anything in the power gamble over the Dniestr Republic, as the secessionist region has more soldiers than the rest of the Moldovan state.~~ The self-proclaimed Dniestr Republic is an embarrassment for both Moldova and Ukraine, ~~which is not exactly to the dislike of Russia.~~ However, ~~the~~ considerable money-laundering and arms trafficking which goes on in the Dniestr have also allowed various Russian oligarchs or criminal networks to do business during the last decade, and they still have some political clout to protect their fiefdom. ~~Despite the recent focus on making accountable the regions that may provide support for international terrorism, there is no one on the premises who could clean up the mess in the Dniestr Republic, and that feeds the mess in Moldova directly and through manipulating the Gagauz special status area. Russia is not pleased with Romania's application to NATO, as she is obviously not pleased with anything else than a dependent and subservient Moldova. The Romanian officials tried to break the ice this spring, but their attempts were in the end reduced to a less than successful visit by Prime Minister Adrian Nastase, who did not even get to see Mr. Putin (whom Moldova's President Vladimir Voronin, seems on the contrary to see with no difficulty), and a postponed visit of President Ion Iliescu. Not even the recent restraint showed by Romania towards the rallies in Chisinau is likely to appease Moscow's annoyance towards a possible NATO expansion to Romania.~~

The pitiful situation of Moldova is only partly of its own doing. The country was helpless during the Dniestr war, and its stalemate with the separatist Dniestr Republic, which ~~receives the endorsement~~has the support of important Russian politicians, has proved to be a major obstacle in consolidating a Moldovan state. ~~On Taking~~ the example of the Dniestr Republic, other minorities show no commitment to the independent Moldovan state, ~~despite the existence of a better alternative~~. The policy of Mircea Snegur policy of to appeasing minorities by ~~reducing/limiting ties the reunification of Moldova~~ with Romania to just cultural communion only has failed miserably. The attempt by Vladimir Voronin attempt to buy peace by returning to Soviet time language policies is also doomed to fail, since not only is it opposed by a majority in opinion polls and by a majority in opinion polls and by considerable crowds in the street, but it does not seem to be enough to gain the benevolence of Dniestr secessionist leaders. ~~Even moderate~~

~~opposition leaders no longer believe the Communists of Moldova have the potential to become enlightened Communists.~~

The international organizations, which assisted Moldova, ~~as well as~~ the international community, ~~should~~ also bear some responsibility in this failure. Totally dependent on Moscow for its energy, with its industry captive in the mafia-dominated Dniestr, could Moldova recover only by privatizing its wine and tobacco industry and pursuing its macroeconomic reforms? Moldova had its ups and downs with the reforms, but that was ~~at least partly~~ also because reforms did not produce expected results ~~in rapidly~~ enough ~~time to~~ ~~buying popular support to~~ reformist Governments ~~some popular support~~. The ~~lack of little~~ attention ~~that~~ Moldova received from the international community, and the double standards applied to the Baltics' policies towards Russian minorities ~~as~~ compared to Moldova's policies, are also to blame for the current ~~deterioration~~ situation. The 'original' state model ~~adopted by~~ Moldova ~~adepted~~, with two special status regions, make it different from successful states in the post-Soviet area, which adopted a unitary state regardless ~~of~~ the percentage of minorities. The failure of the Moldovan ~~state~~ experiment is not of Moldova ~~only alone~~, but also ~~and perhaps primarily~~ of the advocates of this experiment. ~~The Western endorsement of the experiment hid~~ ~~poorly the decision to contain the Dniestr conflict, not solve it,~~ ~~the lack of political will to reinstate the rule of law in Moldova and the open desire not to antagonize Russia.~~ In the case of Baltic States, Europe has ~~played its cards~~ ~~manifested with~~ more interest and sympathy towards the newly created states, and the difference is visible in the results.

~~Notwithstanding the above,~~ ~~it is,~~ however, in everybody's interest that Moldova succeeds in its attempt to create a ~~viable~~ state. ~~Its prospects of reunification with Romania at this time are blurred and the move would destabilize the Romanian economy, which is only at the beginning of its first breakthrough. At present,~~ Moldova has no ~~other~~ options ~~besides i than~~ independence ~~at this point~~, but with ~~aits~~ bankrupt state and separatist minorities, the prospects are poor.

## Recommendations

- Romanian Government.

The choices of the Romanian Government are severely limited. The Government can do little than continue to lobby internationally to support democratic forces of Moldova, and refrain from any public statement which may further be used by Communists in Moldova ~~as proof of to blame~~ 'Romanian imperialism'. The Romanian Government should also persuade the pro-Romanian forces in Moldova to tune down their ~~appeals for~~ reunification ~~message~~, while ~~ste~~ supporting the consolidation of civil society in Moldova through partnerships between NGOs and cultural associations of the two countries. Any other preferential aid for Moldova should be ~~discontinued~~ ~~dropped~~.

- Moldovan anti-Communist forces

The vocal pro-unification message has proved unsuccessful ~~over~~ in the last decade with ~~the a~~ majority of Moldovans. Moldovans may speak Romanian, but they have crafted for themselves a sort of separate identity nevertheless. Even if Stalinist policies contributed to this, today the only option ~~available~~ is ~~seek~~ to broaden ~~the~~ public support ~~basis~~ for democratic parties and ~~ensure that~~ ~~advance democracy and reforms in~~ Moldova ~~is a democratic country~~. Its ~~id~~ identity is the business of ~~its~~ citizens, and both pro-Romanian and anti-Romanian symbolic policies should be relegated to the background, leaving ~~to~~ each Moldovan the choice of language. ~~Such a goal~~ ~~This would~~ means keeping the pro-Romanian discourse only at the level of cultural identity and abandoning its political implications. ~~At~~ ~~Under present circumstances, having this point having~~ as ~~program~~ the reunification with Romania ~~only~~ means having no program at all. Democratic forces need to join under a common banner, and this should appeal to a majority. It should, therefore, be pragmatic and economically oriented. ~~The 'Belarus' model, positively invoked by many Moldovan inhabitants needs to be fought on the economic, not symbolic field.~~

- International donor community, EU

It is not too early to acknowledge that the Moldovan experiment in its current form has failed. Moldova urgently needs a recovery package, it needs a voice to negotiate on its behalf with Russia, and it needs the acknowledgement that state building policies are thean absolute priority. ~~#Moldova~~ also needs a mediator to uniteget all democratic forces together and empower them to build the state from scratch. Neither of these things can be provided by anyone else than the international community, as the intervention of ~~both~~ Russia andor Romania in a mediator capacity is not credible for either one of the parts in Moldova. In particular, ~~the~~ current crisis in itselfChisinau needs mediation ~~as only early elections and a caretaker Government can solve the current deadlock. The alternative for after elections needs considerable coaching, however. In brief, as~~ Moldova heads towards bankruptcy and more social unrest, it badly needs a full recovery plan, ~~as it heads towards bankruptcy and more social unrest~~ and not the kind of formal human rights monitoring applicable to a consolidated state. the formal monitoring of human rights like it would be a consolidated state. A weak state cannot ensure anybody's rights. Moldova is not a state yet, and without the full commitment and support offrom the international community, it may yet implode, ~~on NATO's Eastern flank and Europe's Eastern border,~~ destabilizing Romania and Ukraine the entire sub-region in the process.

ANNEX: Tables in the section one

**Annex 1. Determinants of economic performance in post-Communist societies**

Predictor	Regression coefficients (Standard Error)
Development legacy <sup>1</sup>	0.968 (0.211)***
Economic liberalization policy <sup>3</sup>	-338(102)**
% Minorities	N/S
War	984 (272)*
R <sup>2</sup>	0.89
N	13

Source: Fig. 2 data. Notes: 1- proxy used: 1994 GDP per capita; 2- according to Fig. 2; 3- proxy used: Freedom House index of economic liberalization; (\*\*\*)  $p \leq 0.001$ , \*\*  $p \leq 0.01$ , \*  $p \leq 0.05$ ). OLS regression model with GDP 2000 as proxy for economic performance. 'War' is a dummy variable (dichotomous) measuring if the country was involved in a war, civil or with another country over the last decade.

**Annex 2. Determinants of regional pro-Communist/pro-Russian vote in Ukraine and Moldova, 1991-1999.**

Predictors	Regression coefficients (Standard Error)
Historical experience	-0.264 (0.071) ***
Catholic	-0.014 (0.176)
Ethnic Ukrainian/Moldovan	-0.430 (0.147) **
Urbanization rate	-0.194 (0.182)
Constant	98.209 (20.125) ***
R <sup>2</sup>	0.68

Legend: + signifies a positive correlation, - a negative correlation; \* predictor significant at  $p < 0.1$ ; \*\*  $p < 0.05$ ; \*\*\*  $p < 0.001$  (\*\*\*=strongest association); Source: Katchanovski 2001. Proxy for historical legacy: years of the region surveyed outside Russia or Soviet Union in the 20th Century

**Annex 3. Determinants of the index of pro-Soviet/Communist/pro-Russian attitudes in Moldova**

<b>Predictor</b>	<b>Regression coefficients (Standard Error)</b>
Historical experience	- 0.13 (0.001)***
Ethnic Russian	0.554 (0.063)***
Other ethnic minority	0.494 (0.052)***
Occupation rank	-0.045 (0.013)***
Education	0.013 (0.017)
Born in a rural area	-0.112 (0.048)*
Age	0.008 (0.002)***
Male	-0.085 (0.145)
Constant	2.059 (0.195)***
R <sup>2</sup>	0.21

*Legend: + signifies a positive correlation, - a negative correlation; \* predictor significant at  $p < 0.1$ ; \*\*  $p < 0.05$ ; \*\*\*  $p < 0.001$  (\*\*=strongest association) Source: 1998 Latin/Hough Survey apud Katchanovski 2001. Historical experience- dummy based on the regional experience outside Russia or the Soviet Union in the 20th century.*

# POLITICS

## TREND: WINTER TAKES ITS TOLL.

### Romania May Be Doing Better, but Romanians Feel It's Going Worse

Compared to our previous poll of January, there ~~was~~ a clear downturn in the public opinion. A significant ~~rate-proportion~~ of Romanians are unhappy with their lives, the number of those who believe ~~that~~ the country is heading in the wrong direction has increased, and the number of those who ~~doubt-are confident that~~ the Government has the ability to handle things has decreased significantly. ~~A large minority still, but a minority only (38%) considers the Government can cope with the social and economic problems of the country, while the majority considers it unable to do so (48%).~~ The ~~energy bill~~ hardships of this winter and the ~~recent~~ corruption scandals ~~which plagued the first term~~ have ~~obviously~~ taken their toll ~~on public mood.~~

Fig. 1. Country heading in the good direction

	%
Agree	31.9
Disagree	57.3 (up from 50.9 Jan 2002)
No answer	10.9
Total	100.0

## EARLY WARNING REPORT

**Fig. 2. Satisfaction with one's life**

	%
Not satisfied at all	26.0
Not satisfied	52.4
Quite satisfied	20.5
Little satisfied	0.8
Total	100.0

**Fig. 3. Better off than last year**

	%
Much better	0.4
Better	11.6
Same	40.5
Worse	37.2
Much worse	10.1
Total	100.0

**Fig. 4. The Government can improve things**

	%
Agree	38.1 (down from 45.1 in Jan 2002)
Disagree	47.7
No answer	14.2
Total	100.0

The depressive mood of Romanians also shows in their negative expectations **concerningfor** the future. Most people are **skc**eptical, do not expect things to improve considerably in **the near futurea year**, and **a majority does not expect Romania to be invited to join NATO, despite being supporters of her joining.**

Fig. 5. Expectations of life improvement ~~one year from now~~~~year on~~

	%
Much better	1.7
Better	21.8
Same	32.5
Worse	22.8
Much worse	8.3
No answer	12.9
Total	100.0

Fig. 6. Romania will be invited to join NATO this year

	%
Optimists	34.2
Pessimists	42.0
Do not know	23.8
Total	100.0

This discontent ~~is has~~ not yet turned into political capital ~~for opposition parties~~, be it negative or positive. Party preference has stayed largely the same since our last polling, with a dominant party (PSD), slightly below the absolute majority (47%). The Democratic Party has ~~slightly~~ narrowed ~~a bit~~ the distance separating it from Greater Romania Party (PRM), but the three important opposition parties together do not reach PSD's score. ~~Within the~~ ~~As regards possible future~~ presidential ~~race~~ candidates, Adrian Nastase seems to have consolidated ~~at least partly~~ the transfer from Ion Iliescu's voters. The support of the current President for any of the candidates is likely to play an important role in the 2004 electoral ~~campaign~~ for presidential elections. However, the percent~~age~~ of undecided is strikingly high, and significantly more people are confused concerning presidential elections (50%) than concerning legislative elections (42%).

## EARLY WARNING REPORT

**Fig. 7. Party preferences**

	%
PD	12.4
PSD (PDSR or PSD)	47.5
PNL (and ApR)	10.5
PNTCD	1.5
PRM	14.9
PUR	2.5
UDMR	7.0
UFD	1.9
Other party	1.9
Undecided	42.5
<b>Total</b>	<b>100.0</b>

The profile of NATO-optimists is ~~worth noting~~ rather vague. Pessimism seems to draw equally on urban and rural residents. We found no significant regional differences, although in our sample people from Bucharest were the most optimistic and those from Transylvania the most pessimistic. The more optimistic are likely to be ~~the oldest~~ and ~~the least~~ educated, ~~as well as~~ those in favor of Romania joining NATO ~~tend to be more optimistic.~~

**Fig. 8. President preference**

	%
Adrian Nastase	42.7
C.V. Tudor	16.9
Valeriu Stoica	0.7
Petre Roman	1.6
Theodor Stolojan	7.5
Traian Basescu	16.5
Emil Constantinescu	2.1
Mugur Isarescu	1.6
Ion Iliescu	0.2
Mircea Geoana	3.2
Other	6.9
Undecided	50.0
<b>Total</b>	<b>100.0</b>

Fig. 9. Explanatory model of NATO-optimism

Predictor	Association and significance
Favors NATO integration	+ ***
Income	N/S
Low education	+ *
Aged	+ *
Town size	N/S
R <sup>2</sup>	0.11

Legend: + signifies a positive correlation, - a negative correlation; \* predictor significant at  $p < 0.1$ ; \*\* $p < 0.05$ ; \*\*\* $p < 0.001$  (\*\*\*=strongest association); N/S means that the variable did not turn out to be a predictor

Whilste Romania has recorded some progress in its race to join NATO, although European integration is stalling as usual, Romanians seem not to have noticed themit. By and large they are as pessimistic as they were a year ago, and significantly more scepticalal towards the direction that the country is heading to, and the Government's ability to lead it.

# ECONOMY

## FOCUS: THE TALKS WITH THE IMF: SOME FOOD FOR THOUGHT

*Daniel Daianu*

The economy has continued its recovery and disinflation makes progress, as the data for the first quarter of this year show. But, ~~not—not~~ unlike ~~its predecessors~~previous agreements, the current ~~s~~Stand-by ~~a~~Agreement with the IMF has met a series of obstacles in its implementation. Consequently, the release of the second ~~financial~~-tranche has been delayed and a supplementary letter of intent is in the offing. The main contending issues have been aired publicly and this invites examination, albeit one should be aware of the dangers posed by insufficient technical information in this respect.

### Tax collection

Recently, Prime Minister Adrian Nastase announced an over~~a~~haul of fiscal policy. The reason is easy to detect: tax collection ~~seem~~continues to be the Achille's heel of the current agreement and of the ~~-~~ budget policy. Since tax collection has not improved in 2001, a “sequestration” of capital expenditure was enforced late in the year, in order to meet the budget deficit target. There are several worry~~y~~ingsome aspects in this regard. First and foremost is the very dynamic of tax collection, which determines the size of fiscal revenues. Quite unusually, at a time of swift

economic recovery (GDP went up by ~~cca-~~approximately 5.3% in 2001, see graph 1), fiscal revenues have gone down as a share of GDP (table 2). There is a need to ~~figure out~~understand the root causes of this situation and how to effectively tackle it ~~in a most effective way~~—not simply by attempted quick-fixes, which can hardly work adequately over the longer run.

An explanation for the worsening tax collection can be linked ~~with~~to the ~~evolution~~increase of overall arrears in 2001, which, apparently, have gone beyond 40% of GDP (graph 1). Another cause can be associated with fiscal facilities granted to SMEs and to state-owned companies, some of which were privatized last year. But, in the latter case, one would have to calculate the offsetting positive influence of privatization revenues, which, presumably, entered the public purse. There is also the practice of tax deferral or cancellation for many state owned and, even, private companies, which is a feature of lax financial discipline. The bottom line is that the State has had a worse tax collection last year, and this bodes badly. Moreover, this situation has prompted the Government to seek additional ways to raise tax revenues in order to keep close to the budget deficit target of 3%; consequently, action is under way in order to increase excises for gasoline, alcohol, and tobacco, and remove the VAT exemption for house construction. One can debate the merits of such plans — for instance, the adverse effects (~~increas~~ing tax evasion) of raising tobacco excises— —, but the focus should rather be on the bigger question: namely why has tax collection been worse, and how can it be improved? ~~For instance, imagine how much intake the 19% VAT could bring in against the backdrop of a GDP of almost 40 Billion USD, even if the share of household economy (personal consumption) is deducted. Thence, there is need to mount an effort to improve tax collection, as an optimal means for running a better budget policy.~~

Another worryisomeng feature has been the clamp down on capital expenditure, at a time of deep concerns about a precarious infrastructure and when private capital (whether domestic or foreign) does not seem to be capable (to a certain extent, it will never be!), or interested, to provide a substitute. If things do not improve in this regard, the long terms effects will show up with a vengeance. Admittedly, a piece of good news is that both the domestic and the foreign investment ratios are on the rise, albeit, quite slowly; and EU assistance can help in this respect as well.

The Government has solid reasons to embark on both an overrahaul of tax policy and better tax collection. Actually, the latter could help reduce social security

contributions, which are a ~~big-significant~~ drag on enterprises (the ratio of social security contributions is the highest among ~~st the~~ EU candidate countries – ~~that is to say about~~ 57%). ~~However, But~~ tax policy overhaul is not an easy task and can be ~~pretty~~ disappointing ~~unless it is if not properly~~ implemented ~~properly~~. There are examples in emerging countries where this kind of reform was not rewarding, ~~and this which should constitute a should warn~~ warning to the Government in this respect.

### The budget deficit

The Government has announced ~~the its~~ intention to revise the budget deficit upwards, which, clearly, would not please the IMF. In this ~~regard context, it should be highlighted I would say~~ that a 3% ~~budget deficit and accompanied by~~ a higher quasi-fiscal deficit, may be worse – ~~on the whole overall – –~~ than ~~a~~ 3.2% budget deficit ~~and with a less~~ a decline in the ~~quasi-fiscal deficit. By saying Having said this, this I am we not do not~~ ~~arguing in favor of for~~ changing ~~the this year's~~ budget deficit target ~~for this year; instead rather, I am we are~~ cautioning against unproductive rigidity on both sides ~~of at the discussion negotiation table~~.

### Arrears and inflation

There seems to be an underlying relationship between arrears and inflation. ~~Arguably, High~~ inflation has become chronic in Romania and this is due to the congenital inability of major loss-making companies to pay their taxes, ~~and to moral hazard, that is to say~~ the benefits, which even profit-making companies have by not paying their dues (debtors always gain when high inflation erodes their debts). ~~Equally, T~~ there are ~~also~~ powerful inflationary expectations at work, and wage indexation, ~~too, also~~ plays a role in this respect. The fact is that inflation has become a *sui generis* means for the economy to keep ~~ing~~ arrears stable, more or less, in real terms; otherwise, the economy would suffocate, ~~as for~~ companies would be increasingly unable to pay wages and procure basic inputs ~~owing to increasingly because of cash scarce cash availability~~. It is like saying that the economy is addicted to high inflation.

How can this perverse linkage be cut off, so that disinflation be successful? This is a major policy question for both the Government and the National Bank to respond to. What occurred in 2001, namely, the ~~rise in increase of~~ arrears – against the backdrop of a ~~decline of lower~~ inflation (graph 1) – ~~is worrisome!~~ ~~#~~

~~may be that lower inflation has started to bite exceedingly, and the outcome is a rise in arrears.~~ These rise/increase of arrears can backfire and undermine disinflation, and this is why more financial discipline is a must. In 2002, disinflation has continued, with monthly rates of 2.3% in January and 1.2% in February. ~~This a piece of which is~~ good news. But this positive evolution/trend needs to be accompanied by good results in containing arrears. The Government needs to be more resolute in dealing with the worst tax-offenders. By doing ~~#this~~, it would shoot at two targets: ~~the improvement of taxing~~ collection, (which would help the budget);<sup>7</sup> and making disinflation sustainable.

### Public utilities: finance, price policy, privatization

The issue of tax collection/arrears is closely linked ~~with~~to the financial health of major public utilities; their inability to ~~make good on their financial claims~~collect on their bills (Termoelectrica is the most notorious case) is of longer vintage and ~~reflects~~is due to several factors, such as the ~~relative~~ price of energy, highly obsolete technologies in use, the impoverishment ~~off a growing part of~~ the population, and, not least, the lack of financial discipline. ~~An rise/increase~~ in the ~~relative~~ price of electricity and heating is ~~not unsubstantiated~~ economically justified, bearing in mind ~~given~~ the procurement costs of raw energy ~~from abroad~~imports. There is, however, a critical issue here, ~~which is linked with~~namely the inability of ~~not a few~~many citizens to pay their electricity and heating bills, specially during the winter ~~season~~term and not only. As ~~the author has~~ argued elsewhere<sup>7</sup>, the steady rise of the price for heating and electricity should have been preceded by a mechanism for distributing the ~~new~~ financial burden over a longer period of time – as a device for alleviating the pain for poor households. It is good news ~~to see~~ that the Government envisages a mechanism along this line. Substantial energy savings can also be achieved by both households and industry, ~~by~~through proper measurement of consumption. The longer term solution, ~~however~~, involves heavy investment in energy infrastructure, which ~~demand~~requires capital inflows ~~as well~~ and, in this context, privatization.

As a matter of fact, the IMF mentioned privatization as having been too slow in 2001. But privatization is not enough; proper structures of corporate governance

<sup>7</sup> See “Energy Policy Issues”, *Romania Libera*, February 1<sup>st</sup>, 2002, and *Economistul*

matter tremendously, and ~~that~~ competition policy and adequate regulations are essential in achieving good economic performance, as experience in other countries has shown. ~~And since the focus here is on the energy sector it does make sense to remind all sides involved (including the aid agencies) the experience worldwide, which shows that privatisation in the energy sector needs to be buttressed by well balanced contracts. Such contracts should reward the investors, but, also, protect the local economy.~~ As the current financial plight of Argentina indicates, “sweetheart deals in questionable privatizations”<sup>8</sup> have allowed to charge extremely high rates. Arguably, the very high price of services has contributed significantly to the ~~declining~~ loss of competitiveness, together with the overvaluation of the local currency. In Hungary, ~~too as well~~, there are examples of a highly ~~inflamed problematic~~ relationship between foreign investors (owners) and the Government when it comes to the price of public utilities’ ~~services. At the same time, the pitfalls of deregulation in the energy markets—look at what happened in California—should also be a harbinger of the way to go with privatization in this field.~~

The Romanian Government needs to foster privatization, for this is a means to bring in badly needed capital and impose hard budget constraints. Nonetheless, privatization should be accompanied by a good (and effectively implemented) regulatory framework, which can deal with monopoly behavior, secure fair prices for consumers, and avoid external over-indebtedness. The ~~European Union (through the Phare Program), the World Bank, the EBRD and the EIB~~ international organizations should assist the Romanian Government in ~~order to~~ formulating and carrying out a proper strategy in this field. Quick-fixes do not last, and do not help solve the problem fundamentally.

### External equilibrium and controlling domestic credit

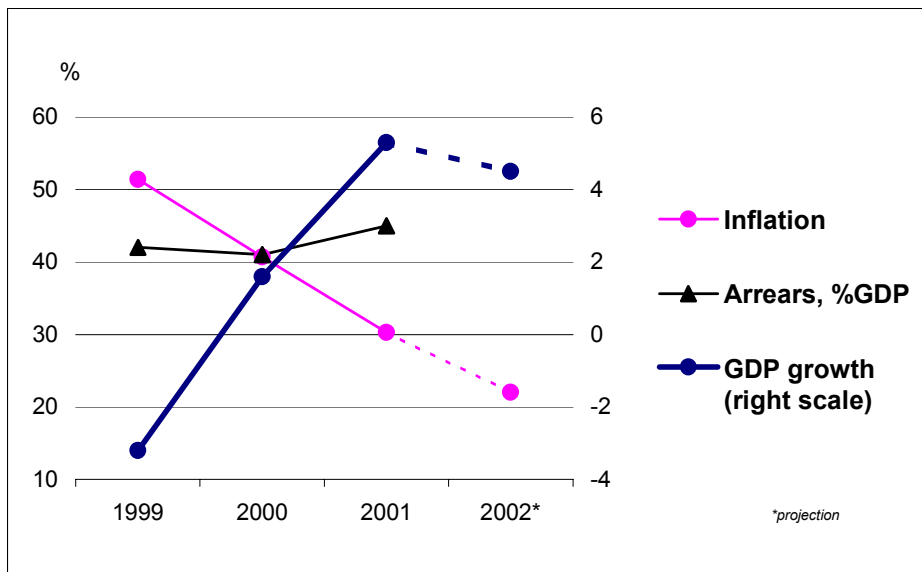
Economic recovery in 2001 has also been helped ~~also~~ by the ease with which Romania has managed to finance~~d~~ its current account deficit; this ~~ease~~ has ~~allowed~~ helped replenish~~ing~~ the foreign exchange reserves of the NBR at more than 3.5 billion USD by the end of the year. But there ~~could~~ may also be, ~~among others~~, a downside effect to this financing, which is related with the real appreciation of the local currency at a time when the interest rate differential is

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<sup>8</sup> As Financial Times put it, 15 February, 2002 (p.2)

~~quite~~ attractive to foreign investors. Not surprisingly, the foreign currency denominated loans extended by local banks have ~~increased~~~~gone up~~ (in relative terms), which illustrates, ~~quite likely, in all likelihood,~~ capital inflows attracted by the combination of real appreciation of the ~~Leu-ROL~~ and the ~~attractive~~ interest rate differential. Unless the Romanian economy ~~can~~ maintains its steady growth and the current account deficit is kept under control, two dangers are looming. One is linked ~~to~~with a possible overexposure of banks to companies, which are not well hedged against the exchange rate risk. Secondly, shocks which may hit the Romanian economy ~~may~~ could trigger a sudden reversal of capital flows, which may cause pressure on the fore~~ign~~ exchange markets and a real depreciation of the ~~ROL~~Leu. This would be bad for disinflation and macroeconomic stabilization, in general. ~~In this context, it seems that~~ the NBR would ~~debe~~ well ~~advised~~ to impose higher reserve requirements on foreign currency denominated domestic credit; and it may ~~also~~ be ~~also~~ good to impose ceilings on banks' short-term borrowings from abroad.

Fig. 1. GDP, Inflation, Arrears evolution :1999-2002



## EARLY WARNING REPORT

**Fig. 2. Consolidated budget revenues and expenditure (% of GDP)**

	<b>2000</b>	<b>2001</b>	<b>2002 (forecast )</b>
Revenues	31.5	32.7	31.8
Fiscal	29.5	30.5	30.0
Non-fiscal	1.9	2.1	1.8
Ex penditure	35.5	36.2	34.8

## FOCUS: PRIVATIZATION. SPEEDING UP WITH LIMITED FUEL

*Liviu Voinea*

The Government recently ~~undertook~~assumed responsibility in Parliament for a “Law regarding certain measures for speeding up privatization” (Law 137/2002). While giving credit to the Government ~~credit~~ for enhancing its privatization efforts, the comment below highlights law~~certain~~ provisions of the law that may ~~generate~~incur moral hazard, and ~~are advisable to~~which should be redressed by means of an emergency ordinance, rather than by methodological norms.

This is not the first time when a law on speeding up privatization is enacted. As early as ~~in~~ August 1994, the “Law on speeding up the privatization process” led to adverse effects: less privatization deals were concluded between September and December of that year, than in July 1994 alone.

Moreover, this is not the first time when the idea of a symbolic price appears. Privatization ‘for 1 DEM’ was experimented in the re-unified Germany, until the head of their privatization authority was shot dead; privatization ‘for 1 FFR’ was also tried in France, but it didn’t last long, as the defense industry producer Thompson was re-nationalized from Daewoo. In 1997, the then Romanian Government tried to sell the ‘1 USD\$ privatization’ idea to the public, but strong opposition ~~emerged~~appeared at that time from its nowadays promoters.

One should also remark that a law on speeding up privatization indirectly sends the message that privatization was ~~asent~~ too slowly ~~induring~~ the previous period. As we mentioned in the Annual EWR 2001, only 121 privatization deals were ~~records~~signed last year; budget revenues from privatization only reached 0.7% of GDP (as compared to 1.8% in 1998), and they were forecasted at 0.2% of GDP in 2002.

This new law should be praised, for introducing a specific administration procedure to prevent asset depletion during privatization, and for the willingness to

## EARLY WARNING REPORT

trade short-term revenues for medium and long term benefits. However, although this road is paved with good intentions, moral hazard may also appear, as a number of issues are, ~~in my opinion,~~ subject to interpretation.

- According to the law (art 5.1), the public institution involved (the administrator of the state assets undergoing privatization) is the only authority competent to decide on the opportunity of concluding the privatization deal. The law stipulates that neither judicial Courts, nor arbitrage institutions can rule on the opportunity of the transaction; they can only rule on its legality. The basis for the opportunity decision (in terms of price, jobs, capital ~~—in privatization deals one cannot speak about job creation, but, at the best, about job preservation~~) lays, however, in methodological norms that are still in the making. Opportunity is not defined, opportunity cost is not considered as a benchmark, and thus the decision-maker is exonerated offrom responsibility. If opportunity is not defined, how can we know what “legality” remains to cover?
- The law (art 5.3) prevents the participation in the privatization process of persons and firms who had already entered a privatization contract and a final and irrevocable Court decision ruled that they did not fulfill it. This, however, does not limit the access of persons and firms who are known to have failed fulfilling their contractual obligations, but a final and irrevocable court decision hasn't yet been reached (there are currently 3,885 cases on trial, in which APAPS took investors to Court).
- During the special administration procedures (art 16.5.b), state creditors will temporarily exonerate from debts all assets to be privatized, and they will recover the money later on, from privatization revenues. What if the companies temporarily ~~debt~~-exonerated from debt companies are sold for 1 EURO (or in the vicinity of this sum)?
- The law (art 18) offersprovides the legal framework for total or partial tax holidays, forgiveness, roll-overs, etc., all with the purpose of making a company more attractive; no mention is made, however, with regard to implementation criteria, and the case-by-case decision is left in the hands of the public institution involved. Tax arrears are written off for selected companies. This is unfair to the other companies, and it also increases the fiscal deficit. Moreover, such a measure runs the risk of being considered state aid under EU competition legislation.

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- The law (art 12) requires companies to ~~raise~~increase their social capital with the value of the land that they own, in case this hasn't already been done. If this occurs after privatization, the added social capital is transferred into shares that become the property of the public institution involved. ~~Thus, the~~ new owner may be put in the ridiculous situation, in which he will have bought 100% of a company, and ~~then he would subsequently still~~ have to buy ~~some more~~additional shares in order to secure control over the company purchased. ~~If the new owner refuses to purchase these shares separately, he may even end up in a minority position, depending on the value of the land.~~

### Recommendations

~~Having in mind the above mentioned remarks~~In the above context, we believe the Government ~~must want to~~should reconsider some aspects of the law:

- define what "opportunity" means (it would be advisable to offer a formula for calculating the opportunity cost).
- clearly stipulate that, in case of 1 ~~Euro~~URO deals, assets can not be separately resold in a certain number of years after privatization, and the company can not be closed down ~~in~~during a certain period after privatization – subject to severe penalties; one idea could be to create a guarantee (equal to the assets' value, or to the amount of non-rescheduled debts), deposited in an account with a Romanian bank.
- do not permit ~~state~~ocial capital increases ~~by~~through land evaluation after privatization; ~~oper~~ate ~~these~~such increases, if necessary, prior to privatization, and stipulate them to investors in an early stage.
- clearly fix a set of selection criteria (based on points scale) applicable to all deals, and include among~~st~~st them the performance of businesses already run in Romania by the potential investors (if applicable).
- limit, to only very specific cases, subject to Government decisions based on a clear set of criteria, the total/partial writing off of tax arrears. After all,

the basic idea of the 1\_EURouro privatization is that the investor assumes existing debts, in exchange efor a symbolic acquisition price.

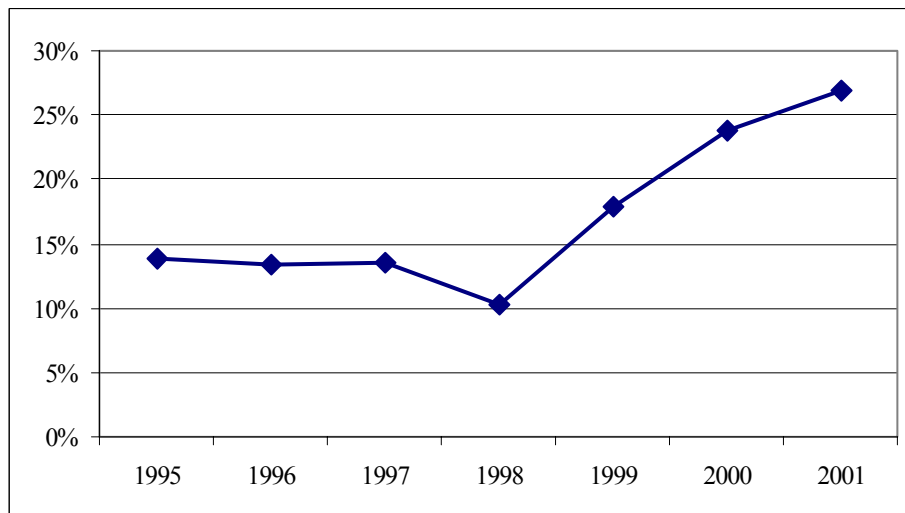
- ~~sinceas~~ these ~~above~~ issues ~~arerepresent~~ more than ~~just~~ procedural clarifications, they should not be addressed in the form of methodological norms, but in a separate emergency ordinance.

## WARNING: CARE NEEDED IN RESHAPING THE FINANCIAL SECTOR

The rules of the game are rapidly changing in the banking system, ~~andas well as~~ on the capital market. Recent regulations adopted, or ~~being~~ currently considered by the National Bank, ~~respectively and~~ the National Securities Commission, aim at reducing ~~various~~ risks and vulnerabilities. ~~This article examines~~ ~~We discuss here~~ what these changes are, where they could lead ~~us~~, and how they fit ~~with~~ the ~~existing naturecurrent~~ system of supervision and competition ~~in~~ the Romanian banking and financial sector.

Over the last years, the banking system has shown signs of recovery, as it became more prudent, if not more consolidated. Foreign private capital holds 58% of total assets, solvency ratio (figure 1) ~~has strongly~~ significantly increased, and 95.1% of total credits (by the end of 2001) were classified as standard.

Figure 1. Solvency ratio in the Romanian banking sector



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Source: NBR

Such an image should, however, not deceive us. Improved overall credit performance is linked to the scarcity of credit (line 5 in table 1) and, when credit is granted, to the wide-spread practice of rolling it over (old credit is paid with new credit).

Furthermore, recent banking scandals (such as BRS, BID, Unirea) still keep newspapers' front pages, and leaving the impression that, while performing better, the system remains neither adequate for financial stability (line 3 in table 1), nor properly supervised.

It is fair to say that the capacity of the National Bank to supervise the functioning of the banking system has been affected by a number of factors, for example:

- the incomplete legal basis for action;
- the National Bank's shyness to exercise its functions, given the changing local environment and various political pressures;
- the existence of a hard-to-control area of financial operations, which is a common fact in foreign environments other countries as well.

The legal basis for action issue is being addressed by current initiatives of the National Bank<sup>9</sup>, on three directions: introducing the "know your customer" rule; raising social capital requirements to approximately 8 million- EUROuro; strengthening the conditions that must be fulfilled by banks' top management personnel. These measures try to protect the banking system through increasing entry barriers (the entry conditions are currently is too easzy right now permissive – see line 1 in table 1).

Following the same risk-averse approach Additionally, the National Bank faces double is under foreign external pressure, from the Basel Committee of the Banks of International Settlements, and from the IMF, to harden the provisions requirement constraints associated with commercial banks' credit operations. An obvious warning to issue in this context, is that A powerful warning that we hereby

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<sup>9</sup> To eliminate a confusion, in a matter indirectly related to the core of our discussion, we-it should be mention ed that NBR does not intend to replace the Sibiu Exchange with its own market for derivative instruments.

~~issue is that~~ this will further restrict access to loans, by making banks even more reluctant to ~~extend~~provide credits, and will undoubtedly increase the cost of ~~making~~doing business in Romania.

Table 1. Indicators ~~assessing~~on the ~~state~~situation of the Romanian banking and financial system in the global context

	Indicator for Romania	Global <del>mean</del> <u>value</u> <del>average</del>	Romania's ranking
	(values from 1-lowest to 7-highest)		(positions from 1-best performing to 75-worst performing)
1. Entry into banking industry	5.8	4.5	5
2. Foreign access to local capital markets	6.8	6.2	7
3. Financial regulation and supervision	2.9	4.7	70
4. Financial market sophistication	2.3	4.2	71
5. Ease of access to loans	1.5	3.2	75

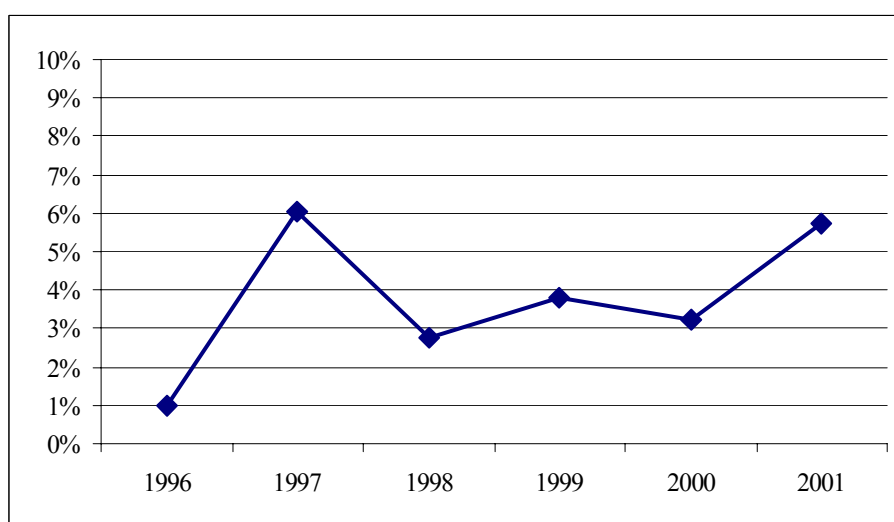
Source: Global Competitiveness Report 2001-2002, World Economic Forum, Geneva, 2002

~~The second set of problems faced by the PCM Government is economical. While this is undeniably rooted in the legacy of previous Governments, the PCM program made its best to turn it worse. Last year Moldova joined the Russia-Belarus union and applied to join a newly created common market (CEEA), made precisely of those post-Soviet states which failed in the attempt to reform their economies and remained close to Russia. It also moved to create a department for price control, stalled privatization, increased wages in the public sector and announced its intention to create worker-owned 'people's enterprises'. The IMF assistance was put on hold due to this type of policies and the amount of external debt the Government has to pay this year amounts to 75% of its total yearly revenues. Following three years of practical technical insolvency, when money to repay loans was found, as a rule, in the last moment, Moldova is heading towards bankruptcy. Its total foreign debt of 1.9 billion dollars amounts to 154% of GDP, a few times higher than the average 35% of developing countries.~~

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Figure 2. Market capitalization, BSE + Rasdaq, % GDP



Source: authors' calculation, based on NBR data

### Sorting out the capital market problems

The wind of change is blowing on the capital market as well. Although aggregated market capitalization (Bucharest Stock Exchange plus Rasdaq) increased in 2001 (fig. 2), it remains way below the average ~~level for of~~ Central and East European economies (which is of around 18% of GDP). Top five listed companies account for two thirds of market capitalization, the shares of about one half of Rasdaq listed companies were never traded during one entire year, and more than 60% of

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BSE listed companies are owned by portfolio investors, who are therefore put in the inappropriate situation to act as direct investors<sup>10</sup>.

The problems of illiquidity, concentration, transparency and corporate governance have been addressed ~~in~~through new regulations put forward by the National Securities Commission, with respect to ~~undertakings for~~ collective investment, securities, financial investment services and regulated markets.

These regulations define market players, their actions and even the organization of the market itself. Amongst ~~prominent~~the effects of these measures, the following are noteworthy:

- The so-called SIFs (former Private Property Funds) will have to limit their ~~holdings portfolio~~ to 5% of ~~all any~~ traded companies. This measure offers an exit opportunity for millions of Romanians who are SIF shareholders without even knowing it<sup>11</sup>.
- The collective undertakings in transferable securities will ~~hold~~be limited to financial investments ~~representing a stock~~ of maximum 10% of a company. This measure will offer an exit window for portfolio investors trapped in the position of direct investor (where they ~~get by~~found ~~themselves~~ trying to ~~avoid~~by-pass the lack of legislation protecting minority shareholders).
- The investors who own more than 90% of a company will be able to de-list their companies from the Stock Exchange. This measure will offer an exit opportunity for trapped minority stakeholders, (because the majority owner will have to make a public offer at a fair price).
- The other speculative investors, who want to ~~get~~become involved in the management of the companies where they hold a stake, will ~~have to~~ organize ~~themselves~~ as venture capital or close-end funds. This measure

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<sup>10</sup> See Daniel Daianu, Liviu Voinea, *Foreign Capital Flows in Romania*, International Center for Economic Growth Occasional Paper, 2001.

<sup>11</sup> Apart from a number of ~~two-three hundred thousand~~200-300,000 persons who invested in buying SIF shares, many became SIF shareholders when companies with SIF participation distributed SIF shares as dividends.

will limit speculative capital involvement in firm management to specialized funds.

- Only open companies will stay on the Rasdaq market. This measure will address the ~~liquidity~~ problem of lack of liquidity for companies that ~~got~~were listed somehow against their will.
- The market itself needs to reorganize as joint stock companies (including Rasdaq ~~inclusive~~) owned by listed companies, with all profits reinvested in market facilities.

These measures are welcome and they indeed deal with many of the existing problems of the capital market. However, offering an exit opportunity does not automatically mean that that such an opportunity can be seized. In the case of SIFs' and collective undertakings' disinvestment from stakes currently above 5%, respectively 10%, the question is who will buy them, and at what price. In the same line of reasoning, market de-capitalization may ~~appear~~occur, at least in the first phase of applying these above measures.

In view of the above considerations, Regarding these recent evolutions in the banking and financial sector, the following recommendations ~~can be issued~~are suggested:

- Keep the legislation simple and enforceable. Do not regulate more than ~~you can be enforced,~~ (it is impossible since you can not anyway to regulate everything).
- Do not increase the cost of making business in Romania (~~by~~through new regulation ~~on enhancing~~restricting provisions for loans granted). ~~Even if the responsibility of designing loans provisions' regulation will be left at the commercial banks' level, but with a prior approval of NBR, the banking system will not be able to finally play the role of promoter of endogenous growth for the real sector. If this~~such a regulation is ~~nevertheless~~ implemented under external pressure, it ~~es~~should be counterbalanced, e.g. by~~through~~ a sharp cut in compulsory reserves requirements ~~—which is what we suggestion.~~
- Protecting the banking and financial system should be interpreted as protecting customers, not competitors. Therefore, the transparency of the supervising ~~on~~ mechanism and of financial transactions must be further

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~~promoted~~implemented, while competitors should be able to protect themselves, by strengthening the role of their professional organizations.

- On the capital market, the exit ~~window~~opportunities must be complemented ~~by~~with information campaigns and ~~by~~with efforts to secure a fair price.
- ~~Problems of~~ ~~#~~lack of liquidity and concentration ~~problems~~ should not be solved at the expense of corporate governance principles. Professional associations should seek to enforce corporate governance principles as a prerequisite for membership.

# LOCAL GOVERNMENT

## FOCUS: FINANCING DEMOCRACY AT ITS GRASSROOTS: BUDGETARY CHALLENGES IN LOCAL GOVERNMENT

Since the introduction, in 1998-99, of the new decentralized system ~~was introduced in 1998-99~~ for public finance, ~~the~~ Romanian's public finance at the sub-national finance level has evolved towards more transparency and predictability. Both conditions are a must if the local gGovernments are to enjoy real autonomy in developing their own budgets and policies. However, there are still shortcomings that undermine the functioning of the new mechanisms. Moreover, important pieces of legislation adopted this year (local taxes) or currently discussed (local finance) may threaten the positive developments achieved/achievements realized so far.

By tradition, the blueprint structure of the modern Romanian state ~~born in the second half of the 19<sup>th</sup> century~~ was modeled influenced by after the centralized, uniform structure of the French state. For Mmost of the time period since its inception establishment, the local Ggovernment (LG) was organized or into two tiers (though there were several attempts to create a third tier). But However, whilst if the details of the administrative structure have changed several times in over the last century and a half, the institutional culture in ~~the~~ local Ggovernment has stayed more or less by and large the same in one important respect: central Government's intervention in ~~the~~ local affairs is tacitly accepted, or at least

tolerated, especially when it comes from the Prefect's office. Local autonomy in Romania has never been as strong as in the Central Europe, which was exposed more to the German influence. Moreover, since nation- and state-building were top priorities in the 19<sup>th</sup> century, all the other political goals had to be subordinated to the ~~urge to~~ objective of creating a modern and functional national body politic state, and with its central bureaucracy. The local needs and agendas were seen as secondary and accepted only as long as they did not threaten the interests of the broader, national community.

Therefore, an uniform pattern of the local units ~~was~~ created, which, though not totally independent of the regional traditions, was meant to serve first of all the functional necessities of the young state. Grassroots democracy was traditionally rather weak, as has been by tradition not very strong, and all the attributions of the local governments, irrespective of the formal constitutional setting, were perceived as mandates or liberties delegated or created by the national state.

The Communist regime, which ~~that~~ took over Romania in 1948, operated many changes in the local government framework, but found the bases of the old arrangements as being fundamentally convenient for its own purposes. Since the local communities were generally accustomed to being patronized – and sometime abused – by the central Government, they did not represent a real obstacle for the new authorities regime. As a result, when a decentralization process was initiated ~~embarked upon~~ immediately after 1989, being regarded seen as a mandatory stage ~~on~~ the 'road towards Europe', the historical experience of local self-government was ~~neither rich~~ limited, and seldom relevant ~~not very useful~~ in the new context. Creating a functional network of local governments turned out to be both a challenge, because of the difficulties, as well as an opportunity, since a new system could be built up from scratch in a coherent manner.

As it happens in real life, however, a complex system such as this could not be organized in a fully ~~entirely~~ rational manner. Many decisions that affected the process of decentralization were taken by default rather than deliberately, and the final ~~end~~ result is sub-optimal<sup>12</sup>. ~~This is the case, for example, with the allocation of~~

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<sup>12</sup> This is the case, for example, of the allocation of transfers and of the equalization grants system.

~~transfers and the equalization grants system.~~ But eventually a system did emerge that relies on four main building blocks:-

- The Law of Local Public Administration (LLPA), adopted in 1991 and amended many times after that ~~date~~, until ~~its was replaced~~ ~~ment by~~ ~~with~~ a new LLPA in 2001. This piece of legislation defines the structure and attributions of the local ~~G~~governments in Romania, at both the ~~local commune/municipality~~ and county level. It actually formalizes the return to the ~~Romanian~~ sub-national administrative structure ~~from of~~ the interwar ~~years period~~ (but with fewer and larger counties). The language is rather general as far as the functions are concerned, enumerating a long list of attributions and making very few distinctions between the two levels of local Government (counties and municipalities).
- The Law of Local Taxes (LLT), adopted in 1993, is likely to be replaced in 2002. This act established in law the notion of ~~own-ocal~~ taxes, controlled and levied by ~~the local G~~governments (though the control has never been total). Thus, the property tax became the main source of ~~own-locally generated~~ revenues for the sub-national ~~g~~Government in Romania.
- The Law of Local Public Finance (LLPF), adopted in 1998, is also likely to be replaced in 2002. This act governs the system of transfers among ~~st~~ tiers of Government, the shared taxes, the equalization grants and ~~the~~ municipal borrowing ~~issues~~. In its current form, it represents an attempt to codify ~~the revenue-sharing system in Romania~~, and ~~to~~ make ~~it~~ more transparent ~~the revenue-sharing system in Romania~~. The Annex of ~~the is~~ law contains the ~~chart of~~ accounts ~~that~~ ~~o~~ ~~must~~ be used by local ~~G~~governments in managing their own revenues and expenditures.
- The Annual National Budget Laws (ANBL), which governs one budgetary cycle (~~January~~ ~~—~~ ~~December~~) and must be ~~passed~~ ~~passed~~ by the Parliament before the end of the previous year. These annual ~~bills~~ ~~budgets~~ specify the total amount of funds that is transferred from the central budget to local ~~G~~governments, in the form of equalization ~~funds~~ ~~money~~ or conditional grants. ~~They~~ also ~~spell out~~ ~~gives~~ the criteria to be used by the Ministry of Finance and counties in the process of equalization.

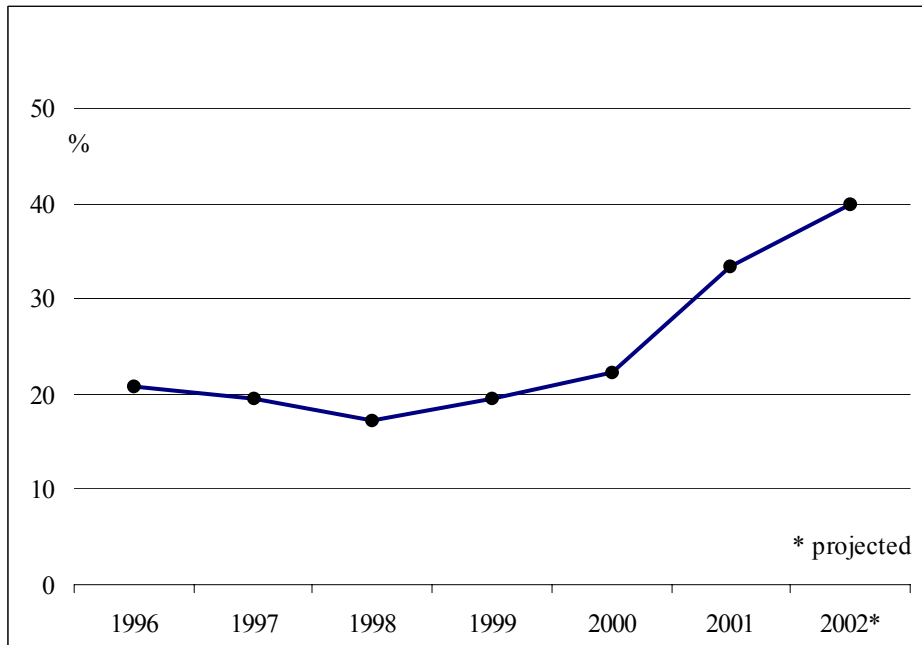
Whil~~ste~~ in the early '90s the ANBL was the main basis ~~e~~for local ~~G~~government policy, reflecting a high degree of centralization in decision-making ~~and~~

~~decreasing predictability at the local level~~, the situation has gradually changed ~~in over~~ time. LLPA and LLT extended substantially the local administrative autonomy and created own sources of revenue for the local ~~G~~governments. However, many fiscal issues had not been sorted out and the ~~allocation process remained highly un~~predictability ~~of the allocation process was low~~.

In 1997-98, key legislative reforms were implemented, ~~with a view to~~ ~~aimed at~~ fundamentally changing ~~interGovernmental fiscal relations and~~ the structure of the finances of the county and local councils. In particular, the LLPF, enacted in 1998, ~~put~~laced local finances and the local budget process on an equal legislative basis with those of the national Government. The law also introduced tax revenue sharing in Romania. Under the new arrangement, the county and local councils receive a share of the income taxes collected from taxpayers in their ~~geographic area of jurisdiction~~, and ~~the discretionary power of the~~ central Government ~~discretion into~~ earmarking ~~sum~~fundss has ~~decreased~~been reduced.

The new legislation also greatly simplified the transfer system. All dedicated transfers for ~~operating~~ subsidies ~~of~~to public service companies and investment subsidies to the local and county councils from the state budget were eliminated. The general transfer was replaced with a 'equalization grant', ~~that~~which aims to ~~correct~~mpensate for differences in expenditure responsibilities and fiscal capacity amongst the county and local councils. ~~Equally, The the authority of the national Government to approve local investment projects reforms also reduced~~was ~~restricted the authority of the national Government to approve local investment projects to larger~~ projects above a certain ~~minimum cost levels~~financial threshold, and to those ~~fully or partially~~ funded ~~partially or fully by~~from the ~~state~~central budget. A vigorous policy of ~~reallocate~~delegating attributions and sources of revenue to sub-national levels of ~~G~~governments ~~was~~ pursued, ~~that~~which ~~substantially~~ increased ~~substantially~~their share ~~of local public finance~~ in the total public expenditure in Romania (Fig. 1).

Fig. 1. Local ~~g~~Government, % total public expenditure



~~As a matter of fact,~~ ~~The~~ central Government has even been criticized for decentralizing too fast and too much, ~~thus~~ overburdening ~~the~~ local ~~G~~Governments. ~~The truth is that~~ ~~Moreover,~~ many new functions are in fact just ~~mandates~~—tasks that are passed ~~delegated~~ down to ~~LGs~~local governments for execution, with ~~some~~ ~~money~~ ~~yearmarked~~ funding, ~~attached~~ but without any decision-making power.

~~On the other hand~~ ~~However,~~ the central Government has a point ~~when they~~ ~~when~~ arguing that many ~~of the~~ newly transferred functions start as ~~just a mandate~~ ~~tasks~~ ~~delegated for execution, as a transitory situation~~ ~~for the first one or two years, just in order to preserve flexibility in conditions of extreme uncertainty,~~ but that ~~A~~ after ~~the situation stabilizes and local governments accumulate more~~ ~~experience~~ ~~accumulates in LGs,~~ the conditionalities will be relaxed and ~~the~~ local authorities will be free to take over the services. This is ~~in particular~~ the case ~~with~~ ~~of~~ primary and secondary education, ~~or~~ ~~and of~~ welfare support ~~policies~~ ~~services,~~ reassigned to local ~~G~~Governments in 2001. ~~It should be highlighted, in this context, that~~ ~~In fact,~~ it is not the central Government, but ~~the~~ ~~other~~ stakeholders ~~involved~~—~~for example, e.g.~~ the trade unions in ~~the~~ education sector) who are the main opponents of real decentralization.

### Sources of uncertainty in the local decision-making process

~~In fact, the~~ on-going reallocation of substantial attributions from the central Government to local governments unavoidably creates uncertainty for the near future couple of years. ~~The trend is clear — Tab. 1 shows that the proportion of sums spent for covering the cost of mandates has risen, at the expense of the non-mandated functions — but the details (calendar, costs) are hard to anticipate. As a result, the unstable policy environment is unlikely to change much on the short term.~~ The Government has an ambitious agenda for the next one ~~or~~ two years, when more attributions will be reassigned to LGs/local governments. ~~These~~ list ~~will~~ includes police, disaster relief, emergency services, and local power plants. The exact impact on ~~the~~ local budgets is hard to ~~estimate~~ anticipate at this stage, ~~but the direction of change will be the same — more mandatory spending, and probably more dedicated transfers paid from the VAT revenues collected at the national level.~~

Fig. 2. Categories of expenditure in the LGs/local governments' budget

			Before 2000	2001-2002
Not mandated	General	local	40%	25%
	services			
	Public		20%	8-9%
	transportation			
Mandated	Education		10-12%	35%
	Welfare policy		5-6%	15%

In the long run, the Government will ~~be~~ probably be able to ~~transform~~ replace some of the earmarked ~~sum~~ transfers and subsidies to local governments ~~into~~ with own sources of revenue for the latter (or at least with general purpose transfers with stable allocation formulas, such as shared taxes), ~~and which will make~~ the local budgetary process ~~will become~~ more predictable and stable. Until then, however, the attempts to ~~do~~ fine-tuning in revenue allocation are probably useless, and the attention should focus on the few big ~~important~~ issues that can make a difference irrespective of what exactly will be how the final list of final functions ~~assigned~~ of functions look like ~~to~~ local governments.

The de-centralization process ~~of transfer~~ is complex and unpredictable, and sometimes even the central Government cannot control it fully. For ~~example instance~~, ~~some certain~~ services that will be transferred to LG local governments must ~~be~~ first be demilitarized (e.g. police, firefighters). This is a sensitive ~~and visible~~ issue and, as it happened with education, is likely to meet fierce opposition ~~will be fiercely opposed by from the stakeholders involved~~ the staff concerned, who will not like to see their special military status abolished and, ~~moreover~~, themselves ~~become~~ local civil servants instead of employees of a central ministry. ~~This~~ Such factors creates uncertainty and political risks until the reassignment of functions is completed. Moreover, it is difficult to ~~make~~ an accurately estimate ~~of~~ the real costs of these services, as long as they are part ~~of~~ central ministries, because many auxiliary operations and overheads are shared with other departments. The only realistic option in this respect is learning by doing – ~~and~~ hence the central Government has one more reason to continue for some time ~~to use~~ ing earmarked sum funds.

On the revenue side, the purpose intent of the current legislation ~~was~~ has been to strengthen local fiscal autonomy by clarifying and expanding local control over the budget process. However, progress in meeting this objective has been partial at best. The rules ~~on for~~ revenue sharing have gone through two amendments. Equally, ~~the~~ simplification of the system of transfers ~~also~~ did not last ~~very~~ long. The national budgets laws of in 1999 and 2000 reintroduced dedicated transfers for roads, housing and child protection, and divided the equalization grant into two parts, one general and one solely to compensate for the cost of residential heating subsidies. The rate of the shared taxes has also been modified each year.

At the same time ~~in parallel~~, there are still ~~some certain~~ special funds, typically dedicated to investments, that are allocated to LGs local governments in a way that is neither transparent nor ~~very~~ accountable. Some matching grants for investments are included in the national budget with a known clearly specified destination, ~~but~~ ~~some of them others~~ are simply allocated given to the relevant line ministries, who are responsible for administering them (most often Public Works ~~or~~ and Industries, since ~~the typical~~ investments are in mostly concern roads, social housing, water ~~systems~~, and gas pipes).

Apart from these shortcomings, the local budget process remains the main source of 'institutional noise' for local and county councils. This is an important point, which is and often overlooked in many assessments of the decentralization that rely solely on quantitative data and spending indicators.

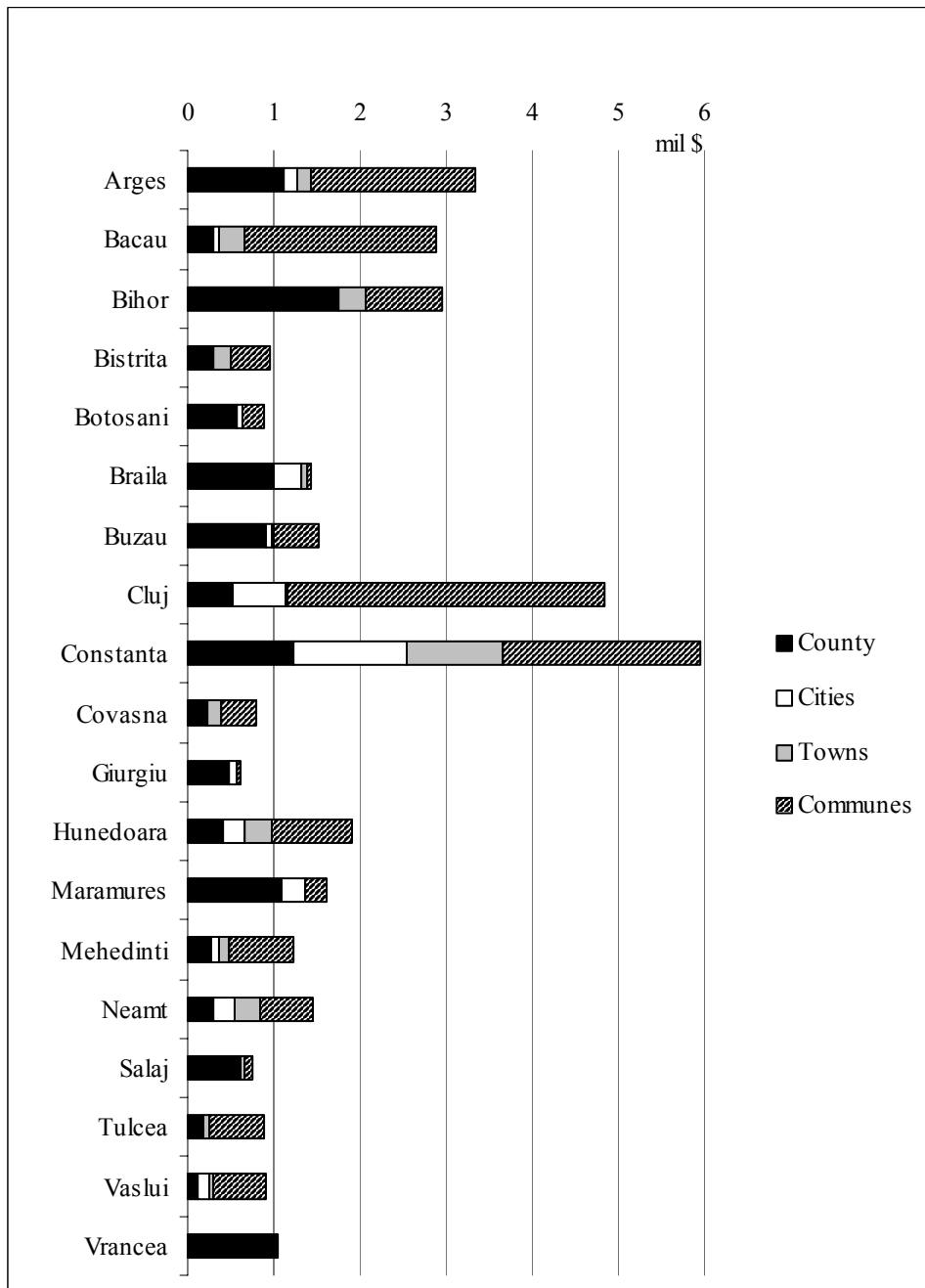
With the approval of the State budget, often occurring as late as February of March of a fiscal year that runs from January to December (the 2002 budget has been the first exception to this rule), each local ~~G~~government has to wait for the adoption of the State budget before can adopting its own budget for the year. First, however, local governments~~they~~ must adjust their draft budget in accordance with the rules set forth in the ~~current~~ State budget law. ~~In each~~Every year since 1991, ~~thisese~~ hasve included changes in the expenditure responsibilities of both local and county councils, ~~and it also has included~~ variations in the volume and type of transfers, (for both general and earmarked transfers). ~~In addition~~Additionally, ~~the~~ local councils must wait for the county council to allocate to each one of them their ~~respective~~corresponding share of the equalization grants received by the county council from the State budget.

This allocation process has followed different rules in each of the 41 counties—, which is clearly against thea departure from the provisions of the Annual National Budget ~~l~~aws. Even tough, according to the text of ANBL, the counties should strictly apply the fiscal capacity formula, deviations from this standard are tolerated on a large scale. The usual practice involves ~~some~~certain quantitative criteria, but the process if far from being strictly based ~~purely~~ on a formula. No local council knows for sure what amount ~~they it~~ will receive from the county council. The process typically involves significant individual ‘negotiation’ between the local councils and the county council, ~~and it is~~ rural communes ~~who~~ are mostly at the mercy of county councils, since for many of them the equalization funds are the main source of revenues.

Fig. 3 illustrates how important the County Council discretion in allocating equalization funds can be. Each month, a share of 15% (16% in 2002) of the personal income tax (PIT) collected locally is given to the county council with the purpose of equilibrating the budgets of localities ~~inunder its~~their jurisdiction. ~~But~~However, the law failed to mention the portion that the county can withhold for itself. Therefore, the allocation becomes entirely unpredictable for localities, as the counties can decide to retain most of the revenues for their own budget – or all, as it happened in 2000 (and in 2001 for that matter) in Vrancea county. This legal loophole creates too much autonomy to counties at the expense of localities. A quick analysis ~~of~~ the data presented in Fig. 23 shows that the problem here is indeed the total discretion exercised by counties: the proportion of funds retained by them has nothing to do with the overall regional poverty, since counties with similar revenue-raising capacity display very different distribution patterns.

Moreover, even when the allocation to localities takes place, sometimes large amounts go to the capital-city-capital (ex-e.g. Braila, Constanta), which runs against the policy objectivegoal of equalization within counties.

Fig. 3. Equalization funds distributed by counties, 2000 (the 15% share of PIT)



Rural communes, who are generally most in need, are the most likely to suffer from this erratic distribution. In this context, it is not surprising that elected officials in many communes – the mayor and the members of the local council – have adopted largely a passive attitude regarding the budget process. Their most ~~critical~~important skill is their ir ability to negotiate with the county council, in order to secure the highest possible equalization grant allocation.

### Loopholes and disincentives

~~Alth~~ough in theory the Government encourages ~~LGs~~local governments to become more self-reliant, this does n~~o~~t always happen in practice. On the one hand, ~~T~~here were instances when county prefects sued local councils in administrative courts when they~~for~~ having tried to introduce new local taxes (as it happened in Bucharest in 2000). Some ministers reprimanded several times local councils ~~that~~for having levied “unreasonable taxes on the already-impooverished population” (e.g. on pets, garbage collection, vehicles pulled by animals, ~~park entrance fees,~~ etc). Equally, ~~T~~he media, ~~more often than not,~~ is also often ready to pour scorn on any such local initiative.

On the other hand, the same Government removed recently from the new Local Taxes Law<sup>13</sup> the possibility efor the ~~LGs~~local governments to go the other way and lower the taxes. ~~The~~ top officials argued that, because of “populist reasons”, irresponsible mayors were ~~jeopardizing~~threatening the local ~~own r~~ revenues by base by lowering the the property tax rate before local elections. The examples given were several large cities, but no hard data were as produced to back in support of these allegations. ~~This~~ Such a limitation of the local decision-making power, based on the assumption that the central Government is somehow more legitimate and responsible than in the local ~~g~~ Governments, runs against the current trend and the very policy stated objective of ‘~~substantial~~ decentralization’.

However, there are indeed disincentives in the local finance system. A ‘race to the bottom’ seems to be taking place in small towns or rural ~~municipalities~~communes: the mayors underestimate their own revenues in the draft budgets in order to get obtain more equalization funds. This is a typical case of the substitution effect

<sup>13</sup> Through the Ordinance 36/2002, which actually replaces the old Local Taxes Law.

(less effort is put in collecting own revenues when compensation comes from the center) induced by the equalization system. It was confirmed by local financial officers and it becomes apparent when one analyzes the difference between the projected budgets and the execution one year later: the projected own revenues have systematically been lower than what was actually collected ~~realized~~.

The formula of PIT sharing introduced in 1999 is simple and straightforward, but it has a downside: it functions as ~~another~~ further generator of horizontal imbalances, especially at the lowest level of LG local governments. Since the tax is collected at the point of origin and then split among st national, county and locality budgets, it benefits those municipalities (usually large cities or towns) who have many official jobs on their territory. In other words, When residents of rural settlements ~~commute to~~ work in the nearby town (which is often the case), the latter collects all the corresponding share of the PIT. ~~Thus, the differences in revenue raising capacity are magnified, both at the local and county levels. Richer counties also benefit, because at the same level of personal income you are more likely to have a formal job here than in a poor county, where a larger part of the real income tends to remain hidden.~~

~~The situation described above creates therefore, the need arises to mitigate the effects of these discrepancies, which make it very difficult for small communities to provide basic public services to their citizens. There are many reasons to do this: it would be politically unacceptable to decrease the provision level under a certain threshold even in the poorest communities. Even if, strictly speaking, not all the local Government functions are national mandates, certain general Government and local services have to be offered to every citizen. Moreover, in ~~the~~ ex-communist statcountries, almost all local communities inherited a network of local services, ~~more or less extended~~, and a strong expectation from the citizens that these services will continue to function, and it is very problematic to ~~Terminate~~ ing this tacit social contract ~~is difficult even in the most dire financial situations~~. Many local Governments are now confronted with the issue of over-extended services and shrinking finances – especially small towns, where the services cannot benefit from economies of scale.~~

Finally, There is one more flaw in the LG local governments' finance system that is shared with almost all of the public sector, namely that: the current cash-based accounting system does not reveal the huge problem extent of unpaid bills (arrears). Local governments are Currently ~~the LGs are~~ constrained by the requirement of having balanced budgets, and, as a ~~result~~ consequence, they tend

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to roll over hidden debts in their books from one year to the next. ~~According to estimates the problem is very serious in itself—and even more so since it cannot be measured with precision.~~ The only way to address ~~it~~this problem would be to start ~~to~~reporting systematically the debts in the local budget execution, ~~preferably~~e.g. by introducing accrual accounting elements.

## Recommendations

In this context, it is now possible to outline an agenda for improvement. It must fix the flaws in the system that have become apparent so far – but on the other hand take into account the need for flexibility generated by uncertainties that will continue for a while. The reassignment of functions to LGs local governments is not yet completed and substantial transfers are on the agenda for the next one or two coming years. The calendar – or, indeed, costs – of these new such transfers of functions are difficult to foresee. Therefore, any attempt to fine-tune and write in stone the interGovernmental fiscal rules are premature. One would expect that it is likely that any new major reallocation assignment of attribut functions to local governments by the central Government will be matched with an additional slice of funds taken from the national general budget – most likely, e.g. from the state's residual share of the PIT or from the VAT revenues. Only after several budgetary cycles would have passed with the new arrangements can the policy be stabilized and more automatic transfers set up that will minimize the vertical disbalances imbalances and stabilize in the long run the horizontal equalization mechanisms.

The agenda for reform should has thus to be organized on several steps organized in a sequence and put into the broader policy context.

- A. **In the short run**, several quick fixes are possible that will address some of the problems identified above in the previous section. They se are likely to function no matter what changes will be further operated in the system:-
- The Government must make an explicit commitment regarding the agenda of decentralization until 2004, so that the L G local governments and the public know what functions will be further reassigned, and when. Some of these things are included in other programmatic documents of the Government, but they should be collected into a White Book of fn Decentralization.
  - The Government should refrain from discouraging L G local governments to find their own sources of revenue. If local councils

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decide to create new taxes – so be it. They ~~too~~ are democratically elected bodies that will be held accountable by their constituencies.

- A cap must be imposed on the percentage that can be withheld by counties for their own budget from the second source of equalization (the automatic PIT share). Otherwise, too much freedom of action at the county level will continue to have an adverse impact at the locality level, where the budgetary process becomes unpredictable.
- A reporting system must be introduced at the county level for increasing the transparency of allocation of funds by localities. Each county should prepare a report explaining how much, and why they deviated from the criteria established by the National Budget Law. This is a minimal requirement that will both offer a useful feedback to the Ministry of Finance, and a means to limit ~~the abuses at the local level.~~
- The implicit policy goal of full compensation for lack of fiscal capacity at the county level should be abandoned. ~~The total pool of money earmarked for equalization should attempt to cover only 75-80% of the fall below the average.~~ This would remove the incentive in local Governments to substitute own revenues with equalization grants, ~~and so address a problem that tends to become serious in the years to come.~~
- In case the ideal of full compensation is not abandoned, other simple measuretricks can be applied to remove the disincentive. Instead of using the projected own revenues for the following year in the fiscal capacity formula, the actual figures from the previous year's execution should be used. ~~It is much easier for mayors and CFOs in localities to underestimate projected revenues that appear only on paper, than the realized revenues from the previous budgetary exercise.~~ Or, alternatively, the fiscal capacity formula should be applied only within regards to the PIT shares, ~~without creating disincentives for increasing the own revenues of municipalities.~~

B. **On the medium term**, depending on the pace of ~~policy reform in~~ functattributions reassignment, ~~there are some elements~~ the Government

would be well advised to take into consideration the following suggestions:

- A horizontal equalization formula, in whatever form, should be enforced upon counties gradually, but with determination. Eventually, the budgetary policy environment should be made more transparent and predictable at the lowest level of local gGovernment. As the reassignment of functions advances and experience accumulates, the need for flexibility in the distribution of funds will correspondingly decrease. ~~The residual national share of PIT can be then transferred to LGs, either in the form of earmarked sum tied to a mandate (and thus meant for vertical equalization) or as a general purpose equalization grant. Additional funds from the national VAT revenues may be also considered.~~
- It is important that the Government resist the temptation to complicate the horizontal equalization system by factoring in various 'normatives' meant to function as a proxy for local needs. Once wethe Government starts to go down on this road, the proliferation of 'needs' will be unstoppable and the system will become unmanageable (Hungary is sometimes cited as an badunfortunate example in this respect). There is a trade-off ~~here~~ between simplicity and transparency on the one hand, and technical refinement on the other. From the experience available so far with the current Romanian system, which is fairly simple and easy to understand, the biggest-real problem turns out to be not the design, but the implementation. As long as rules are not enforced at the lower levels, so that they create stable expectations and the right incentives, the is design is practically irrelevant. *The more complex the system becomes, the less enforceable it will be.*
- There is some room ~~Somefor~~ experimentation with the current PIT automatic shares ~~are possible~~. For example, instead of fully allocating them fully according to the place of origin, they canould be split into two: e.g. half origin-based, and half transferred according to the number of inhabitants in a local governmentLG unit (county or locality). This would help reducing~~It is likely that~~ the current effect of PIT shares, of magnifying the horizontal disparities, will in funds allocation~~be~~ reduced. Thereforeus, the need for horizontal

equalization ~~will~~ ~~be~~ also ~~reduced~~ decrease, and, as a consequence, with the beneficial effect that less money will go around in discretionary reallocations.

- Alternatively, the central Government may wish to consider the idea of transferring the equalization funds directly to counties and localities, in one step, thus eliminating ~~the~~ interference of counties in the budgetary process of localities ~~would be thus eliminated~~. With the current simple and transparent formula of equalization, this can be done at practically no additional administrative costs. The adoption of this solution is politically difficult, however, because it will be opposed by counties, which have a strong lobby at the central level.
- Since the Government intends to generalize the accrual accounting procedures to the whole public sector from starting with 2003, the huge stock mountain of unpaid bills will suddenly appear in the books of local Governments. It is very likely that some localities are less indebted, other more, and some on the verge of bankruptcy. The Government needs to prepare draft a strategy to for addressing the is problem, ~~and clear procedures for the use of LGs in the passing to accrual accounting.~~

C. **In the long run**, when all the reassignments are completed and the situation is stabilized, ~~the~~ local autonomy can be formally increased by transforming most of the earmarked conditional grants into general purpose transfers, automatic tax shares – or even by creating new own revenues in for the local Governments (for example, by turning some national taxes into local taxes, such as the planned turnover tax on micro-enterprises, ~~a proposal now on the agenda~~). ~~The need for vertical equalization will be thus very much reduced. The horizontal equalization mechanisms can also be stabilized, since the final situation will be much clearer about who needs what. After the experiments run in the previous stage, a final decision can be adopted on the details of the equalization mechanism too.~~

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<sup>i</sup> ~~No official figure from the Romanian Ministry of Internal Affairs is available. Unofficial figures vary greatly, between 100 000 to 400 000 Moldovan citizens who also applied for the Romanian citizenship.~~