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SELECTED INDICATORS

	Q1-2001	Q2-2001	Q3-2001	Q4-2001	Jan-2002	Feb-2002	Mar-2002	Apr-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	1.7	↗
Inflation, monthly average, %	2.7	2	1.8	2.4	2.3	1.2	0.4	2	↗
Interest rate (BUBOR, one week) %	3.4	3.2	2.6	2.6	2.7	2.5	2.5	2.4	↗
Industrial output, % change	6.8	-0.3	-0.6	-3.0	4.6	3.8	5.6		-
Trade deficit, monthly average FOB/CIF (mil USD)	274	408	205	504	257	239	263		↘
Unemployment rate, %	10.7	9.3	8.1	8.1	12.4	13.2	13		-
Average net monthly salary, USD	99.2	96.3	92.9	96.4	114.1	106.3	111		-
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

ABSTRACT

The popularity of the Romanian government, which has stayed at high levels over the last year, has begun to erode. This is a normal phenomenon, argues the **Political** section of this EWR, since governments in Romania are prone to become a scapegoat for the overall discontent with the political class. No adequate policy has addressed this issue so far, which plays into the hand of radical Greater Romania Party. The Constitutional reform is perceived by many as an opportunity to embark upon a comprehensive overhaul of the Romanian political framework. However, if it is to be successful, the goals of the constitutional amendments have to be achievable, clear and limited. Otherwise, the initiators of constitutional changes run the risk of raising public expectations to levels that will be impossible to meet.

In the **Economic** section, former Finance Minister Daniel Daianu discusses urgent issues of fiscal policy that confront Romanian decision-makers. The tax reform, it is argued, should be based on creating a unified tax administration department, encouraging voluntary compliance through the delivery of modern and reliable taxpayer assistance services, ensuring well-targeted audit and other control activities, timely following up on unpaid debts, and streamlining the VAT policy, including by terminating an array of exemptions. The tax system must be insulated from the pressure of vested interests. Equally, reducing the payroll tax (currently at 57%, amongst the highest in Europe) may contribute to diminishing labor disincentives. Finally, specialized financial institutions should be set up, in order to facilitate the access to funds by small and medium enterprises.

The Economic section also warns against excessive optimism regarding the latest economic indicators. The range of macroeconomic aggregates generally used in hasty assessments cannot capture accurately the state of the Romanian economy. What lies behind them may be less impressive and requires more prudent judgment.

Wrong incentives in the hospital sector endanger the viability of the health system, highlights the **Social** section. The policy response of the Government to this crisis is weak, and the forthcoming debate on the Hospital Bill is likely to be irrelevant to the real woes of the health sector.

POLITICS

CAN CONSTITUTIONAL REFORM BOOST THE LEGITIMACY OF THE POLITICAL SYSTEM?

WHY TRUST IN GOVERNMENT IS DECLINING

The Romanian Government has done remarkably well in terms of preserving popular trust in 2001. Despite predictions to the contrary, popular support for the Government has remained at a high level until the end of last year. Over last winter, however, there has been a decline in popular confidence that the Government can handle the economic and social problems.

Why has this happened, since Romania's situation has neither worsened during this period, nor has the winter been particularly difficult?

To solve this riddle, we hypothesized the following:

- the decline of the trust in Government is due to disenchantment of 'opportunistic' supporters, in other words, of those who did not vote for PSD, but were ready throughout 2001 to credit it. In this case, we should find a correlation between the vote for PSD and the trust in Government.
- the decline is due to increasing popular perception that the Government is not doing enough to curb corruption and reform the political class. In this

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case, we should find an association between dissatisfaction on how the Government is handling corruption, and the level of trust in Government.

- the decline is due to the worsening of the economic situation of the respondents. In this case, we should find a correlation between those who perceive themselves as faring worse than one year ago and lower trust in the Government.

Our surveys have confirmed all the above hypotheses, with each of them representing a possible explanation for the decline of the trust in Government.

Fig. 1. Explanatory model for trust in Government

Predictors	Regression Coefficients (Standard Error)
Subjective well-being	-0.670 (0.140) ***
Evaluation of the Government's fight against corruption	-1.190 (0.150) ***
Vote PSD	1.476 (0.151) ***
Secondary education	-0.679 (0.299) *
High school, vocational	- 0.888 (0.259) ***
College	- 0.423 (0.233)
Age	- 0.283 (0.207)
Rural	0.058 (0.154)
Income	0.000 (0.000)
Adjusted R ²	0.27

*, **, *** degree of significance (***) = strongest correlation).

The model shows four categories of people more likely to show discontent with the Government's performance:

- more educated people in comparison to the less educated, at similar levels of age, residence and income.
- people who perceive that they fare less well than they did a year ago.
- people who did not vote for the governing party, as compared to those who did.
- people who are not convinced of the Government's anti-corruption campaign (according to polls, 37% of the Romanians do not believe that the Government is doing enough, 37% are more indulgent, but not

altogether convinced, and 20 % believe that the Government is taking the necessary steps to fight corruption).

Fig. 2. Perception of political corruption

How spread corruption is among politicians?	%
Almost all politicians are involved	40
Most politicians are involved	46
Few politicians are involved	8.7
Scarcely any politician is involved	0.4

Any government in Romania is prone to become a scapegoat for the overall discontent with the political class. The perception of politicians as corrupt, inefficient and not devoted to the public interest has increased. No adequate policy has addressed this problem so far, and the discontent with the political class as a whole fuels the support for the radical Greater Romania Party.

Fig. 3. Perception of political conflict

Conflict between elected and electors	September 2001 (%) -urban	March 2002 (%) -national
Yes	51	50
No	34	30
No answer	15	20

Levels of general frustration remain high. As a general rule, there is social resentment towards the better off and the employers. About half of the population is also perceiving a conflict between Romanian and ethnic minorities such as the Roma or the Hungarians. Subjective conflict is higher amongst poorer people residing in small towns and villages.

ROMANIAN CONSTITUTIONAL REFORM REVISITED

Alina Mungiu-Pippidi

One solution to ease the public discontent with the political class, but which has been discussed in a wildly unsystematic manner, is the envisaged reform of the Constitution. Prompted by indispensable changes in view of Romania's EU and NATO accession, the reform of the Constitution was embraced by almost every political party – except Greater Romania – as an opportunity for self-advertising. This article discusses the proposals that have been made for constitutional reform, with a particular focus on the reform of the Executive and of the Legislative. In the next EWR, a section will be dedicated to the reform of the Judiciary.

Over the last years, there has been an increasing debate on Constitutional reforms across the region. Prompted by ethnic conflicts such as Macedonia's, this debate has been based on the assumption, not thoroughly tested, that Constitutions matter. This assumption should be considered with some caution, as there is an emerging consensus amongst experts on the Balkans and post-Soviet countries that informal rules and practices may still be the main factor that shapes public life in this region, and that the replacement of old formal rules with new ones may pass unnoticed by societies used to guiding themselves on signals and habits, rather than on political statements and institutions. Having this reservation in mind, there should be two guiding principles in proposing or analyzing a Constitutional Reform.

A political system can be seen as a functional ensemble of different parts. For the whole system to function, these parts must be connected through functional links. When it comes to operate changes in the political system, each part can be reformed in a variety of ways, however, not all such changes to different parts of the system can function together. Parliamentary systems are associated with proportional vote systems, for instance, and proposing at the same time to adopt a parliamentary system whilst giving up proportional vote, as some Romanian

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parties did, is purely nonsensical. 'Reforms' of this kind have the potential of producing more damage than good.

A Constitution is a mere framework of government, no more. As a classic author put it, whenever a Constitution tries to regulate more than government, e.g. the society, the culture, and so on, such attempts only indicate the underdevelopment of the respective state. The least developed countries in the world have lengthy Constitutions; advanced democracies do with more modest documents. This is not a matter of what a Constitution *should* do, but rather of what it *can* do to achieve the goal of constitutionalists. Romania's 1991 Constitution is closer to the Third World type of Constitution: it includes mentions of temporary organizations (such as the Regies Autonomies), and is provided with a strong mechanism to prevent its revision, whilst doing an extremely poor job in terms of establishing the framework for an independent and strong judiciary, one of the essentials of any Constitution.

By and large, the 1991 Constitution has had remarkably little effect on the Romanian political life. The *partitocrazia* established since the first 1995 government coalition (left) was consolidated during the 1996-2000 coalition (centre-right). The media labelled this division of all public positions amongst political parties, combined with the extensive recruitment of everybody with a position by parties holding office, with various anecdotic names (such as *pedeserizare*), but none of it was an effect of some constitutional arrangement. This combination gathering the worse of both worlds (political cleansing after each swing of government, combined with and followed by *lotizzazione* – division of the pie – during coalition governments) is unusual, and its explanations should be searched elsewhere than in the Constitution.

The second example regards presidential powers. Driven by the desire to gain social peace and to achieve legitimacy with the international community, the Constitutional Assembly designed a semi-presidential system, although at the time there were no political parties to speak of, but only a President with important popular legitimacy (voted by 82% of the voters). This President, however, subsequently proved to be a 'weak' President on all counts, very much in line with his Constitutional status. It should be highlighted that the public would have preferred a presidential republic, and has repeatedly voted with the hope that the President can make a difference. There was little to stop the President to play a greater role; yet, Ion Iliescu chose not to do so. Therefore, a personality factor overrode an institutional factor at the time.

Or take property: did the ambiguous formulation in the Constitution prevented private property from being restored in Romania? Or was it rather specific pieces of legislation, such as Law 18/1991 (land restitution), which was passed before the Constitution, granting ownership to some people on others people's lands? Throughout the past decade, under post-Communist governments, the General Attorney made use of his constitutional right to cancel final decisions of the Supreme Court of Justice, which had ruled in favour of property restitution, thus disfavoured tenants, one of the main client groups of post-Communists. Would this development have been prevented if the Constitution was phrased differently? The answer is no. Even under the current phrasing of the Constitution, a really autonomous Constitutional Court would have declared such interventions by the General Attorney as unconstitutional. The change of a word in the paragraph regarding private property is futile, whilst the right of the General Attorney to put pressure on the Supreme Court of Justice remains unchallenged.

What becomes then important, in order to surpass such fallacies, is to set *achievable, clear and limited* objectives for the Constitutional reform. These must be further adjusted by a check of the popular support for one or the other of the reforms proposed, since, according to the 1991 Constitution, any constitutional change should pass through a referendum.

One of the weakest spots of reform packages proposed is that their objectives are not at all explicitly stated, but are at best implicit. One can only speculate on what the authors wish to accomplish by one or another proposed change. Synthesizing some of the proposals, we identified two main objectives, which shall be discussed together with potential solutions to achieve them, and the public support for such solutions.

1. Empowering the Government

The division of power between two uneven halves of the Executive in Romania's semi-parliamentary system was challenged only twice in the last decade. In both instances, Presidents acted to change Prime Ministers of their own party and replace them with others. However, both Ion Iliescu in 1991, as well as Emil Constantinescu in 1999, were far from being the only actors of such changes, not even their initiators. Iliescu sacrificed Roman during a violent riot by miners; Constantinescu would have stood little chance in pushing Vasile out of office, had not Vasile's own party championed for it. In any of the two instances, the Presidents would not have succeeded by themselves. Can one therefore make

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the argument that, due to their powers entrusted by the Constitution, they managed to get rid of Prime Ministers that they disliked? Hardly so. On the contrary, one could argue that the direct vote for the President (and the legitimacy that derives from it), of little use most of the time, makes sense only in crises such as those mentioned above. Iliescu could afford to let Roman fall because he was the leader directly elected by people who could manage the interim. Constantinescu also had a direct mandate from voters, and he used it to sanction what he considered was at fault in his own camp. Both Prime Ministers might have deserved better fates: they were reformers with a fair score of achievements. But what would have been the alternative, once their popularity started to decline?

If we examine crises such as these, and look merely at organizations, not specific actors, we can hardly say the President can be a threat to the Government. The Republic of Moldova, Romania's neighbour, has moved last year to cripple the powers of the President and make Moldova a pure parliamentary Republic. What subsequently emerged is in no way better, as the main reasons distorting Moldovan political life (a majority of authoritarian voters preferring a single political party system – and therefore voting Communist, plus an overlap between democrats and nationalists) have remained unchanged. In fact, what followed was an aggravation rather than an appeasing of the political conflict. Still, Moldova's reformers were certain of having solved it with their constitutional reform.

The Romanian Government is in many ways weak. This is proven by its poor tax collection, for instance, or by its even weaker capacity of implementing policies and decisions. But none of these problems is due to the distribution of power between President and Prime Minister. The President may be redundant most of the time, which would not justify his direct election, but he is necessary during crises. The Parliament and the political parties are the least trusted institutions. Romanians who believe that MPs work for the public interest make less than 10% of the population. How then to entrust the Parliament with the election of the President? How could the Prime Minister, who would emerge as the sole executive leader after such a reform, handle crisis situations? Iliescu sacrificed Roman; Constantinescu sent Vasile to dialogue with the miners before parting with him. In both cases, it was better for Romania to have two leaders, not one. The Government should be empowered and made more effective and able to enforce its programs, once adopted; but making Romania a parliamentary Republic does not seem to be the best way for doing this, and indeed it does not seem to be a way at all.

Furthermore, the public is committed to the direct election of the President. One can blame it on remnants from authoritarian times, but the fact is that the best side to democracy, as perceived by the public, is the right to directly elect a President. There is an overwhelming majority who supports this system, and a considerable majority considers that the way of electing a President matters. We are dealing here with strong attitudes: there is little hope that a communication campaign can change this situation.

Fig. 4. The election of the President

Should be the President elected directly by the citizens or indirectly by the members of the Parliament?	%
Directly, by the citizens	92.4
Indirectly, by the members of the Parliament	4.1
No answer	3.5

2. Streamlining the legislative process

As bad as it may sound, there is evidence that the Romanian Parliament has done a rather sloppy job over the last decade. Too many drafts were rejected either by the Legislative Council (showing that legislators do now know the legislation) or by the Constitutional Court (showing that their knowledge of the Constitution is also limited). The change of internal rules in January 2001 improved the effectiveness of the Parliament (which was also helped by the fact that there is a one party Government in the current legislature), but did not improve quality. By and large, a considerable number of laws pass through the Parliament (on average, between one third and half of the laws passed in any given year, Government ordinances excepted), which are at odds with either domestic legislation, or with international conventions or with the Constitution. This situation shows that there still is considerable amateurism, after ten years of democracy. It should be highlighted that the present analysis focuses only on the formal aspects of the legislation, and does not discuss at all the adequacy of the laws passed; content may be disputable, but bad form is not. Governments, which have to interact directly with donors assisting the reform process, have always tried to go round Parliaments by passing emergency ordinances, whose effect starts before being discussed by the Parliament. The Parliaments have taken revenge by modifying ordinances when they were finally presented, even if this meant the reversal of decisions already applied, which in some cases generated conflict (e.g. the display of bilingual signs

in Hungarian-Romanian towns in 1997). All governments dreamt of preventing the Parliaments to do so, and all Parliaments objected with good reason that emergency ordinances are unconstitutional in their essence. If Parliament does not check on government, who does? And if MPs are corrupt and ineffective, how to govern well? Is there a constitutional answer to this riddle?

Actually, there are some possible options to address this problem, but none can really solve it for good. No constitutional engineering can cope with the corruption of the political class, for instance. In corrupt societies, vertical accountability is essential: one must rely on voters to remember corrupt MPs and stop voting for them, but if voters fail to do so, no miracle can work. Putting some pressure on MPs and on political parties may help, however, to some extent, and one of the solutions proposed by the Government has a large popular endorsement.

Fig. 5. Public opinion on the number of MPs

Currently you think that the number of MPs is...	%
Too few MP	1.3
Too many MP	84.0
Just about right	7.5
No answer	7.2

Is reducing the number of MPs an option? What prevents the big and the most corrupt to cleanse party lists of the younger and less corrupt? If the power to decide over the party list remains confined with the oligarchy of the party, there may be even fewer new politicians emerging in the near future. On the other hand, it is true that Romania has one of the largest number of MPs as compared to population, and definitely more than it can afford with its current GDP. Furthermore, fewer MPs means larger constituencies, which would help voters know candidates better, allow more media coverage for each of them and so forth. It may also diminish 'pork barrel', that is to say, the favors that a MP provides to his constituency (and which are relatively bigger if constituencies are smaller and more homogenous). Having fewer candidates also means a decrease in the importance of the party list and more stress on individual virtues (and resources). Both are good for politics.

The alternative move (some would say complementary) would have been to change the electoral system. Both the Government party and the Liberals have announced their intention of supporting such a reform, through passing to a mixed

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plurality (MPP) election system. The main advantage of this system would be to remove the decision from the hands of the party leaders, who would somehow be compelled to propose only competitive candidates (assuming these are somewhere to be found). Both theoretical and empirical arguments plead for important reservations, though. A simple exercise with different variants of majority systems shows that the 2000 elections would have produced a Parliament with only PSD, UDMR and Greater Romania Party in all the variants¹. MPP is harder to model, but its effect on reducing political minorities even further, decreasing party discipline and bringing overall unpredictability (by producing many independents) is obvious. This system, which Russia tried after 1993, produced poor results. For better and for worse, Romania's current electoral system produced at least a stable party system.

Voters may want representatives to be more accountable, but judging on their level of political information, they would take little advantage of the uninominal vote². Accountability should be increased by further decentralization of power to mayors (who are directly elected) and local governments, and by a build-up of horizontal accountability mechanisms, shielded from political intervention and cronyism.

However, Romanians are in favour of a pure majority system: they do not like the current system, and see little use of mixed systems. Of course, they know little on the consequences of a pure majority system. Its only advantage, i.e. producing a strong and stable government by a manufactured majority, is certain only in the 'pure' variant (as in Britain). In other variants of plurality (Germany, France, Italy, Hungary) governments need to draw on coalitions as frequently as in proportional systems. And skilful coalition management or informal arrangements in proportional systems, such as currently seen in Romania, do work, despite the terrible example of the 1996-2000 coalition and its frequent deadlocks.

¹ Alina Mungiu-Pippidi et al. 2001. "Reforma electorala – un panaceu?". Crisis Alert Series. No 2, Societatea Academica din Romania

² see Alina Mungiu-Pippidi. 2002. *Politica dupa comunism*. Chapter V "Votantul roman". Bucuresti: Humanitas

Fig. 6. Constitutional arrangements in post-Communist Europe

Country	Number of Chambers	Members of Parliament	Voting System	Polity	State type
Romania	2	467	Proportional	Semi-presidential	unitary
Poland	2	550	Proportional	Semi-presidential	unitary
Slovak Republic	1	150	Proportional	Parliamentary	unitary
Bulgaria	1	240	Proportional	Semi-presidential	unitary
Russia	2	628	Semi-proportional	Presidential	federal
Ukraine	1	450	Mixed	Semi-presidential	unitary
Lithuania	1	141	Semi-proportional	Semi-presidential	unitary
Latvia	1	100	Proportional	Semi-presidential	unitary
Czech Republic	2	243	Proportional	Parliamentary	unitary
Estonia	1	101	Proportional	Semi-presidential	unitary
Hungary	1	386	Mixed	Parliamentary	unitary
Moldavia	1	101	Proportional	Parliamentary	unitary
Slovenia	1	51	Proportional	Semi-presidential	unitary

Source: Freedom House, Nations in Transit. 2001

The next important issue, specially given the Government's claim that Parliament should be more effective, is the distribution of tasks between the two Chambers. Preferably, but not absolutely, one should seek a correlation between the way in which a Chamber is elected and the tasks it performs. However, this is not always the rule: even in Europe, superior un-elected Chambers play considerable roles. One thing is clear, though: that effectiveness increases when the two Chambers have similar roles and compositions (the current Romanian situation), and decreases as these change (in favor of more checking by one Chamber on another, such as the Senate's veto)³. Or, the purpose of the reform is to increase effectiveness. Would the solutions advanced achieve that? Hardly so, at least without producing other imbalances. Having two Chambers with nearly similar roles is not uncommon in the democratic world. Whilst there is little point in adjusting competencies of the two Chambers, it may be better in the end just giving up one of them altogether. Some frontrunner EU applicant countries have done quite well with just one Chamber (see Fig. 6). However, this, neither, is a panacea. To terminate the Senate would remove a legislative check, which has worked in practice a few times: many laws passed in the Chamber were corrected after public debate when they reached Senate, or the other way around.

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Legislating swiftly is not always legislating well; and by the time such a reform would be implemented, Romania would have adopted the *acquis communautaire* and would be more in need of a quality legislative process than of an expeditious one.

To summarize this brief review, here are a few conclusions:

- The 'real Constitution' is as important as the formal Constitution when planning constitutional engineering. Reforms must be analyzed from this perspective as well, and reformers should leave aside illusions that formal modifications will necessarily uproot embedded practices.
- Empowering the Government can better be realized through an internal reform of its administrative structures (see EWR 1/2001) than by a readjustment of power between the two parts of the executive power, or between legislative and executive.
- The reform of the political class is the task of party leaders. Reduction in the number of MPs will help voters know better their elected representatives and is comparable in effect with, and preferable to, the adoption of the uninominal system. Risks are, however, that parties will continue to remain oligarchic even after that, since only party reform, not Constitutional reform, can change the current situation.
- A reduction in the number of MPs by actually giving up one Chamber altogether should also be considered. Some of the more advanced EU applicant countries are doing very well with such systems. Equally, such a move would have popular support.
- The system of electing the President should not be an issue, as the public has a strong opinion on this and favours the current arrangement.
- The change of the electoral system to 'mixed plurality' (MPP) or other forms is not recommended. The current compromise between a directly elected President and MPs elected on party lists is a fair one and should be kept as such. Open lists (preferential vote) are always an option to

³ See Sartori, G. 1994; *Constitutional Engineering*, NY:NYU Press.

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satisfy public demand, although in practice (Estonia) they have failed to produce any difference from closed lists.

- The participation in a referendum on the Constitutional reform is likely to be low. Proposals, therefore, should be few, clear and short to keep participation at a decent level.
- Alternative ways to improve the quality of the political debate and governance should be explored, given that Constitutional reform cannot achieve much on this. The greatest potential is in the reform of the judiciary and of its' positioning in relation to other powers, which will discuss in the next EWR.

ECONOMY

FISCAL POLICY ISSUES: A LOOK AHEAD

By Daniel Daianu

Tax policy is of major concern in all transition economies; the balance of budgets and the need to provide an adequate amount of public goods, in a period of budget retrenchment, dominate public policy. Is there an optimal level and structure of taxation in transition economies, which should take cognizance of their specifics? Can economically advanced countries provide an indication in this respect? Is there a need for tax reform, and which directions should it take? In Romania, taxation efficiency (tax collection) has become a major policy concern, in view of insufficient tax revenues and the need to keep a low budget deficit. Indeed, the EU accession demands a low budget deficit. In this context, the Romanian Government recently announced its intention to undertake an overhaul of tax policy. This brief analysis explores a few fiscal policy issues in transition economies, with particular focus on Romania.

1. Taxation efficiency in transition economies

There are major differences in the effectiveness and efficiency of taxation amongst transition countries. One can easily observe that, on average, taxation is more efficient in Central and Eastern Europe than in the CIS area. But there are

differences within these groups of countries as well. Thus, Central European governments have been more effective at collecting taxes than the majority of their counterparts in South East Europe; and this performance has been due, quite likely, to stronger public administration and institutions, in general. Romania fares in between in this respect (Fig. 1), albeit its objective of joining the European Union and the claims on public expenditure by very sensitive sectors (such as health care and education) demand considerably higher tax efficiency. An improvement in tax efficiency would allow budget revenues to jump from around 32% of GDP in 2002 (this year's budget target) to more than 34.5% in 2005 (according to official projections).

2. Basic constraints for taxation in transition economies

The legacy of a “**premature welfare state**” was a metaphor used by Janos Kornai, years ago, to portray an over-supply of public goods in the communist economies. The bottom line is that many citizens are used to be provided with these goods, in a period of deep retrenchment of public budgets. This is a terrible constraint for policy, whilst the pursuit of balanced budgets (or easy to finance deficits) is a major policy goal. This constraint is becoming even more severe under the pressure of globalization, when governments resort to *competitive taxation schemes* – which is reminiscent of the old competitive devaluations race. Such a competition can bring about a vicious circle for both individual economies and the international economic system as a whole, to the extent that social exclusion gets out of hand.

A “catch-22” syndrome reinforces the issue highlighted above. The production of private goods is “crowded in” by basic public goods (Robert Barro); but the very expenditure assigned to the supply of public goods may overtax private firms, which are forced out of business and, thereby, trigger the collapse of other companies for which switching costs are too high. Thence emerges a target for fiscal policy: optimal taxation. But, in practical terms, this is a fairly complicated task. The experience in many transition countries shows that, frequently, the temptation was to raise taxes (as *quick-fixes*) in order to cut budget deficits, for the sake of macroeconomic stabilization, instead of trying to rationalize (prioritize) expenditure, or of improving tax collection. This temptation quite often prevailed in Romania as well.

A major constraint for public policy is the **fragility of institutions**, which is reflected by a poor capacity to collect taxes, to enforce laws and regulations. This constraint varies quite widely, but it is indisputable that most transition economies are plagued by institutional fragility.

There is substantial **hidden private taxation** in transition economies; bribes and protection taxes raise the cost of doing business. Firms may be willing to pay these “taxes” to a state, which can enforce laws, or enforce them better. But how can this “transformation” take place, and the deadlock be unraveled. Hidden private taxes combine with the temptation to evade taxes and operate in the underground economy. This is a particularly important challenge for public policy in Romania, where law enforcement is relatively weak.

Last, but not least, is the issue of **access to capital markets**. Transition countries differ widely as to the ability to raise money on foreign capital markets, and this ability can be related to how governments use fiscal policy to cover budget needs, and ensure macroeconomic stability, in general.

3. “Best practices” and “catching-up” supportive tax systems

Which structure and level of tax revenues should be a target for tax reform in Romania? Other countries’ experience can be illuminating in this respect.

3.1. Diversity of circumstances

The OECD countries (the developed countries) show, in general, a higher level of tax revenues, as compared to developing countries. But the OECD area, itself, presents variety, with glaring differences between the Anglo-Saxon world and the continental countries (the European Union). There are substantial differences amongst the EU countries as well; several Mediterranean states (Spain, Portugal, Greece) collect less, whilst their informal sectors are, notoriously, significantly larger (Fig. 1). There can be several explanations for this variety. One is rooted in the different patterns of welfare states in various sub-areas of OECD. Another explanation can be the very quest for tax reform in many OECD countries, which complicates, in a way, the search for “best practices”. The EU, as a whole, is contemplating tax reform, which should enhance its competitiveness in the global economy. However, this is made difficult by the fact that the national components of the EU maintain essential prerogatives in the realm of fiscal legislation.

Therefore, examples do exist and they have relevance; but one needs to be careful, since there is substantial variety even amongst the countries that, supposedly, provide good practices. In order to see how complicated is to figure out proper tax levels, it is worthwhile looking at the VAT. In the OECD area, this tax brings, on average, about 7% of GDP. Except in Romania and Macedonia (where the tax intake is about 6% of GDP), this tax brings, in Central, Eastern and South East Europe, considerably higher revenues. Actually, the numbers for Croatia and Slovenia are quite stunning: 13% and 15%, respectively, of GDP. Is VAT an example of massive over-taxation in transition economies? The actual rates are not exceptionally high, which would indicate that there is no over-taxation. In any case, the VAT could bring significantly higher budget revenues in Romania as well.

When it comes to improving administrative skills for tax collection, things appear more clear-cut. But even this issue may be easier to deal with in theory than in practice. As the Argentinian experience amply illustrates – with its largely failed attempt to overhaul (reform) the tax system in recent years, despite heavy guidance from the IFIs – this reform is far from being easy. This, and other botched experiences, should provide warning signals to Romanian policy-makers who intend to undertake a thorough reform of tax administration and pin much hope on this endeavor. Croatia, instead, provides an example of an effective tax administration and policy reform, which deserves a closer look from Romanian policy-makers.

3.2. Which best practices?

It is common knowledge that rich countries used a different level and structure of taxes when they were at an inferior level of economic development. How does this fact bear on the suggestion – which some make – to use their current taxation systems as signposts for tax reform in transition countries? Several questions can be raised in this respect:

- a) which *best practices* does one have in mind? Are taxation systems in the industrial countries the model(s) to follow, as an iron rule? Can an economy leapfrog development stages by just trying to imitate (import) institutions?
- b) do *best practices* mean uniform rates?

c) does it make sense to also look at the experience of economies, be they very few, which scored remarkable economic progress during the last decades (the successful catching-up stories⁴)?

d) to what extent globalization and the rules and regulations of the international economic system (WTO, etc) allow to an economy room for using fiscal devices to foster growth? The case of Ireland is conspicuous in Western Europe; equally, amongst transition countries, the Visegrad group attracted most of the FDI by using fiscal incentives. One can even broaden the discussion and also look at Asian economies. The developmental challenge may be less relevant for the accession countries (albeit, they, themselves, have to close major gaps vis-à-vis the West), but it is certainly becoming of paramount importance for many countries in the CIS area and in most of Southeast Europe.

The conventional wisdom (and the advice provided by the IFIs) stresses the need for non-distortionary taxes, for fiscal neutrality. But how can least distortionary effects of taxes be judged in a world in which there are numerous externalities, asymmetries, adverse external shocks, multiple equilibria, etc? How can one deal most effectively with the multitude of second-best options? And what are the policy implications, in general, and for taxation, in particular?

3.3. The international *tax regime*

At the same time, can one talk about the efficiency of national taxation systems without addressing the functioning of the international economic system – the *international tax regime*? An analogy can be used in this respect: can one talk about the opening of the capital account without examining the working of international capital markets? Similarly, one can question the effectiveness of the fight against tax evasion (avoidance) when individuals and firms can use tax-havens. The fight against tax evasion (avoidance) in transition economies should be seen in the context of combating money laundering, and against the backdrop of the struggle against international terrorism.

Notwithstanding the caveats made above, it is likely that the EU accession countries will have, in general, a smoother path in upgrading their administrative

⁴ One needs to acknowledge, however, that historical and cultural circumstances matter a lot.

skills and tax collection capabilities. This is also related to the degree of cultural and institutional empathy with their western partners, and should be a valid assumption for Romania as well, who needs to capitalize on the technical assistance that it receives from EU member countries.

4. The EU factor

There are several layers for judging the EU's influence on taxation in transition economies, and in the accession countries in particular. One layer is the *Acquis Communautaire*, which shapes institutional reforms in the accession countries. Whether we like it or not, whether we deem it appropriate (fiscally wise) or not, the fact is that the EU accession countries are compelled to adjust their legislations to EU norms. Having said that, one should acknowledge that there is significant room for policy maneuver, since tax rates are not uniform across the EU area. But there are instances – as in the case of excises – when the pressure to move into one direction, and at a certain speed, is considerable.

Another layer is represented by EU's financial assistance to less developed regions and, in this context, to the accession countries. Structural and cohesion funds could supplement the accession countries' budgets considerably – to the tune of 4% of each country's GDP⁵. This revenue supplement could fill in large budget holes and mitigate tax reform pains. On the other hand, the financial benefit of structural and cohesion funds needs to be seen in conjunction with the impact that nominal convergence requirements (the Masstricht criteria) have on budget revenues; lower economic growth rates will, *ceteris paribus*, bring in fewer budget revenues. In addition, as Mitra and Stern rightly observe, the commitments made under the 2000-2004 Pre-Accession Economic Programs (which demand, on average, an improved budget balance by around 0.5% of GDP, while cutting taxes by about 2% of GDP and undertaking additional expenditure of the order of 3.5% of GDP) pose a “formidable fiscal challenge”, which would “require a thorough reappraisal of the role of the state in the economy”. *Mutatis mutandis*, the debate on the nature of the welfare state in the industrial countries⁶ is also illustrated by the dilemmas that policy-makers face in the accession countries.

⁵ According to a decision adopted by a EU ministerial meeting in Berlin, in 1999.

⁶ This debate is of a longer vintage than the one fuelled by Anthony Giddens' “Third Way” (1998)

Romania may not be under the same pressure as the frontrunner accession countries, but the challenge is amplified in view of its lower taxation efficiency. However, one can argue that the lower tax yields in Romania provide substantial room for increase, which would orient policy reform towards improving tax efficiency.

5. Final remarks: improving tax efficiency in Romania

Romania needs to improve taxation efficiency (the collection of taxes) in order to raise budget revenues. Arguably, tax revenues could increase substantially through better tax collection, assuming no fundamental change in the structure of taxation. But for this to happen, a thorough overhaul of tax administration (tax collection) is needed.

The plans to create a unified tax administration department and a large taxpayer directorate are to be encouraged and supported.

The reform of tax administration should aim at improved levels of voluntary compliance through the delivery of modern and reliable taxpayer assistance services, well-targeted audit and other control activities, and timely follow up on unpaid debts. This reform involves a betterment of the skills, professionalism and integrity of tax collection officials.

The tax system needs to be simplified, in order to ease administration and reduce compliance costs. In this context, a streamlining of the VAT policy, which would imply the termination of an array of exemptions, does make sense; this streamlining would also directly help raising budget revenues. The reduction of VAT exemptions should be accompanied by the removal of delays in VAT refunds.

The simplification of the tax system, however, should not turn into policy fundamentalism. One should keep in mind that the EU member countries, themselves, use the logic of non-distortionary taxation in a flexible way.

Romania needs a tax regime that should be friendly to investment, from wherever it comes. This regime should not be captured by vested interests – but this does not necessarily mean not to provide incentives to FDIs when they engage in greenfield operations, which create jobs, bring in new technologies and have trickle-down effects (which benefit the entire economy). Such incentives do not

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harm budget revenues when they involve genuinely new investment; actually, such investments may even raise budget revenues by increasing aggregate economic activity. It is fair to say, however, that when the existence of such incentives prompts existing firms to ask for similar benefits, total budget revenues may be damaged. Arguably, a friendly business environment attracts FDI even without special incentives, but there is a time constraint here: a proper business environment cannot be created instantaneously, whereas, sometimes, fiscal incentives can provide a competitive edge to governments which badly need investment from outside.

The issue of social security contribution (the payroll tax) is of paramount concern in Romania, where the payroll tax amounts to over 57% of the wage fund (in all likelihood, the highest rate in Central and Eastern Europe). The reduction of the payroll tax would be a means to diminish labor disincentives. It is, therefore, good news that the Government announced its intention to reduce this tax in the near future. The initial loss of budget revenues could be offset by a rise in the overall efficiency of taxation.

The Ministry of Finance and the Government should closely watch the implementation of the recently adopted Ordinance, which introduces “rigorous” criteria for the rescheduling of tax arrears and the cancellation of penalties. There is a risk that the new regulation may increase the size of arrears, rather than reduce it.

Low taxation and simplified regulations, combating red tape are essential for the development of SMEs. But only good ideas and entrepreneurial spirit may not be enough when there is need for bank finance and banks demand hardly available collateral. Consequently, one has to be more nuanced when looking at the circumstances in transition economies. Arguably, the BIS' (Bank for International Settlements) new regulations on banks' provisioning for loans will hit severely small and medium sized firms, unless banks find creative ways for financing. If such firms are so badly hit in a country like Germany (where *Mittelstand Betriebe* rely extensively on bank credit), one can imagine the impact of the new regulations in transition economies, where capital markets function poorly and self-financing is often not an option. One way to mitigate the difficulties of SMEs in obtaining finance is to set up specialized financial institutions to cater to their needs; it is a positive sign that the EBRD is among the sponsors of a SMEs focused bank to be set up in Romania soon.

Finally, the speed at which some excises are raised, as part of the EU accession process, may be too high, given Romania's current income per capita – this speed favors tax evasion and the underground economy. The EU should probably be more lenient in this regard.

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Fig. 1. Tax revenues as a ratio of GDP, 1999-2000 (average)

Eastern Europe & the CIS		Western World	
Albania	18	Austria	48.2
Croatia	39.3	Danmark	49.2
Czech Republic	37.2	Germany	38
Slovakia	34	Portugal	33.3
Hungary	36.1	Australia	29
CIS	24.8	Ireland	32.7
Bulgaria	30.5	USA	27.6
Romania	30.5	Belgium	45
Poland	32.6	France	42.2
Slovenia	40.3	Italy	42.8
Russia	33.8	Spain	33.5
		Canada	37.3
		New Zealand	32.5

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

FIRST QUARTER 2002: SOME WORRYING SIGNS

Overall foreign trade stagnated, and it even decreased in the "technology-intensive" group. Industrial output grew at a slower pace than last year, real productivity in the manufacturing industry remained low, whilst real wages spurred in the utilities sector.

The trade deficit decreased slightly, industrial output grew by 5.7%, the ROL appreciated against the Euro in real terms, and inflation reached its lowest

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monthly rate over the last ten years. All these disparate facts risk creating an overoptimistic picture of Romania's economic realities. What lies behind may be less impressive and requires more prudent judgment.

Romania's foreign trade almost stagnated in the first quarter of the current year. Exports grew by just 0.8%, and imports decreased by 0.9% as compared to 2001. One year ago, the trend was completely different, with both exports and imports skyrocketing (by 19%, and 36% respectively).

For many, this may have been a shock, since exports were perceived as one of the engines of growth in recent years. For the readers of our Annual Early Warning Report⁷, this is merely a confirmation. Based on the interpretation of the concentration index, coverage ratio and revealed comparative advantages, we warned that Romania's foreign trade in general, and its trade with the EU in particular, seem to have reached a stalemate. We also highlighted, in the Annual Report, that while in absolute terms trade volume increased, in relative terms trade performance stagnated over the last four years. Trade volumes tend now to stabilize, probably also influenced, with a time lag, by the stagnating foreign demand in the context of the economic slowdown in Western Europe.

Fig. 2. Foreign trade evolution

	1 st quarter 2002 compared to 1 st quarter 2001	1 st quarter 2001 compared to 1 st quarter 2000
Total exports	+0.8%	+19.6%
Exports to EU	+3.4%	+27.7%
Textiles and clothing	+6.8%	+21.3%
Machines and equipment	-6.8%	+61.7%
Metals and articles thereof	-4.9%	+1.7%
Total imports	-0.9%	+36.8%
Imports from EU	+3.0%	+32.9%
Textiles and clothing	+6.0%	+22.5%
Machines and equipment	-10.4%	+42.3%
Metals and articles thereof	-2.7%	+46.3%

Source: adapted from INSSE

⁷ Liviu Voinea, No Harry Potter in Romania's Foreign Trade, Annual Early Warning Report, UNDP/Romanian Academic Society, Bucharest, 2002.

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CEFTA continues to represent a problem for Romania's foreign trade, with exports to this area decreasing by 21.6%, while imports slightly increased by 1.9%. This sharply different evolution validates another remark made in the Annual Report, namely that CEFTA is not an integrated area, and the import concentration index is much below the export concentration index (exports are not import-related).

Equally, trade in metallurgical products decreased, confirming yet another warning issued in the Annual Report, namely that in the context of the accelerated increase in energy prices, metallurgy trade in the SEE area is likely to decline.

A second reason for the stagnation of foreign trade might lie with the real appreciation of the Romanian currency (in real terms, ROL gained 1% to Euro in the first quarter). This, however, is less obvious, as imports were not stimulated; on the contrary, they significantly decreased in import-dependant industries such as machines and equipment.

A third explanation relates to the lower rates of output growth in the main export-oriented sectors, as compared to the same period of the last year.

Fig. 3. Industrial production indices, adjusted according to working days,

corresponding month of previous year = 100	March 2002	March 2001
Industry	102.7	110.6
Manufacturing	103.9	114.0
Textiles and clothing	104.0	114.0
Footwear	96.0	121.8
Wood industry	79.6	95.0
Machines and equipment, mechanical	99.5	114.7
Machines and equipment, electrical	103.2	110.5

Source: adapted from INSSE; Note: at the end of March 2002, stocks represented 38.8% of resources in the manufacturing industry, and 64.5% in the machines and equipment group.

Apparently, the problem in the manufacturing sector is, as stated before⁸, the lack of a development horizon. Amongst candidate countries, Romania is the one that

⁸ Idem 7.

produces most in OTP (outward processing traffic) arrangements, and has failed up to now to pass consistently to the next stage of OEM (original equipment manufacturing)⁹. Low integration in the international networks of production and distribution (see Fig. 4) prevents Romanian manufacturing industry from increasing its value-added.

Fig. 4. Production chain characteristics in the Romanian economy

Indicator	Value	Ranking in the world (out of 75 countries)
Extent of product and process collaboration (product and process development are conducted: 1-within companies or with foreign suppliers; 7-in collaboration with local suppliers, customers and research institutions)	2.9	73
Value chain presence (exporting companies: 1-are involved primarily in production; 7-conduct also product development, distribution and marketing)	2.7	72

Source: Global Competitiveness Report, 2001-2002

Fig. 5. Productivity, wages and prices, March 2002 compared to March 2001

	Manufacturing	Electric and thermal energy, gas and water
Nominal work productivity (production value / number of employees)	22.4%	26.2%
Nominal average wage	13.6%	39.8%
PPI (production prices index)	20.2%	43%
CPI (consumer prices index)	22.6%	

Source: authors' calculations, based on INSSE data

When computing figures for the end of the first quarter, 2002 compared to 2001, two worrying results appear:

- the manufacturing industry records virtually no real productivity gains. The good news is that nominal wage increases in this sector are, however, covered by nominal productivity.

⁹ Denis Eylem Yoruk, Patterns of Industrial Upgrading in the Clothing Industry in Poland and Romania, working paper 19/2001, Center for the Study of Economic and Social Change in Europe, School of Slavonic and East European Studies.

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- large real wage increases, unjustified by productivity levels, appear in the utilities sector. Once again, this demonstrates the extent of structural problems, and threatens the process of disinflation.

Together with the stagnation of foreign trade, these developments (which should, however, be treated cautiously, as they only apply to the first quarter of 2002) constitute warnings on the potential slowdown of economic performance this year. One cannot cheat the economy for too long; and restructuring still has a long way to go (the recent Petrom case, of original interpretation of what laying-off means, in the context of World Bank's PSAL II and of IMF's Stand-by Agreement, is proof of that).



SOCIAL

THE BLACK HOLE IN THE HOSPITAL SECTOR SUCKS IN THE RESOURCES OF THE HEALTHCARE SYSTEM

Wrong incentives in the hospital sector endanger the viability of the health system. The policy response of the government is weak, and the forthcoming debate on the Hospital Bill is likely to be irrelevant to the real woes of the health sector.

The Romanian healthcare service is undergoing one of the worst crises after 1989. Since the start of this year, the public has been bombarded with horrific stories about the state of the health system. Family practitioners, the supposedly winners of health reform, and the one medical category that so far had shown in surveys the most consistent support for the reform process, went on strike over funding. The media focused on an apparently endless series of medical and managerial failures: from Iasi to Arad children were dying because of malfunctioning equipment, or a streak of intra-hospital infections. Echoing public sentiment, Kraft Jacobs Suchard, a multinational, launched on Pro TV a campaign for helping children hospitals. Public spirited as this might be, the campaign was certainly depressing, providing images of shocking decay. Finally, hospitals from across the country announced that they were facing a financial crunch. A psychiatric hospital let it be known that it faced a number of escapes, because it cannot afford to pay for adequate guarding. The crisis hit home when the Fundeni Hospital, one of the most prestigious of the Bucharest hospitals, announced that it was unable to pay its water bill.

While many of these cases can be blamed on exceptionally poor management, it is clear that systemic causes also play a role in such an alarming increase in reported funding problems. More important, the Government seems unresponsive to the problems of health suppliers, and its policy recipe fails to address the real causes of the crisis.

Reform logic - upside down

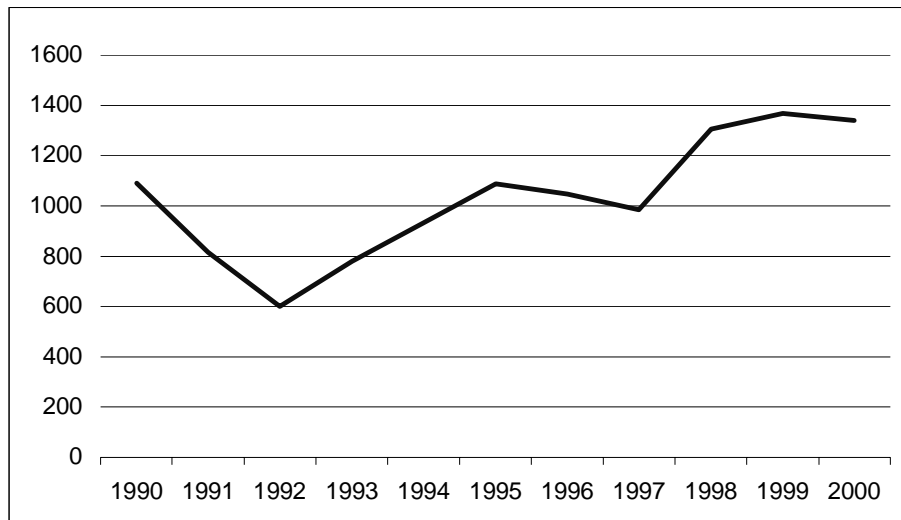
Romanian health reform aimed to increase the overall resources allocated to health care and to shift the emphasis from in-patient to primary care. Four years after the nation-wide introduction of the new funding system, based on social insurance, the pie for health has substantially increased. In spite of comparable utilization rates, however, hospitals consume an even larger share of this pie. This is due to the lack of cost-containment incentives, in a non-competitive system dominated by hospital doctors. This situation presents the risk of crowding out expenditure for the primary care – an essential element of the reform strategy –, and for subsidized drugs – a paramount social issue.

The reform process went further in primary care, which was effectively privatized through the introduction of family practice and the change of the funding system to one based mainly on capitation. There was much less progress in the hospital sector, however. The ownership of facilities is still unclear, and funding is still based on historic budgets. The health funds, which theoretically are the purchasers of health services, and have to contract the providers, failed to act selectively and had little impact upon the behaviour of providers.

General health expenditure

Even in absolute terms, the increase in resources brought by social insurance is substantial. Fig. 1 presents the evolution of health expenditure calculated in US dollars. The absolute expenditure declined with the start of transition – the share of GDP remained constant, but GDP contracted. The introduction of social insurance resulted in an absolute increase of about 25% as compared to 1990, and over 30% as compared to 1997 (the last year before the introduction of social insurance funding).

Fig. 1. Total public health expenditure (million USD)



In relative terms, total health expenditure increased from around 3% of GDP in the early 1990s, to almost 5% at present.

Hospital restructuring

Romania entered the reforms with an over-bloated hospital sector – not unlike most of EU and CEE countries, however. The main indicators used to assess the efficiency of the hospital sector are:

- number of beds,
- occupancy rate,
- number of admissions, and
- length of stay.

According to the latest data available, Romania's figures are at the higher end, but within the expected range, on all these indicators. The rate of admissions (about 20/100 people), and the length of stay (about 10 days) are in the higher numbers in WHO Europe region as a whole, and average for CEE countries. The occupancy rate (about 75%) is in the lower half, whilst the number of beds (over 7/1000 inhabitants) is in the higher one.

In assessing this performance, one has to take into account that all the countries that we benchmark with have a dire situation in the hospital sector: they all attempt to reduce the number of beds, admissions and length of stay, and to increase the occupancy rate. A situation that is slightly worse than their average is rather problematic.

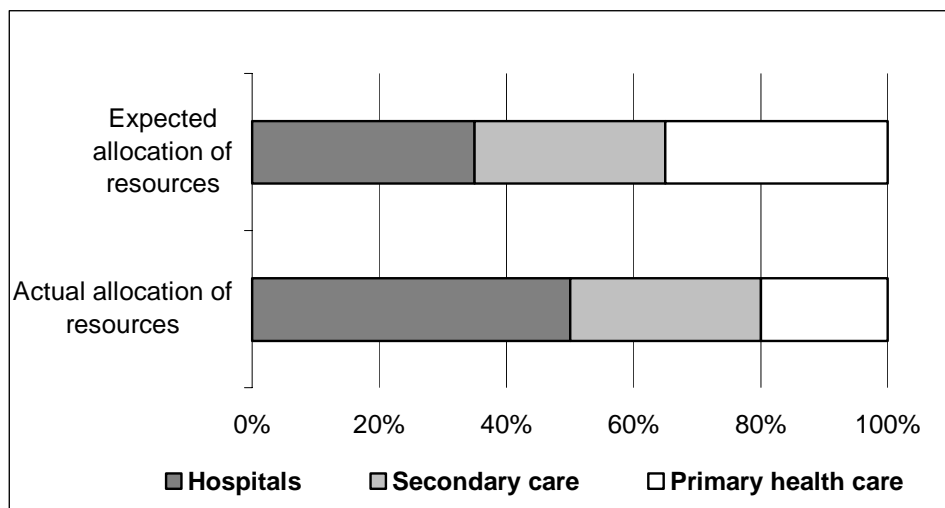
However, it is important that over the 1990s these indicators moved in the right direction. The number of beds declined sharply by about 20%, whilst the admission rate stayed practically the same. This boosted the occupancy rate. The length of stay declined by about 15%.

The most important conclusion from the point of view of funding is that the utilization indicators have not worsened. This shows that the pressure for increased spending does not come from a larger number of cases.

Hospital funding

Fig. 2 shows the expectations of the artisans of the reforms concerning the allocation of resources inside the health sector. We can clearly see the intended shift of resources away from the hospital sector, and into primary care.

Fig. 2. Wishful thinking: the 1997 strategy



Source: BASYS, 1997

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Fig. 3 by contrast presents the actual break down of resource allocation inside the health sector. In parallel with the actual expenses, are presented the provisions of the frame contract (NFC, drafted at the start of the year), and of the summer budget – the mid-term correction of the budget (MTB).

Fig. 3. Health expenditure: comparison between actual expenses and amounts provided by the National Frame Contract (NFC), and revised mid-term budget (MTB)

Tip serviciu	1998 Actual (%)	1999 NFC (%)	1999 MTB (%)	1999 Actual (%)	2000 NFC (%)	2000 MTB (%)	2000 Actual (%)	CoCa 2001 (%)
Primary care	9,01	15,5	9,48	9,05	14,5-15	9,78	9,51	14,5-15
Out-patient (specialists)	5,85	11,75	6,62	6,11	8,75	7,85	7,23	8,75
Hospitals	67,25	40,00	61,24	64,18	59-61	63,99	65,48	50-53
Subsidized drugs	6,81	20,0	9,32	8,03	10-11	12,83	12,41	10
Dentistry	2,66	4,25	2,76	2,36	2,5-3	1,58	1,43	3
Rehabilitation services	0,82	1,00	1,17	1,11	1	0,63	0,65	1-1,2
Protesis	3,23	3,00	0,62	0,28	1	0,33	0,28	1
Ambulance services	4,32	4,50	3,80	3,67	3-4	3,00	3,00	3
Health programmes	0,06	0	4,99	5,20	0,1-1	0,00	0,00	8
Total	100	100	100	100	100	100	100	100

Even though each year the shares of hospitals increased after the budget rectification, it is still over-shot by the actual expenditure. The reverse is true for primary care and drug expenditure. These data show the inability of the budget sector to respect budget constrains. We have to bear in mind that the resources actually spent have always been lower than the estimates: the actual income has been lower in each year compared with the amount in the summer budget. This resulted in lower than expected expenditure. As a consequence, a higher than expected share for hospital expenditure means lower than expected real resources for primary care and subsidized drugs. From the champion of reforms, primary care has become the Cinderella of budget allocations.

Fig. 4. Income and expenses of the Health Funds 1998-2000

Billion ROL	1998			1999			2000	
	Budget law	Mid-term budget correction	Actual	Budget law	Mid-term budget correction	Actual	Budget law	Mid-term budget correction
Income	10296	9541	8372	11967	20443	18386	26725	29002
Total expenses	7626	7584	7403	11368	16997	15958	23907	25261
Reserve fund	-	-	-	598	962	806	1336	1450
Ballance	2669	1957	969	0	2484	1622	2292	2292

To put things into context, Fig. 5 presents the breakdown of resources by sector in healthcare for the OECD countries.

Fig. 5. Public health expenditure break down by sector in OECD countries

Public expenditure by health care sector out of total public health expenditure (%)	Median	Average	Maximum	Minimum
Hospitals	52	54	78	30
Drugs	12	13	27	6
Out-patient services	20	21	40	8

The striking fact is that Romania spends, in relative terms, more on hospitals, and less on primary care and drugs, than most OECD countries. In addition, we have to bear in mind that this breakdown is based on the expenditure of health funds. Were the rest of about 20% of public expenditure to be taken into consideration, the share of hospital expenditure would be even higher.

This is even more surprising if we take into account that in the early 1990s Romania was, together with the Czech Republic, the champion on drug spending. The expectation for a country like Romania is to spend a higher percentage on drugs than western countries, because the price of tradable goods like drugs varies less amongst countries than the price of labour. Therefore, the labour intensive sectors should take a lower share from overall resources in Romania compared with Western Europe.

Incentive misalignments

The root of the problem springs from the lack of adequate institutional incentives for cost-containment at the hospital level. The hospital sector is very powerful politically, as it comprises the elite of the medical profession. The matter is made worse by the fact that members of this elite are the decision-makers at all levels of

the health system: health managers, Ministry of Health, health funds, medical college, and most of the politicians dealing with health.

The lack of competition between health funds (which are regional monopolies, and therefore do not have to compete for clients) creates an institutional setup where there is no incentive for the health fund to take on these powerful interest groups and enforce hard budget constraints upon hospitals. The dominant strategy is an alliance of the purchaser with the provider to pass the costs to the budget.

Equally, the autonomy of hospital managers is limited, which precludes even the restructuring measures intended by the public-spirited managers. Moreover, the only instrument for motivating managers is the indiscriminate threat to be fired, whilst no incentive plans are available.

Governmental reform plans

The leadership in the Ministry of Health and Family has identified the reform of the hospital sector as a priority. However, it is less clear whether the decision-makers understand the mechanisms that led to the current predicament, and if yes how are the policies that have been announced going to mitigate the situation.

The main initiatives consist of changing the funding system to DRG (diagnosis groups), and partial privatization. Theoretically, basing the funding on the case-mix rather than on actual costs would encourage hospitals to be more efficient. The problem is that DRG per se could lead to more efficient interventions, but not necessarily result in overall cost reduction. More important, the full implementation of DRG is a very complicated process, which will take years. Proof to this is the experience of Hungary, the first CEE country to adopt this method. Therefore, whatever benefits it will bring, DRG is not a solution in the short term.

Privatization is a trickier issue. Whether this means outsourcing some services, or even privatizing 'hotel' services, it will improve efficiency. Partial privatization of hotel facilities, however, bears the risk that part of the costs of these private facilities may be passed to the public section of the hospital. A much better alternative would be outright privatization of whole hospitals (or creating new private hospitals out of scratch).

Whilst both policies have things to be commended for, they fail to address the cost containment of hospital expenditure and the looming crises in the primary care and pharmaceuticals.

A new Hospitals Act

The current proposals for a law dealing with specialized care are more remarkable for what they fail to address than for any consistent reform that they promote. As a sign of the perceived urgency of the hospital sector crisis, the Parliament is faced with two new drafts of the Hospital Bill. One is coming from the Ministry of Health and Family, and the other was submitted by the College of Physicians (professional body). The two drafts have many similarities. The main innovation brought by the Government is to increase the financial autonomy of the hospitals by allowing them to borrow up to 15% of the contracted income, provided that the overall debt level is no larger than 20% of the yearly budget. The College of Physicians goes a step further, by allowing depreciation to be counted as a cost. However, both drafts are silent on some fundamental issues:

1. Hospital ownership: the alternative is to transfer them to local governments, or even better to grant them the status of autonomous not-for-profit organizations
2. Financial autonomy: in spite of the welcome permission to borrow, the hospital management will continue to be construed, and, more important, to lack incentives for full financial accountability. The drafts would preserve the situation where the management has no incentive to economize on non-operational costs, which are provided on a discretionary basis by the national or local governments (equipment purchase and building development are funded from the central budget, whilst maintenance costs would be provided by the local government). This contrasts with the situation of the operational costs, covered by the County Health Insurance House according to the National Frame Contract, and which are related to performance (i.e. utilization) indicators.

The effects of the envisaged stronger control over the management's ability to accumulate back-payments are unlikely to make a difference, unless the incentive structure is changed.

Conclusions

The operating costs of specialized care are out of control. Hospitals are squeezing out resources that should go to drugs and primary care. In spite of improved overall funding for health and no increase in utilization rates, hospitals consume an even larger share of health resources. Romania, despite its low wages, is in the paradoxical situation of allocating to hospitals a larger share of public health resources than OECD countries. This situation presents obvious social and political risks. In addition, it undermines the role of primary care as the champion of reform.

The initiatives of the Government concerning the hospital sector fail to address the cost-containment problem. Whilst the shift to case mix funding and privatization are commendable, their effects will not be seen for years to come. Partial privatization (as opposed to full privatization) might even worsen the situation.

The new drafts for the Hospital Bill increase the financial flexibility of the management. The inclusion of depreciation costs in the balance sheet, proposed by the College of Physicians, is specially welcome. However, they do not go far enough:

- the ability to fund investments is constrained by the limits on borrowing
- no motivation factors for managers are introduced; in contrast, exclusive reliance is placed on administrative controls;
- the ownership issue is not solved.

The non-competitive nature of the Romanian social health insurance funds will always create incentives problems. They can be however partly mitigated by:

- clarifying the ownership of hospitals, by transferring them to the local government, or better by establishing them as independent charities
- creating the incentive for managers to allocate efficiently all expenses, by funding capital and operational expenses according to the same mechanism (e.g. from the Health Insurance Fund)
- devising incentive plans for hospitals managers that reward good performance.

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E A R L Y W A R N I N G R E P O R T

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