

SAR ANNUAL REPORT 2008

We joined the EU on January 1st, 2007, and this has been an historic achievement for the nation, but subsequently our performance as an EU member was far from glorious, says **SAR**

ROMANIA'S FIRST YEAR IN THE EU

While the economy continued to grow, the year was lost in domestic infighting among political parties, with a majority in the Parliament seeking permanently to by-pass the country's EU engagements in the sensitive fields of anticorruption and political accountability. At times it looked like a civil war has broken out between the President Băsescu and the parliamentary majority on this subject. The modest economic management capacity that has kept the country on the right track since 2000 is rapidly dwindling away.



1. POLITICAL STABILITY AND THE STATE OF DEMOCRACY

A review of 2007

Romania is a semi-presidential republic. The President is directly elected by the voters, but has limited powers (chairs defense and foreign policy, appoints the PM, but cannot dismiss either him or the Parliament). This French inspired system is common in Eastern Europe (of Romania's neighbors, Poland, Ukraine and Bulgaria have similar systems) and despite the split of executive power between PM and President, it has functioned so far. In France problems have generally occurred in cases of the so-called 'cohabitation' when the electorate returned a President of a different party than the majority in the



Parliament. In Romania the problem is that this French inspired semi-presidentialism needs to combine with a proportional electoral system which has witnessed diminishing majorities over the last four electoral cycles. The risk then appears that a President directly elected by a majority is only tied to a minority party in the Parliament.

The current President, Traian Băsescu, and the current PM, Călin Popescu Țăriceanu, have started as allies in the Truth and Justice Alliance formed by the Democratic Party (PD) and the National Liberal one (PNL). They fell apart over the President's wish to call early elections in order to get a larger majority, since he had appointed Mr. Țăriceanu in 2004 to form a government on the basis of a one vote majority of the coalition.

This divergence over tactics led in time to more serious disagreements and the infighting in the coalition has gradually turned unmanageable. Mr. Țăriceanu has started to govern more with the opposition, especially the Social Democrats, PSD, than with his Democratic allies.

2007 was lost with political struggles and attempts to block the rule of law

To push his own agenda, Băsescu started to evoke his constitutional powers to organize direct consultations. MPs, fearful especially that he might

touch the sensitive areas of constitutional reform (such as powers of the President or the voting system), reacted promptly by trying to curtail his powers. The referendum law became therefore the object of prolonged legal battles in Parliament and Constitutional Court, while the fight between President and PM turned into a vicious war between Băsescu and the majority in the Parliament. His former party, PD, was gradually isolated.

Pushed to the wall by Băsescu's support for the unpopular Agency for National Integrity (ANI), a body requested by the EU to check the wealth and conflict of interests of MPs, as well as by the numerous investigations initiated against them by DNA, the anticorruption department, MPs first passed in February a no-confidence vote against Justice Minister Monica Macovei. In March they threatened to bring down the government unless all PD ministers were removed.

Mr. Țăriceanu eliminated his former allies, filled in the ministerial positions with liberals and his minor ally, the Hungarian party and managed to get an investiture vote despite enjoying less than a third of votes in the two chambers. This minority government also survived two no-confidence votes in 2007 and practically led the majority in an incessant fight with the President. Băsescu and his party are the only ones enjoying popular support above the share of the vote they received in 2004, so they would be the main beneficiaries of early elections. This largely explains why the other parties found common grounds to unite against him and PD.

Following the elimination of the Democrats in March the parliament appointed a special committee to investigate alleged abuses of the Constitution by the Romanian President. The committee was chaired by Mr. Dan Voiculescu, head of a pocket party, the Conservatives. Mr. Voiculescu is one of the important media tycoons in Romania. His fortune originates in Communist times, when he worked for "Dunarea", Ceaușescu's foreign trade and money laundering business. The authority screening the Communist archives, CNSAS, has identified Mr. Voiculescu as an informant of Ceaușescu's secret service. He was also investigated by various state agencies for preferential treatment given to his energy trading company.

Mr. Voiculescu swiftly turned from hunted to hunter and elaborated a long document with alleged infringements of the Constitution by Băsescu. As he had no smoking gun, the document read like a long copy and paste from newspapers critical of the President. Some of the accusations bordered the absurd, like his preference for a certain restaurant or his attendance of government meetings (despite the Constitution allowing it).

Others, such as preference given to his own party despite the Constitution specifying that once elected the President was neutral rang true, but only exposed yet (another) weak spot of the Constitution. Once elected, all French Presidents claim to represent the whole nation, but this did not make Mr. Mitterand less a Socialist or Mr. Chirac less a Gaullist, nor did it diminish their

informal influence in their parties of origin. Băsescu, or any president of Romania, does not have any lever to provide concrete support for a political party (such as financing or government appointments). PSD's Ion Iliescu, who enjoyed three mandates, was always closer to PSD than the opposition.

Despite a ruling by the Constitutional Court that there was no proof of serious breach of the Constitution by the President, the majority of the Parliament voted for his impeachment anyway, on April 19, 2007, with speeches presenting themselves as nation saviors broadcast live on TV. A two thirds majority (322) MPs cast their vote to impeach Băsescu, and Mr. Nicolae Văcăroiu, the head of the Senate and former Communist nomenklatura, became the interim head of state. The Constitution, however, gave the voters the right to sanction this decision in a referendum after a one month campaign.

On May 19, a large majority of Romanians voted against the impeachment of the president, after a campaign which did not give equal chances to both camps. The Audio-Visual Council ruled that the broadcasting time will not be divided equally among those supporting or opposing the impeachment (yes versus no, as voters were asked to decide), but following the proportion political parties enjoyed in Parliament. Băsescu therefore was reduced to less than 15% seats of Democrats with the time of all other parties used against him. As he is a very gifted campaigner, however and as popular indignation had been mounting with the dismissal of Ms Macovei and the casting of Mr Voiculescu in his anti-Băsescu role, this proved enough. He was reinstated with 75% votes in his favor, despite turnout not reaching 50%.

The European elections, rescheduled for November, were held in normal conditions. Turnout was only 28%. PD won about 28%, with the second pro-presidential party, PLD, a splinter of Liberals, also getting about 7%. Liberals scored 13%, and PSD 22%. The two fierce populist parties, Greater Romania and New Generation failed in delivering any meaningful message and as they also divided the radical constituency, so neither made it over the 5% electoral threshold.

How exceptional are Romania's political problems?

While in textbooks on democratic transition, Central and Eastern Europe provides the model of success, the Brussels' concern over the politics of the new members has been mounting for the past year. Romania is not exception in this respect.

A quick glance at the countries of Central and Eastern Europe quickly singles out Slovenia as the only one having no serious troubles. It is the only new member country that already has joined the monetary union and holds the six-month rotating European presidency in 2008, a performance test for any government. The Baltic states also are doing rather well in terms of domestic politics, though during transition they had their ups and downs. All other Central European countries, Bulgaria included, are plagued by populism and corruption.

Five distinct features are apparent in the politically troubled countries of the region:

- 1) the electoral advance of populist groups, whether extremist type or relatively democratic, to the detriment of classic "ideological" parties (as in Bulgaria, the Czech Republic, Romania, Poland, and Slovakia);
- 2) political radicalization on both sides of the main political cleavage – generally the left-right one, though ideological borders are sometimes fuzzy – resulting in a lack of cooperation across the cleavage line and in political instability (as in the Czech Republic, Hungary, and Romania);
- 3) evenly split electorates between the two electoral coalitions, resulting in weak majorities and unstable minority governments (as in the Czech Republic, Poland, and Romania);
- 4) factional behavior, leading to poor cooperation within electoral coalitions and bringing further instability to governments (as evidenced nearly everywhere); and
- 5) occasional actions that violate democratic standards, or are on the margins of doing so—such as attempts to influence justice, rig elections, or restrict the rights of political opponents—which

are generally limited in time and impact and end up in public scandal.

These five features of the current crises in Central and Eastern Europe are often interrelated, yet they can still be distinguished from one another quite clearly. A synthesis of the symptoms in Tab. 1, with the inherent and regrettable simplifications that such endeavors

The new member states share the same post-accession political hagovers

presume, shows that the crisis is indeed general. Some populist gains were recorded in countries with proportional representation electoral systems (PR); two

populist parties have even won elections (namely, for the Slovak parliament and for Bulgaria's EU and local elections). Yet except for the Hungarian street demonstrations in 2006, there is no mass behavior threatening democracy itself, despite innumerable anecdotes that can be quoted on the uncivil behavior of political elites and quite widespread (though unsuccessful) attempts by politicians to position themselves above the law or to pass legislation for their personal advantage.

Politicians in general blame the voters for their immaturity, but regional surveys show that the problems for democracy in the region stem rather from the elites (see

Tab. 1. Political symptoms across the region

	Bg	Cz	Hu	Pol	Ro	Sk
Number of symptoms	4	3	3	5	5	3
Populist electoral gains	+			+	+	+
Political Radicalization		+	+	+	+	+
Weak majority*	+	+		+	+	
Factional behavior	+	+	+	+	+	+
Misbehavior by political elites	+		+	+	+	

* By weak majority we understand here not the lack of a single-party majority, but a weak majority for an ideologically consistent electoral coalition. In PR systems one party seldom receives a comfortable majority. The problem in Central and Eastern Europe is the inability of parties with close ideological positions to form a governing coalition together, either before or after elections, and to hold it together once it is eventually formed.

Tab. 2). The last New Democracies Barometer (NDB) provides ample evidence. Citizens of Central and Eastern Europe's problematic countries are quite critical of their institutions, with a majority of them distrusting parliaments and political parties.

Nevertheless, they are committed democrats, rejecting such nondemocratic alternatives as "strongman" leaders, the shutting down of parliaments, or army rule. A majority rates the current political system above the communist one, as well as above an authoritarian regime. Democracy is clearly not the issue here. Rather, the quality of governance is the real problem: two thirds of the voters complain of corruption and weak rule of law, and perceive their governments as unfair. Trends in the NDB and in the Eurobarometer do not show a sudden deterioration on these dimensions after EU accession. All in all, Romanian voters are fairly representative for the whole region.

While citizens of Central and Eastern Europe feel pro-democratic and are pro-Europe, they remain poor. A majority declares the economy of their household as "bad or very bad", though Romanians are more optimistic than neighboring

Tab. 2. Needy, demanding democrats

	Hu	Bg	Ro	Pol	Cz
Poor personal economic situation	75	90	67	56	47
Positive rating current political system	53	58	66	66	56
Distrust Parliament	54	56	52	44	64
Approve Parliament suspension	17	23	28	19	23
Strong leader better	18	29	27	28	13
Distrust political parties	66	66	66	66	55
Corruption worse than in Communist times	76	71	76	51	70

Source: NDB 2006¹

¹ 2006 New Democracies Barometer data are used here, courtesy of Professor Christian Haerpfer and his colleagues at the Center for the Study of Public Policy at the University of Aberdeen, www.abdn.ac.uk/cspp

Hungarians or Bulgarians. Real wages trailed behind the 1990 level for most of the transition and accession years.

If voters seem more or less normal, the behavior of political elites has shown some degradation after EU accession. Tab. 3 presents the Freedom House NIT democracy scores at the beginning of the EU accession process (averaged for 1999-2000), democracy scores in 2007, the number of downgrades during this interval, and the change in scores during negotiations with the EU,² when EU

Tab. 3. Democratic evolution after transition in Freedom House's *Nations in Transit* scores

	Score 99-00	No. penalties	Change during EU negotiations	Score 2007
Bg	3.58	1	0.4	2.89
Cz	2.08	2	-0.6	2.25
Est	2.25	1	0.25	1.96
Hu	1.88	3	-0.3	2.14
Lv	2.29	0	0.15	2.07
Lit	2.29	1	0.15	2.29
Pol	1.58	4	-0.15	2.36
Ro	3.54	3	0.15	3.29
Sk	2.72	1	0.65	2.14
Slo	1.88	0	0.25	1.82
Av.	2.4	1.7	0.095	2.32

Source: computed on the basis of *Nations in Transit*, www.freedomhouse.org

Legend: Scores from 1 to 7, with 7 the worst quality of democracy; No. penalties = no. of times scores were downgraded by FH since 2000; Progress = evolution of scores during the years of EU negotiations, averaged across categories measured.

² More specifically, column three shows the difference in scores between the year that a country started negotiations and the year that it concluded them and signed the accession treaty. The intervals measured are unequal, as the Czech Republic, Estonia, Hungary, Poland, and Slovenia were first invited to start negotiations at the Luxembourg 1997 EU Council and commenced negotiations in 1998. The rest of the countries (including Romania and Bulgaria), which were considerably less developed on all counts, only received the invitation to begin negotiations in 1999 at the Helsinki summit. Ten countries (the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, and Slovenia, along with Cyprus and Malta) became EU members in 2004, and Romania and Bulgaria signed their accession treaties in 2005 (and joined the EU in 2007).

coaching and conditionality were at their height. NIT scoring awards 7 points for the worst performance and 1 for the best, but to facilitate reading Tab. 3, signs are changed in the third column so that progress is marked with positive signs and regress with negative signs. The minimum unit of progress or regress is 0.25, and smaller units in the table result from averaging across different scores.

The analysis of NIT data shows that there is indeed a risk of democracy backsliding immediately after accession in the Central European countries, though not in the Baltic states or Slovenia. The NIT downgraded after EU accession some Central and Eastern European countries, most notably Poland. This is explained by the persistence of controlling state TV by the government, and of some problems in the crucial area of elections, from the use of administrative resources by parties in power for electoral campaigning, to attempts to manipulate electoral legislation in favor of incumbents. Romania's political problems are therefore largely shared in Central Europe. It would also very likely be degraded by Freedom House in 2008, because from stability to corruption, 2007 was a bad year indeed.

2. GOVERNANCE AND POLICY FORMULATION

The policy formulation process, which has always been suboptimal in Romania, has undergone further degradation in 2007. Bills and counter-bills were pushed on pure political grounds, sometimes from tactical reasons only (for instance to offer a respite to a defendant in a big corruption case, like the revision of the money laundering law), or to satisfy demands from economic interest groups (for instance, exemptions from bankruptcy rules for of a few selected companies).

The lack of a clear majority in Parliament meant that every bill had to be negotiated very pragmatically with every MP. 19 organic laws fell one after another in the fall 2007 session, and often government MPs skipped sessions so that the voting quorum not be reached. Despite the existence within the government of a EU sponsored department for policy formulation and the existence of

legislation requiring bills to have proper justification, an impact evaluation and budgetary resources, proposals reach Parliament that do not satisfy even minimal technical requirements. In an extraordinary blunder, the Parliament adopted a pensions' law providing for a large increase in the pensions until 2009, despite Romania's current pay-as-you-go system being already overstretched.

There are other causes creating policy mayhem. Bills promised in the process of EU accession were crippled by the Parliament intervention after accession – when the EU lost leverage to enforce conditions agreed for Romania's entrance – and the government, still the most exposed to EU pressure, had to promulgate new emergency ordinances to correct them.

Emergency ordinances are a particularly bad way to legislate, but the Tariceanu government made it its favorite way of passing legislation: they issued 130 ordinances by November 15. It frequently

Buoyant, but poorly planned public budgets, and a reversal to primitive, discretionary allocation mechanisms

happens that Parliament modifies them in important points when they come for approval, so after first being applied for months or even years a change of practice occurs again when

Parliament amends them (4 were completely voted down by end November 2007). As most of the important legislation continued to be passed in this way even after Romania's EU accession, when Brussels deadlines could no longer be invoked as an excuse, the result was a continuous legal confusion making life very difficult for legal practitioners.

This traditional uncertainty and short-termism have aggravated last year, which should serve as a serious warning for 2008, when in principle two rounds of elections must be held: local in June, and national towards the end of the year (but neither of them is sure so far). For example, a large sum allocated by the Ministry of Education for schools rehabilitation was made available only in mid-spring to municipalities, who are the legal owners of school facilities, after a few months were lost in attempts to push it through the territorial ministry branches, institutions with no experience in

organizing tenders and supervising works. Most schools were of course not ready for the beginning of the classes in September, which gave rise to a whole hysteria and a round of reallocations suspected of political favoritism.

Other transparent budgetary mechanisms, set up over the last decade with the help of the international partners, were ignored or dismantled altogether. The fund given to county councils for repairing district roads was underestimated in the 2007 budget, because this sum must be in principle distributed according to technical criteria, only to be supplemented by 200% through ad hoc amendments negotiated during the fiscal year with the county council presidents and their lobbyist MPs, on a case by case basis. This was not a genuine planning mistake, but a deliberate strategy, as shown by the fact that roughly the same initial small amount was again included in the 2008 budget.

The most glaring reversal of good budgetary practices took place also in the area of local government finance, where half of the total pool of funds for financial equalization across territorial units will be in 2008 exempted from the legal allocation requirements (a mathematical formula sending more money to poorer localities). Instead, it will be simply passed over to county councils, who will distribute the money further to localities in lump sums according to they wish, as it was the custom before the 1998-99 reforms. The reversal wipes out almost a decade of efforts and assistance from the EU, World Bank, USAID and other international partners, aimed at strengthening and modernizing the local public administration in Romania.

The political implications of this step are clear. The sum concerned is a huge €700 million, significant in both absolute and relative terms: on average each county council will control and distribute €17 million, compared with their own budgets which are on average €30 million. The biggest winners of these move are of course the county council presidents, who in fact lobbied hard for this amendment in the Parliament, and there is no coincidence that the large majority of county councils in Romania are currently controlled by the ruling Liberals, their

junior partners from the Hungarian Alliance, and their informal allies in the Social Democratic Party.

Assuming the transfer money is not withheld by the county councils, but eventually given to mayors, this discretionary decision-making still creates a political filter extending to other, broader policy areas, since the equalization money can be used for pre-financing or co-financing EU projects, for example, and thus the counties see their role strengthened as gate-keepers to the most important sources of local investment. If the legal package for changing the electoral system in Romania, adopted by the Parliament and vetoed by the President, is eventually enacted, and the county council presidents become elected directly by the voters, like the mayors, the extra money come in handy to the current incumbents before the electoral campaign.

3. ECONOMIC STABILITY AND DEVELOPMENT: Stocking problems for later

Romania has witnessed steady economic growth in the last seven years, becoming more attractive as a destination of foreign direct investment. As a result, economy-wise, it is a totally different type of place than it was the case ten or twelve years ago. Three factors explain to a large extent this performance, and they can all be regarded as exogenous to the system of economic management of the country after 2001.

First, the most difficult and painful structural reforms had been initiated and, by and large, completed by the center-right governments before 2000. Second, 2001-2007 were unusually good years for most developing countries, including those in Central and Eastern Europe, where no major recession occurred that might have spread contagion. With strong economic growth worldwide and the consequences of the Asian crisis of the late 1990s withering away, the general climate was very favorable for a country like Romania, where communist legacies, a protracted transition and macro mismanagement in early 1990s had devalued many economic assets. This was simply the stage when

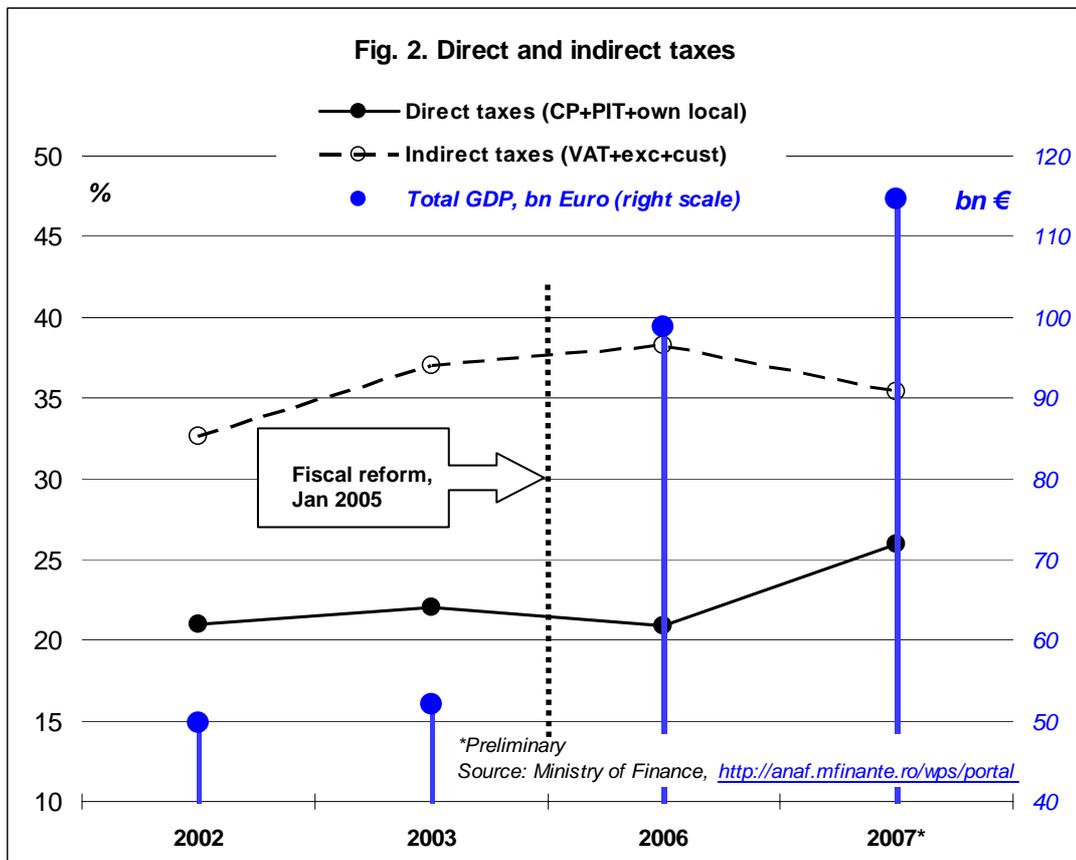
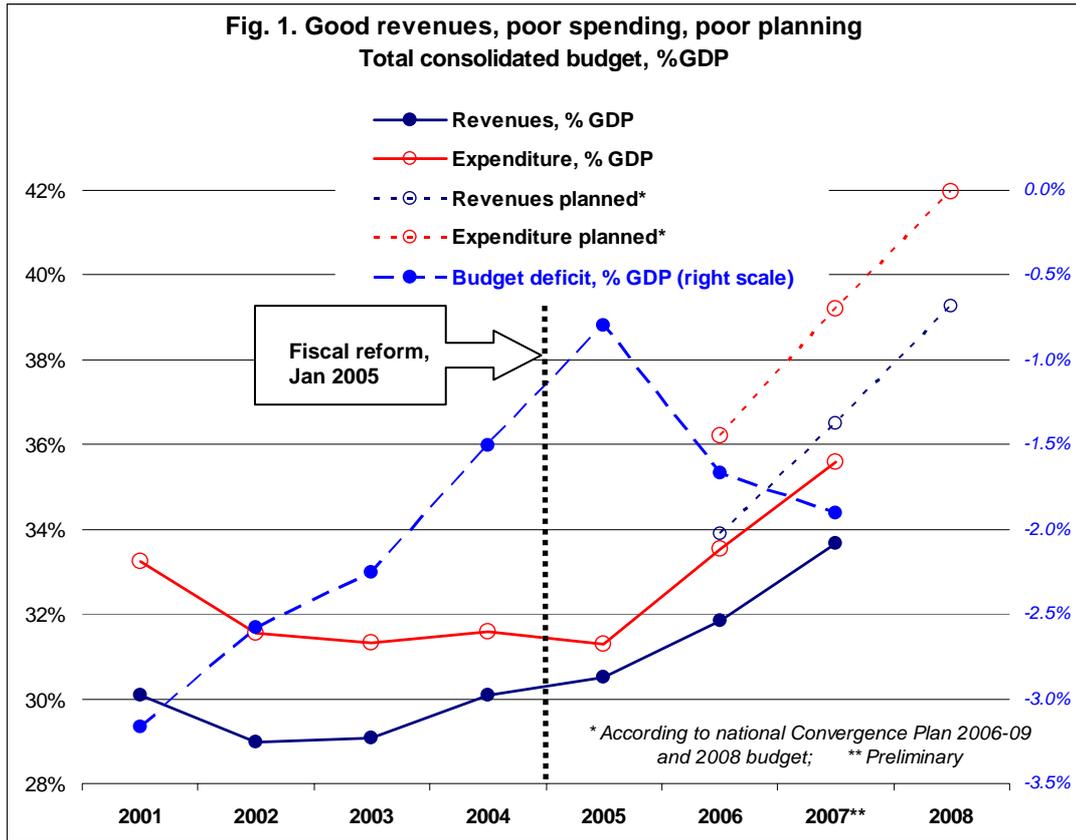
land, buildings and industrial plants have come closer to their true market value.

Third, the prospect of EU membership offered a better anchorage into the *acquis communautaire* and the rule of law, which only bolstered the natural effect mentioned above. People became more optimistic about the country's perspective as some improvements were registered the competitiveness climate, and foreign companies discovered the relatively fresh and expanding Romanian market, offering better promises than the more saturated Western ones.

Most economic actors anticipated by a few years the country's accession in January 2007, becoming increasingly optimistic and assertive, which explains the successful privatizations taking place during this interval, at significantly better prices than before – in the banking, oil, energy and manufacturing sectors. The opening of the EU borders to Romanian citizens, starting with the big bang of visa abolition in January 2002, created a new efficiency gain in the form of remittances and the disappearance of unemployment as an acute social problem (but also some drawbacks later, such as a shortage of labor on the domestic market).

Against this background, the stewardship of the economy after 2000 has been in general reasonable, which allowed the private sector to benefit from the favorable climate. The continuity in this respect between the two governments (center-left 2001-2004; center-right from 2005 on) was remarkable, whether in terms of policies (same macro commitments, no privatization reversal) or personnel (Central Bank). Until very recently, the trends in reducing inflation and the budget deficits initiated in the first years of the decade were maintained. The current government adopted in early 2007 a *Strategy of Convergence* aimed at charting the waters towards the adoption of the Euro, probably in 2014, in which all the macro stability commitments were reiterated.

In general, 2001-2006 can be judged as a period of prudent withdrawal of the state from the economy, which created ample space for the private sector to make inroads. Getting out of the way of private



entrepreneurship took many forms, from the large privatizations mentioned, to the simplifications in the rules regarding the setting up and running businesses, and to the radical fiscal reform implemented at the beginning of 2005. This changes consisted in a tax rate cut for both companies and individuals, the replacement of the progressive tax rate on personal income with a flat one, the enlargement of the basis of this tax and a simplification of administrative procedures as a consequence.

Arguably, the fiscal reform was the boldest move of structural reform made under the last two cabinets, comparable in magnitude only with those forced by the harsh reality upon governments in the second half of the nineties. With the benefit of hindsight, it can be said today that it was also remarkably successful, as none of the fears of the skeptics has materialized: the fraction of GDP collected has not decreased, but increased in the years after the tax cuts (Fig. 1); and there was no marked shift from direct to indirect taxation, which may have increased the relative fiscal burden on the poor (Fig. 2). On the contrary: if the preliminary data for 2007 are confirmed, it is precisely the direct taxes on companies and individuals, where the rate cuts were operated, that mark today a yield increase, in both absolute and relative terms.

Protracted institution building and clientelism at the top

However, all the successful steps made in the last years share one fundamental trait: they were based, as mentioned, on the public sector withdrawal from the economy. Whether it is about privatizations or the tax cuts, if the initial idea was good and the one-off effort to implement it was reasonably carried out, things have run on automatic pilot afterwards, without any need for government intervention.

By contrast, this is not the case with another category of reforms, of a more institution-building nature, which are unfortunately very numerous. The performance of the government in this area has been by tradition much poorer, and there has been no improvement in 2007 in this respect; on the contrary, as

this section argues, things have changed for the worse.

Some of the flaws in the system of national economic governance are inherited, and became more apparent in 2007 just because Romania is now an EU member and the institutions that were supposed to be up and running, after years of preparations and investments made in them, have proved to be weak and unable to function in the common EU space.

The country came close to be punished with the safety clause on Agriculture because successive ministers responsible with the sector during the past year (and before) have intensely politicized the ministry, using all the subordinated structures, including the two agencies responsible with running EU funds (for rural development, previously Sapard; and the new one for direct payments) for building up territorial networks of clientele. Only with the back against the wall, in late 2007, facing the major political disaster of penalties from Brussels and losing a substantial sum of agro subsidies for 2008, did the government decide to appoint a competent technocrat as a minister, who started to fix the problems expeditiously.

The regulatory agencies are another case in point. At least four of five major actions against Romania are currently considered by the EU Commission: one in the telecom sector, where there are

problems of interoperability, while the new legislation does not guarantee political independence to the regulator; others related to large privatizations

(of the Craiova car manufacturer with Ford Motors; a steel plant in Roman with Mittal Steel; and a tractor factory in Braşov with Plavus Investment) in which unreported state aid is suspected. Finally, there is the famous tax on registering second hand cars, which may infringe the free market norms.

All these examples betray the same chronic problem, namely the weakness of the new independent institutions meant to function as market umpires: Competition

Weak regulatory agencies are not able to censor government's decisions and effectively supervise markets

Council, National Authority for Public Procurement, other sectoral regulators. In principle these new actors, in which a lot of EU funds were invested, should become more powerful than many ministries and able to censor the decisions of central or local governments on a regular basis. In practice, they are still not assertive enough, being perceived by the officials and the public alike not as the independent agencies they formally are, but as ministerial branches waiting for instructions from the top.

The contract with Ford Motors, currently investigated by the Commission, is illustrative for the hesitations and lack of coordination in administering the competition *acquis*: an important €60 million privatization contract, which all main political actors agreed it was necessary for the future of the national automotive industry, may be lost because the Romanian part failed in its obligation to notify Brussels in due time about the transaction. In contrast with all the official hype and cheer when the signing of the contract was announced, there is an eerie silence now in government circles as to who exactly is responsible for this bureaucratic lapse that may have disastrous consequences: the Privatization Agency, the Competition Council, or the Ministry of Economy and Finance, where a state secretary was directly in charge with the negotiations? This dignitary left office soon after, and after that the amateurish and unaccountable position the ministry has been "we don't comment, it was his personal responsibility, go and ask him".

2008, the year of increasing structural deficits?

To summarize, the good business climate in our region and the foreseeable EU accession, plus the fact that governments have managed to avoid doing unusually foolish things until mid-2007, have set Romania on the current trend of growth after 2001. The fiscal reform was an additional boost to the private sector and public budgets alike, improving the attractiveness of the country as a destination for direct investments and in the same time allowing the tax collection to keep pace with the booming GDP. For example, the aggregated local government

budgets were in 1996 around 60 USD/cap at current prices, while in 2006 they were almost ten times as high, with 550 USD/cap. Even allowing for some price inflation in USD, the landslide change is obvious: from a cash-strapped, poor administration, to one with decent revenues, where money have in general ceased to be the main obstacle to good governance, being overcome by problems of coordination and implementation capacity.

Unfortunately the good times cannot last forever, and there are signs that its notorious layback attitude has left the government utterly unprepared to address serious problems the country is going to face in the near future. The approach so far was (i) to throw money at problems, because the revenue machine kept surprising the officials with ever-higher sums flowing into the coffers; or (ii) to appoint good and credible people in top positions when the problems accumulate, with the mission to overcome the crisis and mollify the European partners – as it happens with the current minister of agriculture and, before him, with the previous minister of justice, Monica Macovei – only to replace them again with party hacks once the government is off the hook.

However, the international business climate is entering a less optimistic stage. What is more, after such a long period of growth the Romanian economy has structural problems that require attention, consistency in action and a certain degree of courage from the government – and it is exactly on these qualities that we have seen a downward trend lately. 2007 ended, for the first time after many years, with the inflation rate significantly above target, as a result of social subsidies, salary and pension increases announced in mid-year, when this minority government had to adopt measures inspired by the opposition Social Democrats to avoid being toppled.

Producers and importers have responded quickly to inflationary expectations and raised prices, enjoying also a boost from the increased price of foods worldwide, and so by the end of the year most of the extra revenue promised to pensioners was already offset. The current account deficit

continued to widen, and, together with inflation, made the parameters of the *Strategy of Convergence* appear obsolete only a few months after they were nailed down, in early 2007. The steady trend towards lower budget deficits inherited from the previous government was also reversed (Fig. 1).

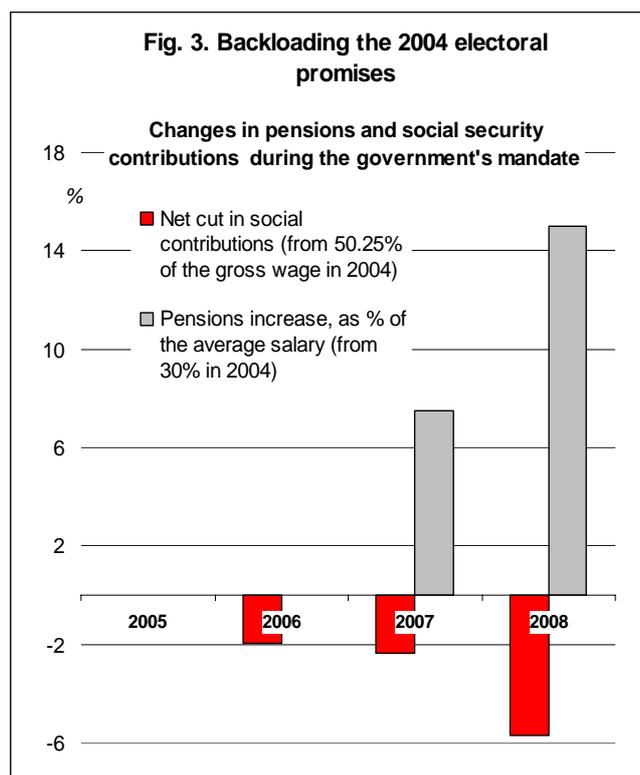
Labor costs have increased overall much above the productivity gains in the economy, fuelled by the severe shortage of human resource in all sectors, while the trade unions have intensified their pressure to push up the minimum legal salary. In the end they have obtained a 14% rise, compared to the 23% requested, but the rest was promised for mid-2008. More serious is the fact that at the beginning of 2007 they managed to impose for the first time a differentiated minimum salary, which is 1.5 higher for employees with secondary education and twice as high for those with university diploma, thus throwing the effective minimum threshold much above the nominal 14% increase. All these are measures at odds with the official government strategy to make the labor market more flexible and control the domestic spending, made possible by its total dependence on opposition's votes in the Parliament.

To add insult to injury, a court in Dolj county, in a case brought before it by the teacher unions, decided that the minimum salary for the economy, negotiated by "social economic partners", should also apply in the public sector, to avoid discrimination. Thus an absurd system has appeared that cannot function in practice: with unions and business associations negotiating each year a threshold that becomes mandatory for the public sector, and the government waiting to see what is this level, in order to know how to draft the budget.

The court decision, based on a technicality and a legal loop, was to some extent predictable, however, and it is entirely the fault of the government that it did not see it coming. The Ministry of Labor is now frantically looking for a solution to remedy the problem – other than the traditional one, that is, which is to ignore the law altogether – but the additional spending triggered by the court decision cannot be undone. The worse fears of analysts and

observers are thus confirmed, that extreme political weakness in government is bad omens for the electoral year ahead.

The increased social spending, plus the pensions and salary rises initiated in 2007 and due to phase in by the end of 2008 – which, incidentally, is also the last year of mandate of the current government – are more than simple one-off electoral handouts. There is every reason to believe that they will create new and lasting structural imbalances in the Romanian economy and social security budgets, on top of the existing ones, which are left unaddressed. This is obvious on Fig. 3, where the spending commitments (in this case, pensions) are compared with the cuts in the social security contributions, also promised by this government: they must be reduced by 10% overall by the end of the mandate.



There is precious little detail from the Ministry of Finance on how the government is planning to close the yawning gap between revenues and expenditure in the social security fund, since the money was scarce even before the measures were adopted in mid-2007. Moreover, the feeling that numbers may not add up eventually is reinforced by the fact that the biggest changes are

conveniently scheduled for the second part of 2008, only a few months before the government leaves office (Fig. 3). The question is legitimate here if this government is not deliberately stoking insoluble problems for its successors.

But why would the Social-Democratic opposition collude with the minority Liberal government and pass through the Parliament decisions that may not be sustainable in the long run – or even in the medium term – threatening the macro stability of the country, at a moment when the international business mood is cooling down? Is this what a normal opposition would do, hoping to be in office by the end of the year and having to administer the mess afterwards? One possibility may be that the Social Democrats see little hope in winning the next elections, while the Liberals have long ago gave up the prospect of continuing in power, and so they both decided in a tacit ruling alliance to build as much political capital as they can right now.

The true opposition, the Democrat-Liberals, part of the coalition that won in 2004 and pushed out of government in the spring of 2007, currently credited by opinion polls to win the next elections, have no power to block any initiatives in the legislative. This bizarre situation in 2008 is very different from the one in 2004, when both the power and the opposition had realistic hopes to win, and as a result a longer time horizons that increased their responsibility.

In contrast to the new profligacy in social spending, public investments and transfers continue to be erratic and subject to poor planning – at least, there is nothing new here, because this has always been the situation in Romania, except that the sums involved are higher every year. The historical symptom is still present of failing to meet the capital investment plan and reallocating money in haste in November-December to avoid the political shame of closing the year on surplus.

The move may be very obvious, like in 2006, when vast sums were passed down to local governments in the last days of the year just to clean the plate, or more subtle, like in 2007. But the real causes of the low capacity to spend money on projects, which are numerous and complex, have never been addressed

systematically, while ministers keep pointing fingers at one another or at local governments. In fact, if the EU programs are anything to judge by, it is ministries and central agencies that have the lowest project management capacity, while at the local level the absorption of funds through investments may be very unevenly across the territory, but it is higher of average.

4. JUDICIAL REFORM AND ANTI-CORRUPTION

The following day after Romania's accession, on January 2nd, 2007 the battle started against minister Monica Macovei and the anticorruption measures agreed with the European Commission. A trivial government ordinance (131/2006) meant to bring in line the powers of the department fighting organized crime (DIICOT) with the rest of the general prosecutor office was met with hostility by the General Secretariat of Government, some political parties and MPs, as well as an important part of the media owned by tycoons under investigation themselves. A provision allowing prosecutors in this special department to see the list of numbers called by a suspect, as well as a list of emails (though not the content of these communications) without a warrant from a judge was considered particularly dangerous, although in countries with good human rights record such as US or Germany it is not even the prosecutor, but police officers who have such rights.

Politicians have constantly tried to control the activity of the National Anticorruption Department (DNA) by changing its legal status or scaling back legal anticorruption instruments. A new law passed in March 2007, decriminalizing certain aspects of bank fraud previously under the jurisdiction of the DNA, challenges the legal stability of the anti-corruption framework. The law is likely to be applied retroactively, so decriminalisation would apply to bank officers that received kick-backs for granting fraudulent loans, leading to the dismissal of numerous pending cases. Despite a report by the American Bar Association showing that Romanian legislation is still behind in granting enough powers to investigate organized crime and corruption, there was

frantical activity in 2007 to dismantle the mechanisms created in previous years.

For example, the Criminal Procedural Code abolished the possibility for the public prosecutor to authorize suitably motivated provisional interception for urgent cases, even though authorization of the judge was required – in any case – within 48 hours. Investigations were limited to a maximum period of six months and the wire tapping to a maximum of 120 days. The European Commission commented that "these amendments would seriously limit the potential of the investigators in collecting evidence, particularly when tackling well established criminal groups or powerful governmental representatives deeply involved with corruption"³.

The American Ambassador in Bucharest joined the European Commission in its warning that such provisions are not suitable for a EU member country, only in order to have the liberal President of Chamber of Deputies, Olteanu, answer that he should mind his own business and that he is himself an ambassador due to his financial contribution to the Bush campaign.

The peak of this political anti-anticorruption efforts was reached in October 2007, when a draft emergency ordinance was prepared to close down DNA and merge it with the department against organized crime within the General Prosecutor's Office. DNA was set up originally as an independent agency at the special request of the Commission. Despite being meanwhile subordinated by a Parliament Act to the General Prosecutor, it has preserved its separate organization so far, with its Chief Prosecutor de facto independent and its own judicial police directly subordinated. It is better organized, due to its special law, and far ahead in terms of performance and resources compared to the rest of the prosecutorial offices. Merging it with the rest would have created the opportunity not only of firing its chief, but also to end its privileged status EC invested in for so long, bringing it in line with the rest of the Romanian judiciary.

In another spectacular move, in October 2007 an emergency ordinance dismantled

³ See EC monitoring report.

the advisory presidential commission which used to clear-out the investigation of current and former ministers. By the law of responsibility of ministers passed in 2005, this commission advised the President on the lifting of immunity of cabinet members charged by DNA. A Constitutional Court decision of 2007 extended its work also for former ministers, answering an appeal by former PM Adrian Năstase. The advice this commission provides is not binding, and the President said he was never going to prevent DNA from investigating anybody. Its closing down, however, opened numerous complications. The Constitutional Court ruled later the ordinance as unconstitutional, freeing the hand of the President in allowing prosecutions. The first victim was the initiator of the ordinance himself – the minister of Justice Chiuariu – who had to resign from fear of being dismissed by Băsescu. While in office, he was widely suspected he dismantled the presidential commission precisely to block his investigation in case of public property swap.

Despite increased efforts from prosecutors, the courts are still extremely cautious in all cases concerning top politicians and generally use any pretext to avoid responsibility and postpone or pass the decision to another court. While the European Commission praised the activity of anticorruption prosecutors, they also noted in their 2007

Getting rid of the DNA – or at least its current leadership – was the real stake of the political struggle in 2007; this may still be the case in 2008

report that rigor in prosecution is not mirrored by proper judicial decisions⁴. An analysis of sentences in corruption cases by the European Commission shows that penalties on average are not dissuasive and in many cases judges grant suspensions of sentences in cases of high level corruption. EC expressed concern that this undermines recent progress in investigation and affects negatively public perception of the political commitment to

⁴ Report on Romania's progress on accompanying measures following Accession Brussels: Commission of the European Communities, 27.6.2007, pp 4-20.

tackle corruption. The public is exasperated that, despite increased prosecutorial activity, courts do not manage to bring cases to a closure. As a result, the perception is that corruption increased again in 2007.

Police continues to be subject to political influence. When in last days of December the transportation minister, the liberal Ludovic Orban, decided not to report a traffic accident he had caused, it took the police 30 hours to call him begging for a report, and this happened only after the whole affair broke out into the media because citizens recorded the incident on mobile telephones. A private garage had by then cleared all traces by order of the minister.

Politicians investigated by DNA invariably claim that the action is a political witch-hunt. One frequent theme is that the former party of President Băsescu, PD, is spared by DNA. No serious evidence exists to back this allegation. A review of the cases from the three main political parties shows that no party was avoided. From the Democratic Party DNA charged Gheorghe Falcă (mayor of Arad and godson of the President) for the crimes of accepting bribe and abuse of office against public interest; Ionel Manțog (former Secretary of State) for bribe, false statements and abuse of office; Stelian Duțu (MP) for abuse of office against public interests; Cosmin Popescu (former secretary of state) for intellectual forgery and for helping a criminal; as well as a number of mayors and lower ranked politicians.

V. OUTLOOK FOR 2008

It is very likely that negative trends described above will continue and even amplify in 2008. Here are some issues to watch.

1. Elections

Romania should organize local and legislative elections in 2008. However, no dates are set and following the bad precedent created in 2007 with the needless postponement of European elections, a new period of uncertainty lays ahead. Organization problems which led to minor frauds in 2004 were shamelessly

buried by a parliamentary committee. There is a difference of one million voters between Internal Affairs data and Statistical Office and therefore quite an important potential for irregularities still. The last year was lost in a sterile dispute over the voting system as a panacea for bad behavior of politicians, despite universal lack of evidence of a correlation between political corruption and a certain voting system. If the government manages to pass its bill, a new issue will arise with the design of single unit constituencies, which are to provide half of the total number of MPs. It is very likely this issue will generate more disingenuous arrangements, gerrymandering and backdoor deals.

Recommendation: the government should set immediately a date for the two rounds of elections and focus on solving concrete, technical issues related to voting procedures, rather than on grand visions about the electoral system.

2. Anticorruption

It is likely that at least some MPs will continue to try to close down DNA or curtail its legal powers. As DNA, besides investigating ministers, is for the first time unveiling frauds at the level of the Supreme Council of Magistracy, Romania's main self-regulating judicial body, its efforts are worth the support of the public and European institutions. Once the government will succeed appointing a new Minister of Justice (the president turned down the nomination of liberal Norica Nicolai, who as a MP was behind many of the attempts to block anticorruption in the past two years), this person might become the sole responsible of the task of dismantling DNA, as was the previous minister, Mr Chiuariu. A National Agency of Integrity with the task of controlling declarations of assets has also come into being, though with smaller powers than originally intended.

Recommendation: the European Commission should signal clearly to Romania that attempts to tamper with DNA's activity in any way would be followed by the activation of the safeguard clause.

3. Government spending of national and EU funds

Watch the 2008 macro parameters, such as the proposed deficit, alongside the government spending commitments made for the second part of the year. In some cases the data presented by the government do not add up, as is the case with the social security fund. It is not clear how the aggregate expenditure can increase by a staggering 6% of the GDP in just one year, to 42%, as the 2008 budget forecasts (Fig. 1), even with the €4 billion of EU grants included, which is in itself an improbably optimistic target (until now we have always spent no more than €2 billion per year). Past deviations from budget plans were never discussed and explained, and no lessons were learned from those experiences.

Recommendation: a system of reporting periodically and ex-officio the EU funds spent every quarter or semester, by the main categories of programs, should be put in place for the benefit of the public, following the model of tax collection reported on the website of the Ministry of Finance. This kind of aggregated data exists in the system and can be shown to the public at zero cost, but is currently kept secret between a small circle of Romanian top officials and DG Regio in Brussels. There is no reason to continue this practice, because only from real-time figures of funds absorption can some institutional problems be discerned.

In a situation where a large informal political alliance runs the country with no stake in the continuation of reforms, a time horizon shortened to a few months time, and a race going on to adopt increasingly populist and expensive measures, probably the best hopes for 2008 are also related to exogenous counterbalances:

- the resilience of the private economy, both in Romania and the region, until the elections are over;
- the few disciplinary instruments that the EU Commission is still having;
- but, first and foremost, the increased level of scrutiny by the domestic public and media over the public budgets, in order to detect and warn on poor policies.

Elections will very likely generate a more balanced and rational Parliament, where the ruling parties govern and the opposition opposes them, but they will not create, under the current proportional system, a clear majority in favor of the president. Since no single winner can emerge from the current political struggle, it would be wiser if Romania's few uncorrupted politicians can strike a deal across parties and major issues, ensuring fiscal stability and good governance, for the economy to be able to bear the usual dose of political misery in the years to come.

Romanian Academic Society (SAR)
61 Eminescu, Bucharest 2
tel/fax (4021) 211 1477
office@sar.org.ro
www.sar.org.ro

