



# **ROMANIA AND THE LISBON AGENDA**

## **SUSTAINING GROWTH AND FOSTERING JOBS IN AN EMERGING ECONOMY (3RD REPORT)**

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**Bucharest  
October 2005**

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

**Acknowledgements:**

The authors would like to thank Cătălin Păuna and Florin Cîțu for the support in drafting and documenting sections of this report.

**This report benefited from the financial support of the British Embassy in Bucharest.**

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## FOREWORD

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*This is the third independent report assessing Romania's economic performance by using the Lisbon Agenda benchmarks. The first analysis, which was prepared in March 2004, provided a scorecard based on a brief evaluation of the main objectives set in the Lisbon Agenda. The second study (of November 2004) tried to focus more on Romania's competitiveness challenge; it suggested some possible policy venues to increase the convergence with EU standards. This third report has been undertaken against the background of the revised Lisbon Agenda; it does use structural indicators in order to assess the Romanian economy comparatively and examines the linkage between policies and the economic recovery/growth of recent years, the challenge of competitiveness in the local context, the ability of Romanian policy-makers to foster job creation as a means to mitigate migration.*

*As our previous report<sup>1</sup> stated the Lisbon agenda may seem a luxury for Romania's emerging economy. For, as it is common knowledge, catching up (emerging) economies rely mainly on the absorption of available modern technologies in their quest to achieve rapid economic growth. Likewise, although substantial economic progress has been achieved in recent years (which prompted Fitch and S&P's to give Romania its first investment grade ever) the structural foundations of the Romanian economy are not yet strong enough. Inter alia, the local financial intermediation is insufficiently developed, agriculture is quite backward, and external deficits have been growing sharply in the last couple of years. Under these circumstances, the effort to move towards a knowledge based economy appears as a pretty daring endeavour. Nevertheless, this effort needs to be undertaken, in a form that fits the specifics of the Romanian economy. The reasons behind such an endeavour are: firstly, because the Lisbon agenda ranks very high on the list of priorities of the club which Romania will soon join, the EU; and secondly, because a knowledge based economy is Romania's chance to upgrade its products and services decisively in the medium and long run, and that the seeds of change have to be sown starting now.*

*The Lisbon agenda is both a vision and a complex set of policy guidelines. But its priorities can be interpreted by EU member and accession countries differently since national performances and circumstances vary significantly. Thus, while older EU member countries are more concerned with job creation and support for R&D as well as reform of the welfare state, Romania has to deal, primarily, with economic restructuring, consolidate disinflation, and improve the basic framework of its business environment. Technology absorption is essential to Romania for the foreseeable future simply because, irrespective of how much one wish, development stages can not be overleaped at will - though the new information and communication technologies can bring wonders sometimes.*

*Confirming the current status of the Romanian economy, knowledge diffusion indicators (including the extent of the information society) are advancing faster, while many knowledge creation indicators are still under-performing. Having said that one has to observe that the key to longer term growth is the production of higher value added products and services, and this policy challenge demands constant focus on education, steady melioration of skills, and technical progress based on the new information and communication technologies. The development of software firms in Romania indicates that there is motion in the right direction in this regard.*

*This third report acknowledges the progress made in specific areas of the Lisbon agenda, particularly business investment, dispersion of regional employment rates, relative GDP level, and relative labour productivity.*

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<sup>1</sup> Daianu et al. (2004) Romania and the Lisbon Agenda, GEA/CEROPE;

*It also provides a series of policy recommendations in order to improve Romania's capacity to conform to the revised Lisbon Agenda's policy guidelines. Romania's performance should be judged realistically, since we are not even close to the EU 25 performances in most regards of the Lisbon agenda and our priorities have to fit our specific challenges.*

*The report has the following sections:*

- 1. The relevance of the Lisbon process for an emerging economy the case of Romania;*
- 2. Structural indicators: how does Romania fare;*
- 3. Policies for stability and growth;*
- 4. Implementing the acquis and the Lisbon guidelines;*
- 5. More and better jobs;*
- 6. A sample of policy recommendations.*

*Some of the policy recommendations, which are included in this report, are listed below.*

- the strengthening of the capacity to absorb EU funds is super-urgent; to this end the setting up of an Infrastructure Development Company is advocated herein. The modernization of the rural economy (society) also depends much on the absorption of EU funds.*
- a broadening of the tax base and a substantially better tax collection is a must so that a "budget shock" be averted at the time of EU accession.*
- a consistent reform of public expenditure is needed in order to improve their prioritization and direct them towards areas that strengthen the country's human capital, infrastructure and administrative capacity. Multi-annual budget programming is a must.*
- a soft version of direct inflation targeting (which does not disregard the potentially large gyrations of the exchange rate) is the way to go under the current circumstances; this policy should beware the danger of an excessive appreciation of the domestic currency, that might lead to a hollowing out of the Romanian economy.*
- a vigorous competition policy should prevent market power abuse (the case of privatized utilities is highly relevant in this regard).*
- avoid the decline of R&D expenditure; state aid should be redirected toward horizontal objectives, in particular towards R&D support; business R&D expenditures need to be supported by indirect financial measures, which are allowed by EU regulations; fiscal incentives could be linked to the share of R&D expenditures in turnover or the share of R&D employees in total employees, or the number of patents registered each year.*
- the non-wage components for labour costs should be reduced, especially for low skilled jobs; hiring and firing costs should be reduced; encourage lifelong learning; continue to improve the Labour Code.*
- strengthen the institutional capacity needed to raise funds and to administer the implementation of environmental projects.*
- given the inefficient energy production and consumption and having in mind the international context on the demand side (the economic rise of Asian economies), it will be very unwise for Romanian companies not to undertake adequate investment in order to reduce primary and final energy intensity.*
- huge floods and dramatic fluctuations of temperature have produced havoc in various European countries including Romania. Such occurrences are likely to be repeated because of climate change, and policymakers have to make proper room for contingencies when they allocate state revenues. There is also need for dealing forcefully with deforestation, inadequate damming, etc. The financial implications of building up proper infrastructure can be quite large and substantiate the need of absorbing EU funds to the utmost and most effectively.*

## 1. The relevance of the Lisbon process for an emerging economy The case of Romania

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

### 1.1 Who fears globalization (outsourcing)<sup>4</sup>

Usually, the less benign side of global free trade is ascribed to effects on countries that either cannot make good use of their comparative advantages, or face stiff protectionism from wealthy economies in certain domains --as in the case of farm products. In general, such economies are to be found in the developing world, which are afflicted by poor governance and inability to absorb new technologies. Recent years, however, have witnessed a rising choir of disquiet in advanced countries as to the impact of global trade on their economies. In the USA, leading politicians have voiced their concerns over what they perceive as multiplying runaway jobs due to outsourcing/off-shoring.

This feeling is even more acute in Western Europe, where, some top national policy makers have not demurred from making their worries about industrial relocation public. And they have not refrained from blaming new EU member countries for, allegedly, practicing unfair competition via lower taxes; fiscal competition would, arguably, further entice jobs to the less affluent East of Europe. How does it come that advanced economies, which have traditionally been staunch supporters of free trade, seem to have second thoughts about it?

As a matter of fact, there are both theoretical and more down to earth reasons for this apparent partial turnaround in the public rhetoric displayed in rich economies. Economics-wise, the arguments which stress the virtues of free trade form the basics for rationalizing commercial exchanges among countries; nonetheless, these arguments lose some of their appeal when the distribution of gains is largely asymmetric and dynamic competitive advantages dominate. Years ago, Paul Krugman and Herschell Grossman wrote seminal pieces on what they called “strategic trade”<sup>5</sup>. One can posit that the economic rise of Asian economies (and most impressively of China, in the last couple of decades) is to be judged through such policy lenses; namely, strategic trade policy, which was embedded into a sort of development, focused industrial policy by using market forces in a smart way.

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

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

<sup>4</sup> Daianu (2005 a);

<sup>5</sup> Helpman and Krugman (1985);

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

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

Against the backdrop of the new ICTs and considerable wage differentials among economies in the world, important shifts in the global distribution of industrial and services activities looks unavoidable. It appears also that some leading industrial economies do not keep pace sufficiently with this process as far as restructuring is concerned; this lagging behind harms some of their labour segments (and puts pressure on their real wages). At the same time, public budgets are increasingly under strain due to population ageing<sup>6</sup>. Thence comes out the fear of outsourcing/off-shoring. One can easily understand this fear in western European countries, where wages are a high multiple of what well educated workers in Eastern and central Europe earn. The Lisbon Agenda sprang out of this fear, albeit the perspective was framed in global (and not continental) terms. The big EU member countries fear Asian countries and the US economy mostly and regard the Lisbon Agenda as a competitiveness policy response. The EU Commission updating of the Agenda has scaled down the super-ambitious ultimate goal, but the policy thrust is unaltered; the EU wants to perform better in world competition.

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

The theoretical explanation presented above can be complemented by the reality of protectionist measures in various countries, which makes the picture fuzzier. The bottom line is that countries which have skilled people, which invest in education and have forward looking public policies, are more likely to enjoy the fruits of technology dissemination on a global scale. For the countries in Central and Eastern Europe industrial relocation is a piece of very good news: since their populations are relatively well educated, and, since local wages are pretty low,

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<sup>6</sup>See also Gros (2005);

they stand a good chance to gain handsomely because of out-sourcing within Europe. But they need intelligent public policies in order to make the most out of it.

## 1.2 The revised Lisbon Agenda: the policy thrust is the same

As the Kok Report<sup>7</sup> says unambiguously, the central goal set a Lisbon in 2000, to transform the EU into the most competitive, knowledge-based economy in ten years time has already proved to be over-ambitious. Other reports of the European Commission or prepared by independent experts have shown that the overall performance of member states is disappointing. This is why a revised Lisbon Agenda has been adopted and the EU Commission has issued policy guidelines for the member countries<sup>8</sup>. The fundamental goal of the Agenda stays the same: to improve the functioning of EU member economies so that higher growth and better quality jobs be secured. Thence the emphasis put on human capital build up (better education), more innovation (better links between R&D and business), and better functioning of single markets product, financial, and services. All these policy directions look very commonsensical, but they are not easy to turn into practical measures. Let us remember all the bickering on the Boelkenstein directive. It is also clear that pressure in the direction of change (reforms) is building up, irrespective of espoused views. The recent intention of the Commission to scrap a series of cumbersome regulations points into this direction.

How to achieve the LA goals is the big challenge. Not only that economic policy recipes involve major trade-offs frequently, but they may be hard to define in concrete terms. On the other hand there is a stark reality in the Union, which can provide policy inspiration and clarity in not a few domains: the existence of a significant variety in terms of policy effectiveness when it comes to stimulating economic growth, innovation and job creation (reform of labour markets). While some member states may be considered overachievers (e.g. the Nordic countries), several others are considerably lagging behind. Part of the answer for such developments can be found in the mix between market-oriented reforms and public policy, in particular institutional national set ups, in the ability to act timely and consistently over time, etc<sup>9</sup>. But, again, there is no miraculous formula that can be applied in order to reach an ideal policy balance. There is general agreement, however that the Lisbon principles of investing in research and human capital, of promoting innovation, of consolidating the internal market etc. are important guidelines for increasing EU wide economic prosperity.

At the current level of development of the Romanian economy the urge for furthering structural reforms tends to obscure the more subtle issue of developing knowledge-based oriented sectors of the economy. Older EU member countries are mostly concerned with enhancing job creation, economic growth and assigning more resources to research and innovation. Arguably, this policy thrust would be less applicable to Romania where restructuring (incl. job destruction), wage control, disinflation and improving the business environment are top priorities.

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<sup>7</sup> Former Dutch Prime Minister Wim Kok was mandated by the March 2004 European Council to lead a high level expert group in order to provide an independent review of the progress achieved in the implementation of the Lisbon strategy. The Report, entitled "*Facing the challenge the Lisbon Strategy for Growth and Employment*", was issued on November 1, 2004, and served as an important input for the preparation of the Mid-Term Review, which took place during the 2005 Spring European Council;

<sup>8</sup> For instance, "Working together for growth and jobs. Next steps in implementing the revised Lisbon strategy", EU Commission staff working paper, Brussels, 29 April, 2005;

<sup>9</sup> Answers are not easy to provide if one keeps in mind that, as the Nordic experience shows, it is not the size of the public budget or the level of taxation that lies, necessarily, at the roots of problems. Sweden, Denmark, Finland show that market oriented reforms can be combined with smart state intervention policy to achieve goals. s pointing at three decades ago (1968), or Thurow two decades later (1993); both analysts were examining economic trends and clashes inside the western world (at a time when Japan was the exception that strengthened the rule). Nowadays, we are witnessing the economic rise of a large portion of the old developing world which is undermining entrenched hierarchies;

As a matter of fact, Romania has embarked on a growth path that matches the experience of most of the countries that joined the EU in May 2004; these countries grow by more than double the average rate in the EU 15. What Romania needs, nonetheless, is to consolidate its disinflation, improve financial discipline, foster more capital formation, so that it can withstand competitive pressures after EU accession. Otherwise, the Romanian economy would face the consequences in the longer run.

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

The targets set by the Lisbon and subsequent European councils are not compulsory in the sense that failure to comply with them does not attract direct negative consequences of an administrative nature. Romania's date for EU accession (2007) is not threatened by the Lisbon targets, be those revised. Yet, Romania's coherent development within an enlarged EU may be at risk, in the medium and long run, were national public policy to underestimate the need to cope with inescapable future pressures.

Two theses can be submitted with regard to the relevance of the Lisbon process for Romania's emerging economy. The first one is that investment in education and intense assimilation of technology do bolster macroeconomic stability and represent the pillar for achieving sustainable and high economic growth, for reducing economic gaps.

Over the last decade, Romania has experienced a rather turbulent macroeconomic history, with episodes of recession (1990-1992; 1997-1999), recovery (1993-1996) and recovery/growth (2000-2005). Disinflation has made substantial progress in recent years, but inflation is still high; unemployment is low compared to other economies in the region, but this owes, on the one hand, to hidden unemployment in the state sector and in subsistence agriculture and, on the other hand, to emigration of a large part of the working population. The budget deficit is well within Stability Pact's limits, but EU accession obligations would produce a "budget shock" unless tax collection improves considerably in due course.

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

The second thesis, which is both explicit and implicit in this report, is that investment in research and development, and innovation in particular, are key to changing Romania's current development paradigm. Various studies and data indicate that foreign capital controlled firms are promoters of R&D in Romania, in the form of technology transfer. But this technology transfer

is nevertheless used for less value added products and the technology imported is, in many cases, not one of last generation by international standards; export products compete on price, not on innovation. E.g., Caceres et al (2002), by using the unit value of products as proxy for quality, found that only 18% of Romania's exports were embedding high technology (which is the lowest ratio in the region). A piece of good news is that this that ratio has nevertheless almost doubled as against a decade ago.

### 1.3 Which model to evolve toward

A major issue, which will, probably, shape increasingly the public policy agenda in the years to come, is which model the Romanian economy would evolve to. The EU represents a certain social and economic model, which underlines the need for preserving social cohesion and extols the virtues of social solidarity. However, inside Europe, too, there is a significant social and economic variety, which makes people differentiate between a Scandinavian variant (with its emphasis on social redistribution, but quite flexible labour markets), a “core” variant in Germany and France, the British variant (which is closer to the American model), and a Mediterranean variant<sup>10</sup>. Likewise, some new EU member countries (from Central and Eastern Europe) practice o more liberal (in the European sense) form of market economy.

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

Although globalization has a non-trivial ideological component the forces at work have acquired a powerful momentum of their own, which is driven by technological change and intensified competition. The latter can be restrained by bouts of protectionism (in trade and competitive devaluations) and security concerns, but its power seems to be unstoppable. The rise of Asian economies in the world economy changes hierarchies and can turn non-zero into zero-sum economic games; hence it appears the fear of outsourcing/off-shoring, of globalisation. For it is quite impossible to compete with economies where labour costs are 10, or 15, even 20 times lower, other conditions being fairly similar.

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

### 1.4 EU and Romania

The EU can play an exceptional part in Romania's transformation and modernization drive; it is an extraordinary chance to overcome the trap of backwardness, to accomplish a secular quest for modernization. Romania has an income per capita that represents roughly 30% out of the average of the European Union, being at the same time a country with a relatively large

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<sup>10</sup>See also Sapir (2005);

population (cca. 22 million), as compared to the average in Central and Eastern Europe.

Under the hypothesis of an average rate of economic growth of 5%, over the longer run, while the EU average rate of economic growth would be 2%, and considering the Balassa - Samuelson effect, Romania would need 10-12 years to reach half the average income per capita in the EU. The catching-up of the average income per capita (at purchasing power parity) would take about two generations by assuming that a substantial growth differential (in Romania's favour) is maintained.

A sustained economic progress would require higher saving and investment ratios in Romania, a public policy geared to the development of human capital and infrastructure, and Romanians' using increasingly what the new ICTs offer.

Romania would have to absorb the EU structural and cohesion funds to the utmost. But such evolutions depend, in their turn, on the functioning of institutions: a strengthening of the judiciary (the rule of law), a competent, honest and innovative (central and local) public administration, a solid financial and banking system, good structures of corporate governance (orientated towards higher economic performances), an education system offering equal chances to children and adults, laws that enjoy social acceptability and a favourable social ethos. The quality of public policy itself depends on the functioning of our institutions<sup>11</sup>.

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<sup>11</sup>For why good institutions are essential for long term growth see Helpman (2004);

## 2. Structural indicators: how does Romania fare

Romania is not much praised in international reviews of the Lisbon Agenda. The London-based Centre for European Reform (2005) places Romania 25th out of 27 countries regarding actual Lisbon-related performance and 26th out of 27 countries regarding progress since 2000 towards a number of 17 quantifiable Lisbon targets. However, only 4 out of those 17 targets considered by CER are on the “short-list” of key structural indicators.

The Geneva-based World Economic Forum (2004) also ranked Romania 26th out of 27 countries with respect to Lisbon indicators. However, the WEF ranking is based on a survey among managers; hence it is not based on Lisbon structural indicators.

We consider that the least controversial and best serving method to assess Romania's current performance and progress relative to the Lisbon Agenda is to refer to what the European Commission has defined as key structural indicators a so-called “short-list” of 14 Lisbon indicators. Table 2.1. provides this information, from a comparative perspective.

We compare Romania's performance not only against the average EU-25 and EU-15, but also against the “cohesion countries” (late comers to the EU in the 80's that faced similar structural problems with Romania namely Greece, Portugal, and Spain), against one of the new member states (Poland because it is comparable to Romania in terms of *structural strain* and inherited problems), and against another remaining EU accession country (Bulgaria). Romania is generally underperforming when compared to EU average, but it has, especially on social inclusion indicators, similar or better performances when compared with cohesion countries or with Poland and Bulgaria.

**Table 2.1. Key Lisbon structural indicators, Romania compared to EU and selected EU economies, latest available year**

|   | EU 25 | EU 15 | Romania | Bulgaria | Poland | Greece | Portugal | Spain |
|---|-------|-------|---------|----------|--------|--------|----------|-------|
| GDP per capita in PPP <sup>12</sup> , EU25=100    | 100   | 109.0 | 32.9    | 31.1     | 47.9   | 82.3   | 74.8     | 98.4  |
| Labour productivity per person employed, EU25=100 | 100   | 106.6 | 37.4    | 31.8     | 60.7   | 97.5   | 68.8     | 99.3  |
| Employment rate <sup>13</sup>                     | 63.3  | 64.7  | 57.7    | 54.2     | 51.7   | 59.4   | 67.8     | 61.1  |
| Employment rate of older workers <sup>14</sup>    | 41.0  | 42.5  | 36.9    | 32.5     | 26.2   | 39.4   | 50.3     | 41.3  |
| Youth education attainment <sup>15</sup>          | 76.7  | 73.8  | 74.8    | 76.0     | 89.5   | 81.9   | 49.0     | 61.8  |
| Gross R&D expenditure, % GDP                      | 1.95  | 2     | 0.4     | 0.5      | 0.59   | 0.62   | 0.79     | 1.11  |
| Comparative price levels, EU25=100 <sup>16</sup>  | 100   | 104   | 40.5    | 42.1     | 53.3   | 84.3   | 79.5     | 85.6  |
| Business investment <sup>17</sup>                 | 17.1  | 17.0  | 19.1    | 17.8     | 14.8   | 21.4   | 18.4     | 24.3  |

<sup>12</sup>PPP stands for Purchasing Power Parity;

<sup>13</sup>Employed persons aged 15-64 as a share of the total population of the same age group;

<sup>14</sup>Employed persons aged 55-64 as a share of the total population of the same age group;

<sup>15</sup>Percentage of the population aged 20 to 24 having completed at least upper secondary education;

<sup>16</sup>Comparative price levels of final consumption by private households including indirect taxes;

<sup>17</sup>Gross fixed capital formation by the private sector, % GDP;

|  | EU 25 | EU 15 | Romania | Bulgaria | Poland | Greece | Portugal | Spain |
|--|-------|-------|---------|----------|--------|--------|----------|-------|
| At risk-of-poverty rate <sup>18</sup> , after social transfers | 15    | 16    | 18      | 13       | 17     | 21     | 19       | 19    |
| Long-term unemployment rate <sup>19</sup>                      | 4.0   | 3.3   | 4.2     | 7.1      | 10.2   | 5.6    | 3.0      | 3.5   |
| Dispersion of regional employment rates <sup>20</sup>          | 13.0  | 12.0  | 3.5     | 6.8      | 7.2    | 3.6    | 3.9      | 8.9   |
| Greenhouse gas emissions <sup>21</sup>                         | 92.0  | 98.3  | 53.9    | 50.0     | 67.9   | 123.2  | 136.7    | 140.6 |
| Energy intensity of the economy <sup>22</sup>                  | 209.5 | 190.8 | 1386.5  | 1756.2   | 663.1  | 250.1  | 251.3    | 226.6 |
| Volume of freight transport <sup>23</sup>                      | 99.7  | 100.6 | 95.4    | 35.0     | 78.4   | 122.7  | 118.3    | 139.2 |

Source: adapted from Eurostat, *Structural Indicators*, Spring 2005

Table 2.2 reflects the progress made by Romania since the Lisbon Agenda has been launched, in 2000.

**Table 2.2. Progress made by Romania relative to the key structural indicators, latest available year against 2000**

|   | 2000   | Latest available year | Progress       |
|---|--------|-----------------------|----------------|
| GDP per capita in PPP, EU25=100*                    | 25.1   | 32.9                  | ↗              |
| Labour productivity per person employed, EU25=100*  | 28.2   | 37.4                  | ↗              |
| Employment rate**                                   | 63.0   | 57.7                  | ↘              |
| Employment rate of older workers**                  | 49.5   | 36.9                  | ↘              |
| Youth education attainment**                        | 75.8   | 74.8                  | →              |
| Gross R&D expenditure, % GDP***                     | 0.37   | 0.40                  | →              |
| Comparative price levels, EU25=100***               | 41.9   | 40.5                  | →              |
| Business investment**                               | 17.0   | 19.1                  | ↗              |
| At risk-of-poverty rate, after social transfers**** | 17     | 18                    | →              |
| Long-term unemployment rate**                       | 3.5    | 4.2                   | ↘              |
| Dispersion of regional employment rates***          | 4.6    | 3.5                   | ↗              |
| Greenhouse gas emissions***                         | 48.1   | 53.9                  | →              |
| Energy intensity of the economy***                  | 1457.8 | 1386.5                | →              |
| Volume of freight transport***                      | 77.6   | 95.4                  | ↘ <sup>1</sup> |

\*latest available year is 2005 / \*\*latest available year is 2004 / \*\*\*latest available year is 2003 /

\*\*\*\*latest available year is 2002

<sup>1</sup> The increase of freight transport negatively affects the environment;

Source: adapted from Eurostat, *idem*

<sup>18</sup> The share of persons with an equivalised disposable income below the risk-of-poverty threshold, which is set at 60% of the national median equivalised disposable income;

<sup>19</sup> Long-term unemployed (12 months and more) as a percentage of the total active population;

<sup>20</sup> Coefficient of variation of employment rates (of the age group 15-64) across regions (NUTS 2 level) within countries;

<sup>21</sup> Percentage change since base year. The target according to Kyoto Protocol/EU Council Decision for 2008-2012 - (in CO<sub>2</sub> equivalents) is 92.0 by 2010;

<sup>22</sup> Gross inland consumption of energy divided by GDP (at constant prices, 1995=100) - kgoe (kilogram of oil equivalent) per 1000 Euro;

<sup>23</sup> Index of inland freight transport volume relative to GDP; measured in tone-km / GDP (in constant 1995 Euro), 1995=100;

Table 2.3. below summarizes Romania's performance towards Lisbon using both the state and the dynamics of key structural indicators. The state-of-the-art reflects performance from a stock-based perspective, while the dynamic perspective reflects a flow-based interpretation. The distinction between stocks and flows is of paramount importance in a rapidly/changing emerging economy.

**Table 2.3. Romania's status and dynamics towards Lisbon, synthetic view**

| Status                               | Dynamics | Progress since 2000  | Stagnant or regress since 2000  |
|--------------------------------------|----------|--|---|
| Comparable* or higher levels than EU |          | Business investment<br>Dispersion of regional employment rates   | Employment rate<br>Employment rate of older workers<br>Youth education attainment<br>At risk of poverty rate<br>Long term unemployment<br>Greenhouse gas emissions<br>Volume of freight transport |
| Lower levels than EU                 |          | GDP per capita at PPS<br>Labour productivity per person employed | Gross R&D expenditure<br>Comparative price levels<br>Energy intensity of the economy  |

\* in the vicinity of EU performance (authors' taxonomy). To fit in this category, Romania's performance must be better than that of at least one cohesion country or new member state (Cyprus and Malta excluded) and have a maximum 15% negative deviation from EU-25 average performance.

Source: the authors, based on tables 2.1 and 2.2 above

Since 2000, Romania has made significant progress at four key structural indicators:

- GDP per capita at PPP;
- Labour productivity per person employed.

However, at these two indicators, Romania still lags very much behind EU average (but above Bulgaria).

Moreover, a substantial part of the progress made in terms of GDP was due also to the strong real appreciation of the national currency against Euro in the last two years, while the progress made in labour productivity can be explained partially by the decrease in employment.

- Business investment;
- Dispersion of regional employment rates;

The progress made in these three indicators is further substantiated by comparable or even better performances than in EU. However, business investment was normal to grow after a period of deep recession (1997-1999), with more foreign capital attracted to Romania (FDI stock tripled after 2000).

As for the dispersion of regional employment rates, it might be that these rates tended to level off due to increased emigration from the regions with higher unemployment.

On the other hand, Romania has stagnated or even regressed with respect to the other ten key structural indicators:

- Employment rate;
- Employment rate of older workers;
- Youth education attainment;
- At risk of poverty rate;

- Long term unemployment;
- Greenhouse gas emissions;
- Gross R&D expenditures;
- Comparative price levels;
- Energy intensity of the economy;
- Volume of freight transport.

The story behind each structural indicator is nevertheless more complex. We will emphasize here some of the tradeoffs that characterize Romania's framework in the context of the Lisbon Agenda.

1. The relative good position of Romania relative to the social inclusion indicators, mainly from a static perspective, needs to be qualified because:

- Most of these indicators (except for the dispersion of regional employment rates) have deteriorated in a period of high real growth rates (a time of slightly catching up in terms of GDP per capita);
- The relative high level of employment is partly due to statistical reasons (farmers are accounted as employed, although their monthly incomes are generally lower than the minimum wage; people working abroad are missing from statistics);
- The relative low level of long term unemployment can be explained by a combination of: hidden unemployment (due to delayed structural reforms), massive emigration from the pool of working age population (1 in 5 households in Romania has at least one member who emigrated, temporarily or permanently, in the last 15 years<sup>24</sup>), black economy, and statistical reasons;
- At risk of poverty rate in Romania is 23% before social transfers and 18% after social transfers, while in EU-25 the same rate is 24% before social transfers and 15% after social transfers. This means that social transfers in Romania are less effective, as compared to social transfers in EU-25.

2. The higher rate of gross fixed capital formation by the private sector is the result of higher economic growth rates, lower interest rates, and enhanced privatization. This increased business investment by the private sector has yet to show up in the evolution of the real economy, as the share of high tech exports in total exports remains low (but higher than in Poland or Bulgaria) and the value added contribution of services in GDP is among the lowest in Europe.

**Table 2.4. High tech exports, 2003**

|                 | EU 25 | EU 15 | Romania | Bulgaria | Poland | Greece | Portugal | Spain |
|-----------------|-------|-------|---------|----------|--------|--------|----------|-------|
| % total exports | 17.8  | 17.2  | 3.3     | 2.9      | 2.7    | 7.4    | 7.4      | 5.9   |

Note: according to World Bank's "World Development Report 2006", data for 2003 are slightly different:

4 for Romania, 4 for Bulgaria, 3 for Poland, 12 for Greece, 9 for Portugal, 7 for Spain

Source: Eurostat (2005) and World Bank (2005)

**Table 2.5. Value added contribution to GDP, 2004**

|             | Europe and<br>Central Asia | Middle income countries | Romania | Bulgaria | Poland | Greece | Portugal | Spain |
|-------------|----------------------------|-------------------------|---------|----------|--------|--------|----------|-------|
| Agriculture | 8                          | 10                      | 13      | 10       | 3      | 7      | 4        | 3     |
| Industry    | 31                         | 34                      | 40      | 27       | 31     | 24     | 29       | 30    |
| Services    | 61                         | 56                      | 47      | 63       | 66     | 69     | 67       | 67    |

Source: World Bank, 2005

<sup>24</sup> According to the National Institute of Statistics;

3. Romania's performance in terms of R&D expenditure must be seen in the context of an emerging economy. When judged by Porter's<sup>25</sup> development stages, Romania is now advancing from a factor-based economy to an investment-based economy. Arguably, for an emerging economy, knowledge diffusion is more needed than knowledge creation. Likewise, foreign companies prefer to undertake their innovative research in other countries, and they only share the costs of that research with their Romanian affiliates (see Daianu et al , 2004).

Certain progress has been made with respect to other R&D structural indicators (not on the short-list). The share of science and technology graduates more than doubled between 2000 and 2003, reaching higher levels than in Poland, Portugal or Bulgaria (see table 2.6). Despite this fast evolution, the number of patents and patents applications remains lowest in EU-27<sup>26</sup> (see table 2.7).

**Table 2.6. Science and technology graduates, 2003**

|  | EU 25 | EU 15 | Romania 2000 | Romania 2003 | Bulgaria | Poland | Greece | Portugal | Spain |
|--|-------|-------|--------------|--------------|----------|--------|--------|----------|-------|
| Tertiary graduates in S&T per 1000 population aged 20-29 | 12.2  | 13.1  | 4.5          | 9.4          | 8.3      | 9.0    | n.a.   | 8.2      | 12.6  |

Source: Eurostat, *idem*

**Table 2.7. Patents, per million inhabitants**

|       | EU 25  | EU 15  | Romania | Bulgaria | Poland | Greece | Portugal | Spain |
|-------|--------|--------|---------|----------|--------|--------|----------|-------|
| EPO   | 133.59 | 158.46 | 0.85    | 3.67     | 2.72   | 8.11   | 4.26     | 25.46 |
| USPTO | 59.92  | 71.34  | 0.17    | 0.83     | 0.43   | 1.92   | 1.29     | 8.00  |

Source: Eurostat, *idem*

The explanation can be twofold: either numerous S&T graduates emigrate after their graduation; or the S&T graduates which stay in the country are employed in non-innovative activities. Both explanations are plausible and complement each other.

4. Although the overall price levels in the economy are still at only about 40% of EU average, a notable exception is that electricity prices are already higher in Romania than in EU for industrial users (see table 2.8). With gas prices<sup>27</sup> still due to rise in the short run (see table 2.9), the Romanian economy is in a difficult position, giving its unusually high energy intensity (which is six times higher than the EU average); households are also at risk, as the relative inefficiency of social transfers already suggested.

<sup>25</sup> Michael Porter created the "competitiveness' diamond" paradigm (World Economic Forum);

<sup>26</sup> Cyprus and Malta excluded;

<sup>27</sup> Electricity and gas prices are also structural indicators for Lisbon, but not on the short-list;

**Table 2.8. Electricity prices, in Euro per kWh**

|                  | EU 25  | EU 15  | Romania | Bulgaria | Poland | Greece | Portugal | Spain  |
|------------------|--------|--------|---------|----------|--------|--------|----------|--------|
| Industrial users | 0.0673 | 0.0682 | 0.0769  | 0.0429   | 0.0506 | 0.0645 | 0.0713   | 0.0686 |
| Households       | 0.1046 | 0.1074 | 0.0655  | 0.0537   | 0.0583 | 0.0637 | 0.1313   | 0.0900 |

Source: Eurostat, *idem*

**Table 2.9. Gas prices, in Euro per Gigajoule**

|                  | EU 25 | EU 15 | Romania | Bulgaria | Poland | Greece | Portugal | Spain |
|------------------|-------|-------|---------|----------|--------|--------|----------|-------|
| Industrial users | 6.01  | 6.12  | 3.68    | 3.78     | 5.30   | n.a.   | 6.03     | 4.68  |
| Households       | 8.52  | 8.80  | 4.03    | 5.61     | 6.19   | n.a.   | 11.75    | 10.25 |

Source: Eurostat, *idem*

The high energy prices only add to other important competitiveness issues of the Romanian economy, among which: the severe appreciation of the national currency against Euro, the need to restructure the state aid policy, the large costs for compliance with EU quality and environment standards.

### 3. Policies for stability and growth

The Romanian economy grew exceptionally rapidly in 2004 due, primarily, to the expansion of domestic demand and a remarkable harvest. For this year a slowdown is expected following the effects of floods, the rise in the price of oil and higher energy tariffs, and the severe appreciation of the domestic currency; the GDP will increase probably by cca 5 percent which matches the average rate for the last five years. Disinflation has continued in 2005, although at a more subdued pace because of powerful adverse shocks; inflation will likely exceed 8% this year as against 9.3% in 2004. External deficits have grown sharply in 2005, which asks for a recalibration of macroeconomic policy in the period to come; this recalibration would also have to prevent a “budget shock” in the accession year.

Economic growth is set to continue at over 5 percent on average annually in the years to come. FDI (including transfer of know-how and management) will increase steadily provided Romania further improves its credit ratings and capitalizes on a relatively cheap labour. As a matter of fact, Fitch (in 2004) and S&P's (this year) have granted Romania its first investment grade ever.

Romania's economic advance should be judged from two perspectives: one that looks at structural changes in the economy; and one focused on macroeconomic policy<sup>28</sup>.

#### 3.1 The economic context

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

The openness of the economy is mirrored by the share of foreign capital in the banking industry and telecommunication. These markets, as well as energy markets, have opened quite rapidly, incidentally, more than in some of the old EU member countries. One has to stress here the importance of effective regulations so that new owners of public utilities should not abuse their market power. The banking system is much sounder nowadays, after a massive clean up operation in the late 90s and the introduction of a new regulatory framework that fits the BIS new recommendations. This evolution has taken place on the background of increasing foreign ownership in the banking sector, which has meliorated corporate governance.

The banking system has increased its capacity to provide effective intermediation between savers and investors, and lending and borrowing rates have decreased substantially. The range of financial products has increased remarkably and has fuelled non-governmental credit<sup>29</sup>; the latter has boomed by over 70%, in real terms, in the last couple of years. It is noticeable that despite this rise prudential indicators are still in safe territory<sup>30</sup>. The non-banking financial sector has developed rapidly; the best indicator is the market capitalization of the Bucharest Stock Exchange: from 1.04% of GDP in 1999 and 3.3% of GDP in 2001, it moved to 8% of GDP in 2003 and cca. 16% of GDP in the second half of 2005.

<sup>28</sup> see also Daianu (2005 b);

<sup>29</sup> The annual yield for t-bills, which was a major attraction for banks' investment policy, decreased from 76.0% in 1999 and 35.7% in 2001 to 17.3% in 2002 and cca 8% in June 2005; this has prompted banks to orient increasingly toward consumer and production finance;

<sup>30</sup> Even if some numbers are likely to be overstated the overall picture evinces a remarkable turnaround as against the late 90s;

### 3.2 A macroeconomic policy geared toward disinflation and growth

The salient feature of the macroeconomic picture in the last few years has been the combination of economic recovery/growth) over 5 percent, on average annually) with disinflation.

Tight monetary and budget policies have not harmed growth; arguably, the latter has been driven by structural changes.

An adequate macroeconomic policy mix has under-lid disinflation (table 3.1). The Central Bank has focused more clearly on fighting inflation and fiscal consolidation has helped it. Although quasi-fiscal deficits blur this assessment it is encouraging that they have shown a tendency of decline lately. Likewise, budget subsidies have diminished and energy prices are, more or less, at EU wide levels; these changes on relative prices improve resource allocation and cost management, though they are quite painful for low-income people and inefficient companies.

**Table 3.1.: Macroeconomic indicators 2002-2006**

|                                    | 2002 | 2003 | 2004 | 2005* | 2006* |
|------------------------------------|------|------|------|-------|-------|
| <b>Real GDP, % change</b>          | 4.9  | 4.8  | 8.3  | 5.0   | 5.3   |
| <b>Inflation (CPI) end of Dec.</b> | 17.8 | 14.1 | 9.3  | 8.3   | 5.5   |
| <b>Unemployment</b>                | 8.4  | 7.4  | 6.2  | 5.8   | 5.8   |
| <b>Budget deficit</b>              | -2.7 | -2.3 | -1.1 | -0.9  | -0.8  |
| <b>Current account deficit</b>     | -3.6 | -5.8 | -6.9 | -9.2  | -8.0  |
| <b>Total ext. debt</b>             |      |      |      |       |       |
| - % GDP                            | 35   | 32   | 30   | 32    | 32    |
| - % of exports                     | 85   | 85   | 81   | 80    | 80    |

Source: National statistics; \* own forecasts.

In 2005, in spite of the huge floods prudent budget policy has not been given up, and the budget deficit will probably not exceed 1.0 percent of GDP.

A major novelty of 2005 is a fiscal policy reform, via a 16% flat tax, which has aimed at boosting inward FDI and making the economy more transparent. This reform can be judged on its own, but also, within the context of fiscal competition that is taking place throughout Central and Eastern Europe. A downside, however, of the fiscal reform is that it was done pro-cyclically, at a time when the economy was being fuelled primarily by domestic demand and external deficits were growing quite rapidly; this means that a fiscal stimulus was hardly welcome at this moment in time and, consequently, the Government was forced to adopt a series of compensatory measures in order to boost budget revenues and control expenditure. In addition, the fiscal reform did not touch social security contributions which, at 49.5 percent of the payroll are pretty high and do not enhance job creation in the official economy<sup>31</sup>. A reduction of these contributions is planned for 2006, when these are to be lowered to 47.5 percent of the payroll.

Domestic financial markets have continued to open due, primarily, to capital account liberalization (KAL), which is quite advanced as a process (access of non-residents to local bank accounts was allowed in April 2005). KAL has been quite complicated because of relatively high interest rate differentials and substantial speculative inflows. The Central Bank has been walking on a tight rope in this respect, but it has done it commendably. A negative fallout, however, is the surge of external deficits owing to the appreciation of the Romanian currency and the big rise of domestic credit.

<sup>31</sup>The social security taxes were reduced to 49.5 percent from over 60 percent in 2000;

It should be said that KAL is a prerequisite for EU<sup>32</sup> accession and relates to direct inflation targeting. The latter indicates the wish of the Romanian central bank (NBR) to bolster its operational independence and focus more on bringing inflation down to a low single digit level.

The current account deficit, which grew to 6.9% of GDP in 2004 (compared to 5.6% in 2003 and 3.6% in 2002) has spoiled the macro-picture somewhat; by including non-repatriated profits the deficit came close to 7.8% that year. The rise of the current account deficit in the first semester of 2005 is about 60% as against the corresponding period of 2004, which might bring it above 9.0 percent for the whole year unless the recent measures of the National Bank to restrict hard currency credit do not come to fruition. The major expansion of domestic credit (of hard currency denominated, in particular) and exchange rate appreciation are at the roots of this big rise. The rise in imports includes machinery and equipment, which is good for industrial renewal. However, the speed of the rise in external deficits is a cause of concern.

It is useful to compare some indicators of the current state of the Romanian economy with the situation of some new EU member countries one year before they got into the Union (table 3.2)<sup>33</sup>. It is telling that Romania does not fare poorly when it comes to the size of public debt and budget deficit<sup>34</sup>. The forecasts for Romania in 2006 would not alter this judgement.

**Table 3.2. Key macroeconomic indicators compared to Maastricht criteria: EU candidate countries one year before they got into the Union (2003) and Romania in 2004**

|                | Budget deficit<br>(% of GDP) | Public debt<br>(% of GDP) | Inflation<br>(%) | Interest rate<br>10 years € bond (%) | Exchange<br>rate stability |
|----------------|------------------------------|---------------------------|------------------|--------------------------------------|----------------------------|
| <b>Target</b>  | <b>-3</b>                    | <b>60</b>                 | <b>&lt;2.8</b>   | <b>&lt;6.4</b>                       | <b>Yes</b>                 |
| Czech Republic | -7.8                         | 34.5                      | 0.4              | 4.63(23/6/2014)                      | No                         |
| Hungary        | -5.5                         | 56.8                      | 4.7              | 5.5(6/5/2014)                        | No                         |
| Poland         | -4.6                         | 44.8                      | 0.8              | 4.5 (5/2/2013)                       | No                         |
| Slovakia       | -5.2                         | 43.8                      | 8.1              | 4.5(20/5/2014)                       | No                         |
| Romania        | -1.1                         | 27                        | 9.3              | -                                    | No                         |

Source: Countries' national banks

### 3.3 Economic weaknesses

The Romanian economy has serious weaknesses, which could undermine stability and GDP growth over the longer term unless they are addressed steadfastly. These weaknesses are rooted in:

- the activity of loss making companies that produce sizeable arrears. The current disinflation puts pressure on these companies, and unless restructuring makes more headway persistent large quasi-fiscal-deficits would burden the public budget in the future.

<sup>32</sup>Capital account liberalization in Romania can be seen as optimization under severe constraints, for interest rate differentials and low monetization (share of financial intermediation in GDP) would have justified a more gradual process. But, EU accession demands full KAL at the time of entry;

<sup>33</sup>For an insightful comparison between the New EU Member States, on one hand, and Bulgaria and Romania, on the other hand, see Koromzay (2004, pp 63-67). See also Lanzeni (2005);

<sup>34</sup>It should be remarked, however, that main reasons behind other countries' rise in public debt and budget deficits lately has been the financing of massive infrastructure projects, a component that is still missing in Romania;

- fiscal and non-fiscal budget revenues are slightly below 30% of GDP while financing needs are bulging. Unless tax collection improves considerably Romania faces a budget “shock” at the moment of accession because of inescapable financial obligations (co-financing of EU funds; the EU budget contribution; etc). Consequently and unless tax collection improves remarkably, the budget deficit could rise again above -3% of GDP, which would worsen public finances; it would also involve a further rise in the current account deficit, which might be unsustainable.
- the energy efficiency of production and consumption is very low.
- the investment climate is plagued by administrative and red tape barriers, by corruption; this relates to the functioning of public administration, in general.
- the pensions system is under increasing strain; it is unbalanced, with much of its financing coming from the health insurance budget. The problem is of a chronic nature, because the number of the retired population exceeds the number of statistically official employees (the ratio is nowadays 3:2, as compared to 1:2 in the early nineties). Intense migration also complicates the story. An unreformed pensions system would strain the public budget in the years to come.
- the state of agriculture is an issue of concern not only in itself, but also in Romania's relations with the EU. About 35% of the population lives in the rural area, while agriculture contributes a mere 12-13% to the GDP formation and hardly, if at all, to the public budget. In the EU there is an ongoing debate to further reform CAP, which could involve even lower agricultural subsidies and Romania would be adversely affected by such a reordering of priorities.
- labour markets are rigid; unemployment has been kept at a reasonable level because many Romanian found an outlet abroad. Some estimates put the number of Romanian citizens who work abroad well over 1 million. The recent changes in the labour code and reduced social security contributions might help improve the situation, but more has to be done in this respect.

### 3.4 Policy dilemmas and options

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

- in order to bring inflation down to cca. 3-4% by 2007/2008 budget policy has to remain tight while needed infrastructure and environment related projects ask for substantial public financing;
- low trade protection (or none existent vis-à-vis EU partners) and substantial exchange rate appreciation could entail further rises in the current account deficit so that the burden of adjustment would fall on the public budget increasingly; overburdening of the budget policy would be intensified by inflation-targeting at a time when EU accession demands higher budget revenues.
- severe exchange rate appreciation, because of substantial capital inflows (including growing remittances from Romanians who work abroad cca. 2.5 billion euro in 2004), could cause a “Dutch disease”<sup>35</sup> unless productivity gains are adequate; this relates to the current type of competitiveness, which is based on wage differential
- interest rates cuts, in order to discourage speculative inflows, may widen external deficits;

The dilemmas outlined above constrain policy heavily; they suggest, at the same time, policy guidelines and options.

- In terms of economic and market structure there is need to harden budget constraints in the energy sector and streamline state aid - which should fit EU requirements. State aid is a policy item that can trigger the safeguard clause and delay Romania's accession.

<sup>35</sup> “Dutch disease” refers to a financial bonanza that befalls a country following the discovery of, let's say, major oil fields. Greatly increased oil related export revenues would appreciate the national currency exceedingly and harm the manufacturing sector, ultimately, unless adequate productivity gains are achieved;

- Privatization in the energy sector can bring in massive, badly needed inward foreign investment and help modernization and restructuring decisively. But energy markets (like financial markets) have to be well regulated so that market abuse be prevented which is particularly important in a much less affluent society. The experience worldwide should be a lesson to Romanian policy-makers.
- Tax collection and the broadening of the tax base have to improve considerably so that the co-financing of EU funds and the provision of public goods respond to Romanian economy's needs; the latter are linked with coping with competitive pressures inside the Union without entailing a big rise in the budget deficit. Hopefully, budget revenues would go up by, at least, 4-5% of GDP in a few years time<sup>36</sup>.
- Multiannual budget programming has to help policy set priorities according to judicious, long term based, cost and benefit analysis.
- The ongoing crisis of the pension system puts an additional burden on the public budget; a new pensions system is required, that would include several pillars (like in Poland).
- The capacity to absorb EU funds is a huge challenge. EU financial assistance (structural and cohesion funds) could supplement budget revenues substantially and increase the provision of essential public goods (infrastructure, education and health care). EU assistance would crowd in other funding, from private and public sources. But the track record of absorption is poor<sup>37</sup> and unless this capacity grows significantly EU funds may diminish in the future - against the backdrop of the dispute between donor and recipient countries over the structure of the Union's budget. Spain's experience in using EU funds should be studied by Romanian policy-makers. An idea to consider is to form a financial institution with the aim of using public and private funds in order to help develop infrastructure (see section 3.5). Privatization revenues, capital raised by issuing long term bonds (on behalf of this institution), plus other mobilized resources, would be channelled toward financing badly needed projects. The latter would have to be prioritized in view of the modernization challenges of the Romanian economy and its EU related obligations, and of the need to relieve the public budget of excessive strain.
- Romania needs to spend substantially more for education and R&D as a strategy for long term development (for endogenous growth), even if local research and development would be linked primarily to the assimilation of imported technology. This is quite normal in an emerging economy, which tries to capitalize on the world stock of knowledge. A challenge is to reduce the dependency on labour-intensive production (exports), which increasingly is dominated by low wage Asian manufacturers. The expected and unavoidable rise in wages in the years to come would price out many firms (sectors) in labour intensive production unless productivity gains are commensurate and higher value added products are gaining share in output.
- A rapid expansion of rural credit mechanisms (that involves the efficient use of EU rural development funds) and land consolidation would be among the solutions for rural development. The fate of Romanian agriculture depends on how the Common Agricultural Policy will be shaped in the years to come and on how Romania will use the EU financial assistance oriented toward this sector.
- Low monetisation, the wide use of the euro<sup>38</sup> and the US dollar in local transactions, complicate the conduct of monetary policy.

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<sup>36</sup> There are pieces of analyses (including a recent World Bank study), which show that with proper a reform of the tax collection system would bring in between 4-5% of GDP additional budget revenues in Romania; this would involve a broadening of the tax collection base;

<sup>37</sup> Currently, this capacity is quite inadequate; for instance, the absorption of ISPA funds (infrastructure and environment related projects) is a mere 12%;

<sup>38</sup> See also Antohi et. al (2003);

Likewise, the still large stock of arrears and potential future pressures on the government budget (such as the high cost of pensions expenditure or fiscal costs in the run up to EU entry) require an enhanced co-ordination of monetary and exchange rate policies with budget policy.

NBR has introduced inflation targeting in August 2005. Arguably, a 'soft' form of inflation targeting (a gradual introduction) is appropriate<sup>39</sup>. This 'soft' monetary framework would focus on inflation but would consider shorter horizon (two-four quarters) than the medium term<sup>40</sup>, it would not neglect exchange rate completely and would work closely with the government on budget policy. The full opening of capital account would be done at the time of EU accession.

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

### 3.5 Why an Infrastructure Development Company (IDC)

Public Authorities all around the world are encountering severe difficulties in funding large infrastructures on public funds. These difficulties lead necessarily to two alternatives:

- do nothing (or do it later, accepting social and economic losses),
- do something, on the condition of finding additional resources.

Public budgets are constrained by the need to maintain a balanced budget by cutting public spending and capping public debt, aiming to achieve sustainable economic growth (in most transition and developing countries) and/or political objectives. (EU Maastricht treaty's criteria).

Romania is facing major challenges with regard to:

- absorption of EU funds (raising the absorption coefficient);
- set clear priorities in view of the public budget constraints;
- working out good projects (due diligence) and monitoring implementation;
- reconciling the need of further disinflation and controlling external deficits (which require a low budget deficit) with the financing requirements of large infrastructure projects and EU obligations.

While IDC projects could relieve the public budget of large expenditure that would show up in lower public budget deficits the volume of aggregate internal demand would stay as a concern in order to control inflation and external deficits. As a matter of fact, this is why the IMF is so opposed to budget deficits bigger than 1% of GDP for the next few years, although such deficits are much lower than in other Central European economies and the public debt of Romania is pretty low.

Infrastructure (roads, bridges, irrigation works, dams, airports, etc) is a key element for enhancing economic development, especially in a transition country as Romania. Many countries try to set up new forms of extra-budgetary or off budgetary financing within the framework of an enlarged and renewed co-operation between public bodies and private companies allowing to develop further, or maintain properly their road network.

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<sup>39</sup> Daianu and Kallai (2004);

<sup>40</sup> This is because still intense required transformation in the Romanian economy complicates the tasks of econometric modeling which is a must for direct inflation targeting;

The success of any search for new forms or methods of financing and their feasibility depends obviously on several factors related to the country concerned, in particular to the political, administrative, economic, financial, social, legal, cultural and other patterns.

Any new infrastructure plan for Romania should take into account the following points:

- development of the motorway network and other major infrastructure projects;
- modernizing the existing road & highway network;
- an estimation of the economic impact of the motorway network and other major infrastructure projects;
- increasing the efficiency of the road/highway & motorway system;

There are various types of road infrastructure financing, from “traditional” public funding through budgetary resource allocation relying on general taxes and duties, to “pure” private funding through limited recourse project financing based on road pricing or toll collection.

Public funding of projects can be optimized inter-temporally and reduce the pressure on annual budgets whereas the involvement of the private sector in project finance, implementation and concession can reduce the overall burden on the public budget (through public-private partnerships/PPPs).

A caveat is essential when it comes to private sector involvement in infrastructure development: when PPPs assign most of the risks to the State it is the public budget which carries the burden ultimately.

Since the start of steep and steady increase of road traffic, provision and operation of public roads, bridges and tunnels have been considered in most countries as a public service. They therefore benefited from “classical” public funding mechanisms, namely budgetary financing and/or sovereign borrowing. But road investment needs are huge and allocation procedures reflect a fierce “competition” with other fundamental public services like health, education, justice and safety, administration and defence among others for the strictly limited amount of budgetary resources (thence the usefulness of PPPs).

There are reasons for the growth in private road financing. Among the more significant are:

- Public expenditure faces severe constraints while the private sector shows its ability to raise large amounts of capital for infrastructure projects;
- The private sector has demonstrated its superior capacity (expertise) to manage public sector companies and services efficiently;
- The “user pay” principle has been gaining ground (including increasing political acceptance) and is being made possible by dramatic advances in electronic tolling.

The legal background and regulatory framework allowing provision of public services by private companies and securing private finance of public infrastructure has to be created before private funding is sought. Two of the most commonly used legal forms are the concession arrangement and/or public-private partnership (PPP). Generally, in these arrangements, by means of a special law, act or contract, the State grants to a *special purpose company*, in private or mixed (public and private) ownership, all or some of the rights of financing, design, construction, tolling and operating a public motorways and high speed railways.

The contract signed between the State and the special purpose company usually regulates conditions and terms relating to the latter's activities and provides appropriate guidance to deal with all foreseeable events. The road concession/PPP period generally extends over a period of 25 to 50 years, reflecting the slow build-up of the traffic volume and revenue stream related to it.

Financing of a concession/PPP project is secured by an appropriate equity/debt mix, defined in compliance with the assumed revenue stream generating characteristics (including the expected governmental contribution) of the project and the assessment of the risks associated to it. Under the usually applied scheme of private funding, the exclusive source for repayment of equity and debt is the net toll revenue. This is the revenue collected as toll from actual users, and/or disbursed from the budget in line with observed traffic as "shadow toll" (or following another agreed schedule) remaining after deduction of management, operation and maintenance expenses of the road infrastructure, as well as of taxes and duties.

### **Organisational and financial aspects of the special purpose company (*The Infrastructure Development Company*)**

The *The Infrastructure Development Company* ("**IDC**") will be responsible for implementing the National Infrastructure (or Motorway) Plan of the Romanian government.

The Ministry of Transport (in conjunction, possibly, with the Ministry of Finance) would be the main authority. As an example, it would provide the initiative for route identification, would supervise the traffic regime, would co-ordinate the most appropriate variant selection, together with Ministry of Environment and other relevant ministries, public initiatives and municipal authorities, etc., while the IDC is the principal company in charge of financial engineering, preparing, organizing and managing construction and maintenance of the motorway network plus other major infrastructure projects.

The IDC would be a joint-stock company, 100% owned by the state. However, the IDC would be given independence with respect to the following duties:

- prepare complete short, medium and long term plans, that consist of feasibility studies production, investment programs drafting, organization of public discussions and public presentation of draft site plans;
- organization of tenders and contract award procedure, land and other property acquisition, works executions, organization of maintenances and operation of constructed motorway, etc.

The creation of the IDC allows for the involvement of private funds for infrastructure. The potential benefits arising from private sector involvement in the provision and/or management of any public infrastructure are widely acknowledged:

- implementation of sound commercial and accounting principles of market economy may lead in particular to more efficient design and construction;
- cost savings and efficiency gains in road management, maintenance and operation, better evaluation and mitigation of all kinds of risks associated with a road infrastructure project.

Part of expected benefits could be achieved under public sector funding as well, especially if implementation or operation is carried out under private sector management.

The involvement of the private sector would allow for the financing and/or operating as well as managing of some economically justified and financially viable public infrastructure projects which otherwise could not be financed from public budgets, because of severe and long lasting constraints which would limit the borrowing capacity of the public sector or because of other priorities for public expenditure.

The funds provided by private investors or raised from financial markets, could either temporarily substitute (i.e., delaying) or genuinely supplement budgetary financing. In the former case, the private capital will be repaid (with appropriate return) and the debt will be serviced entirely from the public budget. In the latter the source of these payments is partially or exclusively the revenue generated by a given road infrastructure, i.e., the toll paid by the users.

This type of institution has already been set up before, in various countries. Relevant to our situation are the European Investment Bank, KfW (Germany), or IDFC (India). It worthy to notice that in the case of IDFC its focus was quite broad: power, roads, ports and telecommunications - a framework of energy, telecommunications & information technology, integrated transportation, urban infrastructure, health care, food & agri-business infrastructure, Education Infrastructure and Tourism. In its sectors of engagement, IDFC has been awarded lead arranger mandates and key advisory assignments.

### 3.6 Summing up

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

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

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

The development of the institutional capacity to absorb EU funds is a huge challenge and the Government has to adopt urgent measures to this end; the absorption of EU funds conditions rural modernization.

The years to come should consolidate the inflation targeting regime; this implies a refining of the econometric models on which this regime of monetary policy rests. An adequate understanding of the monetary transmission mechanism in the Romanian economy (which should enable the NBR to have good forecasts for its policy moves) and further fiscal consolidation, as well as other features of the Romanian economy (degree of euroization, low monetization, intensity of structural change) determine the evolving content of the IT regime. As one can observe already a soft version of inflation targeting is implemented in Romania.

Romania's successful integration into the EMU depends critically not only on the fulfilment of the Maastricht criteria (of which inflation is a crucially important one), but also on diminishing the gap in real convergence criteria. Therefore, only towards the end of this decade should the NBR change again its strategy to ERM-2, which is akin to a form of exchange rate targeting. Also, by 2007 all capital account transactions should be liberalized, calling for a greater flexibility of the exchange rate during this period.

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

## 4. Implementing the *acquis* and the Lisbon guidelines

The updated Lisbon strategy, as reflected in the integrated guidelines 2005-2008 provided by the European Commission, focuses on structural reforms as essential to increase the EU's growth potential, given the need to increase the efficiency and adaptability of its economies.

Three major areas of reform are considered critical for the success of the ambitious Lisbon goals: extending and consolidating the Internal Market, improving the regulatory and business environment and upgrading the infrastructure. However structural reforms are not enough to provide a knowledge-based economy. Investment in research, development and innovation is the key for reaching competitive economic upgrading.

The following analysis will underline the main lines of reform and innovative actions suggested by the EC and will assess Romania's readiness to participate and contribute to this process.

### 4.1 Consolidating the Internal Market

Several reports have highlighted the importance of consolidating the Internal Market as crucial for improving Europe-wide growth performance<sup>41</sup>. Ensuring the free movement of products, services, capital and labour, and the smooth functioning of each of the national markets is a precondition for enhancing competitiveness.

Despite general acknowledgement of the potential benefits of a single European market, the transposition rate of Internal Market directives remains disappointingly low. Furthermore, directives are often not implemented or applied correctly, as illustrated by the high number of infringement proceedings launched by the Commission.

Until last year, Romania has rightly focused more on domestic reform, rather than on cross-border issues such as the internal market. For Romania, the first natural stage of closing the gap with the EU member states was to implement the necessary institutional transformations in order to build a functioning market economy. The progress acknowledgement in the EC 2004 Regular Report has allowed Romania to move to the next preparation stage, which focuses on building the capacity to cope with the competitive pressures and requirements of the internal market. Romania's accession in 2007, which is quite probable, allows little time to implement the intricate system of regulations meant to ensure the free movement of goods, services, labour and capital. In order to accomplish effective integration within the EU internal market, there are at least two important policy areas which need special attention: competition policy and market liberalization.

#### 4.1.1 Enhancing competition

Competition policy is key to establishing a level playing field for all undertakings. Such an environment induces firms to enhance their efficiency and thus enables them to better prepare to compete in domestic and international markets.

As part of the revised Lisbon strategy, the Commission has announced a comprehensive mid-term reform of state aid policy to promote growth, jobs and cohesion<sup>42</sup>. A number of revisions are foreseen to facilitate the targeting of State aid towards supporting knowledge and innovation.

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<sup>41</sup> Sapir (2003), Kok (2004);

<sup>42</sup> State Aid Action Plan: Less and better targeted state aid: a roadmap for state aid reform 2005-2009, European Commission 2005;

The State Aid Framework for R&D will be revised notably to increase collaboration between public research institutes and industry and may be extended to cover new provisions to support innovation, especially for small and medium-sized enterprises (SMEs). In addition, it is foreseen that state support to young and innovative companies is facilitated, not only through direct financial support, but also by facilitating access to risk capital funding. Measures in favour of a supportive environment for innovation, including aid to training, mobility, and clustering may also benefit from more flexible provisions. Altogether, the reform will improve the general conditions for innovation in a simpler administrative framework for Member States. Because competitive markets remain the best framework for fostering innovation and knowledge, the new rules will ensure that state aid is granted only where spillovers for society are significant and competitive conditions are not distorted, or imperfect markets hinder the access of innovative firms to badly needed resources.

The competition chapter (no.6) was among the last ones provisionally closed by Romania in its accession negotiation. The reason is twofold. Firstly, because the competition acquis requires that rules should be observed and implemented for this chapter well before accession. Secondly, because structural hindrances are still affecting the Romanian economy, undermining competition provisions. Several years in a row Romania remained a laggard in terms of implementing European rules on state aid control and to the reduction of industrial subsidies. Data up to 2004 shows an erratic pattern, which suggests an inconsistent enforcement of policy rules.

**Table 4.1.: State aid in Romania 2000-2004**

|                                | 2000 | 2001 | 2002 | 2003 | 2004 |
|--------------------------------|------|------|------|------|------|
| <b>State aid (Euro bill.)*</b> | 1.6  | 2.7  | 1.5  | 1.5  | 2.7  |
| <b>State aid (% of GDP)</b>    | 4.0  | 6.0  | 3.1  | 3.0  | 4.5  |

\*EUR at current prices /

Source: Competition Council and own calculations

After a downward trend in the period 2001-2003, in 2004 the resurgence of aid was due to the important increase of restructuring aid, especially under the form of tax and interest exemptions and exemptions from penalties for late payments<sup>43</sup>.

Given the introduction of a safeguard clause related to competition in the Accession Treaty, the pace of institution building and implementation in the competition area has increased dramatically. The Competition Council has been more active in regulating state aid in 2005 than it was in all its previous history. This should not be read that Romania has solved all remaining problems in the field. However, the progress is remarkable given the low starting point.

Probably one of the most important accomplishments was the creation and implementation in May 2005 of the State Aid Registry (REGAS). Such an instrument was critical for monitoring existing aid, and for limiting the amount of consecutive aid given to the same beneficiary (as in the case of *de minimis*).

The restructuring aid has decreased as compared to 2004, but it still has a considerable weight in the total state aid. Restructuring plans are followed more rigorously in determining eligibility for state support, but there are still cases of leniency towards applying hard budgetary constraints to certain industrial producers, still considered as “*strategic*”.

<sup>43</sup>This category includes privatization-related aid, such in the case of Petrom, the largest oil company, and other public utilities;

As regards antitrust and agreements between undertakings, even the EC shares the view that progress is satisfactory. Several investigations have been launched by the Competition Council, some finalized with harsh penalties<sup>44</sup>. However, even if in the recent years very few actual cases have been registered, the Romanian market has areas where dominant players, usually multinational companies, are apparently setting the rules, by using their leading position. As a result, similar to the need felt by the European Commission itself, the quality of the economic analysis in the Romanian competition authority should be substantially improved by raising staff's skills in industrial economics policy oriented research.

On a medium-term perspective, Romania has to redirect aid to horizontal objectives of common European interest and to target identified market failures. In general terms, state aid that can be approved should serve to generally defined objectives, such as research and development, environment, regional development, or the development of SMEs and only if it avoids undue distortions of competition. This requires a balancing of the objectives and effects of the aid which will be undertaken after the accession by the European Commission in close co-operation with the Romanian policy makers.

The institution building process needs to be further developed. In the past years the Competition Council has received an increased level of resources and has benefited from extensive technical assistance<sup>45</sup>. However, the critical issue is the transfer of expertise to local experts, who need to act as competition inspectors, professionally.

#### 4.1.2 Completing the liberalization process

The ability of European producers to compete and survive in the Internal Market is key to their competitive strength in world markets. Whilst the Internal Market for goods is relatively well integrated, services markets remain, legally or *de facto*, rather fragmented. The services sector has been responsible for almost all the new jobs created in the EU in the period 1997-2002. Services now account for 70% of EU value added. However, services only account for around 20% of intra-EU trade. This applies in particular to energy, telecommunication and transport markets and to the regulated professions. Last but not least, full integration of financial markets would raise output and employment by allowing more efficient allocation of capital and creating better conditions for business finance.

##### *Energy*

The energy sector was the largest loss maker in the Romanian economy: it has recorded a negative productivity dynamics combined with high wage increases. Moreover, most arrears in the Romanian economy were linked to the energy sector.

Romania has initiated a vast reforming process, in view of promoting a fair and active competition on those traditionally state-regulated markets such as energy, communication or financial services.

The first step towards reaching the objective of creating and assuring the functioning of the competitive electric energy markets consisted in restructuring the sector and separating the activities of production, transport and distribution. The Electric energy market consists in the regulated market and the competitive market, and the energy transactions are made wholesale or retail. The market has opened progressively by increasing the weight of the competitive market.

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<sup>44</sup>e.g. cement market;

<sup>45</sup>in 2005 the Competition Council was assisted by British and German expertise;

The degree of opening the electric power market increased at 55% at the end of 2004<sup>46</sup>. The second step is the privatisation of the eight distribution companies, out of which two have already been privatised<sup>47</sup> while the other are in the pipeline.

The degree of opening of the internal natural gas market, for the year 2005, was set at 50%. The opening of the natural gas market will continue, so that by July 2007 it will reach 100% for both residential and non-residential consumers, taking into account the two gas distribution companies are already privatised<sup>48</sup>.

Romania has advanced well in opening up its energy market, outrunning several other member states in this process. As regards energy prices, considerable upward adjustment has taken place, in order to cancel cross subsidies. Employers associations are even arguing that manufacturing energy prices are higher than in several other member states<sup>49</sup>.

Despite all the above positive evolutions the Romanian economy remains the most energy intensive of all EU 25+2 countries. At the same time, the recent increases of energy prices have damaged the competitiveness of numerous Romanian companies and have generated important welfare losses for the population, with possible negative social consequences. As it is emphasized in section 2 of this report, public utilities, which have been privatised, need operate under effective regulations in order to prevent market abuse.

The privatisation of the energy sector distribution should be carefully monitored in order to avoid state monopoly to be transformed in private monopoly, without any efficiency and welfare gains. The overall purpose of opening the market and allow private investment should be the increase of the quality of services provided at competitive costs.

Additional effort should be put in decreasing the energy intensity of the economy. Romania should encourage investment in new equipment and technologies that are environment friendly and require reduced energy inputs.

### *Telecommunications*

After more than two years of complete market liberalization<sup>50</sup>, there are many alternatives to the fixed public telephone services provided by the former monopolist operator. At the end of 2004 there were 60 active alternative providers on the market. According to the category of offered calls, 19 suppliers offered national call services, 17 offered fixed-mobile call services, and 47 international call services.

At the end of 2004 there were 4 companies providing call services through public mobile networks. Moreover, two companies hold the necessary licenses to provide third generation mobile telephony (3G). The penetration rate of mobile telephony, on population level, recorded at the end of 2004, was of 47% (compared to 32% at the end of 2003). This level is still low if compared with more advanced member states, but the positive trend gives hope for fast convergence.

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<sup>46</sup> As compared to 40% at the beginning of the same year. According to the regulations in force, all the consumers that achieve an annual consumption of at least 1 GWh are declared eligible consumers of electric power;

<sup>47</sup> Electrica Dobrogea and Electrica Banat were bought by the Italian company ENEL;

<sup>48</sup> Distrigaz Sud with Gaz de France and Distrigaz Nord with Ruhr Gas AG;

<sup>49</sup> FEPAIUS, employer association in textiles and clothing, argued that at peak hours electricity is more expensive than in Germany;

<sup>50</sup> The Romanian telecommunication market became fully liberalized on January 1st, 2003 with the end of the monopoly of RomTelecom;

## 4.2 Better regulation and more favourable business environment

Market regulation is essential to create a low cost environment in which commercial transactions can take place. It also serves to correct market failures or to protect market participants. Nevertheless, the cumulative impact of regulations may impose substantial economic costs. It is therefore essential for the fulfilment of the Lisbon goals that regulations are well-designed and proportionate.

Significant improvements in the regulatory environment can therefore be achieved by reducing the costs associated with regulation, including administrative costs. This is especially important for small and medium-sized enterprises (SMEs), which usually have only limited resources to deal with the administration imposed by both Community and national legislation.

As part of the revised Lisbon agenda, the EC invites member states to systematically assess the costs and benefits of their legislative initiatives. This implies consultation of relevant stakeholders, while allowing them sufficient time to respond. Member States are also invited to develop better national regulation agendas and report on these in their national Lisbon programmes.

### 4.2.1 Improving the regulatory framework

Romania has tried to streamline its legislation by replacing an array of regulations with legislative Codes, such as the Fiscal or the Labour ones. The effort was worthwhile, as it was meant to simplify the framework of economic activity. Unfortunately, legislative instability has persisted, due to several rounds of amendments made in order to improve the initial versions. Arguably, the radical nature of the fiscal policy reform as made some turbulence unavoidable.

The amendments have generated consultations and debates, and proved to be a decent communication exercise, but the uncertainty regarding the regulatory framework was again much criticized by the business environment.

Despite the existing provisions regarding the transparency of public institutions and of the process of issuing regulations, the track record of genuine ex-ante and society-wide consultations remains weak.

The National Agency for Small and Medium Sized Enterprises (NASMEC), as well as the Competition Council, have tried to introduce hybrid versions of the Regulatory Impact Assessment (RIA), but with limited implementation and results. No consistent budgetary assessment is provided to the public when adopting a regulation with impact on public resources. With a few exceptions, no ex-post or interim evaluation of the implementation of regulations is carried on.

In Romania barriers persist related to the procedures for obtaining operational licences, building permits and respecting environmental and industrial standards. Moreover, most entrepreneurs complain about the inequality in the enforcement of the law (OECD, 2005). The firms complying with the rules often face unfair competition from companies operating informally and avoiding taxes and other regulations. Therefore, firms have strong incentives to operate intermittently between the formal and the informal sectors.

One positive tendency in regulating business environment, especially regarding licences, permits and other authorisations, is the introduction of statements on own responsibility as an alternative for ex-ante control.

As regards market entry, Romania has taken important steps for streamlining and simplifying start-up procedures. The progress made in reducing the administrative burden for start-ups is generally acknowledged. The creation of the Sole Office at the National Trade Registry as a “one-stop-shop” structure has improved the process of setting up new businesses. On-line registration is also envisaged for the near future.

A more systematic approach of implementing the Regulatory Impact Assessment (RIA) best practice should be envisaged by the Romanian authorities. At least budgetary impact assessment of all regulations or decisions should be provided in a transparent way to the public. This process will result in more accountability and better governance.

#### 4.2.2 Supporting enterprise development

Institutional development is necessary but not sufficient in order to ensure economic growth and competitiveness. Supporting entrepreneurship and enterprise development is equally important in order to reach the critical mass for competitive upgrading. While large companies still act as a backbone in most European economies, SMEs provide the dynamism comparable with sanguine circulation, which irrigate the economy with innovative behaviour.

Through the adoption of the European Charter for Small Enterprises, SMEs were given more and more support in redressing scale-related weakness. One of the most important areas of assistance is to improve access to finance, where after the implementation of BASEL II requirements SMEs are especially at disadvantage.

For Romania, supporting SMEs is not only a question of providing more flexibility to the economy, but also a tool for increasing the synergy effect of intra-industry trade and cooperation. There is also a crucial need to improve and augment the SME base in order to fully benefit from the cohesion policy support, as small firms are the most important instruments for absorbing the structural funds dedicated to competitive development<sup>51</sup>.

The weight of the SME sector in the Romanian economy is constantly increasing, both in terms of employment and contribution to GDP, but it still is far from its real potential. In terms of number of enterprises per capita, Romania is still behind all member states. A remarkable evolution is the relative increase of SMEs involved in manufacturing as compared with those focusing on retail and wholesale; this positive trend explains the increase of the overall value-added of the SME sector in recent years. In spite of its flexibility, the Romanian SME sector will likely be strongly affected by the transposition of the *acquis*. Stronger competition on the Internal Market will naturally select stronger companies for the future, but a certain degree of insulation by supporting SME preparation for accession is welcomed.

Romania needs to support the creation of new enterprises and the development of the existing ones in order to provide the critical base for economic flexibility, innovation and absorption of structural funds. Improving the institutional framework will create more business opportunities, but a more proactive approach towards facilitating market access should not be neglected.

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<sup>51</sup> As part of the preparation to participate within the framework of the Cohesion Policy, Romania has already prepared for 2007-2013 a Sectoral Operational Programme focused on Competitiveness, where SMEs are going to be one of the most important recipient categories;

### 4.3 Competitiveness and Innovation

Successful economic development is a process of successive upgrading. As nations develop, they progress in terms of their characteristic competitive advantage and modes of competing. Following Porter's model<sup>52</sup>, we can identify three stages of economic competitiveness. First, there is the Factor-driven economy, where basic factor conditions such as low-cost labor and access to natural resources are the dominant sources of competitive advantage. Second, there is the Investment-driven economy, where competitiveness is a result of increasing the efficiency of production and of improving the quality of the produced goods or services. Third, there is the Innovation-driven economy, where the ability to produce innovative products and services at the global technology frontier using the most advanced methods becomes the dominant source of competitive advantage.

As part of the revised Lisbon strategy, the European Union has established the Competitiveness and Innovation Programme (CIP), as a multi-annual framework (2007-2013) to boost the competitiveness of the economy. The CIP will provide a significant and coherent legal basis for Community actions, which share the overarching objectives of enhancing competitiveness and innovation. It will therefore be composed of three specific sub-programmes: the Entrepreneurship and Innovation Programme, the ICT Policy Support Programme, and the Intelligent Energy- Europe Programme.

The Entrepreneurship and Innovation Programme will bring together activities on entrepreneurship, SMEs, industrial competitiveness and innovation. It will specifically target small and medium sized enterprises, from hi-tech "gazelles" to the traditional micro- and family firms which make up the large majority of enterprises in Europe.

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

Last but not least, the Intelligent Energy Europe Programme's aims to support sustainable development as it relates to energy and to contribute to the achievement of the general goals of environmental protection, security of supply and competitiveness<sup>53</sup>.

All these programmes are meant to provide platforms for promoting Research and Development, which is then translated into innovation through technology transfer.

In Romania most of the domestic firms produce goods or services designed in other, more-advanced countries. Technology is assimilated through imports, foreign direct investments and imitation. Firms have limited roles in the value chain, focusing on assembly, labour intensive manufacturing, and resource extraction. However, there is also a part of the economy, which may be considered investment-driven. The last couple of years have brought new investment in efficient infrastructure and policy measures aimed at creating a business-friendly administration. The products and services become more sophisticated. Technology is accessed through licensing, joint ventures, FDI and imitation. At the same time, embryos of an innovation-driven economy have developed, especially in the Information and Communication Technology (ICT) sector, which has a high competitive potential.

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<sup>52</sup> Porter 2003;

<sup>53</sup> Also see section 4.4 Sustainable development;

### 4.3.1 Providing a developed ICT platform

According to eEurope+ reports, despite the considerable progress scored by Romania in developing ICT, the information technology infrastructure and use still remains far from the level of older EU member states.

The domestic ICT market is booming, with growth rates of over 20% in the last years. Nevertheless, the market structure suggests that Romania has yet to enter the more mature stage of development, as it has first to provide the infrastructure for basic communication networks.

Romania is today confronted with a high digital divide. This is due not only to the low level of penetration rates (PCs, mobile phones, Internet etc.), but also to large rural-urban, and regional disparities, to the important weight of the population living at the poverty rate and also to the low level of digital education for older population.

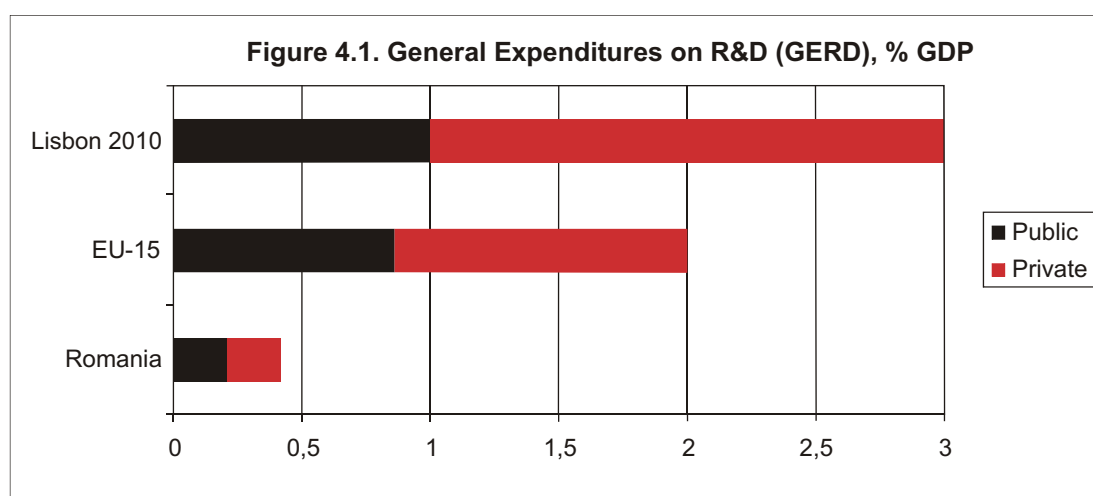
Moreover, it is difficult to assess if Romania has engaged on a convergence path, given the fact that while domestic catching-up focuses on telephony and computers, EU member states have reached a level of saturation in this field, preparing the competitive leap to new technologies. Romania needs to further develop the ICT networks, but at the same time to engage in promoting new technologies, at least in selected areas of expertise, such as data securitization. Particular care should be given to reduce the digital divide between the users and non-users of ICT, possible with the use of structural funds.

### 4.3.2 Upgrading the R&D system

The Romanian R&D system has three major features.

- First, the R&D expenditures, both public and private, are too low.

R&D expenses have stagnated in Romania over the last five years, as a share in GDP. They currently represent one fifth of the EU average and less than one seventh of the Lisbon target for 2010. A target on which Romania committed itself, even earlier than required (2007).

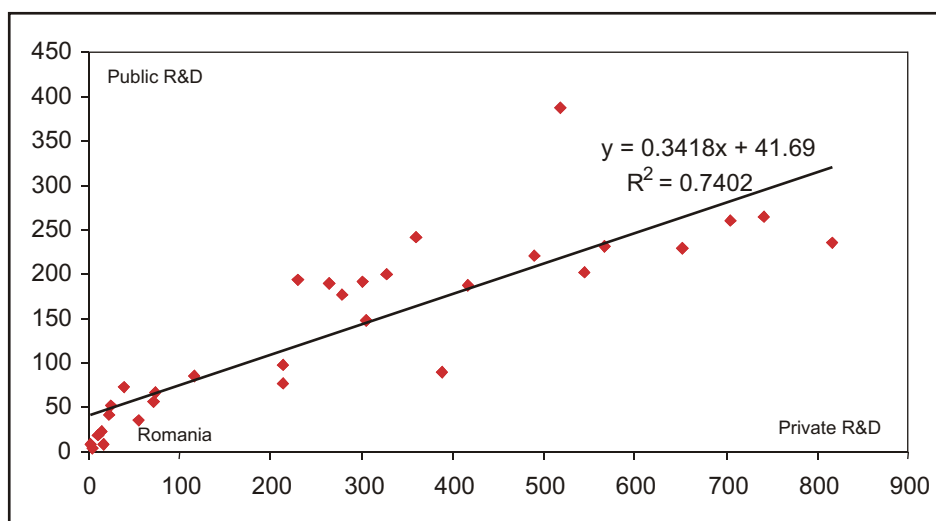


Note: Data for EU-15 are from 2003, and data for Romania are from 2004

Source: authors, based on Eurostat and INS

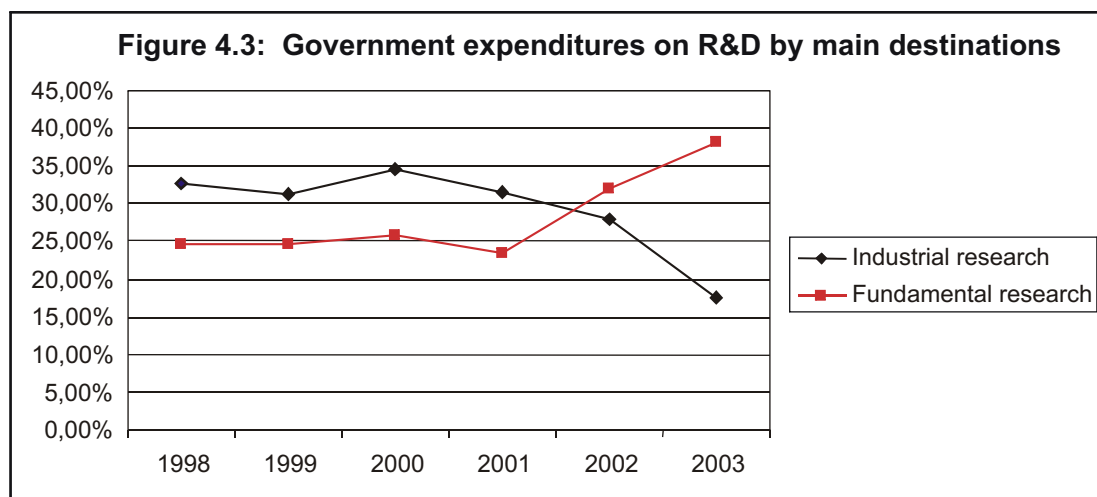
- Second, the public R&D expenditures fail to have a significant effect on business R&D, as general practice in OECD countries demonstrates.

**Figure 4.2. The correlation between public and private R&D expenditures, OECD economies plus Romania**



Source: Voinea (2004)

The explanation could lie with the small and decreasing part of industrial research in Romanian public R&D expenditure (around 17% in 2003).



Source: Adapted from INS (2005)

- Third, both the public and the private R&D expenditures have very low efficiency.

As public funds are regarded, despite an increasing support for fundamental research, latest available figures (World Bank KAM, 2005) indicate that Romania has only 35 scientific and technical journal articles published per million inhabitants, while the average for Western Europe is 479 articles per million inhabitants.

As private funds are regarded, according to Enterprise Innovation Scoreboard (2004), the share

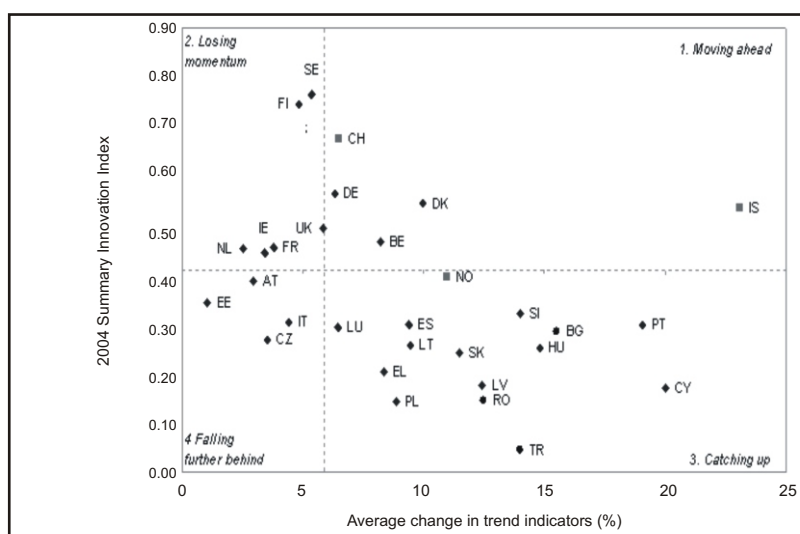
of sales of new-to-the-firm products in total firm's turnover is 16.8% in EU-25 and only 1.6% in Romania.

Romania should increase its R&D expenditure by using a series of fiscal and non-fiscal incentives, especially given the proposal for more lenient state aid regulations<sup>54</sup>. Additional support should be given to applied research, which has more impact on economic efficiency. This said, much care should be given to raising the efficiency of R&D expenditure; otherwise the propensity to raise them should stay low.

### 4.3.3 Enhancing the innovation performance

The recent trends have allowed the upgrade of Romania's position in the Summary Innovation Index (SII) to a catching-up position. Leaving aside the rather debatable meaning that the indicators hold for Romania, hiding various local realities, the catch-up process risks to be rather slow: by assuming frozen European values and sustained rates of growth for Romania, at their 2004 levels, between 5 and 10 years are needed for catch-up even for the fastest growing indicators in the scoreboard. A more realistic scenario, implying learning curves and reasonable assumptions regarding the rate of growth at the European level would push the duration of convergence at over 20 years. The high rates of growth need to be sustainable in order to allow the accomplishment of the catching-up process.

**Figure 4.4: Positions of the countries relative to the EU-15 Summary Innovation Index**



Source: European Commission (2004), *Trendchart. Innovation Policy in Europe in 2004*, DG Enterprise and Industry, Brussels

Despite its technically qualified labour<sup>55</sup>, Romania is struggling among the last positions among the countries in the Innovation Scoreboard sample, both in term of RD based innovation and diffusion of innovation. The obvious failure of knowledge dissemination suggests that Romania is one the few countries producing more RD based innovation that it is able to diffuse.

<sup>54</sup> see also section 4.1.1 on state aid;

<sup>55</sup> Using the results from the Global Competitiveness Report 2005/2006, Romania appears as leader among candidate countries in Availability of Scientists and Engineers. However, it should be noted that the number of engineer graduates has decreased significantly in both absolute and relative terms in recent years;

Romania is still an outsourcing destination, rather far from the production frontier (certain sectors, as ICT, might be find closer, mainly due to their possibility to exploit the advantages derived from the high level of codification of knowledge inner to the domain, making this industry the frontrunner of the globalization<sup>56</sup>). The MNCs are transferring to some extent technology, but less RD know-how, as they are innovating in their headquarters<sup>57</sup>. Again, exceptions are companies in high-tech as IT and telecommunications. We can asses that so far, Romania did not succeeded in transforming the competitive pressure from opening the external trade into a stimulus for local innovation. This situation started to change recently, but again, sectoral and regional differences are very important.

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

#### 4.4 Sustainable development

Since its inclusion in the Treaty in 1997, sustainable development has been recognised as an overarching goal of the EU. The adoption of the EU Sustainable Development Strategy in June 2001 at the Gothenburg European Council marked a turning point: the need to pursue economic growth, social improvements and environmental protection in a balanced way was translated into a set of detailed objectives and actions. At the same time, through the decision of member states, the Lisbon agenda was supplemented by a third, environmental pillar. However, the mid term revision of the Lisbon strategy, with its focus mainly on growth and jobs, somehow diminished the relative importance of the environmental agenda. Although the sustainability of economic development is mentioned throughout the Integrated Guidelines 2005-2008, environmental protection was not declared any more as a pillar of the new Lisbon agenda.

In return, the Commission reiterated its firm support to environmental issues by starting in May 2005 the revision of the EU Sustainable Development Strategy though providing a Draft Declaration on Guiding Principles for Sustainable Development<sup>58</sup>. Consultations are currently on-going, and the final strategy is expected to be adopted in October 2005.

At the instruments level, the 6th Environment Action Programme (EAP)<sup>59</sup> is currently providing EU's environmental roadmap until 2012. As the main vehicle to achieve the environmental goals of the Sustainable Development Strategy, it sets ambitious, often quantified targets which highlight the long-term commitments of the Union to environmental protection<sup>60</sup>. Nevertheless, the adoption of a new Sustainable Development Strategy might imply also the implementation of a new EAP thereafter.

Romania's environmental agenda is defined to a large extent by the commitments expressed in the related accession negotiation chapter<sup>61</sup>. These commitments are structured around the four priority issues of the 6th EAP - climate change; nature and biodiversity; resource management; and environment and health.

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<sup>56</sup> Gheorghiu R., Pişlaru D., Țurlea G (2004);

<sup>57</sup> Some of the MNCs do innovate locally, mainly in order to adjust design, packaging and distribution to correspond to domestic market demand;

<sup>58</sup> Draft declaration on guiding principles for sustainable development, communication from the Commission to the Council and the European parliament, com(2005) 218 final, Brussels, 25.5.2005;

<sup>59</sup> Adopted in 2002 for a ten year period;

<sup>60</sup> Communication from the Commission to the Council and the European Parliament - 2003 environment policy review "Consolidating the environmental pillar of sustainable development", Brussels, 2003;

<sup>61</sup> Chapter 22 Environment;

There are at least two factors to be considered when it comes to defining Romania's sustainable development strategy. Firstly, available resources are limited, and should be allocated to the areas bringing the largest benefits for convergence. Secondly, in some areas, Romania's status is better than current member states and it does not justify investing additional resources in the short run, even if the Commission promotes such investment at the level of the EU.

Compliance with *the environmental acquis* will affect the enterprises' competitiveness in two ways: first, by requiring additional investments to alter production processes or new capital investments, and second, through increased charges, levies and taxes to pay for public sector investments. Table 4.2 below shows the estimated total costs of compliance with the environmental *acquis* for Romania.

**Table 4.2.: Estimates of the Investment Costs of the Environmental Directives (2004-2022)**

| Directive        | Number        | Cost EUR mn.  | Period of compliance | Sectors                   |
|------------------|---------------|---------------|----------------------|---------------------------|
| Water quality    | 76/474        | 933           | 2015                 | Enterprises               |
|                  | 92/271        | 8,000         | 2022                 | State: Central/Local      |
|                  | 91/676        | 1,200         | 2014                 | State and Enterprises     |
|                  | 2001/80       | 1,402         | 2011                 | Mainly Enterprises        |
|                  | 93/12         | 140           | 2007                 | Enterprises               |
| Air quality      | 94/63         | 363           | 2009                 | Mainly Enterprises        |
|                  | 96/62         | 42            | 2007                 | Central State Budget      |
|                  | 98/70         | 380           | 2007                 | Enterprises               |
|                  | 99/13         | 474           | 2015                 | Enterprises               |
| Waste Management | 94/62         | 243           | 2010                 | State and Enterprises     |
|                  | 99/31         | 8,196         | 2020                 | State and Enterprises     |
| <b>IPPC</b>      | <b>96/61</b>  | <b>4,147</b>  | <b>2015</b>          | <b>Mainly Enterprises</b> |
|                  | <b>79/409</b> | <b>10</b>     | <b>2006</b>          | <b>State Budget</b>       |
|                  | <b>92/43</b>  | <b>10</b>     | <b>2006</b>          | <b>State Budget</b>       |
| Other            | 96/29         | 19            | 2007                 | State Budget              |
|                  | 97/43         | 2,500         | 2007                 | State Budget              |
|                  | 2003/54       | 903           | 2015                 | State and Enterprises     |
| <b>TOTAL</b>     |               | <b>29,726</b> |                      |                           |

Source: World Bank (2004)

Of the total cost presented above, a large part will have to be covered by industry, or by the private sector as a whole. On average, for the new member states, the private sector supported 25-30% of the total environmental cost. In Romania, given the increased magnitude of the environmental problems, the contribution of industry needs to reach 40-50% in order to meet the proposed transposition schedule.

Overall, the contribution of industry amounts up to 44% of the total environmental cost over the period 2004-2015, according to the World Bank model. The model was based both on the obligations assumed by the Romanian Government in the accession negotiations as well as on the Polish experience in handling EU environmental requirements (World Bank 2004). In another estimate, provided by the Ministry of Environment and Water Administration, the contribution of industry reaches only 36% of the total needed expenditure<sup>62</sup>.

<sup>62</sup>The total environmental expenditure being estimated at EUR 29.5bn over the period 2004-2021, which is 5bn lower than the World Bank estimate;

Romania needs to invest around 30 billion euro in order to implement EU environment standards. Given the high cost of meeting the environmental directives, it is important to show the benefits of such reform. Research<sup>63</sup> has already shown that the potential benefits related to meeting the air standards are generally the highest, followed by the benefits resulted from implementing water standards. The most questionable fields in terms of benefits are the ones related to waste treatment. The overall economic and social benefits of upgrading air quality can be estimated at a present value of EUR 7.6 billion against a required investment of EUR 2.8 billion.

For water treatment, the net result is negative, with only EUR 4.0 billion potential benefits against a required investment cost of EUR 7.2 billion. As concerns waste treatment, the benefits may be a mere EUR 825 million against a required investment of EUR 8 billion. Certainly, these are only estimates, but they provide a picture on the cost-benefit analysis in terms of sustainable development.

There are at least two other areas where environmental objectives, as defined by the EC, may not follow Romania's short and medium term convergence goals. The first area is that of renewable energy, while the second one is related to freight transport.

Romania benefits from the existing hydro-electricity production, which combined with other modest renewable sources (e.g. wind) provide 28.8% of all energy consumption. It is true that beyond the natural endowment, which offers hydro potential, Romania's efforts to increase the use of renewable energy sources, have been limited. On the other hand, investment in renewable energy is considerably costly and may divert funding from other more productive enterprises.

As regards freight transport, Romania, as many other former socialist countries, has inherited a transport system based mainly on railways, which was designed to serve heavy industries. This legacy implies that the percentage of environmentally friendly forms of transport is already high, as road transport is hindered by the lack of appropriate infrastructure. However, such a perspective, although environmentally positive, is hampering the growth potential of the country. Romania needs massive infrastructure investment, out of which developing a highway network is an important priority.

While Romania should accept the central theme of the EU Sustainable Development Strategy, of decoupling environmental degradation from economic growth, it should be careful in prioritising investment in the short and medium run, in order to avoid excessive strain on available environmental resources. Sustainable development should remain a concern, but more on the short run the focus should be more on increasing resource efficiency.

Water treatment and waste management are the areas of sustainable development in which Romania is severely underperforming, but transition periods should be well used for a judicious phasing of investments.

Investment in renewable energy or limiting road transport should be postponed until Romania upgrades its current convergence status.

Careful consideration should be given to balancing the environmental expenditure between public and private sources on a partnership basis. Moreover, preparation for absorbing structural funds should also be a priority.

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<sup>63</sup> idem.;

## 5. More and better jobs

The progress assessment of the Lisbon Strategy, carried out at mid-term, in the spring of 2005, has resulted in a revised and simplified focus of the Strategy, where the emphasis has shifted towards “delivering strong and lasting growth and more and better jobs”<sup>64</sup>. Under the new Strategy, the importance of developing a skilled, well educated and competitive labour force, better able to adapt to changes in the global environment, has increased.

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

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

### 5.1. The specificities of the labour market in Romania

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

Romania's employment rate for the population aged between 15 and 64 years old was 57.7% in 2004. The negative trend established after the collapse of the communism seems to have finally been reversed, as 2004 was the first year since 1990 when the employment rate increased, from 57.6% in 2003. While in 2000, with the exception of the Czech Republic, Romania had the highest employment figure among the Central and Eastern European countries, in 2004 the picture has changed significantly. Romania is now among the low performers in terms of employment figures. While in most CEE countries, with the exception of Poland, employment stabilized or even returned to growth by 2000, the shrinking of employment continued in Romania up to 2003. Observers attribute the slow reversal of the trend in employment to the protracted enterprise restructuring process and the sluggish structural reforms in the public sector. Some of the reverse in the employment trend in 2004 might be attributable to the cycle of high economic growth rates that Romania has experienced after 2001.

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<sup>64</sup> Common Actions for Growth and Employment. The Community Lisbon Program, Brussels, 20.7.2005;

The recent fiscal stimulus introduced in early 2005, through the adoption of a flat 16% corporate profit and income tax has led to a further expansion of employment, as preliminary evidence suggests.

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

| Employment rates         | 2000      | 2001        | 2002        | 2003        | 2004        |
|--------------------------|-----------|-------------|-------------|-------------|-------------|
| EU (25 countries)        | 62.4      | 62.8        | 62.8        | 62.9        | 63.3        |
| EU (15 countries)        | 63.4      | 64          | 64.2        | 64.3        | 64.7        |
| Euro-zone                | 61.7      | :           | 62.4        | 62.6        | 63          |
| Euro-zone (12 countries) | :         | 62.2        | 62.4        | 62.6        | 63          |
| Czech Republic           | 65        | 65          | 65.4        | 64.7        | 64.2        |
| Estonia                  | 60.4      | 61          | 62          | 62.9        | 63          |
| Latvia                   | 57.5      | 58.6        | 60.4        | 61.8        | 62.3        |
| Lithuania                | 59.1      | 57.5        | 59.9        | 61.1        | 61.2        |
| Hungary                  | 56.3      | 56.2        | 56.2        | 57          | 56.8        |
| Poland                   | 55        | 53.4        | 51.5        | 51.2        | 51.7        |
| Slovenia                 | 62.8      | 63.8        | 63.4        | 62.6        | 65.3        |
| Slovakia                 | 56.8      | 56.8        | 56.8        | 57.7        | 57          |
| Bulgaria                 | 50.4      | 49.7        | 50.6        | 52.5        | 54.2        |
| Croatia                  | :         | :           | :           | 53.4        | 54.7        |
| <b>Romania</b>           | <b>63</b> | <b>62.4</b> | <b>57.6</b> | <b>57.6</b> | <b>57.7</b> |

Source: Eurostat

An important objective set by the Lisbon summit is to increase the participation of women and older workers, aged between 55 to 64 years. Romania's women employment rate is low compared to the EU-15 and EU-25 average, at around 52% in 2004, and it is sensibly smaller than that of the males, of around 58%. The female employment rate has decreased by 5 percentage points from 2001 to 2003, but in 2004, for the first time, the rate has increased.

The figure is a long way out from the Lisbon target. In 2001, older workers, aged between 55 and 64, had an employment rate of 48.2%. This did not depart significantly from the EU target of 50% participation rate by 2010. Unfortunately, after 2001 there has been a significant drop in the employment of older workers, which shrunk to around 40%.

One has to be cautious in interpreting the employment rates of women and older workers. First, the two rates have been decreasing since the beginning of transition. Romania, unlike most of the EU countries, had a tradition of high women participation rates. The drop in the activity of women was largely involuntary, attributable to the decline in output and employment opportunities following the collapse of communism, and the concomitant severe deterioration in living standards and increase in long-term unemployment. We expect therefore a large percentage of inactive women to return to work when labour market conditions start to improve. Labour market transition probabilities<sup>65</sup> from out of the labour force into employment show an important female added worker effect, where women enter the labour market to compensate for the withdrawal of men. At the same time, the participation of women and older workers in the subsistence agricultural sector is even larger than in the case of men. The correlation between the decrease in agricultural employment on one hand, and the decrease in female and older worker participation, on the other hand can not be coincidental<sup>66</sup>. This suggests that the employment figures in the two cases hide bigger imbalances than at a first glance.

<sup>65</sup>Romania Country Economic Memorandum, World Bank, 2004;

<sup>66</sup>See the next sub-chapter for a detailed analysis of sectoral employment composition;

**Table 5.2. Female employment rates for NMS and candidate countries**

| Female employment rates  | 2000        | 2001        | 2002        | 2003        | 2004        |
|--------------------------|-------------|-------------|-------------|-------------|-------------|
| EU (25 countries)        | 53.6        | 54.3        | 54.7        | 55          | 55.7        |
| EU (15 countries)        | 54.1        | 55          | 55.6        | 56          | 56.8        |
| Euro-zone                | 51.7        | :           | 53.1        | 53.6        | 54.5        |
| Euro-zone (12 countries) | :           | 52.4        | 53.1        | 53.6        | 54.5        |
| Czech Republic           | 56.9        | 56.9        | 57          | 56.3        | 56          |
| Estonia                  | 56.9        | 57.4        | 57.9        | 59          | 60          |
| Latvia                   | 53.8        | 55.7        | 56.8        | 57.9        | 58.5        |
| Lithuania                | 57.7        | 56.2        | 57.2        | 58.4        | 57.8        |
| Hungary                  | 49.7        | 49.8        | 49.8        | 50.9        | 50.7        |
| Poland                   | 48.9        | 47.7        | 46.2        | 46          | 46.2        |
| Slovenia                 | 58.4        | 58.8        | 58.6        | 57.6        | 60.5        |
| Slovakia                 | 51.5        | 51.8        | 51.4        | 52.2        | 50.9        |
| Bulgaria                 | 46.3        | 46.8        | 47.5        | 49          | 50.6        |
| Croatia                  | :           | :           | :           | 46.7        | 47.8        |
| <b>Romania</b>           | <b>57.5</b> | <b>57.1</b> | <b>51.8</b> | <b>51.5</b> | <b>52.1</b> |

Source: Eurostat.

The dynamics of unemployment affects the overall labour market participation. Although in Romania open unemployment emerged inevitably as a consequence of enterprise restructuring and output contraction, in recent years it appears to have stabilized at around 7-8% of the labour force. This is less than the EU average figure. This relatively low registered and Labour Force Survey (LFS)<sup>67</sup> unemployment levels can be partially attributed to the limited restructuring that took place in the enterprise sector.

At the same time, the decline in employment has not been matched by a proportional rise in unemployment, as long unemployment spells discourage people from actively looking for jobs, and pushes them out of the labour force or into subsistence agriculture.

The large informal economic sector, estimated at least 20% of GDP, may also explain the low formal employment figures and the low unemployment paradox. The grey economy appears to provide a large number of low paid jobs to mostly unskilled individuals who cannot find formal employment. External migration and the high economic growth rates achieved in the last years are other factors that explain the low unemployment figures. At the same time, more than 50% of the unemployed are long term, with unemployment spells of more than one year, indicating a profound mismatch between skills and labour demand.

According to the World Bank CEM<sup>68</sup>, the transition probabilities of moving from one state of the labour market to another, in one-year time, are relatively high. An unemployed person had in 1999 a 32.3% probability of finding a job, a 52.5% probability of staying unemployed, and a 15.5% probability of moving out of the labour force. This indicates that a large percentage of the unemployed is long-term. Unemployment cannot be avoided, especially in an economy that requires substantial labour reallocation across sectors, as is the case of Romania. However, long-term unemployment is detrimental to an economy and its workers, from a number of reasons: it contributes to an erosion of skills; employers associate long term unemployment to unproductive workers, and therefore are reluctant to hire them; long term unemployment spells have an effect of discouragement of the unemployed, and push them out of the labour force or into the informal sector. Long-term unemployment affects asymmetrical different age categories. It is very high among new graduates and low level educated youth, indicating

<sup>67</sup> According to the Romanian National Institute of Statistics (NIS) methodology;

<sup>68</sup> Country Economic Memorandum, see before;

a mismatch between skills that the education system provides and labour market demand.

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

First, the establishment of new business should be encouraged. Last year, in 2004, Romania has taken additional steps to reduce the period of time necessary for the registration of a new business, and has adopted an action plan to improve the business environment. The new legislation reduces the period of time in which a business can become operative to three working days, provided that it carries on with the registration procedures. This is a step in the right direction, although there are some voices arguing that the process is more expensive, and more complicated than before. The World Bank 2006 Doing Business report ranks Romania as one of the top ten reformers in the world in terms of simplifying and expediting business start-up procedures.

Improving registration conditions is not enough to create new sustainable jobs, if the competitive environment in which firms operate is not conducive to performance. Enhancing fiscal and financial discipline and eliminating the treatment of granting soft budget constraints to selected companies is a crucial ingredient to achieving a competitive environment based on a level playing field for all market participants. According to a recent study<sup>69</sup>, which analyses company behaviour between 1995 and 2002, the top 20% companies, totalling around 80% of the sectoral turnover, also accumulated almost 80% of the total debt. The finding was consistent throughout the analysed period.

This indicates that there are distortions in the economic environment and that some large companies are given an unfair advantage over the rest of the firms, discouraging otherwise profitable firms from setting up, or from growing, and preventing new job creation. Evidence shows that SMEs constitute a major employer, generating more than 40% of total employment in Europe. Most of employment growth, in general temporary and part-time, takes also place in the SME sector.

**Table 5.3. Non wage component of the labour costs**

|                | Social security contribution |              |              | Health care contribution |              |              | Contribution to the unemployment fund |             |             | Total       |
|----------------|------------------------------|--------------|--------------|--------------------------|--------------|--------------|---------------------------------------|-------------|-------------|-------------|
|                | Employer's                   | Worker       | Total        | Employer's               | Worker       | Total        | Employer's                            | Worker      | Total       |             |
| Bulgaria       | 0.37                         | 0.02         | 0.39         | 0                        | 0            | 0            | 0.04                                  | 0.01        | 0.05        | 0.44        |
| Czech Rep.     | 0.2                          | 0.07         | 0.26         | 0.09                     | 0.05         | 0.14         | 0.03                                  | 0           | 0.03        | 0.43        |
| Hungary        | 0.22                         | 0.05         | 0.27         | 0.11                     | 0.03         | 0.14         | 0                                     | 0           | 0           | 0.41        |
| Poland         | 0.1                          | 0.1          | 0.2          | 0.07                     | 0.09         | 0.16         | 0.04                                  | 0           | 0.04        | 0.4         |
| <b>Romania</b> | <b>0.22</b>                  | <b>0.095</b> | <b>0.315</b> | <b>0.07</b>              | <b>0.065</b> | <b>0.135</b> | <b>0.03</b>                           | <b>0.01</b> | <b>0.04</b> | <b>0.49</b> |
| EU             |                              |              | 0.24         |                          |              |              |                                       |             | 0.13        | 0.37        |

Source: World Bank

<sup>69</sup> Mereuta, C. Analiza nodala a sistemelor de companii, Editura Economica (2004);

There are various ways to encourage companies to create more jobs without distorting the market environment. This could be done by reducing the non-wage costs faced by the employer, or by enhancing the flexibility and competitiveness of the labour markets through a more favourable legislative framework.

In recent years, Romania has taken steps to reduce the non-wage labour costs. In 2003 the social contribution levels have been reduced by 5%, from around 34% to 29% of the gross average wage. It is a well-deserved relief and further cuts are envisaged<sup>70</sup>, but the non-wage costs of employers and employees added together still amount to 49% of the gross wage. This is a very significant non-wage cost that hampers the process of new job creation, especially in the case of low paid workers. As table 5.3. shows, Romania has the highest non-wage component of the labour costs even when compared to other CEE countries.

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

This is partly offset by the introduction of the institution of temporary work agency. However, most of the growth in employment in the EU in the last decade is based on term contracts, and has led sometimes to significant declines in unemployment, such as in Spain. Second, the employer's rights to labour retrenchment for economic reasons are severely restricted. Valid reasons for dismissals are economic hardship, but firms may need to shed labour in order to improve their competitiveness as well.

The flexibility in the area of labour and labour relations includes the possibility to employ, adjust, distribute and dismiss workers based on job requirements, to ensure the ability to adjust to the external market criteria like changes in the economic environment, to maintain competitiveness by means of cost control.

Economic reasons should be added on the list of valid reasons for dismissal, because preventing firms from adjusting their workforce hampers efficiency and the external competitiveness of the economy. Third, the automatic application of branch contract agreements to all contracts in the sector should be revised. Mandatory extension of industry wide collective labour agreements to non-participating employers should be discouraged, or there should be an "opt-out" option for employers for whom complying with the industry level agreement is too costly. Small firms are forced to comply with industry level agreements that are negotiated above their heads. The negotiated salaries and benefits may be too high for firms to afford, pushing them out of business.

Overall, although the labour code has introduced some positive changes which simplify recording procedures and limit the opportunities for abuse and corruption, it has not been promoting a flexible environment in which labour market need to operate. Several changes in the code have been made in 2005 to correct some of the imbalances, but the fundamental rigidities have not been removed. It is expected that workers be protected by a proper legislation from abuse by employers. At the same time, however, a rigid labour market is not conducive to job creation and sustainable economic development.

While the creation of new jobs *per se* is important, the quality of the human capital they embody is equally central. The distribution by levels of education of the labour force is positively

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<sup>70</sup> In 2006 a further cut of 2% of the social security contribution of the employers is planned;

correlated with value added, and hence with the overall competitiveness of an economy. According to a recent survey, Romania has the highest percentage of early school leavers in the region, with 23% of the population between 18 and 24 leaving all forms of education, and the lowest percentage of life-long training. In 2003, only 1.3% of the population aged between 25 and 64 was participating in training or education. Expenditure on education is one of the lowest among CEEs countries, at around 3.4% of GDP.

Long-term unemployment among recent graduates indicates a mismatch between the skills the education system provides and the labour market demand. To address this challenge, the education system is undergoing a comprehensive reform, which has already produced significant changes, especially in compulsory educations. Reform measures were piloted in the vocational education and training system. An important issue that needs to be addressed is the quality of education. The scores of the Romanian students at TIMSS<sup>71</sup> have been consistently among the lowest compared to the eight EU countries which participated in the study.

## **5.2. An analysis of sectoral employment in Romania vis-à-vis the European Union.**

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

According to this measure, Romania needed the largest reallocation of labour both in 1989 and 2001. In 1989, around 30% of the labour force would have been required to change occupations and sectors in order for Romania to reach a sectoral employment comparable to that of the EU. The index, instead of decreasing, which would have indicated an adjustment towards the EU levels, had deteriorated further and, in 2001, more than 40% of the work force would have needed to change occupations.

With the exception of Bulgaria, the rest of the CEE countries under investigation have made significant progress in convergence towards EU employment structures. This finding provides evidence in support of the fact the Romania's aggregate employment figures present a picture rosier than the reality may be. It suggests that the present employment structure will not help Romania to withstand the competitive pressures that a single market will bring, without a large degree of reallocation across sectors. The large migration of Romanian workers to EU member countries is a facet of the needed labour reallocation.

In Romania, agriculture has played throughout the transition the role of the "employer of the last resort". In countries with high agricultural employment, when the process of job destruction in the industrial sector has not been accompanied by job creation elsewhere, laid-off workers have turned to small scale farming as an alternative to open unemployment. This is the case of Romania, where employment in agriculture has risen from 28% in 1989 to 42%<sup>72</sup> of the total in 2001.

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<sup>71</sup> TIMSS is an international mathematics and science study that provides an assessment of students from different countries. The study was run in 1995, 1999, and 2003;

<sup>72</sup> Labour Force Survey figures;

Since 2001, employment in agriculture has decreased significantly, from 42% to 32% in 2004. The decrease is an anticipated move in the right direction. Among the NMS, Poland is the only country with a large share of agricultural employment, although significantly lower than Romania's, at around 18%. Scattered evidence shows that the decrease in agricultural employment was attributable not only to labour reallocation across sectors, pushed by the need to compensate productivity gaps, but also to external migration, as Romania has a large outflow of migrant workers. Part of the decrease can be attributed to some classification changes, as well.

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

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

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

Source: ILO

### 5.3. Labour market productivity

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

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

| Hourly labour costs | 1996  | 1997  | 1998  | 1999  | 2000        | 2001        | 2002        | 2003  |
|---------------------|-------|-------|-------|-------|-------------|-------------|-------------|-------|
| EU (25 countries)   | 16.03 | 16.71 | 17.24 | 18.05 | 19.48       | 19.75       | 20.67       | 20.95 |
| EU (15 countries)   | 19.14 | 19.95 | 20.51 | 21.34 | 22.73       | 22.59       | 23.51       | 24.32 |
| Euro-zone           | 20.44 | 20.37 | 20.65 | 21.18 | 22.13       | 21.83       | 22.81       | 24.13 |
| Czech Republic      | 2.8   | 2.97  | 3.23  | 3.41  | 3.86        | 4.64        | 5.39        | 5.47  |
| Estonia             | 1.85  | 2.13  | 2.42  | 2.6   | 2.85        | 3.22        | 3.67        | 4.01  |
| Latvia              | :     | 1.59  | 1.71  | 1.85  | 2.22        | 2.29        | 2.39        | 2.37  |
| Lithuania           | 1.32  | 1.68  | 1.95  | 2.16  | 2.63        | 2.76        | 2.9         | 3.1   |
| Hungary             | 2.86  | 3.15  | 3.02  | 3.14  | 3.63        | 4.04        | 4.91        | 5.1   |
| Poland              | 2.95  | 3.38  | 3.73  | 4.05  | 4.48        | 5.3         | 5.27        | 4.7   |
| Slovenia            | 7.35  | 7.9   | 8.51  | 8.94  | 8.98        | 9.58        | 9.7         | 10.54 |
| Slovakia            | 2.16  | 2.61  | 2.91  | 2.76  | 3.07        | 3.26        | 3.59        | 4.02  |
| Bulgaria            | :     | :     | :     | :     | 1.23        | 1.29        | 1.32        | 1.39  |
| <b>Romania</b>      | :     | :     | :     | :     | <b>1.41</b> | <b>1.55</b> | <b>1.67</b> | :     |

Source: EUROSTAT

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

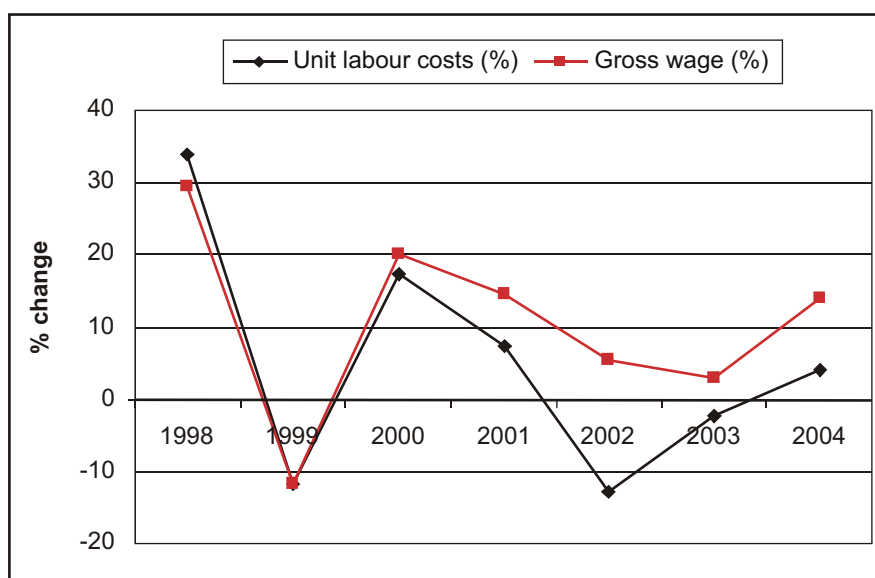
**Table 5.6. Unit labour costs, PPP adjusted, Austria = 100**

|                | 1997        | 1998        | 1999        | 2000        | 2001        | 2002        | 2003        | 2004        |
|----------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| Czech Republic | 27.1        | 29.5        | 29.9        | 31.5        | 34.5        | 39.6        | 38.4        | 38.6        |
| Estonia        | 32.1        | 34.7        | 35.4        | 35.9        | 37.7        | 38.9        | 40.1        | 40.7        |
| Latvia         | 29.4        | 31.1        | 32.7        | 35.1        | 34.7        | 34.5        | 32          | 31.2        |
| Lithuania      | 26.4        | 28.3        | 30.1        | 32.5        | 30.4        | 31          | 29.9        | 30          |
| Hungary        | 24.5        | 24.9        | 26.4        | 28.1        | 31.9        | 37.8        | 39          | 39.5        |
| Poland         | 33.2        | 35.4        | 41          | 45.7        | 51.5        | 47.1        | 39.9        | 38.7        |
| Slovenia       | 66.4        | 68.3        | 69.9        | 67.6        | 69.7        | 69.2        | 67.5        | 73.9        |
| Slovakia       | 27.4        | 27.5        | 24.8        | 26.6        | 27.1        | 28.2        | 29.3        | 31.5        |
| Bulgaria       | 16.8        | 17.1        | 17.5        | 17.2        | 16.8        | 17.1        | 17.5        | 18.5        |
| <b>Romania</b> | <b>23.4</b> | <b>31.6</b> | <b>27.4</b> | <b>32.2</b> | <b>34.1</b> | <b>29.1</b> | <b>27.7</b> | <b>28.6</b> |

Source: WIIW Handbook of Statistics: Countries in Transition 2004

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

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



#### 5.4. Summing up

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

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

If measures for stimulating job creation and higher employment are to be successful, several aspects have to be taken into considerations. First, they should allow for the downward

adjustment of the labour costs. This can be achieved through the reduction of the non-wage components of labour costs, especially for low skilled employees.

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

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

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

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

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

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

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

## 6. A sample of policy recommendations

### Policies for stability and growth

- There is urgent need for multi-annual budget programming (MABP), which should assess future pressures on the budget thoroughly; a “budget shock” in 2007 has to be averted.
- A consistent reform of the public expenditures is needed in order to improve their prioritization and redirect them towards areas that strengthen the country's human capital, infrastructure and administrative capacity. Together with a broadening of the tax base and better tax collection this would make room for sustaining the additional EU related accession costs.
- The reform of the health and pension systems is crucial to counter the expenditure pressures of an aging population and to improve the sustainability of the public finances.
- The development of the institutional capacity to absorb EU funds is a huge challenge and the Government has to adopt urgent measures to this end. The setting up of an Infrastructure Development Company is advocated by us.
- An adequate understanding of the monetary transmission mechanism in the Romanian economy, as well as other features of the Romanian economy (degree of euroization, low monetization, intensity of structural change) is required given the evolving content of the inflation targeting regime currently implemented in Romania.
- Romania has a low efficiency in producing and consuming energy. Having this in mind, and in particular the international context on the demand side (the economic rise of Asian economies), it will be very unwise for Romanian companies not to undertake significant investment in order to reduce primary and final energy intensity. State support should also be provided in order to help companies tap into such efficiency reserves.
- A rapid expansion of rural credit mechanisms (that involves the efficient use of EU rural development funds) and land consolidation would be among the solutions for rural development. The fate of Romanian agriculture depends on how the Common Agricultural Policy will be shaped in the years to come and on how Romania will use the EU financial assistance oriented toward this sector.
- The impact of climate change needs to be taken into consideration as huge floods and dramatic fluctuations of temperature have produced havoc in recent years. Policymakers have to make adequate room for contingencies when they allocate state revenues; there is also need for dealing forcefully with deforestation, inadequate damming, etc. The financial implications of building up proper infrastructure can be quite large and give more salience to the need of absorbing EU funds to the utmost and most effectively.

### Implementing the *acquis* and the Lisbon guidelines

#### Internal market and competition

- Romania has to redirect aid to horizontal objectives of common European interest and to target identified market failures. In general terms, state aid that can be approved should serve to generally defined objectives, such as research and development, environment, regional development, or the development of SMEs and only if it avoids undue distortions of competition.
- The privatisation of the energy sector distribution should be carefully monitored in order to

avoid state monopoly to be transformed in private monopoly, without any efficiency and welfare gains. Abuse of market power has to be forcefully fought against.

- Romania should encourage investment in new equipment and technologies that are environment friendly and require reduced energy inputs.
- A more systematic approach of implementing the Regulatory Impact Assessment (RIA) best practice should be envisaged by the Romanian authorities. At least budgetary impact assessment of all regulations or decisions should be provided in a transparent way to the public.
- Romania needs to support the creation of new enterprises and the development of the existing ones in order to provide the critical base for economic flexibility, innovation and absorption of structural funds. Improving the institutional framework will create more business opportunities, but a more proactive approach towards facilitating market access should not be neglected.

## **RDI**

- Romania needs to further develop the ICT networks. Particular care should be given to reduce the digital divide in between the users and non-users of ICT, possible with the use of structural funds.
- Romania should increase its R&D expenditure by using a series of fiscal and non-fiscal incentives, especially given the proposal for more lenient state aid regulations. Additional support should be given to applied research, which has more impact on economic efficiency. A system of periodic review should be introduced for assessing the efficiency of public expenditures.
- Romania should concentrate all efforts in disseminating knowledge and supporting technology transfer. From an institutional viewpoint, the promotion of networks, clusters and cooperation between universities, research and industry should be prioritised.

## **Sustainable development**

- Romania should be careful in prioritising investment in the short and medium run, in order to avoid excessive strain on available environmental resources. Sustainable development should remain a concern, but in the short run the focus should be more on increasing resource efficiency.
- Water treatment and waste management are the areas of sustainable development in which Romania is severely underperforming, but transition periods should be well used for a judicious phasing of investments.
- Investment in renewable energy or limiting road transport should be postponed until Romania upgrades its current infrastructure and convergence status.
- Careful consideration should be given to balancing the environmental expenditure between public and private sources on a partnership basis. Moreover, preparation for absorbing structural funds should be a priority.

## **More and better jobs**

- If measures for stimulating job creation and higher employment are to be successful, they should allow for the downward adjustment of the labour costs. This can be achieved through the

reduction of the non-wage components of labour costs, especially for low skilled employees.

- Hiring and firing costs should be reduced. Employers should be allowed greater flexibility in adjusting employment to respond to opportunities for economic development.
- Further deregulation allowing flexible labour contracts is needed, particularly to encourage temporary and part-time employment. Measures that promote part-time employment have been successful in increasing female employment rates in the EU countries, as well as for bringing parts of the informal employment into the formal sector.
- The quality and skills of the labour force should be upgraded, by encouraging people to enrol in higher education programs and lifelong learning. Education institutions should conduct studies to identify match and mismatch situations and reorient profiles, study streams, and curricula, in order to create an educated labour force with the right qualifications. The unemployed should be stimulated to undertake training in order to update or even change their skills. This requires an increase in the budget devoted to active labour market programs, towards EU levels. At the same time, firms should be encouraged through non-distortive incentives to invest in their workers, by upgrading their skills through on the job training or lifelong education.
- Assistance and consultancy for the small business should be widely available.
- A competitive business environment where all actors participating play by the same rules, needs to be consolidated, which implies eliminating the practice of allowing firms to operate just because they have a large working force, or the right political connections.
- The use of early retirement policies should be made more restrictive both by gradually increasing the retirement age and by limiting the categories of workers and individual cases that qualify for special treatment.
- The balance of the pension system is still not assumed. The new pension system has corrected some problems, but has not managed to solve them. The introduction of alternative pension schemes should alleviate the problems that the state pensions system is currently experiencing, but not in the near future. It is important to resist the temptation to resort to populist practices (that would increase the fund's deficit) in order to gain electoral support.

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