ROMANIA 2007

Policy warning report (PWR)

Romanian Academic Society (SAR)

Romania has joined the EU in January 2007, but its European agenda is still work in progress. We don't know for sure what exactly we need to do in the near future, beyond setting up the institutional system required for managing the EU funds. We never discussed what substantial changes are needed at home in order to function properly as a member of the wider club. And this is mostly because domestic, short-term politics has always occupied most of our time, and as a result we never had the patience to identify the sources of our structural problems. With this report SAR invites you to look into four crucial policy areas that will make or break our success as a new member state.

What's inside

Other reports on governance, studies on politics and public policy, as well as the political science quarterly *PolSci*, all published by SAR, are available from www.sar.org.ro

Foreword

EU ACCESSION IS NO END OF HISTORY

Only the day after we realize how superficial our Europeanization is and how much we still need to do to achieve it

There is, to paraphrase the Czech novelist Milan Kundera, an unbearable lightness to the EU accession of the former Communist Europe: only after it is done it becomes obvious how much more is still needed to experience a quality of life similar to that of the 'old' Europeans. People in our country have yearned for a 'return to Europe' throughout Communism. After its fall they have undertaken brave reforms to be accepted in the European Union. The expectation was that Europe will miraculously cure all their ills inflicted by historical underdevelopment and Communist perverse social engineering. When this is slow to happen, anger grows.

Romania, a new EU member since January 1st, is the last to experience this ambiguity. We feel astonishingly gloomy for how well they actually fare. Only sixteen years ago our people were bankrupt and hungry, with empty shelves in the stores, no passports and a redoubtable Communist secret service spying on our private lives. These days nobody starves any more, we manage very well unemployment, attract increasing foreign investment every day and what is left of the secret service files is opened to the public. However, our publics express in polls their distrust in our Parliament; they see politicians as worse predators than criminals and believe that elections can only change governments, but not to bring substantial improvement to their lives. The management of the economy by national governments has gradually improved, but politics remains confusing and fragmented. Former Communists are strong and shameless. New democrats are often corrupt and incompetent.

Why, after the European target is reached, do we see such discontent and unrest in nearly all Central European capitals, feeding populism? One answer is that EU integration deprived of any real substance the politics of these countries for many years, as all governments, regardless of ideology, focused only on this very popular objective. Once the intensely sought after accession takes place, the anesthetic effect of the effort is gone, and the ache resurfaces. The 'day after EU' just makes the veil drop that covered for many years the uneven change of these societies, reflected in their improvised politics. These are countries of many political facts but very few developments indeed. Years pass, and parties and politicians seem not to learn any lessons. Everybody else does learn: but they lag behind.

Europe has worked remarkably well as an incentive for the transformation of countries in our region. Without the European prospect, Romania would be today like Belarus. Romania's European perspective is accountable for the fact that Romanians ceased voting for Ion Iliescu after a third term, while the Belarus citizens kept on voting for Alexander Lukashenko. The incentive of European integration lured even the successors of the Communist party and empowered the initially weak pro-European constituencies in Romania and Bulgaria. Transition may have seemed long and strenuous for Romanians, but from Ceauşescu's snipers and Iliescu's vigilante miners to the signing of the Accession Treaty with the EU only fifteen years have passed. The remarkable speed of EU integration, however, has put considerable tension between the formal EU-like institutions adopted and the informal practices of our country's politics and society which could not evolve so fast. If one compares the governance scores assigned by Freedom House *Nations in Transit* to these countries at the beginning compared to the end of the EU negotiations the results show stagnation rather than progress[1].

Even in areas of considerable EU investment, such as governance and reform of the judiciary the 'real country' has lagged seriously behind the 'legal country' in recent years. We tend to attribute this distance between written rules and current practices to the hypocrisy of our politicians alone, rather than acknowledging the difficulty of doing so much in such a short interval of time. The task was simply enormous: not only market and democracy had to be built during transition, but society as well.

Out and away from the social uniformity and the distortions that Communism inflicted on these societies whole new social categories had to be created, from politicians and entrepreneurs, to journalists and real estate agents. This is post communism, which often feels worse than Communism itself. Times with competing value systems and a daily institutional upheaval can hardly provide an environment for great life satisfaction, despite the enjoyment of freedom at a scale undreamed of during communism. Here lies the source of the unbearable lightness of Europeanization, in the many new institutional shapes still waiting for their proper contents to catch up. A superficial observer might get it wrong and call it a failure. It is not: it just needs more time and patient effort. Although this is not what our battered country wants to hear, EU accession is no 'end of history'.

1 For the relevant data and a broader discussion on EU's influence see Alina Mungiu-Pippidi, 'EU Enlargement and Democracy Progress', in *Democratization in the European Neighbourhood*, Michael Emerson, editor, CEPS Paperback Books, Brussels, 2005 , pp 15-38, http://shop.ceps.be/downfree.php?item_id=1267

Executive summary

Section 1 of the report is the economic forecast.

The 2007 economic forecast of SAR is mostly positive. Our experts predict a growth of 6.3% and inflation of 5.2%. In December 2007 the exchange rate is likely to be 3.36 RON/Euro and the budget deficit 2.9%. The main concern is for the adjustment of governmental policies to post-accession conditions in 2007.

Section 2 of the report is devoted to the regional development in the European Romania.

In Romania, like in other CEE countries of comparable size, the old patterns of geographical distribution of development have proven resilient over time: historical disparities appear difficult to alleviate, in spite of the energetic interventions under the Communist regime, or the more democratic and modest ones of recent times. The experience of the West in this respect is not very encouraging either, as the debate has intensified in the last years about the role and effectiveness of the EU regional policy, especially following the publication of the Sapir report in 2003. Structural funds of the type that become available in Romania starting with 2007 have financed interventions in many parts of the Old Europe for decades. However, the "*Mezzogiorno* syndrome" has not disappeared in many of its regions: a stubborn mixture of relative poverty and dependency, rooted in both the economic base and social structure of communities. For every Ireland that used the EU funds smartly, shaping herself up and becoming a modern country, there are counter-examples that did not, burying the money in projects with low impact and reinforcing the closed traditional society.

Arguably, it was the redistributive nature of the assistance from above which made the syndrome more resilient than it should have been. *Therefore, this report strongly recommends that during the budget cycle 2007-2013 efficiency should be preferred by the Romanian authorities to the mechanical understanding of "cohesion" as an equal distribution of funds in territory, formally or informally, through the Sectoral / Regional Operational Programs and the Rural Development Program.*

As regional disparities are not very high in Romania today, when compared with other European countries, such a strategy should not create disproportionate political strains. The public authorities can only speed up growth and modernization if they encourage consistently: (i) the most efficient economic activities, wherever these happen to be located, with neutral policies; (ii) public infrastructure projects with the highest benefit-cost ratio, not "cathedrals in the desert"; and (iii) good fundamental and applied research, where the latter is measured by the accepted international standards of the profession.

Section 3 of the Report deals with the problem of energy.

The architecture of Romania's electricity and gas sectors is largely in line with EU requirements and the best international practices. The liberalization of our electricity market has been a remarkable success so far, despite the criticism it has attracted from hurried, but not very well informed commentators: currently, Romania is the only country in the region with a day-ahead market and a balancing market for electricity. The prices of the kilowatt on these markets are among the lowest in Europe. By contrast, as recently as 2000 the energy sector in Romania was generating a staggering quasi-fiscal deficit of 5% of the GDP, through power and heat prices lower than costs, domestic gas prices well below import price, and substantial bill collection problems in power, gas, and heating. The progress made in just five-to-six years is impressive, even for the most cautious critics.

However, the Road Map adopted by the Romanian government in 2003 should be revised urgently in view of the latest shifts on the world energy market, and more open discussions should be launched in order to make the broader public aware of the importance and direction of the Romanian energy strategy. Due to the incomplete restructuring of its economy, the country still consumes much more energy per unit of GDP than the EU average. The risk of corruption, or at least inefficiency, is still high in bilateral negotiated contracts: deals concluded between producers and suppliers or eligible consumers, on mutually agreed terms. Currently these contracts make up roughly a third of total consumption, of which less than 10% are concluded under transparent terms and prices. All these problems should be addressed at source, through increased transparency and more liberalization, with iron rules applicable to everyone, and not by hasty political interventions on the natural gas or the electricity price. The claims, repeatedly made in the past months, that Romanian consumers pay "the highest prices in Europe" are not true: in fact we pay among the lowest unsubsidized prices, but – or maybe, precisely because of this – use still too much energy. Reintroducing, directly or indirectly, state subsidies in the energy price, or concluding bilateral agreements with suppliers like Gazprom, with below-market prices that may slow down the industrial efficiency improvement and make the domestic market captive to political decisions made elsewhere, can throw us back to the dire situation before 2000, canceling the benefits of reforms implemented with so much pain and effort in the last years.

Section 4 of the report deals with the capacity of Romania’s research and education systems to contribute to the fulfillment of Lisbon objectives.

This section of the report deals with the Romanian education system in the broader framework of the Lisbon Summit objectives. It is not its purpose to enter into details of the organization and reforms of the education system, but rather to argue for more evidence-based policymaking in this field, instead of the mechanical implementation of policy recommendations ungrounded in Romanian realities. The conclusions are that Romanian education and research sectors’ institutional arrangements foster mediocrity and corruption and discourage innovation and performance. More taxpayer money or blind implementation of often poorly evidence-grounded European policies will not solve our problems.

The report makes six generic recommendations:

- **Reestablish the primacy of performance by pure administrative means,** for instance selecting only internationally acknowledged academics in the bodies dealing with academic promotion and distribution of research funding. Unless evaluators are themselves submitted to the test of quality any discussion of quality remains futile and hypocritical.
- **Invest strategically.** The individuals and disciplines which perform well even in the present difficult circumstances should take the bulk of funds. When you have a tenth of your researchers performing relatively well you earn more by investing in them than spreading the butter thin over all universities and research institutes. Rely on them to create a new generation of researchers.
- **Open the system.** Rules and laws should be amended to eliminate disincentives for performance. Diplomas from universities featured above Romanian ones in the Shanghai top should be automatically accepted in the Romanian academia to encourage repatriation.
- **Make the system accountable**. Corruption in the education system was little understood, so it was neglected by the anticorruption wave of the last years. The problem is not of occasional soft payments to teachers, but of massive fraud at exams, of the falsification of evaluation systems, of the total lack of accountability of the higher education and research system, which needs being reinvented. The report suggests measures to increase accountability within the universities, as well as the introduction of a periodical audit by a newly created special control body.
- **Foster dialogue and cooperation with business,** especially the knowledge intensive sector.
- **The Bologna Declaration should be seen simply as a framework for European cooperation,** not a tool to reform the Romanian higher education system. Its implementation should be revisited with the view to foster quality, not spread it thinner than it already is. The real European education objectives can be found under Lisbon,

not Bologna, and those badly need a national strategy reflected in new, better grounded education policies.

Section 5 of the Report deals with the problem of increasing Romania's competitiveness.

Romania is a factor-driven economy to a large extent, moving only now towards an efficient-driven development stage. We have basically two options ahead of us: (a) to compete on the European market and globally with Poland, China and India on the labor-intensive product markets; or (ii) to devise a sound policy for efficient investments that may turn Romania from a spectator into an active player on the high-technology based global market. Taking into account the uncertainties associated with the option (a), we are left to play the second card. So, firms in Romania will not be able to compete internationally only on the basis of natural resources and low wages, but rather on the basis of higher diversification, productivity and quality, ingenuity and innovation in product and process design and delivery. After the accession into the EU, there will be strong pressures on Romanian wages towards convergence with Western European standards. Strong growth for Romanian labor productivity is forecast over the next two years by the European Commission. In both productivity and wage levels, expansion is likely to be higher than in most EU-27 member states. But if the labor productivity per employee is outpaced by employee compensation, as the Commission forecasts, it will lead to a direct short-term threat to competitiveness. On the other hand, it may bring more emigrants back home, with higher skills and motivation.

The use of Structural and Cohesion Funds in improving the business competitiveness is subject to shifting priorities at the European level that must be taken into consideration in Romania as well. Competitiveness should involve more than just the central Government, so that Romanian economic development relies on a collaborative process, involving government at multiple levels, companies, teaching and research institutions.

Macroeconomic and Business Environment Indicators

Indicators		2001	2002	2003	2004	2005	2006e	2007f	2008f	2009f	2010f
Gross Domestic Product	EUR Mill.			52,606	60,784	79,258	95,858	112,128	127,027	141,149	154,090
Economic growth	%	5.7	5.1	5.2	8.3	4.1	7,0	6,5	6,3	5,9	5,6
Gross added value in industry	%	4.4	5.1	4.6	6.8	2.5	6.4	4.8	5.2	5.4	5.6
Private sector in GDP	%	68.0	69.4	67.7	72.2	70.4	71,4	-	-	-	-
Domestic demand	%	8.4	3.9	8.4	12.1	8.3	9.5	8.6	7.8	7.3	6.9
FOB Export	EUR Mill.	12722.0	14675.0	15614.0	18934.7	22255.1	26100	30550	34750	39300	44400
CIF Import	EUR Mill.	17383.0	18881.0	21201.0	26281.0	32568.5	40260	36100	52300	58790	65850
FOB / CIF trade balance	EUR Mill.	-4661.0	-4206.0	-5587.0	-7346.3	-10313.4	-14160	-15550	-17550	-19490	-21450
Foreign direct investments (Balance of Payments)	EUR Mill.	1312	1194	1910	5127	5237	8500	5800	5600	5600	5600
Inflation rate (Dec / Dec)	%	30.3	17.8	14.1	9.3	8.6	4.7	4.5	3.5	3.0	2.5
Exchange rate RON/EUR*	%	2.6027	3.1255	3.7556	4.0532	3.6234	3.525	3.43	3.38	3.35	3.35
Budgetary deficit in GDP	%	3.6	3.0	2.7	2.1	0.8	1.4	2.8	2.7	2.2	2.0
Number of employees in economy, *out of which:*	1000 pers.	4,619	4,568	4,591	4,469	4,559	4,615	4,745	4,825	4,900	4,960
• Industry (total), *out of which:*	%	41.2	41.4	40.3	39.0	36.7	35.5	34.6	33.8	33.0	32.4
- Extractive industry	%	7.4	7.2	6.9	6.8	6.8	6.3	6.1	5.8	5.6	5.3
- Processing industry	%	83.6	84.3	85.6	85.7	85.2	85.6	85.7	85.9	86.1	86.3
- Electricity and heating energy, gas and water	%	8.9	8.5	7.5	7.6	8.0	8.0	8.2	8.2	8.3	8.4
Unemployment rate	%, end of the per	8.8	8.4	7.4	6.3	5.9	5.4	5.3	5.1	5.0	4.9
Labor productivity per employee, in industry	%	6.7	5.0	5.4	11.8	7.0	7.4	5.5	5.8	6.0	6.2
Average gross wage											
• gross	Euro	162	170	177	202	267	323	370	414	458	499
• real	%	5.0	2.4	10.8	10.5	14.3	8.8	6.5	7.9	5.5	5.3
Unit labor cost											
• nominal	%			16.3	11.4	12.7	8.6	5.3	3.6	3.4	3.3
• real	%			-6.1	-3.2	0.6	-1.2	-1.4	-1.3	-0.5	-0.1

*Notes: * preliminary estimations base on 2006 achievements.*
Source: National Institute of Statistics, National Commission for Economic Forecasting, National Bank of Romania, Romanian Agency for Foreign Investments, The National Trade Register Office, 2006

Forecasts

GROWTH WILL CONTINUE IN 2007

As always at the beginning of a new year, SAR has surveyed for you a panel of twelve economic experts

By and large, the forecasts are more optimistic than last year. If the average GDP growth rate foreseen in 2005 was higher than the actual rate (6.2% as against 4.1%), the situation reversed in 2006, when our figure was about 3 percentage points below the real one measured at the end of the year (4.6% as against over 7%). Excessive caution also influenced the forecast on the 2006 inflation, as the positive deviation from the forecast was of more than 2 percentage points in this case (7.1% as against 4.87%). However, SAR forecasts were closer to reality than other forecasts at that time, so we are proud we could offer a useful benchmark for both businesses and analysts.

This year, following the good economic performance of 2006 and increased optimism generated by the EU accession, or more favorable international circumstances like the recent cuts of oil prices to under $50/barrel, the figures in the table above may be viewed as a standard equilibrium trend for the economy, or the so called steady-state equilibrium trend. However, the possibility of negative shocks later on cannot be ruled out, of course.

Macroeconomic indicators: SAR's 2007 forecast

	Average	Margin (min-max)
GDP growth rate, %	***6.3***	5 – 7.5
Inflation rate, %	***5.2***	4.5 – 6.5
Number of employees increase, %	***2.7***	0.2 – 10
Unemployment rate, %	***5.4***	4.8 – 6
Real wage increase, %	***9.5***	5 – 15
RON/Euro exchange rate, Dec 31, 2007	***3.36***	3.1 – 3.7
Budget deficit, %	***2.9***	1.5 – 4
Current account deficit, %	***10.6***	9 – 12
BET stock exchange index increase, %	***24.3***	12 – 30

The estimates provided by our panel have all stayed within a reasonable dispersion range. The panel experts provided values inside relatively narrow margins for the three fundamental macroeconomic indicators describing the current stage in Romania's economic development: economic growth rate (5-7.5%), inflation (4.5-6.5%) and unemployment (4.8-6%). The estimates for other indicators are more widely dispersed, however: number of employees (0.2-10%), real wages (5-15%), budget deficit (1.5-4%) and the BET index (12-30%). If last year most of the specialists considered the target inflation rate proposed by the NBR as too low, the estimates for this year are closer to the official ones. Reversing the trend of unwarranted wage increases will be decisive in controlling inflation, as wage increases must be based, in a sound economy, mostly on economic performance and productivity. To this end, the average forecast value for the actual wages might prove too optimistic towards the end of 2007.

The exchange rate forecast shows that, both for savings and/or investment, RON should be the currency of choice. However, contrary to the other economic indicators, the exchange rate could easily exhibit strong unexpected variation. The capital market may also be an alternative to bank savings accounts, especially for more sophisticated investors.

Finally, the deficit expansion is explained by the current drive to convergence with the EU, which implies simultaneous opening of markets and massive public expenditure (leading to budget deficits) for modernization needs, including massive imports, all causing current account deficits. The balance will be achieved by new entry of foreign capital (of which the most beneficial are foreign direct investments), attracted by the combination of the interest rates and the exchange rate dynamics, but also by the improved business environment and opportunities created by the high economic growth rate. Domestic producers need to become more competitive in order to both regain a bigger share of the domestic market and achieve a better export performance.

What do you will to be the most concerning economic trend in 2007?

The main issues of concern for the Government in 2007 lie in the *adjustment of governmental policies to post-accession conditions.* Almost all panelists stressed the need to focus on the absorption of EU funds for Romania and on securing macroeconomic stability, as new risks or even some slippage in economic policy may emerge as a result of Romania's poor experience as a new EU member state. The answers may be grouped in two categories.

Short-term (in connection with the absorption of EU funds)

Most experts are concerned by Romania's low capacity to absorb EU funds:

- The inability to spend money efficiently (or, more concretely, given the ministries' inability in the past years to spend the amounts allocated in their budgets, will they be able to administer additional EU funding?);
- The generation of eligible projects for EU funding;
- The availability of matching funds from the budget;

The impact of EU membership on the budget is still unclear. It is possible that we see negative effects in the first year, i.e. we may end up as net contributors to the EU budget. However, the situation may improve in the subsequent years.

Medium term

The difficulties have to do with various strains generated by the higher public expenditure and budget deficit provided for the 2007 budget, on one hand, and the need to strengthen macroeconomic stability on the other, especially by a controlled increase of wages in the public sector, maintaining the disinflation and foreign balance trends.

- The current account deficit is perceived as a problem in the long run;
- The impact of Romania's economic entry into the Single European Market, in other words the impact of the convergence and competitiveness gap between Romania and the EU on the real economy. On short and medium term it is expected an increase in investment and consumption. If the effect will be higher imports, then the deficits are likely to surge. What will be the response of domestic producers to the need for increased investment and growing local consumption, as the means of protecting domestic producers have been considerably reduced? The situation in 2007 will provide a more realistic measure of the ability of Romania's economy to cope with the competition on the Single European Market.

What will be the economic impact of the EU accession in 2007?

As opposed to the first question, this question has yielded a large scope of answers, given the unprecedented extent of accession-generated effects but all converging towards a common conclusion. In the long run the impact is positive leading to economic growth while on short and medium term we may witness both positive and negative aspects.

The EU accession and the improved credit rating of Romania have increased investor confidence, and we can therefore expect significant growth in foreign direct investments (FDI), and a massive expansion in greenfield investments.

- Romania's new position as an EU member will make trading in goods and services with non-EU markets easier, because of better tariffs. This improved access to the Eastern markets (especially Russia) will lead to higher exports levels for Romania.
- We foresee a strengthening of the national currency, with the concurrent risk of decreased competitiveness due to higher relative prices for exporters.

- We expect domestic consumption to grow much faster in 2007, as a result of a massive inflow of EU development funds and FDI. There may be strong inflationary pressures and an increase in imports (which would increase the trade deficit) if the supply-demand gap is not narrowed.
- The liberalization of the provision of financial services will mean lower interest rates in the long run.
- We forecast an increase in labor force participation and a drop in unemployment overall, but it is possible that market imbalances between supply and demand in certain sectors will bring strong upward pressures on wages.
- Experts also mentioned the underlying problems with the social security budget and national budget.
- EU accession may lead to a decline in some sectors (most notably in the light manufacturing industry and in the food industry) because of differences in productivity and the low quality of some products. Also, we estimate that some of the production capacity in these sectors will be shut down because of noncompliance to the new environmental regulations. However, the overall influence of EU accession on socio-economic development is widely agreed to be strongly positive.

What is the trend in the Romanian economy you consider extremely important but largely ignored in the current public debates?

This question has triggered a diversity of responses, such as:

- The current political volatility has, surprisingly, had impact on the financial markets, at least so far.
- Romanian investments abroad are on the increase, as some of our companies are on a marked regional expansion.
- Both nominal convergence and the use of the Euro currency depend on restructuring and on the changes in real economy, but approaches do not go deeper than global indicators. Two examples: there are discussions about the size of foreign deficit (balance of trade and current account), but less about its structure; the explanations provided for trends in the Romanian economy are not in line with structural analysis.
- The expansion of supermarket chains is affecting the traditional outdoor markets, and implicitly small farmers. Last year the prices for vegetables went down 10% while the price for live pigs is 50% lower than in 2005. Moreover the trend is likely to continue, pushing along other factors towards the restructuring of the agriculture.
- The trend is visible towards opening of call-centers and service-centers, where thousands of people are currently employed and where tens of thousands will be employed in the near future.
- Fast increase of the public sector wage ratio as part of the GDP, in parallel with a decrease of the capital expenditure ratio, while the ratio of public expenditures as a fraction of the GDP is the lowest in Europe (except for Lithuania). This trend is difficult to correct on a short term basis and reveals the rigid nature of public expenditures and generates substantial pressures on the budget deficits.
- There is a lack of coherent strategies for rural development.
- The Romanian national currency has strengthened and the structure of exports has changed over the past year. This may lead to major structural shifts in the Romanian economy or, at least the improvement of some sectors.
- The labor deficit is increasingly severe and results in mounting wage pressure.

Regional development

HOW TO AVOID THE "*MEZZOGIORNO* SYNDROME"

Go for performance, not uniform territorial distribution across the country, when allocating the EU funds

Annoyed by the long and inconclusive discussions about patterns of regional development in EU and their causes, a participant in the 2006 congress of the *Regional Studies Association* (RSA) held in Leuven stood up, asked for silence and aired a very personal opinion. Thus, according to him, what we see today when we travel across Europe is very hard to explain with econometric and spatial models, but much easier to understand if we watch the Italian neorealist movies of the '40-'50s. Commissioner Danuta Hübner, who was present in the panel, was a bit reluctant to agree, which is understandable: it is part of her job description to be optimistic about the transformative capacity of policies, after all. But this example serves as a vivid illustration of painful reality: the notion of ***path dependency***, i.e. a vicious circle in which past under-development creates conditions for its own perpetuation. From that point on, as if spelling out this unspoken intuition present in everyone's head had lifted some mental floodgates, the discussion broke up on spontaneous groups, and everybody in the 400-large plenum hall started to explore "how many Sicilies do we actually have in Europe today?"

To be more accurate, as some people quickly noted, we should ask ourselves "how many *Mezzogiorno*-s are there", because this stubborn pattern of under-development is a feature of larger regions, like the whole Southern Italy, not just the island's. Some found two: the Italian one, and Eastern Germany after unification. Predictably, others added in smaller tracts of Portugal, Spain and Greece. East Europeans were quick to point out that, depending on the threshold used, one could as well include almost all of the New Member States; or, alternatively, at least the Eastern halves of Poland and Slovakia, plus the area East of Middle Danube (historically, outside the old Roman *limes*). Then, an even more interesting challenge arose: to identify how many such regions actually exist *within* each country. This means sub-national territorial units that are not only poorer on average, but were also poorer in the past, and where public intervention, by the national state or the EU, only managed to generate "cathedrals in the desert", as they came to be known in East Germany or, before that, in Southern Europe.

This issue is a crucial one, since the "*Mezzogiorno* syndrome" is not only about being below a certain threshold (for example, the 75% GDP per capita of the Union's average, set by the Commission for eligibility for Cohesion funds at NUTS II level). It is much more than this: a resilient situation of dependency, rooted in both the economic base and social structure of communities. Here, when assistance funds flow in from the outside, the prices and demand for services respond normally, i.e. they go up. However, the local supply being very limited and rigid, for various historic and cultural reasons, the inputs have to be provided also from outside, and thus the dependency of the whole area increases. When a modern factory is built here, specialized labor has to be shipped in from elsewhere at high costs, because locally this resource is scarce. When a new highway finally arrives, it doesn't bring in much development; on the contrary, locals use

How many Sicilies are there in Europe?

the easier access to flee away, and the younger and more mobile are the first to do so, leaving the home region worse off.

The chapter dealing with Competitiveness in this report argues that Romania as a whole has indeed a chance to avoid becoming one of "Europe's Sicilies", trapped in a developmental dead end. Nevertheless, inside Romania there are areas threatened by the "Mezzogiorno syndrome". This chapter aims to show that this is indeed the case, and to discuss how we should conceptualize the situation and the policies to address the problem, especially in the light of the substantial resources earmarked for Romania in the Structural Funds.

1. Regional development: policy or destiny?

In Romania the transition to market and democracy was more difficult and traumatic than in other CEE states, due to the secular legacy of under-development and the severe distortions inherited from a Communist regime which was more inept than the regional average. The attempts to distribute more or less evenly industries and wealth over the whole territory of the country, an explicit policy guided from Bucharest for many decades before 1990, led to perverse effects: over-investment in prestige projects and under-investment in basic infrastructure, maintenance and human capital; industrial *white elephants* – poorly planned and unsustainable projects, decided on purely political reasons; and, as a result, to the emergence of mono-industrial towns or micro-zones, relying on a single large company or industry branch for their whole socio-economic life, in the middle of an otherwise backward region ("cathedrals in the desert"). A complex network of cross-subsidies between industries and regions made it impossible to judge what was economically viable and what not.

Lingering disparities and failed socialist urbanization

Beneath the surface of this formal socialist economy paraded as modern and booming, the social structure of deep Romania has endured in many places more or less unaltered until today. First and foremost, the hard core of autarchic peasant households engaged in strip-farming survived – or, paradoxically, was even reinforced as a viable economic structure during the long decades national mismanagement and food shortages under Communism. This semi-survival, traditional agriculture on small plots was practiced by the members of agro cooperatives alongside – or at the expense of – the official state agriculture. But also by a large proportion of the new industrial workers, who were in fact semi-urbanized peasant commuters, more attached to their land and garden than the factory that paid their nominal salaries. As a result, Romania has entered the EU in 2007 with an estimated number of 4.4 million agro exploitations ("farms"), out of which only about a third have registered so far for financial support under CAP. A good share of the rest are simply too small and under-capitalized, and therefore fall off the radar screen of any conceivable European policy. In fact, these are just aging rural dwellings completely insulated from the monetized economy. Their distribution across the eight Romanian development regions (NUTS II) is uneven, with higher proportions in the South and East of the country.

The economic restructuring with partial deindustrialization after 1990 was an obligatory stage in which some of these distortions and over-investments were eliminated, especially in the heavy industry. Without the conditionality from international financial institutions or the EU, things would have probably gone in the same direction, under the pressure of the open markets, only more slowly and hesitantly, with all the political slippages that usually accompany such a process in societies with a weak system of governance. Today, after seventeen years of transition and ten years of approaching the EU on fast forward, a number of conclusions are discernible regarding the relative potential of development in the Romanian regions. In a tentative summary of the factors that determine the wealth and dynamism of our regions, to be demonstrated with data in this chapter, one can say that:

- Old, historic disparities in development could not be erased by the massive efforts and investments, lasting decades, under Communism. The regime only managed to create an appearance of social homogeneity and some unsustainable economic insertions which disappeared as soon as the protecting glass case was removed.
- The divergence between regions after 1990, apparent especially during economic booms – the richest ones grow faster than the poor ones in good

times – is therefore to a large extent a reflection of the historical patterns prevalent under Communism and even before.

- Apart from inherited development and its pre-requisites, additional factors influencing regional growth seem to be playing a role today: geographic location (the closer to the Western border, the better, but this overlaps by and large with the historical patterns anyway); and easy access (the cases of Bucharest, or the city of Constanța at the Black Sea; or other sub-regions that grow faster than their regional average).
- Demographics will matter increasingly in the future in a way that is completely new for Romania, reproducing trends that occurred after World War II in some parts of Western Europe. First, we share with most of the rest of the Union a general population decline. Second, this aging process is very pronounced in some parts of our rural society, especially in vast plains of Southern Romania, which will probably lead to depopulation and a complete change of the agro economy in a few decades. Economically such a process makes sense, but many social problems will have to be solved along the way, and may temporary palliatives will have to be applied to ease the pains of change at such a breakneck pace.

All these factors are exogenous to governance and lead to the pessimistic conclusion that, ultimately, the patterns of development in Romania are largely pre-determined. The same conclusion was drawn by researchers in other countries that more or less share Romania's problems, such as Poland[2]. There are no traceable success stories of policy interventions that managed to change these patterns before 1990, and such success stories are even less likely to appear after the collapse of Communism, when the scope and instruments of social and economic intervention were substantially reduced. Currently there is a hope, shared by many decision-makers and public administrators, to spread the development more evenly with the help of large infrastructure projects, financed mainly by the EU. However, such expectations should not be played up excessively: the theory of planting highways in backward regions in order to generate development leads to poor investment strategies in cost-benefit terms, and is in general honored more in rhetoric than in reality. What we observe on the ground in OECD countries is that, when infrastructure projects are successful, this is so because they are prioritized so as to serve economic activities where they already exist and are constrained by the insufficient transportation and utility networks.

This is a well-known problem going down to the core principles of the development theory: development as a phenomenon is complex and elusive, difficult to trigger top-down by government policies, even well-meaning ones. It resembles a living body easy to destroy but hard to regenerate from scratch. Creating a favorable environment for it is one thing the governments can do, and here we come to the orthodox package of competitiveness, functional bureaucracy, low corruption and stable institutions. But this should be a nation-wide strategy, not a region-specific one, and even in this respect, things are easier said than done. In Romania the general policy framework and the business environment are largely determined at the national level, so there is not much a mayor or county councilor from a poor region can currently do to push things in the right direction. (The converse is not true, however: they can do a lot of harm if they choose so; so a useful advice would be to avoid wrong-headed local policies that kill the little growth that is happening naturally in a specific community). All in all, development appears easier to tackle as an object of measurement and evaluation by analysts, than a policy target for decision makers.

Old patterns of development die hard

On the other hand, working against this deterministic view, which says basically that markets should be left to play their role and effects will appear in due time, the truly historical novelty in our part of the world is the process of EU accession. There has never been in this region before such a consistent and institutionalized foreign intervention, with technical, financial and political components, and with the declared aim of modernization and development. The *crescendo* of assistance in the last decade reaches a climax two or

2 A very good overview in Grzegorz Gorzelak, 2006. "Poland's Regional Policy and Disparities in the Polish Space". *Regional and Local Studies Journal*, special annual issue, RSA-Polish section and Warsaw University.

Fig. 1. GDP/cap in the NUTS2 regions
€ in current prices

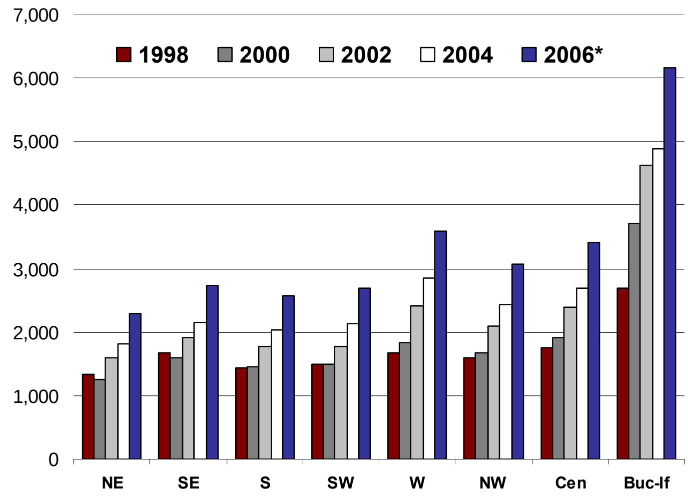
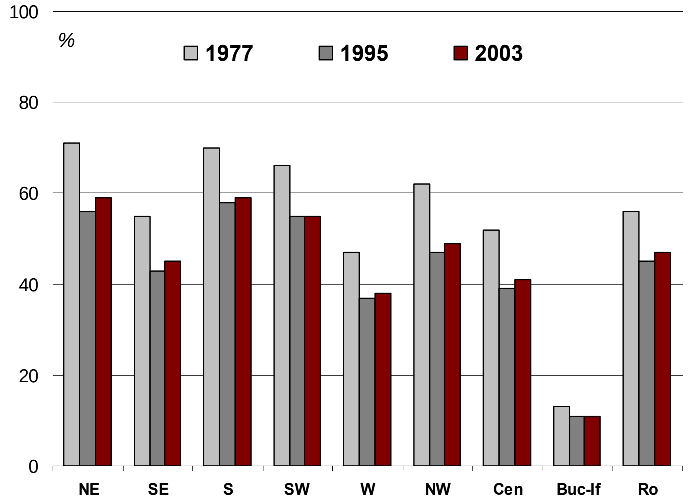


Fig. 2. Rural population by region, %



three years after a country becomes full member; in the case of Romania, around 2009-2010, with grants totaling up to 200 euro per capita annually, which as a percentage of GDP surpasses the level of assistance through the Marshall Plan in Western Europe after the war. If there is something that can alter the old patterns of regional development, probably this is the factor. This does not mean that things will run on automatic pilot once a country joins the Union and money starts flowing in even larger quantities. For every Ireland which used the EU funds smartly, shaping itself up and becoming a modern country, there are counter-examples that did not, burying them in projects with low impact and reinforcing the closed traditional society.

Another important variable to be considered is the opening of the European borders for Romanian citizens in 2002. This was arguably one of the most significant changes for ordinary Romanians in the decade and a half of transition[3], with an impact still hard to quantify. The massive circulatory migration between Romania and Western Europe in the last four years has brought into the country more money than the official assistance through EU pre-accession instruments. Since the emigration pool is very diverse in terms of skills and community of origin, with the poor rural sector in Eastern part of Romania very well represented, the benefits from this migration are relatively evenly distributed by social categories and regions. In turn, this contributes to a more even geographic distribution of newly-added resources, thus moderating after 2002 the general trend of regional divergence, triggered by the natural economic growth. On the other hand, the outflow of workers, reaching a peak in 2003-2004, has created a very tight labor market inside Romania and, increasingly, severe labor shortages in some regions and professions.

2. Current trends

As already mentioned, GDP per capita has steadily risen in Romania in real terms since the EU accession negotiations begun, but unevenly across the eight development regions (Fig. 1). Region 8 (Bucharest-Ilfov), with its special profile, benefited the most, followed by the Western parts of the country and Constanța county (at the Black Sea, which pushes up the average in South East).

Since 1998 Region 8 has doubled its GDP/cap, which is remarkable: adjusting up the number with the Purchasing Power Parity (PPP), it catching up rapidly with the EU25 average. Wages have followed the same trend, though less pronounced: salaries in NW and the Central region are not as high as the GDP level would predict it, and this gap may be explained in many ways, from the concentration of the declining state mining sector in SW, to the variable share of the underground economy across regions.

Demographics reflect the changing socio-economic conditions in Romania during

3 Or ever, as some argue: even before Communism, when borders were open, it was the intellectual and business elites who traveled abroad mostly, and not so much ordinary people.

transition. There is a general decline of population, which is nothing new, due to the falling birthrate and emigration. The last factor plays an uncertain role in the long term, however: if most of those who left to work in the EU will return, the effect will be temporary; but if many of them settle down for good in Western Europe, statistics will register a substantial one-off drop in population in the early years of the decade. In any case, data show that:

- The poorer North and East are more affected currently by the outflow of people, these being areas of highest external and internal emigration
- There was a reverse in the general, historical trend in urbanization during the transition, especially between 1994-2000, as many urban dwellers moved (back) to villages (Fig. 2). This was part of a subsistence strategy of blue collar workers confronted with massive industrial restructuring. Things look as if the forced urbanization under Communism led to a backlash immediately after the regime collapsed. This stage is probably over by now and the long-term urbanization trend has resumed lately.

The population aging is obvious especially in South and South West, where it is close to the European average (Fig. 3). Since the younger people still around are strongly attracted by the adjacent Region 8 (primarily Bucharest), a gradual depopulation of these areas is to be expected in the future. Which, economically, makes sense: the consolidation of land and agro economic activities is a must, especially in the Romanian Plain. But the changes will be accompanied by social problems which require vision, determination and resources to be tackled. The policy of life annuities for old peasants in exchange for land recently announced by the Ministry of Agriculture and agreed with the EU Commission may address this problem if properly implemented, but on the other hand it has the potential to accelerate the uprooting of traditional communities.

Unsurprisingly, the differential in aging trends is also reflected in the social dependency rate, which varies by region. Again, the southern parts are on top at the pensioners / employee ratio (Fig. 4). Demographics and industrial decline have contributed to this result, as the successive Romanian governments have been happy

Fig. 3. Population by age and region 2004

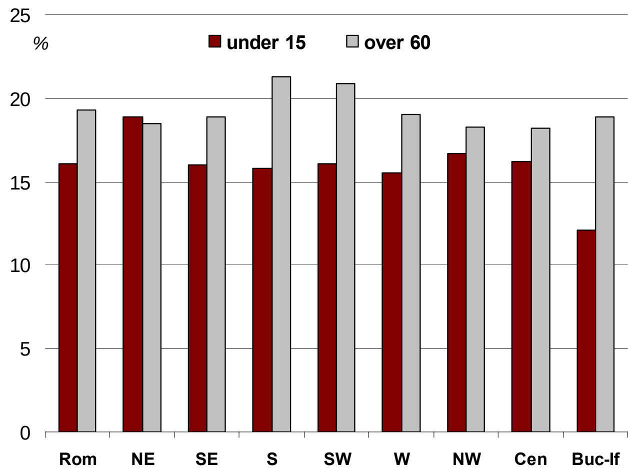


Fig. 4. Social problems by region, 2005

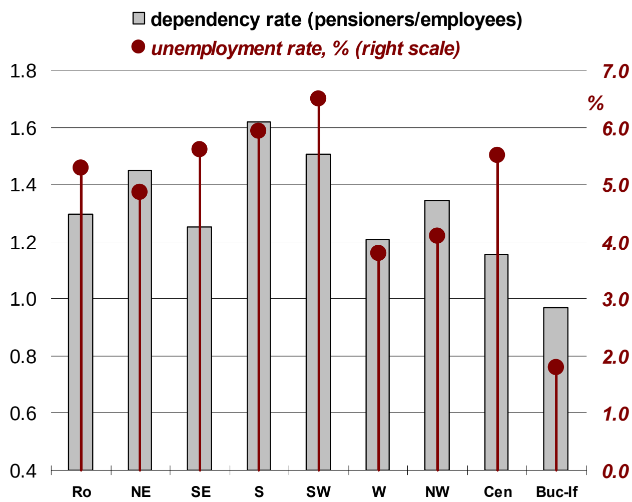


Fig. 5. Structure of labour by sectors and regions, 2003

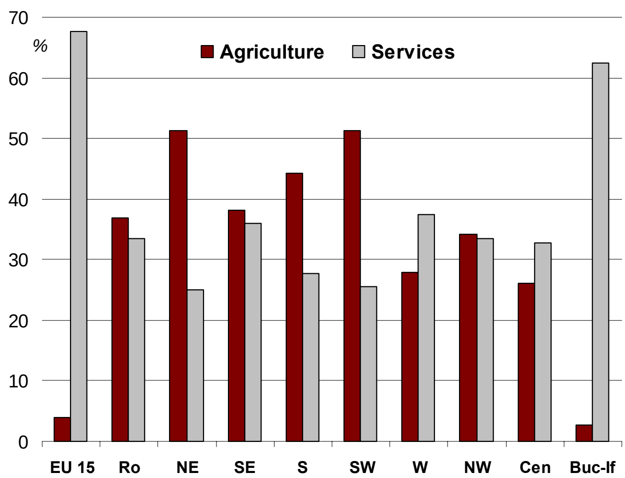
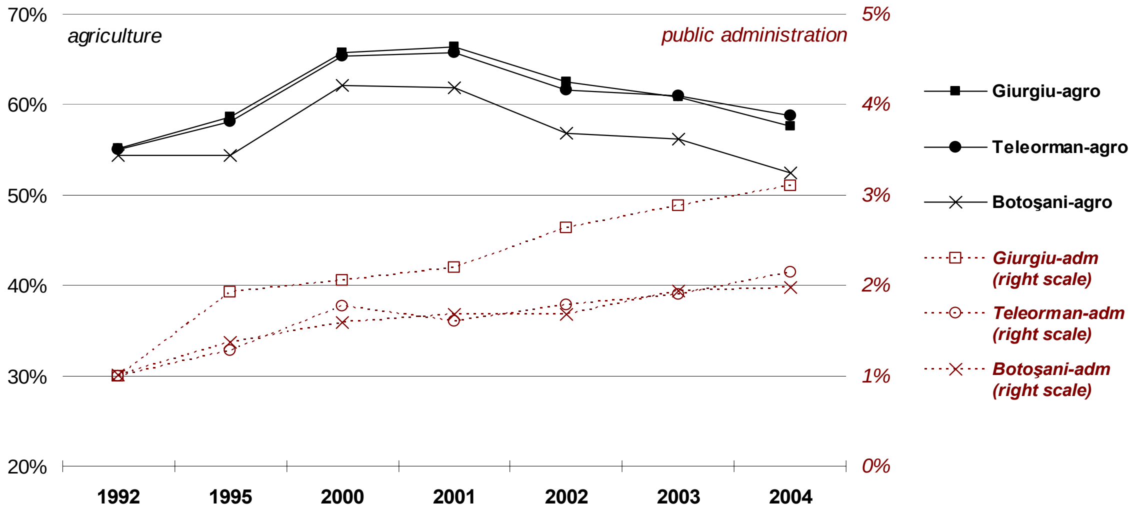


Fig. 6. Agriculture and public administration, as % of total employment, three "*Mezzogiorno*" counties



to camouflage the under-employment of people with low qualifications through early retirement and migration to villages. The absolute level of unemployment is quite low for a country supposed to be undergoing massive economic and labor reallocations (Fig. 4), but this numbers do not account for the fact that many individuals of working age are under-employed "farmers", keeping themselves busy by scratching the land on their tiny plots and gardens.

The future does not look much rosier, for the current distribution of labor by sectors (Fig. 5) and the stock of human capital are not favorable for sustained development. Actually, the whole Romania should look more like Region 8 in order to come closer to the EU occupation structure. But this will not happen soon, due to social rigidities, which make difficult for older and unskilled people in villages to respond to the labor market signals, and the relative high costs (financial and emotional) of relocation from one part of the country to another. In general, the decline of the occupation in agriculture after 2000, even in the least advanced counties, has not released labor for industry and services, but was most likely the effect of natural decline of population, emigration or a steep increase of occupation in the public administration (Fig. 6). In these "Romanian *Mezzogiorno* regions" it is possible that the EU assistance remain without the desired effect, as it is not clear if these communities have enough resources, energy and expertise in the private sector to use it effectively. There are strong signs already that the formal, urban labor market is both changing its structure and becoming increasingly stretched.

Should we be concerned about the rural depopulation in the mountains and the South-East?

Forecasts[4] show that, apart from occupations requiring higher education, there will be an increased demand in the near future for skilled people in agro-related jobs and various services, technicians in life sciences, health and other similar specializations, as well as industrial machine operators with general, adaptable skills. The demand is disappearing for routine jobs, even in manufacturing industries, and is on the rise for skilled workers with good general knowledge, transferable skills, and with a pro-active, entrepreneurial attitude.

There is an increasing shortage of free-lance technicians or associations able to subcontract small amounts of work flexibly on short-term contracts. As one businessman in the West Region pointed to us, during an evaluation of EU projects in the region we did there in mid-2006, investors are ready to "pay their weight in gold to small and reliable handymen who could be hired for three months for a specific project. Last year, for example, I needed four-five people to build a warehouse, and ideally these should be an organized team with their own tools and led by a foreman, whom I would negotiate with, agree an overall price and a firm deadline – and that would be all, I don't have time to organize them.

4 *Regional labor market supply: forecast 2013*, The National Research Institute for Labor and Social Protection, Bucharest, 2005.

But since I couldn't find any such teams here, I had to bring one from Szeged in Hungary, and they were perfect"[5]. In a similar vein, the 2005 *Business Environment and Enterprise Performance* (BEEPS) survey of the World Bank identified the poor skills of employees and scarce labor as the main problem of the companies. But in well-off regions they are hard to find because they are all overbooked or have emigrated, while in poorer regions there were few of them to start with.

The effects of the international migration of people of active age, and the increased demand for workforce, especially in the Western regions of Romania and in Bucharest (Fig. 7) predict an ever tighter labor market in the future, with shortages in almost all skill and qualification groups[6]. Companies and the public sector are increasingly outbidding each other for good employees, or try to move the little manpower available from other parts into the Western regions or big cities. The chances are high that in a few years the tight labor market would have generalized at the country level, spreading into the poorer regions too. The upside of this situation may be the continuation of the current trend of development with low unemployment and rising salaries, which have already doubled in Euro between 2001 and 2005 as a national average (and maybe trebled if we account for the informal sector of the economy), pushing companies up on the added-value ladder and freeing human resources from labor-intensive industries. The downside is that the wave of development and economic modernization sweeping Romania from West to East looks poised to replace the old regional cleavages with a new one: urban-rural, where disparities are likely to grow fast especially in the relatively poorer Southern and Eastern parts, as cities and their immediate surroundings pick up with the rest of the country and leave the "deep rural Romania" behind.

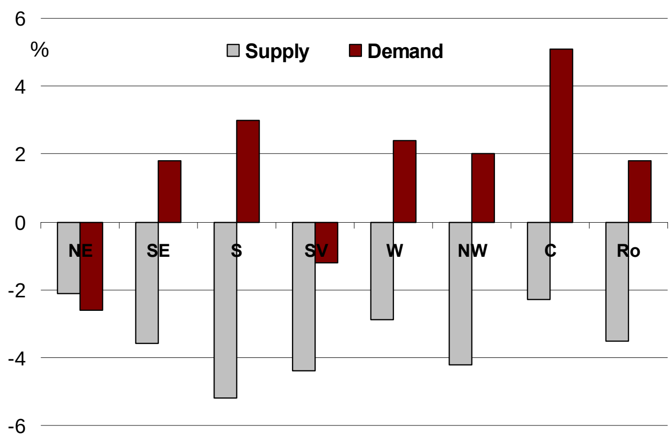
3. Current patterns of development and the EU assistance

To summarize the complex dynamics of regional development in Romania, two broad determinants are discernible that have shaped the pace and direction of change over the last decade, and will probably continue to do so. As said, they reproduce well the historical lines of change and modernization, this being a process "*a la longue durée*" (Fig. 8).

A. First, the *tidal wave model*, advancing from West to East at a pace of about 30-40 km per year. If we accept this simplified but highly visual description, take as the starting point the Austrian border, and the initial moment the late eighties, when Hungary launched its pro-market reforms, the sustained growth of the Western parts of Romania in the last years fits well this model of a progressing wave of development.

B. Second, the *polycentric diffusion model of development*, where administrative modernization, economic diversity and opportunities, coupled with higher land price, spread around from a small number of cities that have good access, are large enough to sustain a vibrant social life and therefore manage to attract and retain a critical mass of investors and professionals. In many ways, these cities are better linked with the network of global *metropoleis* than with their immediate hinterland, especially when an international airport exists. For instance, in terms of "institutional distance", Timişoara and Bucureşti are closer to Brussels than to Oraviţa or Caracal, respectively.

Fig. 7. Labor force supply and demand by region, forecast for 2005-2013



These two vectors of development can work in conjunction, but also cancel each other's effects sometimes. For example, better access through new transportation networks brought in by the progressing wave may paradoxically shorten the radius

5 OECD cross-country survey on local labor, skills and economic development (IESED), to be published later this year.

6 *Regional labor market supply: forecast 2013*, The National Research Institute for Labor and Social Protection, Bucharest, 2005.

of development around development nuclei. Instead of diffusion, what we observe is a draining of resources by the large city of the territory in its vicinity. In the case of Warsaw, for instance, development impetus is felt within a radius of about 30 km around the capital, whereas the area in a 50-100 km radius is characterized by the draining of resources from the metropolitan region to its metropolitan center[7].

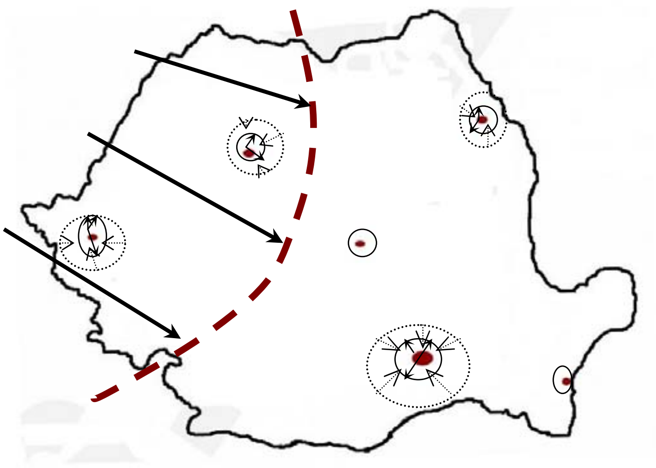


Fig. 8. The two vectors of regional development: the West-East tidal wave; and the opposing diffusion-draining effects of large cities

Businesses relocate to benefit from the network effects of the capital, while better commuting allows labor to travel from farther away. This kind of influence may well be temporary, but where it exists it is strongly felt and may take a long time to wear off. Bucharest, which resembles Warsaw as a large metropolis in the middle of a relatively backward region, arguably creates the same kind of effect in the adjacent, relatively poor counties.

With the increase in the volume and complexity of EU assistance over the next seven years, the question arises what will be the impact of these large programs on the existing, "natural" patterns of regional development shown on Fig. 8. Traditionally, European regional policy strives to reduce differences between regions by supporting development processes (or counteracting regression processes) in the least developed regions. Such an approach has been increasingly criticized in the last years on the grounds of its ineffectiveness and its social, and not developmental, orientation.

Vibrant large cities can be both sources of growth and resource drainers in their neighboring areas

Recently, disparities among NUTS II regions have increased in some countries and decreased in other, despite the considerable expenditures incurred by the European Union with the aim of reducing differences between regions. Even where disparities have decreased, it is not clear to what extent this is directly attributable to the EU regional policy.

Most famously, the Sapir report commissioned by Brussels and published in 2003 has forcefully argued that in the competitive global economy, with development driven by innovation, a different approach to regional policy is needed, one in which the issue of regional disparities is no longer central. It also indicated that the dilemma between equality and efficiency is still valid, contrary to what the European politically correct line may be. Another study, by economists at Ecofin Council, points to the same conclusion: that the twin goals of competitiveness and convergence pursued by the structural funds may be at odds with each other. Therefore, one can choose to pursue "cohesion", in a narrow sense, which nevertheless is the one that prevails in practice; or alternatively it is possible to opt for an acceleration of the country's development and accept the existing disparities between regions, or even for an increase in such disparities, as long as everybody is better off in absolute terms[8]. As the regional disparities in the new member states may continue to increase after accession, at least in some larger countries, balancing the two goals will become an increasingly political issue, influencing the discussion about decentralization and national development policies in general.

The Romanian government has set as its explicit goal to employ the six Sectoral Operational Programs (SOP) agreed with the EU in order to sustain the national development process and close the gap with the rest of the EU. In the same, they decided to use the seventh (Regional Operational Program, ROP) to reduce disparities between Romania's NUTS II regions. Thus, the authorities intend to trigger a two-tier push, transposing into national policy the EU-wide objective of convergence on many levels. Since the ROP makes up only about 14-15% of the

7 Gorzelak, 2006, see footnote 1.

8 Thus satisfying the condition for a Pareto improvement.

total EU assistance in Romania, it would seem that the Romanian government has adopted the pro-growth scenario.

However, at a closer look this is far from certain. It is unlikely that this clear-cut and rational concept will be put in practice without numerous and tacit adjustments at the margins, which may finally alter it substantially. For example, even in SOPs a set of indicative allocation rules were included, mostly following pressures from below, that will guarantee that in a way or another each region – and, probably, county – will "get their share" of funds. This is just a local reflection of the current uneasiness and debates around the notion of "convergence" in EU circles: does it mean simply redistribution of resources with the aim to achieve some equalization of inputs; or a more sophisticated meaning can be accepted ("functional cohesion"), which assumes that regions or sub-regions will continue to play different roles in the economy, with poles and peripheries, and this arrangement is acceptable as long as everyone is better-off tomorrow than today (the "raising wave" model)? We expect that this unsolved dilemma, never addressed explicitly in national debates so far, will continue to haunt our politics and administration for a long time still.

If a clear commitment is not made for one or the other scenario, and the policy will result in hesitation and muddle, we expect a number of other institutional factors which are already present may in fact reinforce the existing development patterns, consolidating the trend of historical path-dependence described at the beginning:

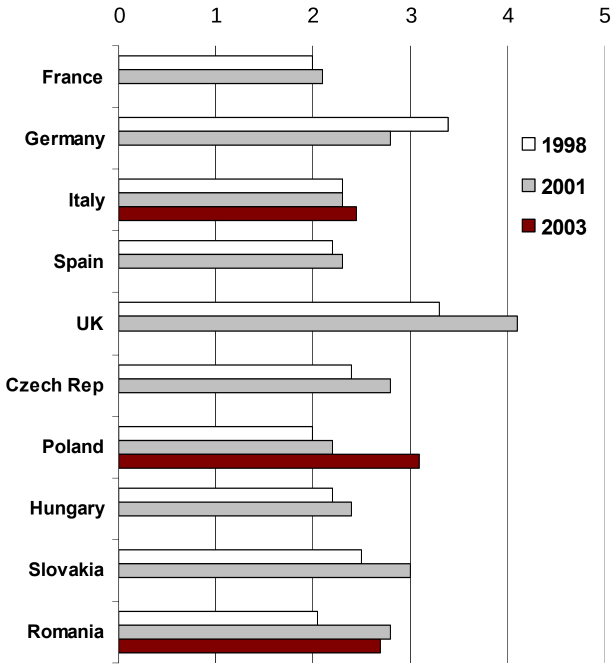
- The main problems in running EU assistance at all levels are related to the actual implementation of individual projects. Poor project management and scarce expertise are recurrent themes of discussion. Consultants, engineers and architects are in short supply in many parts of the country, especially in the rural areas, and any project above €30,000 requires a certified expert. This is why project beneficiaries sometimes cut corners and try to do as much as possible with the few people available locally, and as a result run into problems of incompatibility and conflict of interest.
- Most public administrators in Romania still do not realize what project management means, and tend to focus exclusively on the calendar of physical works when preparing a project. They are not planning ahead properly for stages of the project such as the issuing of licenses and permits, repetition of tenders, legal problems with the contractor, dealing with utility providers, etc. This poor management results in delays, and this is more likely to happen in less developed and urbanized regions, where the pool of expertise in project management and consulting is scarce even in the private sector.
- Sustainability of the infrastructure projects may be an issue, but it is still too early to judge this in 2006. According to the SAPARD regulations, for example, beneficiaries are checked on during the 5 years after completion of the project to determine if they are fulfilling the contract requirements for operating and maintaining the investment properly. There are signs that in a number of cases – especially roads – the cost and management of maintenance operations are a significant burden on poor rural local governments, so the investment gradually runs down. If such cases proliferate, they may indirectly affect the overall absorption rate in the long run, as the authorities will have to tighten the regulations for awarding project grants. Again, this is more likely than not to reinforce the current territorial wealth distribution.
- An easy way to increase the absorption rate on business promotion has been to set up business incubators and technology parks. About two dozen of these function in Romania currently, most of them developed with PHARE funds, and more proposals are likely to come in the next program cycles. However, even if they were implemented reasonably well from the point of view of the initial physical investment operations, their long-term effectiveness is questionable. Reportedly, only a few came anywhere near to covering their operational costs, the rest remaining practically empty after completion. Probably there is no coincidence that the few successful examples are located in the W and NW regions, or in large university centers, which confirms the dual direction of development mentioned at the beginning of this section. Those implanted outside the areas with the right economic and social conditions are unlikely to trigger

growth, remaining empty cathedrals in the desert[9].

4. Recommendations: don't create dependence

In view of all the above, *this report strongly recommends that during the budget cycle 2007-2013 efficiency should be preferred by the Romanian authorities to the mechanical understanding of cohesion as equal distribution of funds in territory.* There are two reasons why this strategy is better than the alternative, or a politically-motivated combination of them: first, in order to ensure an overall high rate of growth and modernization of the country; second, to avoid creating or perpetuating the *Mezzogiorno* effect in the Romanian sub-regions where there is a predisposition towards it. As the regional disparity is not too high in Romania when compared with other countries (Fig. 9), this strategy should not create disproportionate political strains.

Fig. 9. Disparities among regions max/min GDP/cap



One reason why the regional disparities may continue to rise in Romania is that differences in their innovation potential will be steadily growing. The gap between 'central' and 'peripheral' science is not decreasing, and regional differences in the enterprises' potential for innovation are also significant. In both cases, the 'large city' factor plays a critical role. Regional differences in the academic potential and enterprises' propensity for innovation is strongly convergent with the regional differences in the GDP per capita level, which have increased over the past decade. A particularly rapid economic growth in large cities (notably Bucharest, Fig. 5) is a result of the transformation of their economic structures from industrial to service-oriented, including services related to knowledge-intensive economy. Looking at other relatively less developed countries that joined the EU recently – or indeed to the old EU members – we can anticipate that:

- Regions that already benefit from one or the other "natural" development drives in Fig. 8 have a competitive advantage, so they will be able to embrace the opportunities offered by the single European market for their business entities;
- They will also have a better capacity to make an effective use of EU funding. Important: this does not mean that honest efforts are not made by the Romanian authorities in "Mezzogiorno" to shape up their communities. On the contrary: currently there are no discernible variations in output performance (absorption rate) by region, while the stage of institutional preparation for Structural Funds (procedures, accreditation, etc) is relatively even across the country. What we mean here is that the final impact in society (outcome) over the long term is likely to be more pronounced in the other regions, at similar level of public effort to push the funds and absorption rates, simply because the productivity of the capital invested may be lower in the "Mezzogiorno" areas.

Although these forecasts should be treated for just what they are, i.e. simple predictions, the polarizing variant of the effects of EU assistance seems more probable than the equalizing one. The situation is, as we have already mentioned, rather common and acceptable, if the Pareto criterion is satisfied (everybody becomes better off in absolute terms). It can be found in many regions of the world, including Western Europe, where the gaps between the most and the least developed regions have also been

9 Like a high-tech industrial park built in a mid-sized city in North eastern Romania, where there is no university center large enough to produce the necessary pool of specialists.

growing. Since the economic system in the liberalized EU has become largely independent from the decisions of public authorities, especially sub-national ones, the latter can influence the spatial distribution of development to a lesser degree than before. Well-meant, yet not very effective regional policies of individual states and international organizations can generate changes in the regional development patterns only to a limited degree. Experiences across the world indicate that even sustained efforts and substantial sums from the budget cannot guarantee development where this "does not want to appear".

Still, what can governments and regional authorities do in order to support growth, beyond crossing their fingers and pray that one of the natural vectors of development will extend its influence in their parts? There are a number of Do-s and Don't-s learned from the international experience, which the Romanian authorities may want to consider.

Don't:

- … split up sectoral development programs by area and locality, trying to provide "equal shares" to everyone. Public schemes aimed at increasing competitiveness should be focused where the growth is generated, and these sources of development are not evenly distributed in territory.
- … push too much funds into programs where the impact is hard to measure, but there is anecdotal evidence that effects are minimal. "Soft" and complex areas such as investment in the human resource or research should be approached with extreme care. Many safeguards should be put in place to ensure money are not thrown at inefficient institutions and sectors with limited output but strong rent-seeking habits.
- … try to mimic elusive and poorly understood "models". The high admiration, based on superficial analysis, for the "Irish model" should give way to a more informed assessment of why some countries benefited more than others from the EU accession. For example, how important were for Ireland the pre-existing good and competitive education system, the large English-speaking diaspora, the country's location, or the low-tax and balanced-budget policies pursued by the Dublin government, which were against – rather than in line with – the prevalent views in Brussels. Arguably, it is these elements which contributed most to the country's spectacular growth after accession, and not so much the structural funds as such. Apart from relentless growth-oriented policies, which would set Romania on a collision course with the more socially-inclined old EU members, it is not clear what exactly can we copy very quickly from the Irish model.
- … fall prey to intellectual fads or lobby groups that push for this or that economic sector, because "it represents the future". Among the 293 NUTS II regions of Europe, there is barely a single one which doesn't have as top priorities in its strategy to become an IT hub, pioneer some sort of e-government and promote tourism (classic, cultural, agro, eco, etc) in order to capitalize on its "unique beauties and strategic location". In reality, nobody knows what the future will bring in terms of this versus that. The public authorities can only speed up growth and modernization if they encourage consistently: (i) the most efficient economic activities, with neutral policies, and (ii) good fundamental and applied research, where the latter is measured by the accepted international standards of the profession.

Do:

- Keep the economy open and the macro-framework favorable for business, and ensure fiscal neutrality towards all economic activities. Picking up champions is not cost-free: giving preference to one sector is done at the expense of the others, and setting up a zone with special treatment somewhere leads to problems in other parts.
- Remove whatever administrative barriers may still exist against the integration of the major Romanian cities into the international and regional networks. The recent row around the road transit taxes at Romania's borders with the EU shows how trivial bureaucratic details can sometimes lead to disproportionate negative effects. Bucharest should become the business hub and the airport of choice for 1.5-2 mil

inhabitants from Northern Bulgaria, as Vienna is for Western Slovakia; planting administrative obstacles in their way makes no sense.

- Pursue large public investments with as little political interference as possible, by following the principle of cost-benefit optimization. For example, in road transport, a coherent program to eliminate the main current bottlenecks – with ring roads around major cities, parallel tracks for pedestrians and carts in villages, improvements to the main passes through the mountains – may generate more social benefits than one extra highway, at the same cost.
- Look twice where and why you invest. New rural infrastructure in areas with rapid depopulation is unlikely to reverse the trend, as the youth will continue to leave, especially if there is a big city no more than 100-150 km away. No matter what some brainy development experts may say, or what the government does, in twenty years from now Romania cannot possibly have the same share of 45% of the population in the countryside, mostly relying on agriculture, simply because there is no other EU member with this type of social structure.

Growth is good for you, wherever it comes from; go for it, not for redistribution

- Make sure all beneficiaries of public investments, central and local, have an incentive to maintain the new assets properly. The more public investments will pop up across Romania, the more expensive they will be in terms of operation and maintenance, and without careful planning these costs will be difficult to cover from the local budgets, especially in poorer regions. Since the EU does not provide funds for such activities, and the tradition in the Romanian bureaucracy is to overlook maintenance costs, the danger is high to end up with expensive and dilapidated cathedrals in the desert.
- Set up a good national source of expertise for urban and regional rehabilitation projects, which are probably the most complex type of intervention eligible for EU funds during the 2007-2013 cycle, combining aspects of legislation, local economy, welfare policy and urbanism. Such projects, if successful, can have a dramatic impact on local communities, much more than a shiny new road nearby, changing the whole dynamics of local development, and making (again) parts of cities or regions attractive through post-industrial reconversion. However, the expertise for running such demanding schemes is almost inexistent in Romania today, and there is just one small project funded by EU and completed so far[10]. Managing properly larger interventions currently on the agenda, like the rehabilitation of historical centers of Bucharest or Brăila, will represent the real test, and the signs are not encouraging.
- Finally, keep an eye on the overall picture. As long as the whole country grows and the wave of development lifts all the boats, though some more than others, there is no reason to panic. Being poorer does not necessarily mean *Mezzogiorno*, but being poor and dependent, yes.

10 In Baia Mare. Sibiu, one of the two EU capitals of culture in 2007, is in a somehow special situation and its experience is difficult to generalize.

Energy

ROMANIA'S GAS AND ELECTRICITY SECTORS ARE JOINING THE EU

We are well prepared for the EU market, but many deals at home avoid the new, transparent institutions. Energy prices are not too high; our problem is that we consume too much

Just as it was preparing to join the EU in January 2007, Romania was shattered by a series of public scandals regarding the national energy policy, triggered by opaque privatizations, suspicious supply contracts and allegations of price manipulation. Precious few things have been clarified since then, despite media attention to the subject. This is unfortunate since it is precisely in the energy sector where we have a unique opportunity to become more assertive and contribute to a solid EU-wide energy policy, although in principle the country has a lot of catching up to do with the rest of Europe, But in order to be able to do so, we must first avoid hysteria and try to understand where we are in the process of energy policy reform, and what mistakes we might have made along the way. Second, we clarify better which action plans and steps must be taken in the immediate future. While it is true that the public rows about gas prices and electricity supply contracts reveal that some institutional weaknesses are still present, they also represent an occasion to go beyond superficial sound bites and see what is true in the allegations made by the parties involved, and what lessons can be learned in the future.

1. The EU Context for energy policy

Europe is currently searching for a common energy policy because it wants to secure energy supply at competitive and affordable prices, as its dependency on energy imports will unavoidably increase in the future. A common market would ensure a high leverage in dealing with major external suppliers (for example, Russia for gas); and internal competition would produce cost-reflective tariffs and energy-efficient consumption. In theory, this would lead to convergence of end-consumer prices at a lower level and similar energy costs for companies that compete on the Single Market. But in spite of all the talks, public statements, and attempts to better regulate the sector, this objective still looks like a distant dream. This is why:

- First, there is a high market concentration for both gas and electricity. Three European producers control half of the electricity market of the EU. Gas market concentration is also high, at 70%. The last few years brought a number of controversial merger attempts[11].
- Second, Russia's political arm-twister Gazprom has discovered the benefits of playing EU countries against each other, against the Commission and the US. Gazprom lately concludes agreements with each EU country separately (starting with Germany) offering apparently convenient alliances against the European Commission, which insists on strict liberalization. The pressure to defect on

11 1. Spain's largest gas supplier Gas Natural launched in 2005 a hostile takeover bid for Spain's largest electricity producer Endesa. The bid was successfully countered by the German E.ON, but now the Spanish government creates additional barriers for the finalization of the deal. 2. The French gas monopoly GdF announced its merger with Suez, a French energy company dominant in Belgium. The measure was inspired by the French government in order to counter Italian ENEL's hostile takeover bid for Suez. 3. Earlier, in 2002, E.ON had merged with Ruhrgas into a giant utility provider.

such selected few is high, due to the juicy inducements from Moscow.

- Third, the larger Member States still regard energy primarily as a matter of national politics. This is a natural temptation given the importance of the political sector in any economy and the sensitivity of customer welfare. The mergers mentioned above were presented by governments as means to "protect the national interest;" however, neutral observers see them as deals protecting vested interests. France and Germany are unenthusiastic about the upcoming energy markets liberalization. Their economies are based on energy companies closely linked with the national political elites, and liberalization threatens this cozy relationship.
- Fourth, EU countries vary significantly in how their energy sectors are organized. Northern countries have very liberalized markets, whereas in France and Germany there is a long history of centralized energy sectors. Directives meant to bridge these differences are vague, and based more on general internal market rules. Additionally, liberalization is difficult to transpose in reality for a number of physical constraints: the specific rigidity of the energy markets and the limited interconnection capacity, which allows EU countries to trade among themselves only 10% of their total consumption.

In light of recent developments, it is imperative that the EU devise a common policy and focus its efforts on the following: energy security; a pan-European, well-functioning network; and a set of common rules applied consistently across the Union.

Romania is more prepared institutionally than many people think for a liberalized energy market...

If Romania can take advantage of its strengths and pursue a consistent long-term strategy in the energy sector, it can become a regional promoter of a coherent EU energy policy. While its energy sectors perform well, there are aspects recently exposed by media controversies surrounding a number of major actors in the Romanian energy sector. Publicity regarding Petrom, Turceni, Rovinari, and others highlight issues which must be corrected in the next year or so. Apparent loss of strategic vision and the lack of transparency in certain energy deals rank among the most serious.

2. Romania's Electricity and Gas Sectors: Institutional and Regulatory Framework

The architecture of Romania's electricity and gas sectors is largely in line with EU requirements and the best international practices. The liberalization of the Romanian electricity market has been a remarkable success so far, despite the criticism it has attracted recently from hurried commentators who know little about the sector. Reform started just eight years ago, but by 2004 the National Regulatory Agency (ANRE) had become the best electricity regulator in the South-East Europe Regional Energy Market (SEEREM). As recently as 2000 the energy sector was producing a staggering 5% of GDP in terms of quasi-fiscal deficit, through power and heat prices lower than costs, domestic gas prices well below import price, and substantial bill collection problems in power, gas, and heating. The progress made in just five-to-six years is impressive, even for the most cautious critics.

Currently, Romania is the only country in the region having a day-ahead market and a balancing market for electricity.[12] In 2008, OPCOM (Romania's wholesale electricity market) may become a regional power exchange. It has a new transaction platform, operational since July 2005. The day-ahead market is just above 7%, but this is already more than the European average, making OPCOM one of the best-functioning power exchanges in the region. In the second half of 2006 it performed better than the French power exchange in terms of the share of net consumption transacted. The prices of the kilowatt on OPCOM are among the lowest in Europe. The bilateral contracts market is around 3%, but this is not bad after only one year of trading.

However, there are concerns regarding the perspectives for future transparent trade

12 Wholesale traders use mostly long-term contracts to trade electricity. In addition, they have the possibility to trade electricity on short-term – from one day to the next ("day-ahead"). On the "day-ahead" market, at the end of each day, suppliers must provide information about the energy they will supply the next day. If they do not stick to the program, they are penalized for the deviation. The penalties are determined by the "balancing market", as a cover for losses incurred by the buyer.

Tab. 1. Key Indicators of regulatory efficiency: the two agencies compared

	ANRE (electricity)	ANRGN (gas)
Coherence	Clear methodologies for licensing and tariffs; Political influence possible	Same
Independence	Own revenues from licenses; Under PM; Senior management changed on political criteria before end of legal term	Same
Accountability	Under PM; reports to PM and Min. of Economy; Decisions can be appealed in Administrative Court	Under PM
Transparency	Methodologies, commercial code, other regulation disclosed; Publishes reports on activity	Same
Predictability	Responsibilities instituted gradually as agreed with EU Political influence possible	Predictability of end-consumer price affected by factors beyond ANRGN control (*Petrom* case)
Capacity	Highly qualified staff (economists, engineers), but staff turnover is increasing; Investigation/ arbitration adopted recently Not fully developed market monitoring/ surveillance Difficult to deal with cross-cutting issues involving other regulators (e.g. ANRGN); Benefited from TA from EU / IFIs	Same

on OPCOM. An Order of the Minister of Economy, issued in spring 2006, required that by the end of 2006 all state-owned companies trade electricity through bilateral negotiated contracts only on OPCOM. The Order was cancelled in December without compelling arguments and the contracts previously negotiated by Electrica were extended with a few months. Because of this decision, trade transparency and fair competition are jeopardized. The Ministry should provide explanations on why the initial order was cancelled and, if the reasons are not convincing, the order should be immediately reinstated.

Compliance with EU's general principles on energy. The vagueness of the Directives allows EU members to create appropriate institutional structures as they see fit, as long as a few principles are followed.

I. "Unbundling". Both sectors – electricity and natural gas – have been vertically (and horizontally) unbundled in the past years in Romania. Activities were separated in regulated natural monopolies (e.g. transmission) and competitive units (e.g. generation). Unbundling eliminates potential conflicts of interest, which can appear when one producer can influence the transmission network and does not allow a competitor to use it.

II. Consumer eligibility. Romania's market opening for electricity and gas is 100% for industrial consumers as of January 2007 and 100% for residential customers as of July 2007. Consumers can actually choose their supplier in a competitive market. Gas prices are now scheduled to reach import parity by the end of2008, a few months after full liberalization.

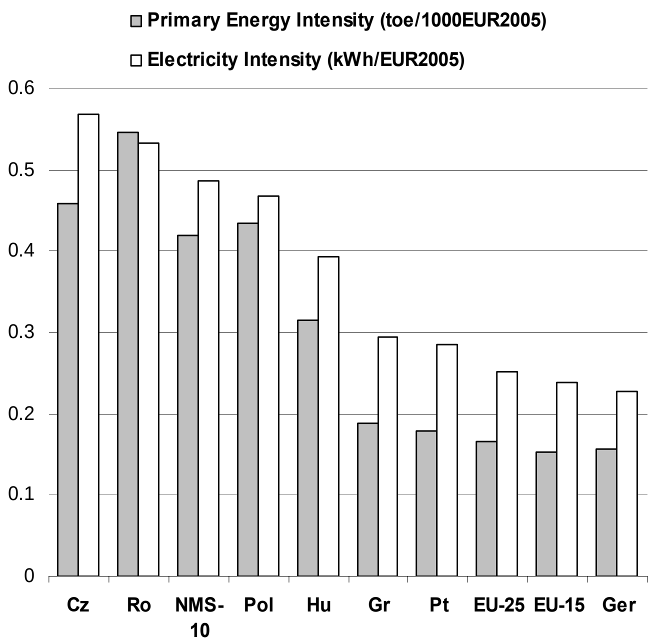
III. Regulatory framework. The two regulatory entities (ANRE for electricity, ANRGN for gas) are performing reasonably well, and there is a sequential approach to improve the few remaining issues (e.g. minor tariff regulation aspects for ANRGN). Fig. 1 below illustrates the key indicators of regulatory efficiency. An effective regulation for a well-functioning energy market depends however not only on regulatory design, but also on factors such as the judiciary, strength of property rights, and quality of the rule of law in general.

... but reversals are still possible because of populism and hasty decisions on price control

3. Romania's Energy Strategies

As agreed with the EU, Romania prepared a "Road Map" for Energy, covering the period 2003-2015. The document is comprehensive, coherent, and at the time of preparation its content was agreed with EU and IFI's. However, the Romanian Ministry of Economy and Trade (MEC) has

Fig. 1. Primary Energy and Electricity Intensity, 2005



not yet published any assessment on the status of implementation of this strategy, or an updated version. Market conditions have changed dramatically since 2003, for example: gas and oil prices went up, which may have improved the fundamentals for some coal generators (TPP's) that previously were incurring heavy losses, thus increasing their chances to survive. The Road Map should be reviewed urgently in accordance with recent developments, and more open discussions should be initiated to make the broader public aware of the importance and direction of the Romanian energy strategy. A few passing words from the president, hinting at a reorientation towards coal and nuclear energy, are not enough if we are to have a democratic policy making process.

In October 2006 MEC posted on its website a draft energy policy document for 2006-2009. One month later, the Petrom scandal prompted the National Security Council (CSAT) to examine the energy strategies and inquire about possible renegotiation of existing privatization contracts. Any intention to renegotiate such contracts should be careful weighted in terms of costs, risks, and benefits. One cannot "renegotiate" unilaterally; if one wants to discuss again some terms to improve the Government's position, compensation should be offered to the investor in exchange. In addition, haphazard decisions made by Romanian authorities would scare off the private sector. What is more, it is not clear if CSAT is the best qualified forum to deal with details of the national energy policy, beyond certain broad, strategic directions. The privatization process could be also seriously jeopardized by the government's messing around with the *privatization authorities.* Energy sector privatizations are not done simply to gain some quick funds to the treasury: privatized companies and plants should still be part of the energy policy and the Government must use a combination of incentives and penalties to influence the investors' behavior. It is also a negative message to transfer the privatization to another authority (that is, from MEC's specialized unit OPSPI to the "general" privatization agency AVAS), on short notice and without due consideration of consequences. Such moves make the public believe that both privatization and energy policy are merely battlefields for party politics.

Petrom privatization was a good deal for the state; vandalizing domestic gas resources with a low price policy is not

Romania's consumption of primary energy per capita is half the EU-25 average. However, the comparison of energy intensity (much higher in Romania than in EU) reveals a very low degree of enterprise restructuring. Romania's industry still relies on high-energy consumption plants and indirect subsidies, through inputs supplied and below-market prices. The potential for energy efficiency savings is about 25% - 50% in the residential component and 17% in industry according to MEC estimates. The energy consumption per GDP is expected to decrease along with economy restructuring: mine closures, the growth of services as share of GDP. The Government should prepare as soon as possible a plan to increase energy efficiency, with concrete measures and time frames.

4. Romania's Gas Sector: Key Points in the Recent Debates

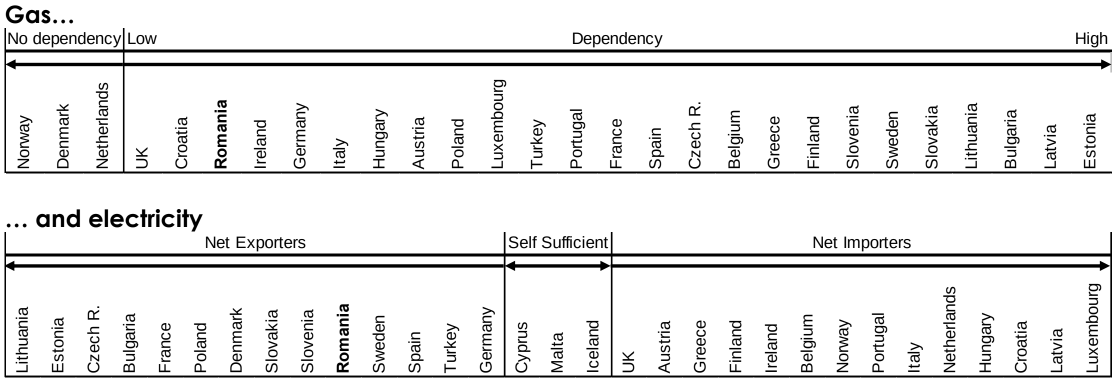
Romania imports about 33% of its gas, but this share will grow steadily as domestic reserves are declining (in 2015, import dependency would be around 38%). Romania has the lowest gas price for households in EU, except Latvia and Bulgaria. The gas price is a weighted average of domestic and import prices. The Government has certain control over the domestic component (now mainly through the state-owned Romgaz). There is a strong temptation to manipulate lower prices of Romgaz (and Petrom's as well, before privatization) in order to deal with consumer affordability issues.

The import price parity was a condition initially negotiated with the IMF years ago, and later agreed upon by EU and Romanian Government during negotiations. IMF meant to "push" Romania to provide incentives for private investors to continue exploration; and accelerate enterprise restructuring. Even though Romgaz tariffs cover its operational costs and depreciation, they are not high enough to stimulate development of new fields.

has control on what happens in the sector. Looking on the bright side, it has prompted the Government to finally accept the disclosure of privatization contracts. The privatization contract actually makes no reference to the prices that Petrom is entitled to charge for its own production, as these should be determined by the market.[13]

It is clear from the unfolding of the events that MEC still maintains an influence over

Fig. 2. Energy dependency in Europe, *Eurostat* 2004



5. Controversial cases: the "PETROM scandal"

One recent scandal raised concerns about the soundness of the gas sector institutional structure, the privatization strategy, and the risks associated with import price parity when you have only one foreign supplier. In the fall of 2006 Petrom (part of the OMV group) decided to increase its production price. The gas distributors, who have their final prices to end-consumers overseen and limited by the regulator (ANRGN) with a "price-cap" methodology, complained loudly that they were squeezed in the middle, and that the regulated price at which they could charge the consumers was too low to cover their justified costs. Finally, Petrom accepted a lower price (135 USD) than initially demanded, because MEC's representatives in its Board took action. In a second move, ANRGN approved an 8.5% increase of the end-consumer price in November. ANRGN then publicly declined its capacity to update in this climate of uncertainty the schedule with the evolution of domestic gas prices until 2008.

The scandal raised concerns on how the privatization of Petrom actually took place, what the contract clauses say, and to what extent the energy policy-maker still

Petrom's pricing policy through its members on Petrom's Board. ANRGN had its hands tied, since it does not regulate producer prices. This scandal was actually unavoidable sooner or later. Until import price parity is reached, no amount of government intervention short of full nationalization of the energy production could have prevented it.

In fact, in spite of public hysteria, Petrom privatization was a success story and an excellent deal for the public money. In addition to privatization proceeds and significantly higher income taxes and royalties, Petrom's three billion EUR investment plans make the state's current share in Petrom more valuable than the total net assets of the company before privatization.

Thus, we can see no "strategic" rationale to keep gas and oil production in state hands. The problems we face are caused by the fact that Romania's gas sector is not fully compliant with free market rules. Those who say that Romgaz should be state-

13 Another legend shattered by the disclosure was that OMV obtained more favourable royalty fees for oil and gas than permitted by the Oil Law. In fact, it turned out OMV's fees are exactly the those specified by the Law.

owned is the ground their opinion on fear of unaffordable prices because of the over-dependency on Gazprom. However, keeping down one's own domestic price is certainly not an option, because:

- It would have a contrary effect, making the market in the long term even more sensitive to the vagaries of Gazprom's policies;
- Price is a signal for the economic behavior of consumers. Low gas prices and the reluctance of the Government to implement a coherent district heating strategy have grossly distorted the market for heating (see textbox).
- Low gas prices represent a general subsidy for the whole economy. Poor households should be offered a lifeline through a targeted subsidy, not by a general support from which also non-restructured industry benefits as well.

6. And another controversy: what to do about Gazprom

A recurrent discussion is that now Gazprom has a monopoly control on our foreign gas supplies. Gazprom has a reputation to be more a tool for high politics than a purely capitalist business. True enough, Gazprom is our sole foreign gas supplier. The two trading companies in charge with gas imports are controlled by Wintershall, a joint venture between Gazprom and the German BASF (which is, for all practical purposes, also commercially controlled by Gazprom). Gazprom publicly announced its interest in Romgaz if it is put to privatization.

However, Romania is not as "captive" as it may appear. The good news is that oil and gas are quite substitutable, and for oil there is a reasonable degree of competition in supply. This means that Gazprom cannot set an unreasonably high price for Romania's imports. Worldwide, given the substitution, gas follows the oil price trend with a lag of six months. After a period of high prices (70 USD a few months ago), oil costs now 54-55 USD/ barrel, so one could expect a matching decline in gas import prices (this could be the explanation for the decrease by 12 USD of import prices in January, which led to a reduction of 3-5% in end-user price).

We should add that, in case prices had reached import parity in October, when Gazprom's prices had reached a peak of 315 USD, we would have still had prices for end-users comparable with other East European countries. To avoid over-dependency on Gazprom, the solutions are:

- in the long-run, to diversify supply (Nabucco pipeline to get gas from the Caspian area. This takes many years and requires coordination of several governments. Still, as long as gas consumption cannot shrink as fast as our domestic reserves, it is probably the only long-term solution);
- reduce consumption through increasing efficiency (which, by the way, is difficult and irrational while prices are low);
- raise domestic production as price increases make new fields profitable.

District heating (DH)

Until recently, residential DH consumers in Romania could not regulate the heat consumption nor the price they paid (there were meters only for blocks, and one could regulate the temperature only by opening the window). For affordability purposes, consumers paid a "national reference price", well below producer costs, and producers were supported by direct subsidies from state / local budgets. Still, DH was quite expensive for most consumers. Gas was relatively cheap and unlike in DH, one could regulate the consumption from an individual gas boiler. So many residential consumers switched to gas. DH is normally much cheaper and more energy-efficient, if consumers can control their consumption. Eventually, the oversized DH producers could be scaled down and made more efficient. But now, the unreformed producers, many of them gas-fired also, require larger subsidies to survive and consumers who have switched to gas boilers are more affected by gas price increases. The Government has not assessed the total impact of this wrong policy, nor the costs directly attributable to gas under-pricing. To give just a hint of the probable magnitude of the distortions, direct subsidies to DH producers amounted to around 300 million USD in 2003 only. A DH producer was rehabilitated in one town, but by the end of the rehabilitation works the whole town was disconnected whereas most of the consumers probably moved to gas. A DH reform strategy has only recently (spring 2006) been approved, even though the measures had repeatedly been recommended by IFIs and EU-financed studies since four years ago. The Government must assess these impacts and use the evidence to obtain public acceptance for gas price increases.

These fears are not compelling enough to justify continuing full state ownership at Romgaz. A private investor would have incentives to continue exploration and improve efficiency, just like in case of Petrom, which plans to invest 1.5 billion EUR in new fields. The privatization strategy which must be prepared should analyze the options for Romgaz privatization – strategic investor or otherwise – and make a decision.

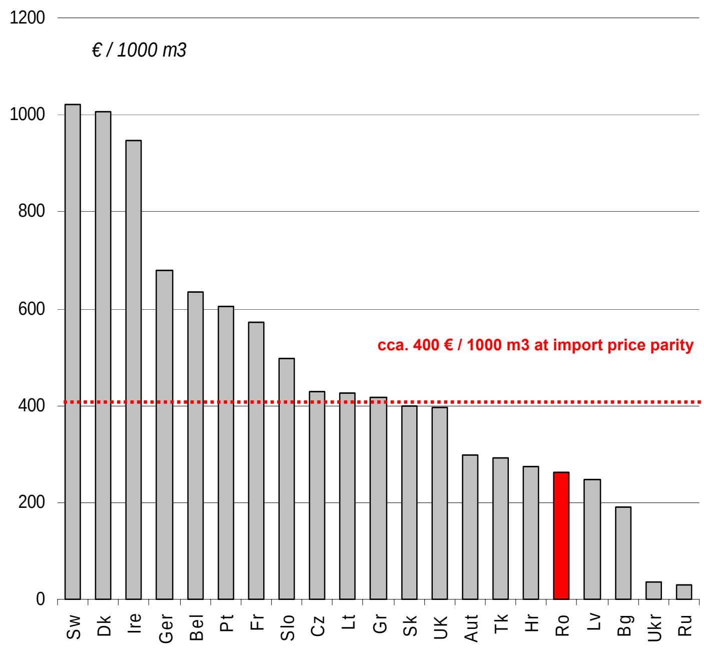
Over the long term, Romania should promote the common EU energy policy. The way to do this in the gas sector would be to consistently help the EU countries to diversify their energy supply. In addition to the Nabucco project, in which Romania has a direct stake, it should support projects like Arad-Szeged line (by which the West could also be connected to the Nabucco pipe becoming less dependent on Russian gas) or the Constanța-Trieste line (by which Caspian oil would become available in the West).

7. Romania's Electricity Sector: Key Points in the Recent Debates

Romania is now a net exporter of electricity, has a diversified generation, and prices for end-users still below EU average. Electricity prices will have to increase, because of investment needs in generation and transport capacities: 3.6 bn€ only in 2006-2009, and an additional 1 ban€ for environment in gas and electricity sectors. Inclusion of these costs in tariffs would probably result in a shift upwards of about 15-20%. Around this level tariffs could marginally move (a) downwards, if efficiency in generation is stimulated, or (b) upwards, if Romania would have to close generation capacities for failure to comply with EU environment standards.

If we follow **the first scenario (a)**, a competitive diversified generation reduces regulatory burdens and benefits consumers. In any country, generation plants vary significantly in terms of cost structures and production method. For example, in Romania hydro tariffs cover operational costs, depreciation, rehabilitations, and generate part of the funds needed for future investments. Still, these tariffs are much lower than those of certain thermal generators. However, to cover consumption (in Romania, hydro can cover only maximum 30%) and reduce risks (such as weather), a cheap hydro plant and an expensive hard coal based generator must sometimes survive in the same market. In a well-functioning electricity market, competition emerges naturally not between cheap and expensive generation plants, but rather between companies with similar cost structures. This creates a market on which there are incentives for efficiency in generation, and consumers benefit from secure and well-priced supply. For this reason, in most EU countries, companies active in generation (or wholesale trade) supply electricity "pooled" from generation units with different costs and production technologies (see the French EdF, or the Czech CEZ).

Fig. 3. Average Household Gas Price in Europe, Q4 2006



Romania has now a rather unique electricity generation profile, with thermal, hydro and nuclear generators separated into different companies. If all three types of units are put up for privatization, the private sector would do the "pooling" in a natural way, to spread risks. The private sector could either invest in "pools" of generation capacity or engage in wholesale trade from a "pool" of generators. In addition, there would be incentives to close or improve inefficient capacities. The state may very well keep a number of generation units of strictly justifiable strategic interest, such as Iron Gates in hydro, and provide a "last resort" supply for consumers.

On **the second scenario (b)**, the environment-related commitments to EU require rehabilitation or closure of highly-polluting TPPs in 2008-2013. Such rehabilitation requires planning and investment that could be done best by the private sector. The majority of TPPs exceed maximum pollution limits; their closure would make Romania a net importer of electricity. In terms of institutional fine-tuning, as in the case of gas, media reports on dubious deals magnify weaknesses.

Tab. 2. Electricity Prices for Households and Industry in Europe

Average Electricity Price per kWh			
Households, all tax		Industry, all tax less VAT	
EU-25	*14.16*	*EU-25*	*8.65*
EU-15	*14.44*	*EU-15*	*8.78*
Lithuania	7.18	Lithuania	4.98
Estonia	7.31	Estonia	5.11
Czech Rep.	9.85	Poland	6.33
Romania	***10.23***	Slovenia	6.51
Slovenia	10.49	***Romania***	***7.04***
Hungary	10.75	Czech Rep.	7.31
Poland	11.9	Hungary	7.61
Slovakia	14.48	Slovakia	7.73
Spain	11.47	France	5.78
France	12.05	Spain	7.57
Austria	13.40	Austria	8.63
Germany	18.32	Germany	9.94
Italy	21.08	Italy	12.98

Turceni and Rovinari electricity sale. In the summer of 2006 a case was reported when private intermediaries bought cheap electricity from the state-owned Turceni and Rovinari lignite power plants and sold it again to state-owned Electrica at much higher prices. This raises concerns on the institutional framework that should be in place to avoid such suspicious deals.

Bilateral negotiated contracts should be made more transparent; ideally, they should be done on the power exchange only

Romania's electricity market is based on four types of sale-purchase agreements: bilateral, negotiated contracts; bilateral, regulated contracts; day-ahead, and balancing market. The last two are transparent and done on the power exchange. The regulated bilateral contracts have prices set up by ANRE.

Problems appear in the category of bilateral negotiated contracts: deals concluded between producers and suppliers or eligible consumers, on mutually agreed terms. Risks of corruption or inefficiencies appear whenever one of the parties involved is state-owned and its management might be more interested in side-payments than in profits for the company. Currently these contracts make up roughly a third of total consumption, of which less than 10% are concluded under transparent terms and prices. Things being so, they represent a significant distortion of the total electricity market, and moreover, they have been highly visible recently due to suspicions of corruption and illegitimate windfall gains. The best solution would be to put these deals on the power exchange, to the test of free competition, pressuring the state-owned entity to choose the market's best offer. Alternatively, if for any reason this is not possible (though we do not see why, as this was exactly what the cancelled Minister Order was doing) they should at least be entrusted to an independent reviewer (e.g. ANRE in coordination with the Competition Council).

8. Conclusions and Recommendations

Romania has a strong energy sector, with largely sound institutional and regulatory framework, but "the devil is in the details." The remaining issues should be addressed promptly and with responsibility:

- **Coherent, stable, predictable strategies** must be in place. The strategies should be correlated with other sectors (DH; mining sector restructuring; and a hoped-for Energy Efficiency plan that has not yet materialized). Strategies should also be consistent with EU-negotiated aspects (Road Map, liberalization, import price parity for gas, environment). Otherwise, Romania risks becoming more dependent on imported energy.
- The **"Road Map"** should be periodically reassessed under changing circumstances (such as gas price increases and Gazprom's policies). The assessment should be closely coordinated with the EU.
- **Privatization** is vital in both electricity (thermal, hydro, and nuclear generation) and gas, to cover investment needs and improve efficiency. Tampering with existing privatization contracts, moving privatization responsibilities from one institution to another, and contradictory public statements seriously impair the credibility of Romania's energy privatization policy.
- Policies, strategies, periodical status of implementation, and privatization contracts should be **publicly disclosed and transparent**. The Government

should agree with the investor from the beginning to disclose privatization contracts.

- Energy trade deals **in which one party is the state must be transparent and at an arm's length**, by trading the contracts on the free market (bilateral negotiations on OPCOM). Alternatively, but less desirable, such deals could be reviewed by an independent party (ANRE + Competition Council). MEC must explain the cancellation of its Order by which electricity contracts involving state-owned companies should have been negotiated since end-2006 on OPCOM. In case there is no such good explanation, the Order must be reinstated as soon as possible.
- Policies should be consistent with the long-term objective of becoming a key player in the region (EU/SEEREM). Romania must stick to its commitments as a **reliable partner**, to give a strong political signal to the other countries.

A long-term strategy (2015 and beyond) should deal with the following aspects:

- Romania can assert itself as key player on the EU energy market and should not settle for less. Allies should be sought in Poland and the Baltic countries, countries that saw the risks they face with Russia as monopoly over their energy supply. The EU has no chance but to act coherently in front of Gazprom, to make the company as dependent on them as they are on it, and thus have a higher leverage for negotiation.
- Romania can prompt action from the other EU members if it can provide a concrete plan to diversify the EU's energy supply. (Constanta-Trieste oil pipeline or the Arad-Szeged natural gas main).

Human resources

LISBON, BOLOGNA AND THE MANUFACTURING OF MEDIOCRITY IN THE ROMANIAN EDUCATION SYSTEM

The Romanian education and research sectors foster mediocrity and corruption, discouraging innovation and performance; more national and EU funds, or the "Bologna process", will not solve the problem

This section of the report deals with the Romanian education system in the broader framework of the Lisbon Summit objectives. It is not its purpose to enter into details of the organization and reforms of the education system, but rather to argue for more evidence-based policymaking in this field, instead of the mechanical implementation of policy recommendations ungrounded in Romanian realities.

1. The European context

In recent years, a ghost has haunted the debate on economic growth in Europe: that of education. If the Enlightenment scholars presumed that the poor could attain freedom and civilization by learning, if United Nations has interpreted education as the first source of empowerment of individuals and countries, many contemporary policy scientists in Europe think that education holds the key to competitiveness in the global era. While the correlation between long term development of a country and human capital is undisputed, that between education and growth is however far more complex and fraught with ambiguity. In fact, as an excellent survey shows[14], an extension of schooling, either by bringing new people in, or by extending the time of study of the school population, is no guarantee of growth. Development remains seriously hindered by factors which make education not so relevant, notably corruption and poor rule of law.

The pivotal role conferred to education in the debates about growth and European competitiveness was therefore shadowed by ambiguities from the onset. The 1999 Bologna declaration put forward a plan of convergence for European universities that countries set on to apply on a voluntary basis. The rationale underpinning Bologna was that by implementing its recommendations EU will narrow the performance gap separating it from United States. The action program set out in the Declaration presumed to create a European space for higher education in order to enhance the employability and mobility of citizens and to increase the international competitiveness of European higher education by:

- adopting the common framework of readable and comparable degrees;
- the introduction of undergraduate and postgraduate levels in all countries, with first degrees no shorter than 3 years and relevant to the labor market;
- ECTS-compatible credit systems also covering lifelong learning activities;
- a European dimension in quality assurance, with comparable criteria and methods;
- the elimination of remaining obstacles to the free mobility of students (as well as trainees and graduates) and

14 Easterly, William, 2002, "Educated for what?" in *The Elusive Quest for Growth: Economists' Adventures and Misadventures in the Tropics*, Boston, MA: MIT Press.

teachers (as well as researchers and higher education administrators)

- greater importance to lifelong learning.

At the Lisbon Summit in March 2000, European Heads of Government committed themselves to the objective of making the European Union the world's most dynamic knowledge economy by 2010. The approach was this time considerably more complex and qualified, discussing the knowledge based economy as a whole. Unlike Bologna, whose implementation went further and faster than expected, more countries volunteering to implement it than the original expectations forecast, the ambitious Lisbon Agenda needed a re-launch at the European Council in March 2005 and some of the countries national Lisbon programs met strong criticism for their lack of vision and daring to engage on a new path. Only straightforward tasks, for instance that Member States should ensure that all schools have access to Internet resources by the end of 2001, were largely accomplished. Labor markets, including the crucial sector of research and teaching, are still not flexible enough within the common EU space. The best European researchers continue to flee to the United States. Countries which took Bologna literally, such as Italy, assuming that getting closer to the US percentage of enrollment in tertiary education means getting also closer to US economic performance, nearly imploded their higher education systems. New university branches and programs sprang up, standards plummeted and the overall effect on Europe's most serious problem, youth unemployment, remained elusive. The US economy has continued to grow more rapidly than the European economy, not to mention the dramatic growth rates achieved by countries like China, India and even, more recently, Russia and Japan.

The attainments in the field of education of Asian countries threaten to level the field and to show that the competition is no longer just between Europe and the United States. There are two sources assessing universities globally on a systematic basis presently. Shanghai Jiaotong University publishes a list of the top 500 world universities. And the Times Higher Educational Supplement in the UK has ranked the top 200. While there are some differences in individual rankings in these two league tables, they tell the same story about the competitiveness of European universities. The Shanghai Jiaotong table in 2005 included 37 American Universities in the world's top 50, with 5 from the United Kingdom and just 4 from the rest of Europe. The Times list shows 20 of the top 50 universities as being in the United States, with 8 in the United Kingdom and 5 in the rest of Europe. In the latter ranking there are more top 50 universities in Australia than in the whole of continental Europe.

The progress recorded on Bologna targets meant that more cooperation exists presently between European universities than ever before, except perhaps in the Middle Ages. However, with very few notable exceptions, no change was recorded in the funding and management of European universities, which remain in the public sector, with non-significant private support. Private-public partnerships in education remain scarce. There is also evidence that investment in research and development in Europe has been lagging behind the United States, and that research and development has been somewhat less effective in producing innovation and productivity improvements in European companies. In this context, the European Commission has adopted on 20 April 2005 a Communication which recognizes the pivotal role of education and training in the knowledge society and which calls upon universities to deliver their full potential to contribute to the Lisbon Strategy.

"Romanians are feared in Europe as redoubtable hackers. Then why, if they have so good computer skills, the production of new technologies in Romania is so poor?" ***[Italian journalist, winter 2006]***

This review, brief as it is, highlights some of the sources of ambiguity at the origin of the latest wave of reforms of European higher education. The awareness of sliding down the performance slope in education, which revived the debates on universal quality standards, is undoubtedly positive. The presumption that some quantitative education indicators, such as tertiary enrollment, can serve as proxies for educational attainment was an error, and undermined much of Bologna's usefulness as a preparatory stage for Lisbon. The histories of the university in United States and Europe show a marked difference. While European universities got gradually nationalized in various forms, the American universities remained private and highly competitive. Over three hundred years of

Tab. 1. The Implementation Stage of Bologna in Europe

STATE	EDUCATION LAW ADAPTED	3 CYCLES STRUCTURE	ECTS	MOBILITY	EUROPEAN COOPERATION	JOINT-DEGREES
Austria	2002		Yes			
Belgium		Yes	Yes	Yes	Yes	No
Bulgaria	1999	Yes	Yes	Yes	Yes	No
Cyprus	2002	2	Yes	No	No	No
Czech Rep.	2001	Yes	No	Yes	Yes	Yes
Denmark	2003	Yes	Yes	Yes	Yes	Yes
Estonia	2003	Yes	Yes	Yes	Yes	Under way
Finland	2003	Yes	Yes	Yes	Yes	Yes
France	2002	Yes	Yes	Yes	Yes	Yes
Germany	2002	Yes, in parallel with the old system until 2010	Under way	Yes	No	As european MAs
Hungary	2004	Yes	Yes	Yes	No	No
Iceland	1997	Yes	No	Yes	Yes	No
Ireland	1997	Yes	Yes	Yes	Yes	Yes
Letonia	2000	Yes	No	Yes	Yes	No
Lichtenstein	2004	2	YES	YES	YES	NO
Lituania	2000	Yes	No	Yes	Yes	No
Luxemburg	2003	Yes	Yes	Yes	Yes	Yes
Malta	2002	Yes	Yes	Yes	No	Yes
Olanda	2002	Under way	Under way	Yes	Yes	Yes
Norway	2002	Yes	Yes	Yes	Yes	Under way
Polonia	2002	Under way	Under way	Under way	Yes	Under way
Portugal	2004	Under way	Under way	Yes	Yes	No
Romania	2003	Yes	Yes	Yes	No	No
Slovenia	2004	Under way	Under way	Yes	Yes	Under way
Slovakia	2002	Yes	Under way	Yes	Yes	No
Spain	2001	Yes	Yes	Yes	Yes	Yes
Sweden	2002	Under way	Under way	Yes	Yes	No
Switzerland	2003	Yes	Under way	Yes	Yes	No

Source: Dennis Farrington – Legislative Initiatives in the Context of the Bologna Process: A Comparative Perspective (UNESCO 2005)

different histories cannot be erased by simplistic recommendations, such as enrolling more people in MA programs. The much talked about knowledge-based economy is not just about schools and universities, and definitely not about degrees. It is a complex concept requiring a wide range of policies. If Bologna is gradually considered a marginal process in the quest for increasing European competitiveness in the world education market, useful only as an exercise in coordination among member states it is because it opened the door to poor public policy. No serious research on the EU-15 labor market and its association with the European higher education system led to the Bologna recommendations, but only simplistic deductions of poor policy analysts. Presently, various European countries, especially the marginal and the poor (Ukraine, Russia, Romania, Bulgaria) or stagnating (Italy) are fully implementing measures whose connection with objectives is loose at best. It does not really matter because, as it often happens in public policy, implementation itself has meanwhile become the objective. That is, as long as we do not expect education to deliver more competitiveness of the European economy.

Countries that took Bologna literally, such as Italy, made their higher education systems nearly implode

Attempts have been recently made to redeem the process. A popular view at the European Commission is that Bologna should not only be seen in the framework of the UN/UNCE Education for Sustainable Development (so in ideological terms), but also of the Lisbon Strategy (so in pragmatic terms). As far as the European Union is concerned, the Bologna Process should fit into the broader framework of the Lisbon objectives. However, other Lisbon components are crucial for performance in both education and economy than standardization of degrees. Those range from motivating the workforce for lifelong learning in the context of employability, developing skills for the knowledge society, improving quality assurance, ensuring access to Its for everyone, increasing the recruitment to scientific and technical studies, keeping highly skilled researchers inside the borders of the EU, developing a real partnership between the corporate world and public education and making the best use of available resources.

2. The Romanian Context

The efforts of Romania to modernize its education system pre-date Bologna, although it was the implementation of the Declaration which stirred the greatest debate. Romania inherited from Communism a system with high standards (tough admission entry exams at the most desired high-schools or universities), massive participation (although eroding) and a considerable stress laid on science and technology. Innovation and initiative, however, were feebly encouraged. However, it would be wrong to assume that all Communist inheritance was bad. The most negative one was a lack of flexibility which led to ossified hierarchies, especially in the higher education. This is not unknown, however, in non-Communist countries (Germany is the best example). Some features persisted from the Communist times education, such as lack of flexibility. Others, like participation and the stress on science and technology have actually regressed. After 1989 a relative flourishing followed of human and social sciences, as well as of law and economy, which had deliberately been kept underdeveloped during Communism. As Romania had no trained faculty in these fields, however, the present massive numbers of students and teachers in the newly developed fields are not matched by the quality of teaching or research. The same sciences which managed to earn some international reputation prior to 1989 continue to be competitive, while in the fields of law and economy entire faculties do not manage to publish one peer-reviewed paper in an international language. Graduates called to work in the 'knowledge based economy' owe little to their universities. As focus groups with fresh graduates show[15], the equipment for the first job of a student is as a ground rule individually acquired and is mostly general, consisting in basic computer and communication skills. As one student put it: 'At my first job interview I went with my self-cut clothes, with my shoes from high school and just the hat from the university, for show mostly". Students increasingly acquire this first job during their undergraduate years, and go on to obtain a diploma just to make sure they have one. The main deliverable of the Romanian university is not the education, but the degree.

Romania spends proportionally less on education than any other EU member countries, although the budgets are on the rise. It is home to many paradoxes, such as more universities per capita than the US, but less students enrolled in some form of tertiary education than the European average, which is lower than the US. Romanian universities do not make it to the 500 selected in the Shanghai top, although a growing number of Romanian students graduate *magna cum laude* from top universities in Europe and the US. Reforms have slowly advanced during transition years, due to social reasons, and have often been reversed when encountering opposition. More often than not, reforms were grounded in some normative principles rather than on knowledge or understanding of the needs of the Romanian economy. Reformers did try to change the system (Andrei Marga or Mircea Miclea, although with different visions, were both reformers), but despite an inflation of new European-like institutions (credits, evaluations of quality) the system continues to lose rather than gain quality[16].

Romanian universities do not produce education, but degrees

15 Focus groups with students from different disciplines were organized especially for this paper by a SAR team.

16 In one of the best accounts of a decade of reform, former Minister of Education Andrei Marga finds as main defaults of the system the transmittal of a knowledge it itself had ceased to generate, the operation on the basis of local rather than universal criteria, the stress on formal qualification rather than knowledge, and the stimulation of corruption. See Andrei Marga –

2.1. Is the education delivered good or bad?

According to results of international evaluations the Romanian education system is mediocre at best[17]. I would however phrase this problem using a metaphor, that of an education supermarket where buying is free (the product is fully subsidized by the government) but one has to spend time in deciding over products, selecting them and then carrying them away. Students who plan to live and work in Romania Know, as ground rule, that few items are needed from the supermarket, and that little reward awaits those who bother with more. Those who plan to leave for a more advanced society where educational attainment also meets economic attainment are busy to shop for free everything valuable that they can find. The supermarket, indeed, holds many valuable items for those who take the trouble to find them in the back shelves, although it does not offer them as a full package.

Pockets of competence and quality do exist, but there is no incentive in society at large to expand and use them

Ambitious students can therefore exit very well equipped with no cost at all. However, they will take their shopping carts into another economy than Romania's. A vicious circle is thus created where the supermarket is continuously depleted of its few assets by those who exit the system forever, while those who stay behind produce insufficiently to keep it well supplied. Reforms do not affect the incentive system of those involved, as they presume that mere reorganizations of the shelves can deal with the problem, and so Knowledge capital gradually wears out instead of growing.

The answer to this problem is therefore not straightforward. Tenths of thousands of students are accepted in European and American universities, many with full scholarships, but in the Romanian labor market human resources are stretched, quality of the work done low and the contribution of research to economy or policy negligible. The top companies, which employ however a small part of the total workforce, train their own people. The rest deliver the typical low-cost, low-productivity labor which is nearly general in the Romanian economy. From the point of view of selected individuals, the system performs. From the point of view of the taxpayer, the system sucks. Returns to the Romanian society are less beneficial than they should be seeing the costs. A good education system would provide the average student, not the exceptional one, with far better equipment for her to be an innovative worker, a competent public servant, an organized individual and a better citizen. It would simply not allow anyone to go empty-handed out of the supermarket. Also, at least in higher education professors are expected to contribute by their research to the advancement of science. Universities are not simply band-wagon producers of degrees. On the average, however, only 17% of the faculty manages to publish internationally, and only 20% of university professors.

2.2. Is the Romanian research sector in good or bad shape?

About 26 000 researchers operate in Romania, 0.26% of active population, half the percentage from new member states and a third from the EU-15. The overwhelming majority of them activate in the public sector. About a third has managed to publish at least one internationally acknowledged paper (by ISI standards[18]). About 7% publish regularly in international journals. This is lower than in EU-15 or US and cannot be entirely blamed on the language. According to Ad-Astra, only a third of the competitive researchers of Romania work in the country, the rest being active abroad. Individual performances of universities are poor. Departments of sociology, law, economics, government and administration, which clearly matter for economic performance are particularly uncompetitive. Whole research centers or departments are often unable to present one international article or book to justify their existence. There is no evidence that increased research budgets translate themselves into a better performance when the yearly national grants competition is concerned. Despite growing investment in recent years, the output shows no difference.

Anii reformei 1997-2000, Ed. Fundației de Studii Europene, Cluj (2000)

17 Results reported in the 2005 Ministry of Education report show an average performance of pupils at learning the curricula (TIMSS), but a low one at getting competences necessary for their professional and personal lives (PISA).

18 International Science Index.

Over an interval of five years Romanian researchers manage to author about 4000 papers and 5000 chapters in collective books, with only 273 books published in Romanian and 73 in an international language. This is less than what one good American university produces in one year. How dramatic the situation really is shows in the field of innovation. One in six Europeans apply with a patent each year (three in Germany), while only one in a thousand Romanians do so. 57.734 Europeans of a million get a patent acknowledged yearly, compared to just 0.206 Romanian in a million. Romania obtained under three hundred patents in the last five years. The poverty gap between Romania and EU is mirrored by a knowledge gap.

2.3 How open, transparent and prone to reform is the system?

The difficulties of reforming the Romanian education systems are twofold. On one hand, if we consider stakeholders in the system it is not clear if the majority stands to lose or win from the present mess. Many semi-qualified people teach in poorly paid but tenured positions with no concern of professional upgrading. Many students get their diplomas without bothering to go to school at all, not to speak of learning. License dissertations can be bought cheaply on the Internet, showing how low the quality of the only alleged serious examination is. The great majority of private universities and all new founded state ones received accreditation and grant diplomas liberally. Jobs are never advertised, as they are granted beforehand.

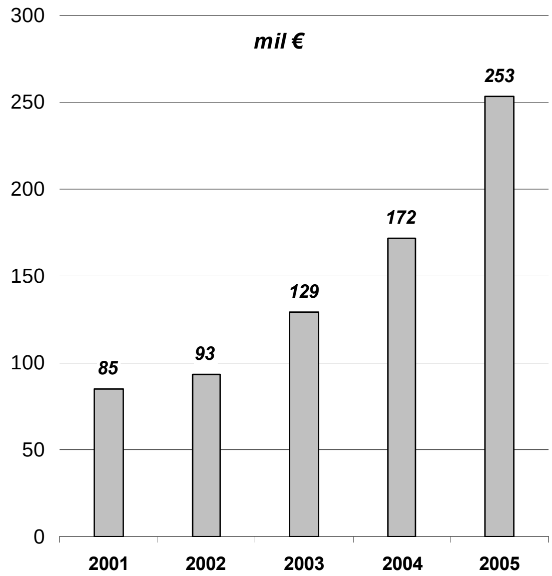
Promotion is rarely based on international publications. As most students themselves have little incentive to invest in an education they do not pay for and which does not equip them with what they need for the labor market (most of them already work by graduation in a field unrelated to their diploma) students have not managed to become a critical consumer group, and their evaluation of teachers and professors, even when undertaken remains largely formal. Pressure from businesses is also low. Dialogue attempts between the public and the private sector when education is concerned is conspicuously missing. The higher education and research sectors should not be attractive. Except full university professors, wages are below 300 euros. New entrants fall under half of this sum.

Tab. 2. Performance of Romania's researchers at a glance

ISI quotations (2001-2005)	4,148
ISI indexed papers	4,610
Chapters in international books	5,311
Books in Romanian	236
Books in a foreign language	73

Source: Source: The White Book of Research, Development and Innovation (WBRDI); CNCSIS; Romanian Ministry of Education and Research.

Fig. 1. Trends in Romanian public funding for research



However, the system is almost fully closed. Not only are tenths of thousands of jobs blocked to allow those already in to be employed three-four times over[19], not only do the same professors often teach both in state and private universities, but entrance is blocked especially for the few young who repatriate themselves. The potential repatriate faces the situation that there are no jobs to apply to. She or he would have to cut an individual deal with a dean. They would be asked to teach for some years without a contract as a ground rule and paid under 50 euros a month. If they graduated abroad, they would need to have their degree confirmed by the Ministry of

There is no proof that bigger budgets bring better performance

19 The NGO EDU-CER reports university administrators, such as deans and rectors, cumulating 7-8 teaching jobs! See www.edu.cer.ro

Education, regardless if they come from a top-500 university or not.

Not only do they need to submit documents and pay fees, they also have to get a notary-certified diploma, make a summary in Romanian of the dissertation, get two people to write reviews for free and submit the syllabuses of all the classes they followed in their graduate years. A graduate of Oxford thus is considered less trustful than one from Bacău or Brăila, with their syllabuses with Romanian-only readings. If in the end the aspirants manage to enter the system, they are assigned to various routine jobs for which other people are paid: deans, department heads, staff. Research institutes are also poor and have strict hierarchical career systems. One may published more international papers than the colleagues in the institute and still remain a third degree researcher unless a more senior colleague dies, leaving a vacancy. Despite all this, some people do try to research and publish. They represent a minority, as most researchers need to have a second or third job to survive, and these are often not in teaching or research.

Research grants are decided by people who have never published in peer-reviewed journals; the autonomy led to the "privatization" of universities by small groups of cronies

Creating a really competitive environment in the Romanian education system is therefore bound to meet considerable opposition. Members of quality evaluation boards themselves, as well as reviewers of research programs funded from public funds (CEEX) are hardly above the national average in terms of scientific performance. A few years ago a clash over standards led to the resignation from the national board (CNCSIS) accrediting universities of the only researcher with international acknowledgement. About half of the successful projects admitted by the CEEX have as directors academics who have never managed to publish an article in a peer-reviewed journal (and are no longer young), while about 40-45% of projects turned down belong to people who do have such a performance[20].

2.4. Did reforms so far really address the problems?

Reviews of reforms undertaken until the implementation of the Bologna Declaration in Romania are generally critical towards the results achieved[21]. Perhaps the biggest and undisputable achievement, with the contribution of foreign donors, is the endowment with IT equipment of nearly all urban schools and of some rural ones. For the rest, most of the reforms introduced had no accountability mechanisms built in, so they backfired.

(a) Autonomy of universities. On the bright side, it led to the development of a few universities (Babes-Bolyai and Iaşi are among the most successful examples). A combination of managerialism and democracy brought about both funding and academic results to these universities. More often than not, however, old prestigious universities decayed due to corruption (notoriously some medical schools). The self financing of universities did not translate into an improvement of resources, but into greater pay for administrators. The reputation of Romanian universities declined after an international scandal broke out showing that medical diplomas had been granted on a purely corrupt basis. Autonomy frequently led to the 'privatization' of universities by small groups of cronies (sometimes even families, see www.edu.cer.ro) who distribute degrees and jobs as they see fit for their self-enrichment. The absence of any serious control body of 'autonomous' management also led to infrequent intervention by prosecutors or other law enforcement agents until after public scandal broke out. Recommendations of the Audit Court following financial audits are not implemented, since there is no legal follow up even to the most negative conclusions. The current amendments to the Education law foresee such a control body, but, unsurprisingly, many academics oppose this innovation.

(b) Adequacy of curricula to the demands of democratic life and the labor market. The curriculum was repeatedly reformed, but changes remain superficial. Romanian educators continue to believe that to make a good citizen one needs lectures on citizenship rather than participation and to make an organized man the integral calculus is more useful than an introduction to the Excel program and the organization

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20 Răzvan Florian 2005. Oamenii de ştiinţă şi recunoaşterea lor internaţională. Ad Astra 5 (1), 2006 www.ad-astra.ro/journal Ad Astra

21 Coord. Adrian Miroiu, Vladimir Pasti, Cornel Codiţă, Gabriel Ivan, Mihaela Miroiu – „Învăţămîntul românesc azi", Polirom, 1998; Andrei Marga – Reforma învaţamăntului şi provăcările noului secol – Colegiul Noua Europă (1999); Andrei Marga – Anii reformei 1997-2000, Ed. Fundaţiei de Studii Europene, Cluj (2000)

of a school party. The school continues to be as reluctant as in Communist times to encourage initiative and team spirit. In science, as in Romanian gymnastics, performance nearly collapsed with the Communist system and needed some years to recover. Before, participation to some form of science Olympics was nearly compulsory. Today, it is an exception.

However, the transition from elitist education to democratic education has not been completed. The system hangs in a no man's land. In higher education the situation is no better. As the entrance in the system is the result of individual negotiations, not departmental strategy, the curricula also reflects this situation. Attempts by accreditation authorities to impose certain core disciplines backfired, because it was more important for university administrators to accommodate their clients. The solution was to entrust the teaching of these key disciplines to the clients, qualified or not. If a simple ground rule would be implemented, banning anybody who had not published a peer-reviewed paper in a certain discipline to teach it, the universities would lose half their faculty or more.

The worlds of business and education remain far apart. About 10% of businesses reportedly invest in the continuous education for their employees. Given the absence of unemployment in Romania, neither workers nor companies show a great interest in upgrading labor knowledge. Communication is nearly absent. Despite our investigations we were unable to unravel any attempt of the Department of Education to organize a discussion framework with business, at least to fundraise for the national research fund.

(c) *Adequacy of reform steps to problems.* The European accession had an important role in the development, or perhaps the underdevelopment of the policy environment in Romania. It provided governments with low policy design capacity with sets of ready made answers. Most of these answers were however not ready for Romania, or Romania was not ready for them. Many education policies fall under this category.

One of the most important errors of Romanian educators was to implement Bologna literally and without any flexibility or research on its impact. The bottom line was that the whole system can be reorganized on this occasion with a twofold benefit: saving money and streamlining curricula. Undergraduate programs were thus unnecessarily cut from four to three years nearly everywhere (in order to fund new postgraduate programs out of the same budget; the requirement was for three cycles, but there was no obligation to make the first one in 3 years), once again leading to favoring clients and sacrificing quality, which led to protests by students and further disorganization of the curricula.

Bologna was implemented blindly, at the expense of quality, as if it were a clear recipe for education reform; it wasn't

Students who enroll in MA programs, often improvised by poorly prepared universities have the surprise to work harder in finding a job at the end than undergraduates, since their entrance two years later on the job market with practically no superior education and greater expectations about pay is a hindrance, not a help. So most MA students already have a job and show up at the University only for exams, when the

Tab. 3. The vicious circle of underdevelopment

BROADER PROBLEM	EDUCATION PROBLEM
Uneven development with rural areas at great disadvantage	Improper schooling conditions in rural areas needing high investment
Low productivity	Poor training of labor force
Weak presence of high technology industries	Weak institutionalized innovation and research capacity
Lack of administrative capacity, low absorption of EU funds	Lack of adequate training for management in the public sector, both at grassroots and executive level
Insufficient economic output, low wages	Lack of funds to finance permanent education of labor force
Uneven and often low demand for high skills	Lack of motivation to continue study, Brain drain.
Dominance of economic sectors with no need of knowledge (subsistence farming, retail, lohn)	Low technological creativity

original purpose of the whole reform (inspired from the problems of a different society) was to help them find work! If professors insist on students being present at class they are more likely to make them lose their jobs.

With 20% university professors ever to have passed the trial of peer-review publishing, granting of doctorates in many universities is a sham and a profitable industry. Not so profitable for students, though, as Romanian doctorates are not greatly appreciated in the Romanian labor market. Job career and academic career for working students, a growing category, often advance on separate unrelated paths. Overall, the implementation of Bologna was made in disregard to preserving or promoting some standards of quality and with no real debate on what old problems would these reforms solve, if any, and what new problems would they generate. Nobody bothered to measure some quality indicator at the beginning of the process to know at the end what was really achieved. Rumors claim that reforms are needed for Romanian graduates to be able to find work in Europe (what they already successfully do), so directly feeding the legitimacy of the supermarket paradigm. Protests from students and lack of success of some graduate programs will compel administrators in the end to pull back from some of these ill-planned, ill-implemented reforms, but the harm done might be lasting. The only positive outcome, a stress on quality, was also temporary. The Ministry stepped back from enforcing universal standards and again the quality evaluators were selected on a political basis rather than by counting their peer-reviewed publications.

The closed education and research systems are among the causes of the brain drain

3. Back to the real world

Do the problems of the Romanian education really matter for the development of the Romanian society, or are people able to learn, adjust and cope by themselves? The answer is that poor education policies matter greatly, and they will matter even more from now on, with Romanian joining EU and competing with countries with clear superiority in the field of knowledge of every kind. The table below presents a brief review of just how deep education problems mirror or are mirrored by broader societal problems, feeding a vicious circle of mediocrity and underdevelopment.

The stable persistence over time of a closed system of higher education and research, as well as the insufficient demand for high skills has led to an important brain drain of Romania's most creative young. Combined with the poor management of transition which still makes more lucrative to be a taxi driver than a physician, this produced important disincentives for people to actively seek to acquire the highest skills with the goal to work in our country. Exceptions do exist, but it is unlikely that EU integration by itself will succeed in addressing this problem. An active policy, involving both the public and the private sector is needed if we want Romania's economy to collect more than the individuals who settle for less as a life rule. No great added values will result from such an attitude.

4. Recommendations

It is in SAR's the tradition to recommend new policies rather than new legislation. New legislation is unfortunately often necessary due to the hyper-regulatory environment of Romania. This review paper was not designed to propose comprehensive solutions to the many problems of the education system, although a consultation organized by SAR on this topic is ongoing. The following recommendations are more of a general interest and target the role of education in the fulfillment of the main Lisbon objectives, increase of economic competitiveness by means of superior production and use of knowledge.

4.1. Re-establish the primacy of performance by pure administrative means. No change of legislation is needed to reestablish the main evaluation bodies on a sound basis. Romania has two crucial bodies for the careers and work of its academics, the National Committee for Accreditation (Consiliul National de Atestare a Titlurilor, Diplomelor şi Certificatelor Universitare - CNAT), and the National Research Council (Consiliul National al Cercetarii Stiintifice din Invatamantul Superior - CNCSIS)[22]. These two bodies operate without any conflict of interest regulations and reflect passively the poor performance of the original disciplines of their constituents. Members

22 http://www.old.edu.ro/cnatdcu.htm; http://www.cncsis.ro

are therefore on the average, when they should be the best of the best, those able to appreciate and encourage excellence in academic performance. These bodies should be purged of academics who have never published a peer-review paper in an international journal or a book in an international language, with the exception of artistic fields (which need a special, more flexible regime anyway). If those are few, the committee should be smaller, and funds should be allocated to pay for Romanian and European qualified evaluators and reviewers. Unless evaluators are themselves submitted to the test of quality any discussion of quality remains futile and hypocritical.

4.2. Invest strategically. Even in the present circumstances, some individuals perform. They should take the bulk of funds. The difference between the list of individuals who win the very much prized EU research funds and those who win CNCSIS funds is simply of measure of domestic corruption. CNCSIS should not organize new competitions prior to evaluating how many peer-reviewed papers resulted from prior ones and create a system to employ professional evaluators, either Romanian or European. When you have a tenth of your researchers performing relatively well you earn more by investing in them than spreading the butter thin over all universities and research institutes. Rely on them to create a new generation of researchers.

4.3. Open the system. Rules and laws should be amended to eliminate disincentives for performance. Diplomas from universities featured above Romanian ones in the Shanghai top should be automatically accepted in the Romanian academia only by presentation of an original. The current tenure system combined with sufficient pay for university professors' only acts as a powerful disincentive for creating a young and bright faculty body. In fact, it acts as an incentive to counter-select and keep young faculty. Real academic competitions have to be recreated. We need to foster competition if the system is to be revived. We also need to submit to a periodical reevaluation those who have already succeeded to be on top of their profession. Otherwise any reform will be accused of hypocrisy, since thousands of degrees to professors and doctors were granted in the last years on no merit basis. Joint research and teaching projects involving Romanian émigrés should be encouraged and funded as a counterbalance to brain drain. The same applies to older Romanian academics of international reputation. The principle is the same, we need to keep the best involved in the system regardless of age and country of residence. Restrictions which place qualification over knowledge should be eliminated. They make an important difference between our closed rigid system and a competitive open one, where proof of competence (publishing) overrides the type of qualification.

4.4. Make the system accountable. Corruption in the education system was little understood, so it was neglected by the anticorruption wave of the last years. The problem is not of occasional soft payments to teachers, but of massive fraud at exams, of the falsification of evaluation systems, of the total lack of accountability of the higher education and research system, which needs being reinvented[23]. Rectors should be elected by the entire faculty, not just Council members. The Council should include by rotation the entire faculty, prohibiting more than one term in a sequence for a person. University administrators should be recruited by an open competition. Universities should be audited periodically by a special control body acting on a regular basis or at the request of the Audit Court to make sure that funds from both budget and own sources reach their targets and do not go into the pockets of university mafias. Students should be encouraged to set up watchdog bodies to denounce malpractice in schools and universities.

4.5. Foster dialogue and cooperation with business, especially the knowledge intensive sector. In the field of vocational training some steps were made and a regional basis for regular consultation exists. Steps must be undertaken to foster cooperation on more fields and at a national level as well.

4.6. The Bologna Declaration should be seen simply as a framework for European cooperation, not a tool to reform the Romanian – or any other – higher education system. Its implementation should be revisited with the view to foster quality, not spread it thinner than it already is. Far more flexibility is needed from discipline to discipline, and new programs, such as doctoral schools, should not be set up if resources do not exist. The real European education objectives can be found under Lisbon, not Bologna, and those badly need a national strategy reflected in new, better grounded education policies.

23 Based on a study of the Department of Sociology of Babes-Bolyai University (Mircea Comşa) and a research by SAR (Ana-Maria Dima).

Competitiveness

A ROUGH RIDE TO CATCH UP WITH EUROPE

The EU can offer only a reasonable framework, more or less liberal, in which everyone competes, but little in the way of a substantive strategy for growth

Competitiveness is a comparative concept measuring the ability and the performance of a firm, an economic sector or a country to sell and supply goods and services in a given market. For example, the European Union is the largest exporter in the global market, but it is still lacking in competitiveness compared with the United States and Japan. Even though most of the economists share similar diagnostics of the European problem – the taxes and regulations imposed by Europe's elaborate welfare states – the European policy-makers, starting with Jaques Delors (1993), have shown that the root cause of European unemployment is the lower level of investment in infrastructure and high technology. Becoming *the most competitive nation by 2010* — the goal of the Lisbon agenda — was soon replaced by the *growth and jobs strategy* as the main road towards competitiveness. In this context, the current key policy challenges identified in the *European Competitiveness Report 2006* (December 2006) consist in: the energy market liberalization, efficiency and security of supply; the regulatory of business environment; innovation and technology policies that contribute to a successful lead market strategy.

Determinants of national competitiveness: costs and prices, but first and foremost business performance

Competitiveness remains a concept not very well understood, despite the widespread acceptance of its importance. Nevertheless, all the economists agree that the national economic welfare is determined by productivity, in both traded and non-traded sectors of the economy. Therefore, to understand competitiveness, the starting point must be the sources of a nation's prosperity. A nation's standard of living is determined by the ***productivity*** of its economy, which is measured by the value of output - goods and services - produced per unit of inputs used by a nation or a region - especially its knowledge, human, capital and natural resources. In other words, productivity sets a nation's or region's standard of living, through wages, returns on capital and on natural resources[24]:

- Productivity depends on the value of products and services (e.g. uniqueness, quality), as well as on the efficiency with which they are produced;
- Prosperity does not rely on what industries a nation or region competes in, but how firms compete in those industries;
- Productivity in a nation or region is a reflection of what both domestic and foreign firms choose to do in that location. The location of ownership is secondary for national prosperity;
- The productivity of "local" industries is fundamental to competitiveness, not just that of traded industries;
- Devaluation and revaluation do not make a country more or less "competitive".

Yet nations and regions compete in offering the *most productive environment for business*. Here the public and private sectors should play *different but interrelated roles* in creating a productive economy. A

[24] Porter, M. E. (1990). *The Competitive Advantage of Nations*, *Macmillan*, London.

sound macroeconomic, political, legal, and social context creates the potential for competitiveness; it is still not sufficient. Only firms can create wealth, not the government. The main factors behind increasing a firms' competitiveness are:

- Costs – such as wages, utilities, and prices - their impact on the ability of firms to compete in international markets;
- However, better business performance is paramount, above all efficiency factors, such as a good physical infrastructure, high levels of education, training and research and a regulatory and tax environment that encourages entrepreneurship, enterprise, competition, productivity and innovation.

Looking at the groups of companies, Michael Porter defines four "pillars" in the "*diamond of national competitiveness*" that lead to competitive strengths and weaknesses of countries and their major sectors:

- the existence of resources (i.e. human resources and research and information infrastructures);
- a business environment that stimulates innovation;
- a demanding local market;
- the presence of supporting industries.

Therefore, strategy-makers have to look for the resources allocation and performance, but also for the overall business environment improvements and the social progress. A more competitive economy is one that is likely to grow faster over the medium to long run.

1. Romania's growth and productivity performance

After the *European Council in Helsinki* (1999), when Romania was invited in order to negotiate the EU membership, our efforts of adjusting the political, economic, social and legislative systems have increased significantly. Relevant upgrades in the management of the public and private sectors during Romanian transition to a functional market economy have been induced due to the integrative pressures of the *acquis communautaire*. The coherence of these policies has grown. As a consequence, a buoyant and dynamic economic environment emerged after 2000. Constant economic growth led the Romanian GDP per capita to exceed 34% of the EU-25 average level in 2005. It is estimated for 2006 to be 36% at purchasing power parity (PPP) and 17% at the market prices.

Romania's integration into the global economy through the strategic partnership with the European Union has been so far based on cheap labor as well as low and medium-technology exports. The creation of new jobs has helped solve many severe social problems. Yet such exports are low value added and have a small contribution to raising the living standard through high and lasting economic growth rates.

In the EU-27 internal market, especially as Romania is set to join the European Monetary Union in 2014, the only force contributing to economic catching-up will be the competitiveness of each individual, company, sector and business environment as a whole. There are some Romanian success stories. Still, with very few exemptions, most of the international classifications throw Romania at the European periphery in terms of prosperity driving forces' performance. Escaping it urges a much higher and long-run economic and human development in Romania than the EU average.

Romania has closed its GDP gap with the EU25 by 10% on average over the last seven years

With a GDP per capita (PPP) of $9,446 in 2006[25], Romania is considered an upper-middle income economy, according to the World Bank Country Classification Groups. Romania improved its competitiveness relative to EU-25 average and new EU members in some important indicators:

- Romania has one of the highest GDP per capita average growth rates in the region (about 10% annually during 2000 – 2005, at PPP), overcome only by Estonia. Despite this dynamism, we still had the lowest level of GDP per capita in 2005, relative to the other EU members used for benchmarking, except for Bulgaria;
- GDP increased even faster in 2004-2006 than earlier. In 2004, GDP growth was 8.4%, one of the highest in Europe. This rate was halved in 2005, mainly due to floods in significant agricultural areas. For 2006 growth is estimated at

[25] IMF World Economic Outlook, *Economic Indicators for Romania, 2004-2007*, April 2006.

7.0%. For the next years, the GDP growth potential is evaluated at approximately 6%;

- Labor productivity growth of 80%, between 2000 and 2005 shows that Romania put up a good regional performance. The main cause is a significant reduction of the total labor force, by more than 1.5 million. Again, the 2005 labor productivity level is one of the lowest in the EU, 2.8 times lower than the EU-25 average and 3.6 times lower than in Ireland. Surprisingly the economic restructuring was accompanied by a low level of unemployment, 5.1% in November 2006, much lower compared to other middle-sized or large European countries such as Poland (14%), Germany (12%), France (9%), and Spain (7.6%).

- Labor productivity in industry increased by 11% in the first three quarters of 2006, fueled mainly by the productivity growth in the mining and quarrying industry (26.6%), followed by manufacturing (10.5%), energy, gas and water industries (5.8%).

- Although the Romanian exports per capita increased more rapidly than in many other CEE countries between 2000 and 2005, their nominal level remains by far the lowest. Structural upgrading is also presently in favor of medium-tech (35% share in total exports 2006), and to a lower extent of high-tech, products (gaining 5% in the exports structure in the last seven years, reaching almost 13% in 2006). Still the resource-based exports and low-tech branches are dominant, accounting for 36% and 14% respectively.

Fig. 1. Comparative growth performance in EU

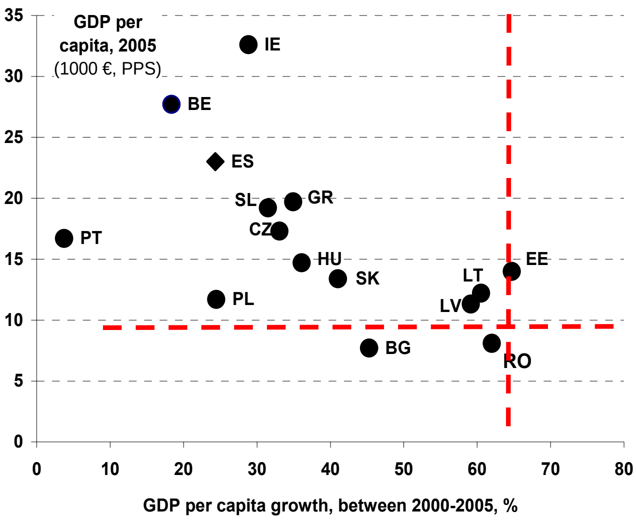


Fig. 2. Comparative labor productivity in EU, 2005

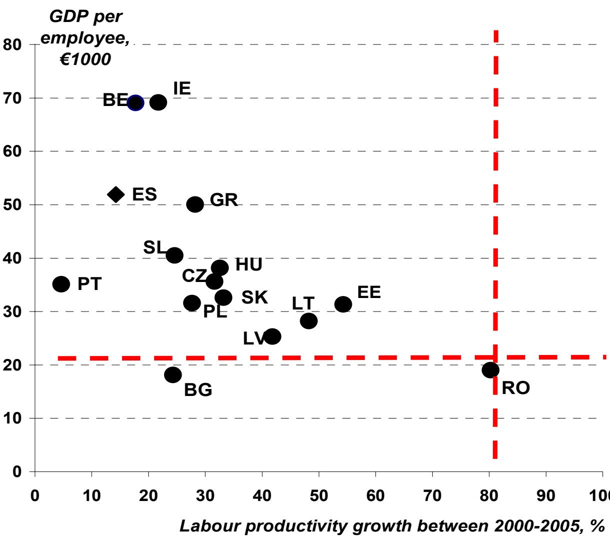


Fig. 3. Comparative export performance in EU

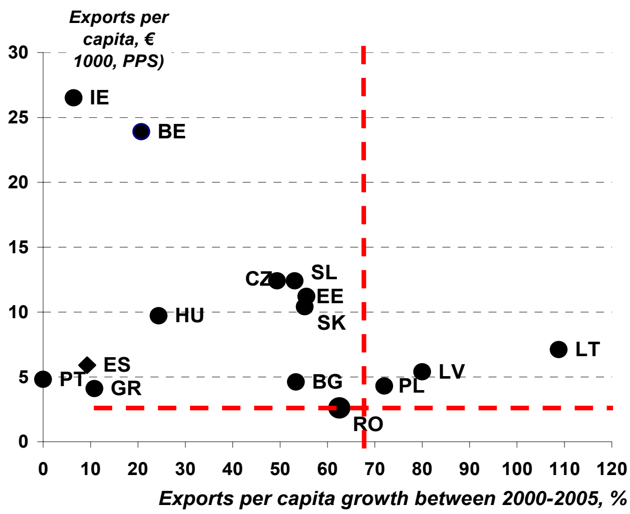
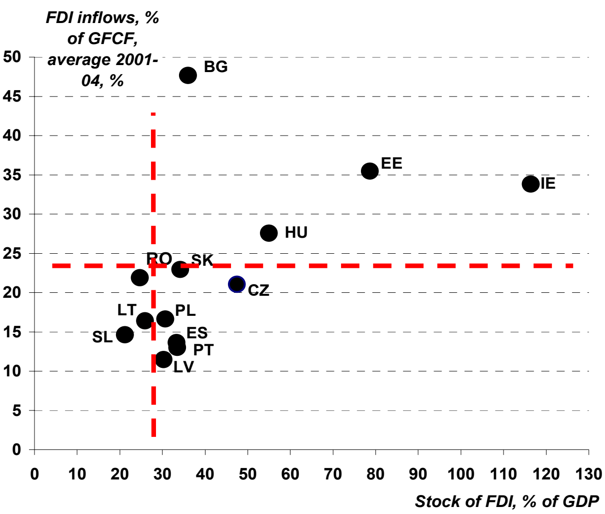


Fig. 4. Comparative performance on FDI received, 2004



Romania's main exports are clothing and textiles, leather and footwear, with 25% share in total exports (FOB prices), followed by industrial machinery, electrical and electronic equipment (18%), metallurgic products (13%), mineral products (10%), wood and furniture (10%), cars and other auto vehicles (9%), chemical products (6%), software, pharmaceuticals and agricultural products (fruits, vegetables, and flowers). Trade is mostly centered on the member states of the European Union, with Germany and Italy being the country's largest trading partners. Yet the foreign trade deficit is expanding. Imports exceeded exports by almost 50% in 2006, significantly more than in the previous years.

Benchmarking Poland and Romania, a comparative report finds that the specialization pattern of exports ranks the two countries on the strongest positions in low-tech and medium-low-tech industries on the EU market, while the market shares attained in high-tech industries are very small[26]. Poland has had a more advanced export structure –there were recent gains in the medium-high-tech sector; productivity increased more rapidly than wages– thus unit labor costs in manufacturing declined by 17.8% during 2002 - 2005. The costs of Polish producers diminished and they could compete with lower prices and sell larger quantities. By contrast, in Romania productivity did not increase as fast as the wages during the same period, which led to an increase in manufacturing unit labor costs of 24.5%. Romanian producers could not sell as much as before in the same quality. They were pushed to increase export prices even if quantities had to be limited. Still, the Polish unit labor costs are on average higher than in Romanian manufacturing sector as a whole; but kept below Romania in key export industries: textiles-clothing-leather, machinery, electrical and transport. Romanian exporters could align costs and prices and maintain competitiveness through quality increase, but they could not substantially increase the amount of exports. At the opposite, Polish producers increased the quantity of exports relatively more rapidly than the quality.

Flows of foreign direct investments (FDI) into Romania increased. Still, as late as 2004, Romania was lagging behind the other countries in terms of FDI stock in GDP, except for Lithuania and Slovenia. A fifth of the annual gross fixed capital formation was covered by the average inflow of FDI, during 2001-2004, 2 times lower in Bulgaria.

A much stronger increase of FDI followed in 2005 – 2006, making Romania the single largest investment destination in Southeastern and Central Europe. These performances (5.2 billion Euro in 2005, and 8.5 billion Euro in 2006) were explained partly by several large privatization deals in banking (e.g. the acquisition of Banca Comerciala Romana by Erste Bank - Austria). In addition, the privatization of natural gas providers and their purchase by Gaz de France and Ruhrgas (Germany), led to a stock of almost 29 billions Euro in 2006 (close to the Polish performance in 2004, of almost 30% in GDP). Another record level of FDI is expected in 2007. This should help competitiveness through bringing new international best practices, management skills, expertise and capital investment into the local business environment.

Relevant explanations for the Romanian economy late FDI increase reside in the unfinished privatization process, on one hand, and from the introduction of the flat tax of 16%, for both personal income and corporate profit - one of the lowest fiscal burdens in Europe, on the other hand. These have been accompanied by measures to improve the business environment, especially in terms of ease of starting a business, policy incentives leading to the increase of employees and private sector profitability (reaching an unprecedented 5% level in 2005). Actually, government intervention in the Romanian economy is to some extent even lower than in other European economies[27].

The business environment reform. The regulations of launching a business in Romania are more favorable than in the region and in the OECD countries. The procedures, costs and time required significantly diminished, placing Romania on the 7th place worldwide in ease of opening a business and entering the market (*Word Bank, 2006*). Relevant improvements have been achieved in facilitating the imports and exports, thus gaining a competitive advantage over other 86 countries worldwide in 2006. The protection of investors and contract

[26] Hunya, G. (2006), *EU Membership – Support and Challenge to the Competitiveness of the Polish and Romania economies*, Draft paper to be presented at EUIJ Kansai, 9 December 2006 and at EUIJ Tokyo, 11 December 2006

[27] Heritage Foundation, *Index of Economic Freedom*, 2006

EU membership does not guarantee higher competitiveness: the case of Central and East European countries (CEECs)

Competitiveness improves before accession. Czech Republic, Poland, Hungary etc. have taken particular measures in early the 1990's to promote the competition among enterprises, to strengthen the governance and to stimulate foreign direct investments, aiming at including domestic companies in the global production network. They reaped soon the benefices of competitiveness.

In an international comparison, CEECs show a relatively strong economic growth performance, coming close to that of the first and second tier of Asian Tiger countries over the past decade, which emerge as the best growth performers (setting aside China, with an average economic growth of almost 10% in the last two decades). Its dynamic growth performance has even accelerated despite an economic slowdown in their most important trading partners. Despite being considerably smaller than their competitors in East Asia (taken together about half the size of China), the CEECs have gained a very considerable market share in the EU-15 which is their main export market. Meantime, pronounced reduction in their trade deficits, despite weak demand in EU and strengthening currency, reveals significant competitiveness improvements.

Regional growth forecasts: CEE as a world leader

Real GDP growth	2006	2007-2011
North America	3.2	2.6
Western Europe	2.8	2.3
CEE	6,3	5.5
Asia	5.3	4.5
Asia without Japan	5.9	5.2
Latin America	4.7	3.7
Middle East / North Africa	5.8	5.2
Sub-Saharan Africa	4.3	5.0

Source: EIU, Jan 2007

CEECs are to become between **2007–2011** the **fastest growing region of the world,** according to the *European Intelligence Unit* estimates from January 2007. This trends lead to an unprecedented rise of competition in the region in the next few years:

- CEECs produced only 4% of world GDP in 2005, (at market exchange rates), but the highest economic growth rate in 2006;
- Today, the CEE region gets more foreign direct investment than anywhere else in the world (record FDI in 2005 of $80bn, *UNCTAD, 2006*), adding between $1.1 and $1.3 trillion in market size annually. Labour intensive manufacturing will continue to go to cheaper locations in CEE region, but high value added manufacturing, research and development, shared services etc. are moving too, at unprecedented levels.
- Significant comparative advantage because of lower perceived risks relative to Latin America, China, India, Middle East or Africa.
- EU funding 2007-2013 equals $140bn – a major opportunity but it depends on how much it will be absorbed.

EU membership does not guarantee faster growth. The old members are likely to maintain a competitive edge in advanced business services. But in terms of infrastructure (human capital, telecommunications, etc.), the ease and reliability of doing business, the new members occupy rank four behind the two groups of advanced economies (EU and other OECD) and the first tier of Asian Tigers. Romania and Bulgaria rank generally lower, thus having to defend their position more intensively against competition from the second tier of Asian Tigers and emerging market economies, such as Turkey and Mexico. The two giant emerging markets, China and India, still have a long way to go to catch-up in these qualitative indicators. A distinguishing feature of EU-10 is their strong performance in terms of human capital and business infrastructure, which is yet not totally matched by an equally strong performance in institutions, guaranteeing a reliable and sound business environment.

enforcement are relatively solid. The flat tax rate is also competitive, but the number of tax payments, the procedures and time for registering a property are still relative high. Despite the above-mentioned positive outcomes, the quality of the legislative regulations adopted during 2004 - 2006 was unsatisfactory. Overly rigid non-wage costs, the difficulties faced in firing workers and in shutting down a business are other added weaknesses of the Romanian business environment that put a break on the development of entrepreneurship. The sectors with the fastest growth in 2006 were:

- constructions and related industries – building materials industry, metallic constructions and metal products industry – estimated growth of13% in 2006, with a further 12% growth forecast for 2007;
- electronic equipment industry (10.6% growth in 2006);
- telecommunications industry;
- production and distribution of electric and thermal energy;
- furniture industry;

A fast-growing financial sector supports the industry development. *The banking sector* is highly developed, with a banking assets volume of approximately 38 billion Euros. There are 39 banks currently active on the Romanian market, 6 of which are branches of foreign banks. 58% of the banking assets are concentrated in the first 5 banks in the system, while the majority of the banking assets are held by foreign-owned banks (87.8%). *The insurance sector* has developed exponentially, representing, at the end of 2005, 1.2% of the GDP. In 2006, estimates indicate a growth of almost 20%. Although less developed than the banking system, *the capital market* is one of the most dynamic markets in Europe, with a capitalization of approximately 21 billion Euros, in 2006. Enhancing the legislation on investor protection, introducing the mortgage bonds, launching the private pension funds and the EU accession generate positive prospects for the ongoing development of these sectors.

2. Key policy challenges

We should not fall prey to illusions, however, and lose sight of the bigger picture. Romania is a factor-driven economy to a large extent, moving only now towards an efficient-driven development stage. We have basically two options ahead of us:

- To compete on the European market and globally with Poland, China and India on the labour-intensive product markets, or
- To build a sound policy for efficient investments that may turn Romania from a spectator into an active player on the high-technology based global market.

Taking into account the perishable nature of the first option, we are left to play the second card. So, firms in Romania will not be able to compete internationally only on the basis of natural resources and low wages, but rather on the basis of higher diversification, productivity and quality, ingenuity and innovation in product and process design and delivery. Romania has no choice but to become a vibrant knowledge economy, being in a position to cash in on its integration opportunities, economic strategic location, savvy foreign policy, abundance of natural resources, sound macroeconomic policies, booming industries, high-skilled and still inexpensive labor force and the stock-market growth. Pragmatically, economic planning has to be coherent and unitary, as to cover a few key objectives, even though every field seems a priority that is those niches that could sustain the ongoing development.

Romania remains a factor-driven economy, with timid in-roads into the knowledge-intensive sectors

Nonetheless, what creates productivity in Sweden is different from what drives it in Romania or Bulgaria, and again different in Ghana. Porter (1990) notes that countries are separated into three specific stages: factor-driven, efficiency-driven, and innovation-driven, each implying a growing degree of complexity in the operation of the economy.

a) *In the first stage*, competitiveness hinges mainly on well-functioning public and private institutions, appropriate infrastructure, a stable macroeconomic framework, and good health and primary education. See for example the Romanian pattern of specialization in the world-wide footwear cluster, in the presence of Italian subsidiaries. They focused on lower to medium-price range products, but recent orientation towards design, marketing and premium shoes was influenced fundamentally by linkages and spillovers across firms in competition (Fig. 5).

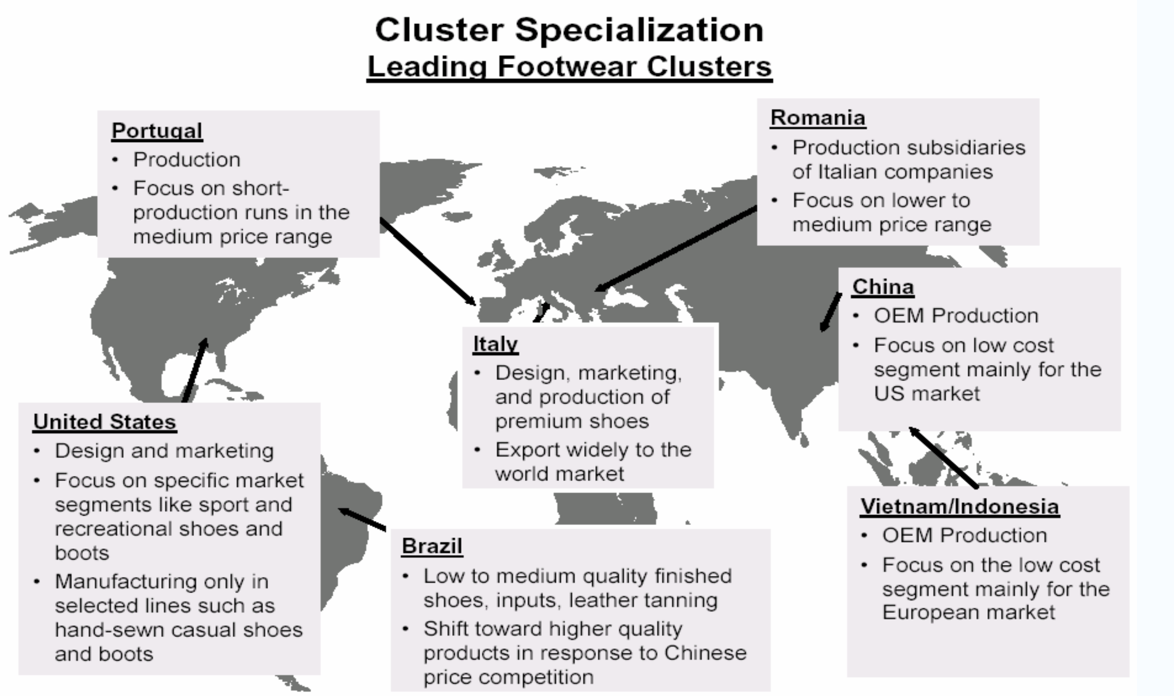
b) As wages rise with advancing development, Romania should move into the *second stage*, when we must begin to develop more efficient production processes and increase product quality. At this point, competitiveness becomes increasingly driven by higher education and training, efficient markets, and the ability to harness the benefits of existing technologies. These are currently exactly the main bottlenecks in raising Romanian competitiveness, on which we are to focus further on.

c) Finally, as countries move into the *third stage*, they are only able to sustain higher wages and the associated standard of living if their businesses were capable to compete with new and unique products. At this stage, companies must compete by producing new and different goods using the most sophisticated production processes and through innovation. For example, even though Singapore is one of the most impressive success stories of economic growth in the 20th century, with the highest export per capita in the world in 2005, it is now on a challenging path to move from an economy based on efficiency to one based on differentiation and innovation.

Going through different country and regional experiences leads to the conclusion that the transition through the different stages is not necessarily linear or gradual. Nor does it happen automatically. Therefore, Romania has to simultaneously address stringent issues related to the traditional competitive assets and to the main competitiveness shortcomings, and also to develop new competitive assets. Specific post-accession competitive pressures consist in the loss of competitiveness in labor-intensive and low skill industries, partly due to a gradual loss of cost advantages, but also to the increasing import pressure from China and other low cost producers in European markets.

In 2007, after the EU accession, there will be strong pressures on wages towards convergence with Western European standards. Improvements in the Romanian labor productivity are anticipated for 2006-2008 by the *European Commission*. In both productivity and wage levels, expansion is likely to be higher than in most EU-27 member states. But if the labor productivity per employee is outpaced by employee compensation (a proxy for wage growth), as EC forecasts suggest, it will lead to a direct short-term threat to competitiveness. On the other hand, it may bring more emigrants back home, with higher skills and

Fig. 5. Romania's role in the footwear cluster



Source: Research by Harvard Business School student teams in 2002 – Van Thi Huynh, Evan Lee, Kevin Newman, Nils Ole Oermann (Porter, 2006) motivation.[28]

However, the *National Commission of Prognosis* estimates an annual negative real unit labor costs growth (Fig. 6) during 2006 – 2010. It actually means that labor compensation will shift from the 2005 trend, and it will grow less quickly than labor productivity. This is partly because until 2004, competitive wage costs made Romania an attractive Eastern European relocation destination for labor-intensive industries. Since then the growth rate of cheap but high-skilled industries, such as IT industries and call centers, increased significantly.

Currently, wages in Romania are increasing from an extremely low base, by comparison with Western Europe. A recent survey[29] indicated that a typical 2006 weekly gross wage costs in Romania is 66 Euro - 80% higher than in Bulgaria and similar to Latvia, but more than 2 times lower than in Hungary, almost 4 times lower than in Slovenia, and finally more than 10 times lower than in Germany.

Such issues remain a concern, but simultaneously excessive wage growth must be prevented. Pay levels in many of the EU's global competitor countries are much lower even than in Bulgaria, Latvia and Romania (Fig. 7). Both India and China are rapidly growing production and IT service centers, while Russia is attracting considerable inward investment because it combines a huge internal market for goods and services with very low wage costs.

There are a number of other stringent issues the Romanian Government must be working on, in particular the main four sectors that are heavily dragging down the economy productivity. These are the agriculture, energy, and tourism industries, along with the lack of a proper infrastructure base. The economy is currently heavily agrarian. Over 10% of Romanian GDP comprises agricultural production, as opposed to around 2% in EU (e.g. 3% in Poland). Additionally, one third of the Romanian population is employed in agriculture and primary production, one of the highest rates in Europe. But its share in exports is insignificant. However, agriculture is the main destination for the European structural funds. If we take also into consideration the low price of arable land and the investments forecasted in rural agriculture, this sector becomes one of the most attractive economic branches, with a substantial growth potential in the future.

Fig. 6. Labor costs vs. labor productivity, trends

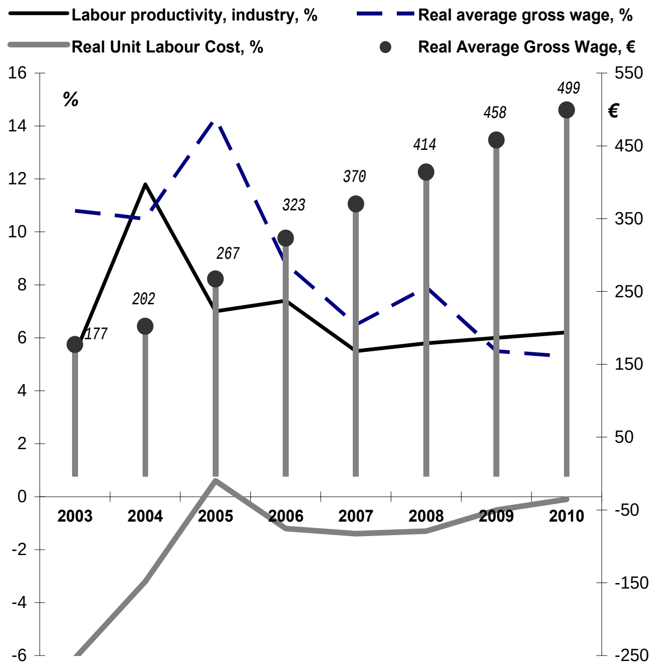
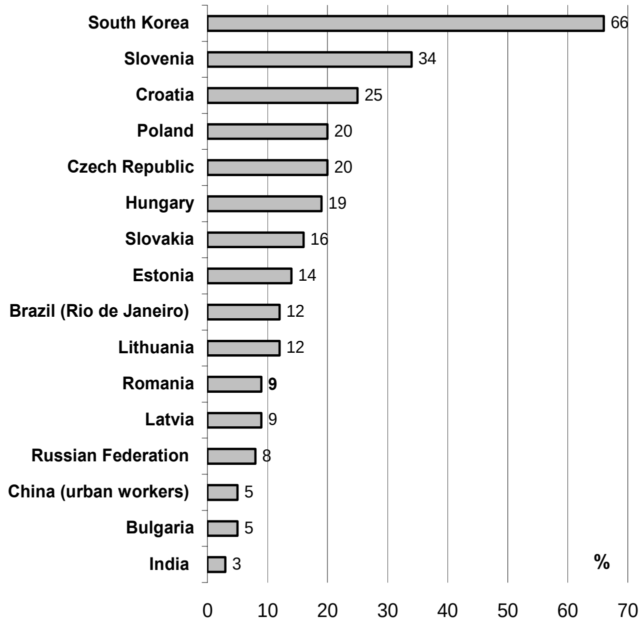


Fig. 7. Median gross weekly private sector earnings in 2006, Germany =100%



[28] Lately, only 12% of the returning Romanian emigrants were carrying in their luggage a higher education diploma, much lower than in Bulgaria or the other CEE countries (World Bank, *Migration and Remittances: Eastern Europe and the Former Soviet Union*, A. Mansoor, B. Quillin, 2007).

[29] FedEE, Pay in Europe 2006, www.fedee.com

Energy intensiveness of the Romanian economy is four times higher than the EU-25 average[30]. This lack of efficiency appears at the production, the distribution and the consumption levels as well. The on-going liberalization process has not yet yielded an efficient market with competitive prices;

Tourism in Romania has a three times lower contribution to the economy than in countries like Spain, Italy, and Greece, where tourism is an important economic asset. Its weight in exports is 2.5 lower than in the EU-25. Bulgaria was early to understand this opportunity and reacted accordingly, adjusting their offer to Germany and the United Kingdom, which are by far the biggest spenders. Romania should capitalize mainly its business tourism, spa and agro-tourism assets.

With only 200 km of highways, Romania is far behind Hungary or Poland and this puts a significant upward pressure on infrastructure and transportation costs. With an economy in expansion, the necessities related to the transport infrastructure development are very high. The government has developed a very ambitious strategy for the next ten years, based on:

- the modernization of the road network: a special attention will be paid to highway construction (approximately 1050 km);
- ensuring the railways' interoperability (reaching 1100 kilometers in length);
- increasing of the merchandise traffic in internal and maritime ports, as well as the modernizing of airport equipment and facilities in four airports of national interest (delivering services to 11.3 million travelers a year).

Moreover, in an increasingly knowledge-based economy, human capital education and life-long learning are key factors linked to economic success, productivity, social cohesion, full employment and a better quality of life and work. Yet, the education and research sector remains severely unreformed - unlinked to the market needs and future labor markets dynamics - despite the recent substantial improvements in the allocated funds. 2007 budget increases education spending to 5.2% of GDP, more in line with "old Europe", as well as to 0.56% of GDP for research, development and innovation (RDI). The quality improvements are still expected. For example, the Romanian universities are lagging much behind the performance of top 500 universities worldwide (*according to the Shanghai classification, 2006*). Only one out of ten Romanians over 25 has a tertiary education, half the average EU-25 level. The propensity towards life-long learning is even four times lower than in the EU.

Romania's innovation performance remains very weak[31]. Thus, Romania ranks 2nd to last out of 33 countries. Only two indicators are above the EU average: the percentage of Small and Medium Enterprises (SMEs) that have introduced non-technical change and the new-to-market product sales. Innovation is mainly limited by the poor implementation of intellectual property rights, by the low levels of life-long learning, by the inadequate supply of venture capital funding, by the public and private expenditures for RDI, by the state aid for innovation, by the exports of high-tech products, and by the weight of expenses with communication and information technologies in the GDP, of the new to firm product sales[32]. Actually, 83% of the Romanian companies are non-innovative, 3% are strategic innovators and only 2% implement new technologies.[33] There is little innovation and, as a consequence, there are few industries using new technology intensively.

The challenge is to move up the value chain in production and exports

Romania is committed to increasing the public funding for RDI up to 1% of the GDP by 2010. Many challenges are left to be addressed. Until now, in developing the innovation capacity, the public policies have focused on strengthening the human resources and the research capacity in the research institutes and the university sectors. Fewer measures were geared towards the development of innovative performance in industry.

The private spending of 2% in the GDP is actually a utopia and it will remain

[30] Atlas method of World Bank, 2005

[31] The Romanian aggregate innovation index is 38% of the EU and in the last year, Romania was still losing some ground, being part of the 'non catching–up' group of countries, according to the *European Trendchart – Romania 2005* (European Commission, January, 2006).

[32] European Innovation Scoreboard , European Commission, 2006

[33] *CIS 3 Report of the National Institute of Statistics* , European Commission, 2006

unchanged, unless the presence of public instruments to support it. At least four business RDI challenges should be addressed:

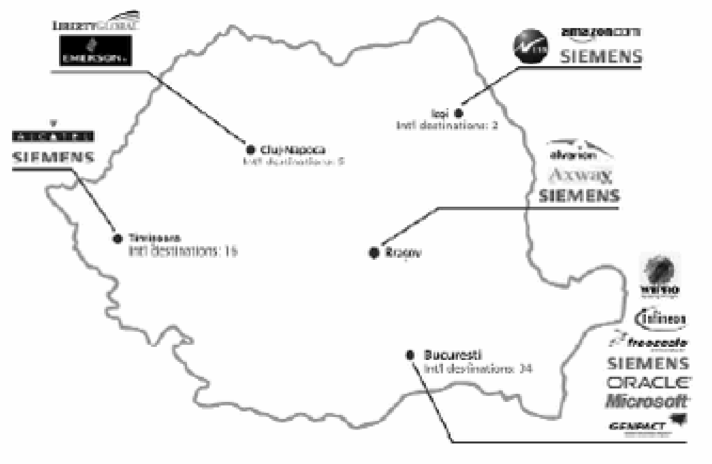
- The very low level of public funding of innovation (only 10% of innovative firms receiving funding);
- The very low levels of innovation expenditures (3% of the innovative firms' turnover);
- The failure to commercialize R&D breakthroughs;
- The weak innovation culture in the country.

Moreover, as presented earlier, almost half of the export capacity is significantly reliant on basic commodities (i.e. ores, coal and salt), cheap textile and footwear products, and other low-tech industries. Moving up further the value chain to an increased contribution of services and higher-tech industries will be necessary, as less skilled work is low labor costs dependent in preserving its competitive advantage. Newly announced engineering and software development centers by multinational firms, for example, are encouraging in this respect. They are to take advantage of the high level of information technology and communication (ITC) engineers per capita, more than anywhere else in the world besides India. Diversifying the economy, particularly developing the IT sector, is a key knowledge-economy goal.

The ITC is one of the most dynamic economic sector and a relevant competitive asset in EU-27. Increasing four times in the last seven years (2000 – 2006, and with 25% during 2005-2006), its actual contribution to GDP is 4.2%[34]. Telecom services predominates (3.1% in GDP), followed by software and hardware industries (with 0.8%, respectively 0.25% in GDP). Further development opportunities come from the less ITC expenditures than half of EU-15 average (3% in GDP). As a consequence of the low level of domestic demand, Romania is a net software exporter (three times higher than imports), but still a net importer of hardware products. Industry specialists agree that the current software export growth is fueled by the major offshore and services centers, as well as from domestic companies offering patented software products, services and business process outsourcing. In a high-tech local industry emergence, four evolution stages in climbing the ladder of know-how have been identified in the Romanian post-communist business environment – endowed with highly-skilled labor force, but lacking open markets and management knowledge:

- The research and development division of a foreign company;
- Software outsourcing provider for foreign companies;
- Complex software solutions provider and owner of a portfolio with copyrighted products – entering successfully the regional competition;
- Acquisitions of local players by international competitors follow as an attempt to cope with the increased world-wide competition.

Fig. 8. IT clusters in Romania



Romania is a highly attractive outsourcing market. Many western companies have taken an interest in either investing or setting up partnerships with local software companies. Oracle, Hewlett-Packard, IBM, Microsoft are strong global players present on the Romanian software market and Canon CEE GMBH, Fujitsu Siemens, HP, IBM, Intel Corporation, Konica Minolta, Philips or Xerox on the hardware market. Major Romanian IT clusters have developed around the large cities. They rely on the output of the IT/science universities (i.e. graduating software engineers) to support their growth. Labor demand is however increasing much faster than the overall number of IT graduates per year

Against all odds: the rise of software industry in Romania

[34] ITC share in the total number of active companies is 3% and in the total number of employees 2.3% in the economy in 2006

Romanian Competitiveness landscape in 2006

Strengths and opportunities:	Weaknesses and threats:
o Solid macroeconomic policy; o 7th largest member of the European internal market; o Flat tax rate of 16%; o Low unemployment; o Increasing living standards and number of employees; o The deflation process looks sustainable; o Large and expanding consumer market; o Short-term competitive wage advantage; o Relevant business environment improvements; o Selected successful manufacturing sectors, such as the rapidly developing ITC sector; o Relative lower government intervention in the economy; o Positive trend of SMEs development; o Liberalization of telecommunications market. o Established industrial and technology parks, incubators and clusters; o Member of CEECs – fastest economic growth region in the world the next five years – expanding the prospective regional demand; o Significant sources for investments from structural and cohesion European financial instruments; o Potential regional hub in gas and energy transport; o ITC export development and branding; o Ending the privatization process and focus on attracting high-technology greenfield investments; o Supply chain for foreign companies, following the Barcelona target of 3% for RDI in GDP, but the low domestic demand for RDI; o Competitive markets regulations improvements; o Service sector liberalization in EU-27, reaping the cross-border investments advantages; o Increased export potential, according to the National Export Strategy; o Significant agricultural and tourism export potential. o Niche tourist destinations.	o Reinforcement of position and image as a low value-added economy; o Loss of competitiveness if the wage and other inputs costs increase is not surpassed by labor productivity; o Price convergence with EU and risk of investments reallocations to lower costs regions; o High losses in electricity/thermal energy, oil and gas transport and distribution networks and thus high costs for the business sector; o High energy intensity of the economy; o The lack of objective, relevant microeconomic data to analyze competitiveness and track the impact of competitiveness efforts; few independent research organization separate from the government to tackle the issue; o The ability to implement and enforce policies and ensure a stable policy environment for business is weak; o The legal system still suffers from low credibility in terms of predictable and fair application of the law; o High share of traditional agriculture in GDP; o Increasing trade deficit; o Limited entrepreneurial culture; o Poor SMEs access to business finance and services; o Under developed ITC infrastructure and services; o Undemanding home consumer market; o Old technology / high costs of non-labor inputs; o Low level of inputs for education and RDI sector, but even lower outputs quality - weak connections to real economy; o Weak development of Technology Transfer and RD infrastructure; o Migration abroad of highly-skilled labour fource; o Relative low share of population with completed higher education; low propensity to life-long learning; o Weak tourism infrastructure and poor marketing; o Competitiveness gap between urban and rural areas; o Administrative barriers to business and traps in the Labor Code; o Lack of capacities in managing properly the European funds for improving economic competitiveness; o Romania perceived as the EU member with the highest level of corruption.

(around 7000). The education system reform should address this issue.

For comparison, the pharmaceuticals market turnover was similar to the software industry, but with a significantly lower growth rate (17% annually, during 1999 - 2005). Strong multinational players enter the market, highlighting again the development opportunities. Expenditure per capita on healthcare is still more than six times lower than in the EU-25 and the drug consumption is among the lowest in Europe (less than half in Hungary, the Czech Republic and Poland; 14% of the EU average). However, imports account for 20% in consumption, being concentrated on more sophisticated, patent-protected, and drugs. Meanwhile, the domestic producers largely focus on the production of low-value generic drugs.

Overall, the large Romanian consumer market - with 4.4% in the EU-27 population - is ongoing expansion, so that the local demand is the main contributor to GDP growth, unlike the EU-25, where the exports dominate. The contribution of foreign demand (export-import) to the real GDP increase has remained negative (-4.4%).

The strong wage and credit growth fuels this excess demand, pushing the annual current-account deficit above 10% of GDP. Given the expectation of significant revenue from privatization and inflows of foreign direct investment such levels have proven so far sustainable. Nevertheless, the expected decline in privatization receipts in 2007-2008 seems to increase Romania's external vulnerability, unless the domestic producers overcome the disadvantaged position relative to the imported goods. In certain economic sectors – such as industry and energy – prices tend to adjust faster to the EU, increasing the utilities' and other intermediary products' costs. Another serious consideration for exporters competing in European markets is the substantial real exchange rate appreciation, accompanied by strong wage growth, which damaged profitability and competitiveness in some sectors. In 2005, these pressures were higher than in many other member states. Higher interest rates, the full liberalization of the capital account and a generally positive view of Romania's prospects after EU accession will stimulate further the speculative capital inflows in 2007-2008. However, modest real appreciation is expected.

The central bank met its 5% year-end target for inflation in 2006, but raised its forecast for 2007 inflation from 4% to 4.4%. This measure issues an even stronger warning about upward pressures, including rapid growth in aggregate demand. High levels of public consumption and investment activity in 2007-2008 will lead to expansionary fiscal policy. Investment activity is the main engine of growth, as new and modernized production facilities come online and large public investment projects get under way. In this context, prudence in wage policies and productivity gains are strongly recommended.

We cannot improve the national competitiveness, without overcoming the ongoing obstacles, for which Romania was many times criticized for being EU-compliant only on paper. It is mainly the corruption, the unreformed public administration, the legislation of low quality and low predictability, the relatively rigid employment laws, and low investor protection that induce higher costs in the business environment.

Domestic production is outpaced by the local consumption

Social conditions remain challenging in many parts of the country. Poverty persists in the country, with over 15% of the population living below the poverty line. Two-thirds of Romania's poor live in rural areas. Risks of job losses are likely especially in these areas, where small and medium enterprises are unready for the European competition. Training skilled workers and attracting investment outside Bucharest will be crucial goals in the struggle to diminish the regional gaps and keep up high long-run economic growth.

3. Benchmarking the Romanian and Bulgarian competitiveness performance

Monitoring the international comparisons of national competitiveness factors proves helpful in obtaining a clearer picture of Romania's position and of the trends in the global and European economy. Bulgaria is used as a benchmark because of the progress similarities under the competitive pressures of EU integration.

The most comprehensive reports on competitiveness are those done by the World Economic Forum, in its Global Competitiveness Report, and the Institute for Management Development, in its World Competitiveness Yearbook. Romania ranks 68, respectively 57, far behind the other CEECs. The Global Competitiveness Index, made up of over 90 variables, captures

Tab. 1. World rankings of Romania and Bulgaria in international reports, 2006

No.	Competitiveness indicators	Ranking		Best performing
		Ro	Bg	
1.	**GDP at PPP**[1]	*44*	*66*	*USA*
2.	**Population**[2]	*51*	*94*	*China*
3.	**GDP at PPP / capita**[2]	*65*	*64*	*Luxembourg*
4.	**Global competitiveness**[3]	*68*	*72*	*Switzerland*
5.	**World competitiveness**[4]	*57*	-	-
6.	**Exports** [2]	*55*	*69*	*EU*
7.	**Exports/capita** [2]	*60*	*58*	*Singapore*
8.	**Imports** [2]	*44*	*65*	*USA*
9.	**Human development** [5]	*60*	*54*	*Norway*
10.	**Quality of life** [6]	*58*	-	*Ireland*
11.	**Corruption perception** [7]	*84*	*57*	*Finland, Island, New Zeeland*
12.	**Economic freedom** [8]	*92*	*64*	*Hong Kong*
13.	**Economic Globalization**[9]	*30*	-	*Singapore*
14.	**Ease of doing business**[10]	*49*	*54*	*Singapore*
15.	**Innovation capacity**[11]	*32*	*26*	*Sweden*
16.	**Bertelsmann Economic transformation index**[12]	*19*	*16*	*Slovenia*
17.	**FDI performance index** [13]	*24*	*9*	*Azerbaijan*
18.	**Agricultural output** [14]	*32*	*76*	*China*
19.	**Industrial output**[15]	*53*	*72*	*EU*
20.	**Services output**[15]	*50*	*67*	*USA*
21.	**Electricity consumption** [16]	*41*	*55*	*USA*
22.	**Natural gas consumption** [17]	*32*	*55*	*USA*
23.	**Carbon dioxide emissions per capita** [18]	*84*	*71*	*United States Virgin Islands*

Sources:

1. *International Monetary Fund, World Economic Outlook Database, estimations for 2006 – out of 176 countries;*
2. *CIA World Facts Book 2006 – out of 232 countries;*
3. *World Economic Forum: The Global Competitiveness Report 2006-2007 – out of 125 countries;*
4. *IMD International: World Competitiveness Yearbook 2006 – out of 61 economies;*
5. *Human Development Report 2006 – out of 177 countries;*
6. *The Economist: The World in 2005 - Worldwide quality-of-life index, 2005 - out of 111 countries*
7. *Transparency International: Global Perception Report 2006 – out of 163 countries;*
8. *Heritage Foundation: Index of Economic Freedom 2006 – out of 161 countries;*
9. *AT Kearney: Foreign Policy Globalization Index 2006 – out of 62 countries;*
10. *World Bank, Doing Business in 2006 – out of 175 countries;*
11. *European Commission: European Innovation Scoreboard 2006 – out of 33 European countries;*
12. *Bertelsmann "Economic Transformation" index, 2006 - – out of 119 economies;*
13. *United Nations Conference on Trade and Development: Foreign Direct Investment Performance Index 2006 - out of 141 economies*
14. *CIA World Facts Book 2006 – out of 162 countries;*
15. *CIA World Facts Book 2006 – out of 163 countries;*
16. *CIA World FactBook 2006 – out of 196 countries;*
17. *CIA World FactBook 2006 – out of 213 countries;*
18. *US Department of Energy's Carbon Dioxide Information Analysis Center (CDIAC) for the United Nations Statistics Division – out of 182 countries.*

the set of institutions, policies, and factors that lead to sustainable current and medium-term levels of economic prosperity."[35] The variables are organized into nine pillars, each representing an area considered as an important determinant of competitiveness. The World Competitiveness Yearbook, with its 312 criteria, describes how nations and firms perform in creating and utilizing their wealth.

Somewhat similar annual reports are the Ease of Doing Business Index and the Indices of Economic Freedom. There are various criticisms. For example, any positive effect that a low level of taxes might have is much more disputed than the importance of rule of law, lack of political corruption, low inflation, and functioning property rights. Some of the highest ranking countries in the *economic freedom index*, like Iceland (5), Denmark (8), Finland (12) or Sweden (19) are widely recognized as having some of the world's most extensive welfare states, which are strongly opposed by advocates of laissez-faire.

The proponents of the Ease of Doing Business Index argue that the effect of business regulations is more important than government consumption. The Global Competitiveness Report looks at several other factors that also affect economic growth such as infrastructure, health, and education. The World Bank is a strong supporter of the importance of economic growth for reducing poverty. However, the World Bank does not believe that laissez-faire policies are an effective way to achieve this goal if they allow large inequalities of wealth to develop.

The intensity and magnitude of the economic transformation (and political as well) is still relevant for the post-transition economies and it is measured by the Bertelsmann index. Slovenia, Estonia and Czech Republic are the best consolidated market-based economies. Romania is the last in the group of market-based economies, in process of consolidation, but lagging behind Bulgaria.

Romania improved almost all its competitiveness factors, climbing in the international rankings last year (except from the *Global competitiveness*, *Starting a business*, *Enforcing contracts* – descending in each ranking 1 position, *Getting credits* – 7 positions). Pre-conditions are favorable for medium- and long-term economic development. Strategic investors are adjusting their perception of risk, according to the votes of confidence received lately:

- World Bank ranked Romania on the 2nd place worldwide in terms of speed and quality of reforming the business environment and 1st in Europe. However, Romania stands at the 49th place in terms of ease of doing business in 2006.
- Again, Romania ranked 2nd in the top of economic transformation most-improved countries in terms of according to the Bertelsmann index, after Pakistan;
- In terms of foreign direct investments performance, Romania ranks 24 in a list of 141 countries, benchmarked by the United Nations Conference on Trade and Development (UNCTAD), up 7 positions from the last year – the favorable legislative framework and the flat tax rate of 16% have been the main reasons for these changes.
- Moody's upgraded the foreign currency long-term debt rating to Baa3 (investment grade) from Ba1.

Even so, Tab. 1 shows that Romania is still lagging behind not only the other EU-25 members, but Bulgaria as well. Valuable exceptions are:

- the *global competitiveness* – because of the Bulgarian fall by 11 positions in the 2006 rankings;
- *ease of doing business* – explained by the Romanian jump of 22 positions in comparison to only 5 for Bulgaria in 2006; a competitive advantage of the business environment places Romania on the 7th place for *starting a business*, relative to the Bulgarian's 85th. Still, the latter's better performance in innovation, getting credits, registering property, closing a business etc. is associated with a higher performance of Bulgaria in attracting the *foreign direct investments*.

Romania's economy needs major improvements on all factors that determine competitiveness

Actually, both countries have a long way towards convergence with the living standards of the most developed countries, from the size of GDP to the level of carbon dioxide emissions per capita.

[35] World Economic Forum, *The Global Competitiveness Report 2006-07*

4. Policies for increasing competitiveness

Few policy-making Romanian initiatives have been related in the last years to the sectoral competitiveness perspectives, and not a broad national approach, with rather hectic impact on the whole economy:

- *National Export Strategy 2006 – 2009;*
- *National Plan for Research, Development and Innovation 2004 – 2006, respectively 2007 – 2013.*
- *National Program to Increase the Competitiveness of Romanian Industry Products 2002 – 2005 and 2006 – present;*
- *Sectoral Plan for RDI in Industry 2006 – 2008.*

The Romanian integration to EU brings an element of relative innovation in public-policy making concerns. The preparation of coherent, comprehensive, long-term national development strategies in the EU-12, and in Romania in particular, is the first opportunity for drafting strategies linked to clear and certain resources.

Strategic target of the NDP for 2007-13: to reduce by 10% the GDP/cap gap to the EU average

One such strategy is the *National Development Plan for 2007-2013* (NDP 2007-2013), focusing on the sustained economic growth and competitiveness as the first Romanian Government's priority. Its strategic *vision relies on narrowing the GDP per capita gap relative to EU average by at least 10% in the next 7 years.* The competitiveness objective is addressed by the *National Strategic Reference Framework 2007 – 2013* (NSRF 2007-2013), which is however rooted in the NDP 2007-2013 policy-mix.

Two shortcomings of the national competitiveness strategy are obvious. *First*, it gives priority only to the public investments for development, addressing only those objectives that are compatible with the intervention areas of the Structural and Cohesion Funds. The funds to be allocated are worth 58.7 billion Euro, of with 43% are coming from the EU budget. However, this plan cannot replace a national competitiveness strategy, and this is where the Government efforts should focus in the post-accession period.

Second, if benefits are to be drawn from joining the EU, the Romanian Government should develop a much longer-term strategic vision, focusing on maintaining a high annual economic growth rate of at least 7% for the next three decades (from an average of only 5.5% during 2000-2006). This may guarantee a real catching-up with the EU in the next 25-30 years. To achieve this target, we need a more productive economy through efficient resource allocation, higher national and foreign direct investments and a high technology-based business environment.

4.1. Settings priorities

Member states are designing strategies in different policy contexts, with different priorities, and different implementation challenges. There are three broad groups of strategies identified by the *European Policies Research Centre*, depending on the main goal set by each national government:

- *convergence strategies* – EU-12 new member countries;
- *regional competitiveness strategies* - many EU-15 old member countries
- *"mixed" strategies* - Greece, Italy, Portugal, Spain.

The priorities of Romania's competitiveness strategy follow closely the characteristics of the first group of strategies. Seven sectoral instruments (Operational Programs - OPs) are called to achieve the national interlinked priorities of the NSRF with the EU. One of these is aimed squarely at boosting economic competitiveness: *The Sectoral Operational Program "Increase of Economic Competitiveness"* (SOP IEC).

Its objective is to increase Romanian economic productivity by an annual average of 5.5%, reducing the disparities to the average productivity of EU. Considering that labor productivity in European Union will increase until 2013 by an average of 1% per year, this target will allow Romania to attain 55% of EU average productivity by 2013. *This will be achieved* by concentrating efforts on ***five priority components***:

1. An innovative productive system;

2. Research, Technological Development, and Innovation for Competitiveness;

3. ITC for private and public sectors;

4. Increased energy efficiency and sustainable development of the energy system;

5. Promoting Romania as an attractive destination for tourism and businesses.

The European Regional Development Fund (ERDF) contribution to this objective, of 2.55 billion Euros for 2007-2013, represents 13.3% of the Community contribution to the Romanian NSRF. About twice as much EU funding is dedicated to the upgrade of transport infrastructure, followed closely by the environmental protection program. Regional and human resource development objectives each receive approximately 50% more funding than competitiveness (Fig. 9). Within the competitiveness objective, priority item 1 benefits from the most substantial financial allocation (31%) of total ERDF funds (Fig. 10 and 11 for sources of funding to each priority item).

The relative importance given to the competitiveness operational program through the allocations of European funds (ERDF+ESF+CF) is higher in Romania than in Poland, but lower than in Bulgaria, Estonia, Czech Republic, Slovakia, Hungary, or Latvia (Tab. 2). Ireland is mentioned as a "*best practices*" example in EU funding public management in most of the specialized studies on this issue. Its experience is outstanding in integrating community assistance within a coherent, macro-economic policy framework, supported by social consensus. The Irish have established human resources financing as a priority in the last decade, with a weight of 35% in the total structural funds, as compared to a 25% average in the other European states, for education and training (Fig.12).

Fig. 9. NSRF allocations by operational programs in Romania, 2007-13

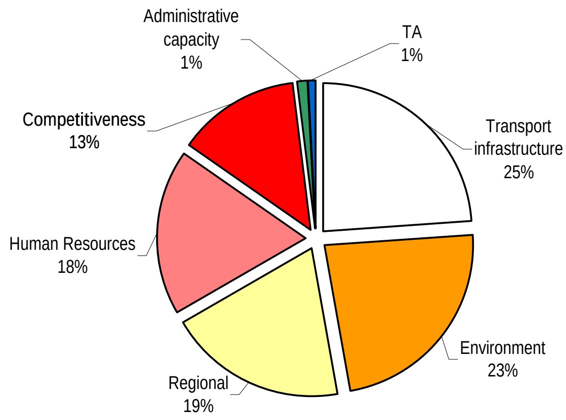
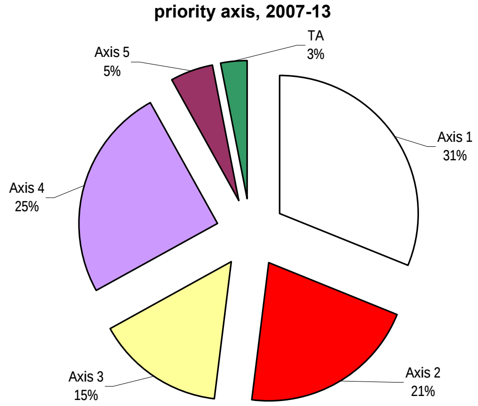


Fig. 10. ERDF funds allocation to SOP Competitiveness, by priority axis, 2007-13

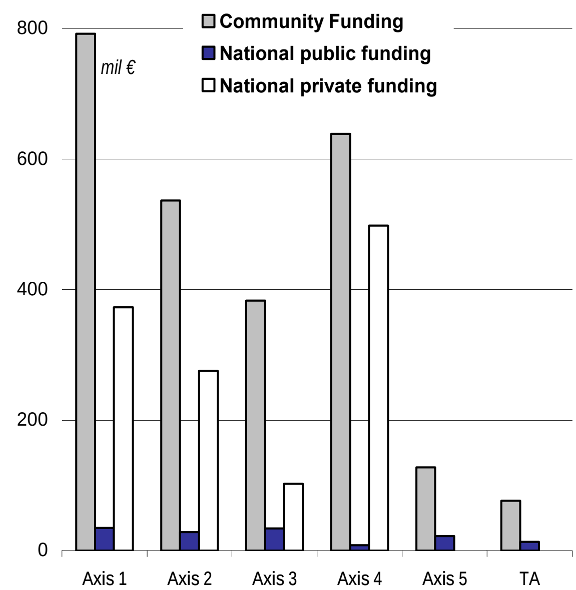


4.2. Territorial dimension of investments in innovation

The competitiveness sectoral program does not focus the priority-settings and financial efforts on poles of growths, nor on disadvantaged, urban or rural arrears, despite the Romanian peculiarities (relevant endowments with agricultural, natural resources and tourism potential, huge gaps in regional distribution of income, enterprises, research and development capacity, the dominance of rural social challenges etc.). The capacity of the regions to develop and implement innovation policies depends not only on their own strengths and weaknesses, but also on the diversity of the national regulatory environments and on the extent of co-operation between the major stakeholders at this level.

Actually, direct grants to enterprises are the most important Romanian approach to improve their capacity in RDI absorption.

Fig. 11. SOP Competitiveness, by source of funding, 2007-13



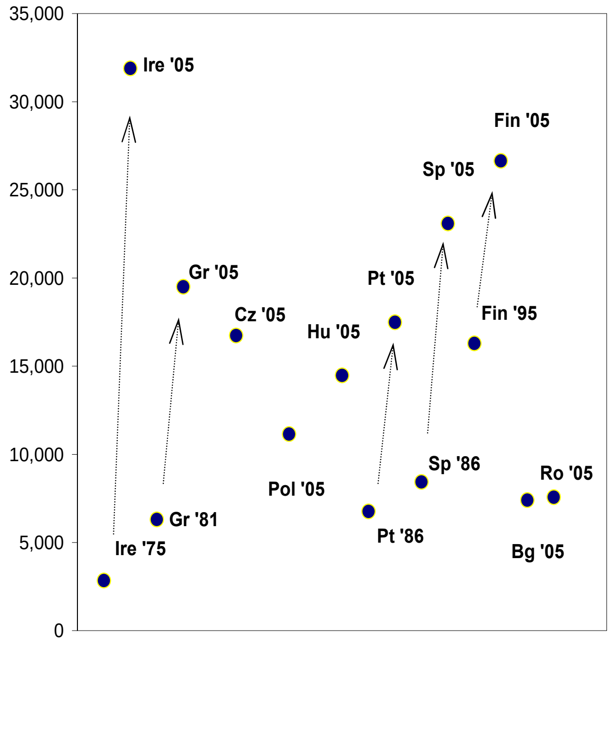
The Government's motives for this course of action reside in the fact that the entire territory of Romania is under the convergence objective and this strategy is in accordance with the European guidelines' proposals. This approach is also extended to the energy, traditional and SMEs sectors that are facing global competition, and must therefore make additional efforts to remain competitive.

Tab. 2. National allocations of EU funds for competitiveness, 2007-13

	Total funds, bn€	Out of which for competitiveness	
Pol	55.3	*12.7%*	Economic competitiveness
Ro	19.2	*13.3%*	Economic competitiveness
Bg	5.9	*14.2%*	Competitiveness
Est	-	*14.8%*	Entrepreneurship - 13,7%
			Research and development - 11%
Cz	26.6	*18.0%*	Entrepreneurship and innovation - 12%
			Research, development and innovation - 6%
Lv	4	*19.2%*	Competitiveness and knowledge economy
Sk	10	*20.8%*	Innovation and knowledge-based economy
Hu	24	*31.3%*	Economic competitiveness, including here-in the 20% allocated to transport

Source: Data from the CEE Bankwatch Network, March 2006

Fig. 12. Economic growth after accession
GDP, €/cap at PPP



Direct support is combined with several actions reinforcing business support services, in both the supply and the demand sides, in order to foster entrepreneurship and R&D activities and promote the information society. The need for infrastructural endowments in remote areas (for ITC) and interconnections (for energy) is also particularly emphasized if Romania is to become a more attractive place to invest and work. At the European level different approaches envisage a territorial dimension. Some countries focus on:

- *areas of potential – growth poles, competitiveness poles and excellence poles*: e.g. Austria, Czech Republic, Greece, France, Italy, Netherlands, Poland;
- *disadvantaged areas*, with preferential allocations or criteria: e.g. Czech Republic, Latvia, Poland, Slovakia;
- support for *specific types of territory*: (i) urban areas such as city regions (UK), urban districts (Czech Rep), major urban areas (Belgium, Finland), cities and urban systems (Italy), gateway towns (Ireland), sustainable urban centers (Greece); (ii) rural areas (Czech Rep, Greece, Poland, Spain); (iii) peripheral areas (Finland, France); (iv) islands (Malta);
- *territorial, multi-regional operational programs* (Greece, Hungary, Poland, Romania).

Therefore, there is no single "*miracle strategy*" to make economies more innovative. The key European Commission recommendations for the next programming period (2007-13) are[36]:

- To identify a limited number of priorities for regional innovation policies, where the region can develop a competitive position;
- To focus support more on the demand than supply side of innovation;
- To balance the technology focus with other forms of innovation;
- To invest sufficiently in human capital;
- To ensure better co-ordination of innovation policies.

Overall, the implementation responsibility rests with the Managing Authority of the Competitiveness Operational Program,

[36] European Commission, Directorate General Regional Policy: *Innovation in the National Strategic Reference Frameworks*, 31 Oct 2006

within the Ministry of Economy and Trade. It has to remain constantly alert to ensure that the directives set out in the National Strategic Reference Frameworks are actually implemented. There is also a further need for actions at the operational level:

- To establish transparent and efficient selection systems for projects to be funded;
- To introduce a degree of flexibility and risk in policy planning;
- To improve the monitoring and evaluation culture to increase the value-added of interventions.

Competitiveness must also become a bottom-up process. The central Government is the only driving the policy proposals, decisions and incentives. Roles and responsibilities must be decentralized, so that Romanian economic development relies on a collaborative process, involving government at multiple levels, companies, teaching and research institutions, and other institutions. Individuals, companies, and institutions should undertake this responsibility.

5. Policy recommendations

Efficient use of European Funds for improving the business competitiveness. The use of Structural and Cohesion Funds in improving the business competitiveness is subject to shifting priorities at the European level that must be taken into consideration. There has been a de-emphasis of general business investment support (often through grant schemes), especially for new start-ups and SMEs; provision of premises, creation or equipping of business centers; or site (re)development / rehabilitation,

… towards more support for:

- inter-firm cooperation / business networks;
- advisory/counseling services to business (esp. strategic planning, internationalization);
- integrated, multi-service business support within business centers;
- targeted start-up support (university graduates, young entrepreneurs, women, innovative activities, employment-intensive growth areas);
- micro-enterprises' and community enterprises' access to finance.

These are part of long-term trends in regional policies.

Efficient use of European Funds for more and better jobs. There is a shift from general skills-based training measures (employed / unemployed); sector-specific training programs; or investment in the training infrastructure;

… towards more support for:

- targeted training on specific groups – i.e. women, youth, disabled, immigrants;
- development of new training methods (ITC teaching techniques, distance learning, Human Resource Development management);
- training related to innovation and ITC.

Efficient use of European Funds for innovation and the knowledge economy. Assistance is moving from investments in Research – Technology - Development Infrastructure (RTDI) - science parks, technology centers, university facilities; or incentives for business R&D and innovation; or business-research links;

… towards more support for:

- integrated support (regional innovation system approach) – research services, entrepreneurship, training, business advice;
- broadening of business-research links towards innovation networks;
- ITC access/use by businesses (e-commerce), communities, public sector;
- access to specialist finance (risk capital, venture capital, seed capital);
- environmental RTDI;
- human capital – training of researchers.

Efficient use of European Funds for environmental sustainability. While significant support is still needed for environmental infrastructure projects (e.g. waste-processing); clean-up and rehabilitation of derelict / contaminated sites; or protection / enhancement of areas of ecological interest;

… support will shift towards:

- company-based environmental and energy management,
- development of green areas, outdoor space, natural parks, protected areas;
- investment in renewable energy sources;

- sustainable development management/monitoring projects;
- preservation of biodiversity / wildlife.

Romania needs to improve its competitive standing and become one of the top 30 in the global rankings. National public and private funds should accompany the European support for improving the competitiveness factors. It may not be possible to excel in every indicator. But government policies should adapt the development strategies by managing not only the domestic resources and competencies, but also by adapting to global changes. This will mean adopting the worldwide *best practices* for each competition factor that may be improved. Raising competitiveness will bring improvements in international rankings and, more importantly, deeper integration with the developed economies.

There should be a deliberate effort in the direction of higher added value. Rather than try to win back low-wage and low-skill assembly jobs, Romanian Government should undertake three essential steps to further the economic development:

- encourage the transition to higher-value-added activities,
- identify and exploit our comparative advantage (e.g. highly educated and moderately paid Romanian scientists and engineers), and
- push forward with reforms that create more competition, entrepreneurship, and flexibility.

The expansion into higher-value-added activities comes not from a shift into entirely new industries, such as high tech, biotech, or nanotech, but from the natural evolution of companies within existing industries[37].

As low-skill, labor-intensive operations head elsewhere, Romania should resist the temptation to try to lure them back with tax breaks or other financial incentives. Such initiatives are not likely to influence foreign investment significantly and won't compensate for rising wage rates over the longer term. In some cases they can lead to counterproductive overinvestment. Instead Romanian Government might use the funds to improve the transportation networks, the power grids, and the telecommunications lines. A strategic direction should focus on capturing in Romania to a larger extent the new wave of the outsourcing in high value added manufacturing, in research and development, as well as in shared services moving to the CEECs. Beyond that, policy makers must boost competition in the broader economy so that companies are compelled to improve their operations, to adopt best practices and to innovate. Predicting changes in the business sectors is also to become an integral and explicit step in public policy making.

Create a Romanian Competitiveness Institute (RCI). This should become a think-tank, based on a public-private partnership, focused on the current and forthcoming economic policies[38]. It should build capacity in order to address the following questions in a meaningful way, and assist decision makers with informed policy options:

- What is the impact of current policies on the Romanian economy competitiveness?
- What roles should the country play in the European internal market?
- What unique or specific values can we provide for a business location?

[37] In northern Italy's textile and apparel industry, for example, the majority of the garment production has moved to lower-cost locations, but employment remains stable because companies have put more resources into tasks such as designing clothes and coordinating global production networks. A similar trend is discernible in other developing countries: companies start in the simple, labor-intensive industries, and move up the ladder as they gain enough experience, into more profitable areas, such as marketing, product design, and the manufacture of complex inputs.

[38] Some countries have national competitiveness councils. Ireland (1997), Greece (2003), Croatia (2004) and the Philippines (2006) are just some examples that have advisory bodies or special government agencies that tackle competitiveness issues. The latter came into being under the initiative and financial support of the Philippine Exporters Confederation - the country's biggest business group, as part of the national action agenda to make it easier for business to operate efficiently.The older Irish National Competitiveness Council uses a *Competitiveness Pyramid* structure to simplify the factors that affect national competitiveness. It distinguishes in particular between *policy inputs* in relation to the business environment, the physical infrastructure and the knowledge infrastructure and the *essential conditions* of competitiveness that good policy inputs create, including business performance metrics, productivity, labour supply and prices/costs for business.

- For what range or types of businesses and functions can Romania be competitive?

The Romanian Competitiveness Institute should also become a central facilitator of the regional co-operation on competitiveness. The action plan should not be too sophisticated. We cannot however omit the huge need for developing a competitiveness research database and for case studies and international reports analyses. Last, but not least, RCI members should to undertake education and training programs, especially in microeconomic of competitiveness and public policy courses, exploring customized programs from European governments, while also looking to those from the USA, ASEAN or other countries. The necessary conditions for RCI success are: a strong leadership; world class research; clear intellectual framework; inclusiveness; permanence and independence.

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