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**Study on the Potential and Needs of the  
New Member States Country report:  
Romania**

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Institute of National Economy

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# **Study on the Potential and Needs of the New Member States**

## **Country report: Romania**

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## **NOTE**

This study was drafted in order to assess how Cohesion policy funding in 2007-2013 can assist New Member States to engage with the main developmental challenges and opportunities that they face. The study provided separate conclusions and recommendations for Romania on the main dimensions of Cohesion policy strategy building. The Study was carried out with the European Policies Research Centre, at the University of Strathclyde in Glasgow, UK in 2005.

Final editorial intervention was undertaken by the European Policies Research Centre, at the University of Strathclyde in Glasgow, UK

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## **ACRONYMS**

CEE	Central and Eastern Europe
CRP	Regional Committees for elaborating Regional Development Plans
CVT	Continuous Vocational Training
EDIS	Extended Decentralized Implementation System
ESC	Economic and Social Cohesion
FDI	Foreign Direct Investment
GHDR	Global Human Development Report
HDI	Human Development Index
HRD	Human Resources Development
ICP	Inter-Institutional Committee of NDP elaboration
IE	Interim Evaluation
IEN	Institute for National Economy
IFIs	International Financial Institutions
MIE	Ministry of European Integration
NDP	National Development Plan
NEP	National Employment Plan
NES	National Evaluation System
NHDR	National Human development Report
NVTP	National Vocational Training Plan
RDA	Regional Development Agencies
SME	Small and Medium Enterprises
TI	Transparency International
TEN	Trans European Network
VET	Vocational Education Training
WB	World Bank

## **EXECUTIVE SUMMARY**

This study provides an overview of the developmental challenges and opportunities facing Romania and relates these to an analysis of the issues to be addressed by the future EU co-financed Cohesion policy strategy in 2007-2013.

The report argues that the main focus of future Cohesion policy should be on constructing and enhancing public infrastructure, particularly in the field of transport networks. Romania's current connections with EU markets are of poor quality, thus acting as an obstacle to business development, trade and the attraction of foreign direct investment. As well as enhancing the Romanian sections of relevant Trans-European Networks, there is also a need to ensure effective linkages to these networks.

There are further investment needs in other areas of infrastructure, such as water and waste water systems, education and training facilities, and IT infrastructure and equipment. Other types of support needed relate to improvements to the productive context for business activity, and investment in human and knowledge capital. Further weaknesses relate to institutional capacity.

As well as considering the appropriate ranking and sequencing of EU Cohesion policy funding in order to maximise socio-economic benefits in 2007-2013, the report also explores potential interactions between different categories and sub-categories of Cohesion policy expenditure, for example between the global goals of economic growth and environmental sustainability.

A further set of issues considered relates to the dual challenges facing Romania in terms, on the one hand, of the importance of facilitating national catching up with EU levels of development and, on the other hand, of limiting the emergence of more acute interregional disparities in terms of GDP per capita and unemployment rates.

The report also explores the various ways in which the domestic policy context can condition the effectiveness of Cohesion policy strategies. This covers not only the need for policies that ensure macroeconomic stability, as well as sufficient availability of domestic co-financing for Cohesion policy programmes and projects, but also the regulation of the labour market and the business context.

Finally, the report examines the extent to which Romania is characterised by institutional weaknesses that act as serious obstacles to economic development, and whether Cohesion policy could help policy-makers to overcome any such obstacles, for example by investing in institutional capacity.

This report was drafted by Dr. Victor Platon, Dr. Valentina Vasile and Dr. Florin Marius Pavelescu from the Institute of National Economy, part of Romanian Academy.

## 1. INTRODUCTION

This study aims to assess how Cohesion policy funding in 2007-2013 can assist Romania to address the main developmental challenges and opportunities that it faces.

As Romania is still a Candidate Country, Cohesion policy has not yet been introduced, although preparations are underway to set up the necessary plans, structures and legislation. Because these changes are still ongoing, it has not always been possible to find all the data requested, so that some dimensions of the report rely on qualitative rather than quantitative assessments.

In our view, the future Cohesion Policy strategy in Romania should take into account the following major issues:

First, there are serious challenges in relation to transport and environmental infrastructure. Significant investment will be needed over a long period of time and will be of critical importance in providing conditions that are conducive to economic growth and job creation.

Second, there is a need to enhance the functioning of the labour market, in order to facilitate labour supply in support of economic growth and also to ensure that the appropriate incentives are in place to allow for an expansion of employment opportunities.

Third, regional disparities are currently not so high in Romania. It is expected that the whole of Romania would be eligible for future Objective 1 / Convergence status. The main priority should be to ensure that conditions are in place to allow for regional economic development, rather than focusing on redistributing funds between regions. However, geographical disparities may increase in future, so that steps may be needed to address the possible resulting imbalances.

Fourth, institutional instability and frequent legal changes have created difficulties in building a stable and well-coordinated administrative structure for undertaking the work of drafting the Cohesion Policy strategy. More broadly, these difficulties have also prevented the creation of a well-trained body of civil servants. In the future, EU Cohesion Policy support may facilitate a degree of stability in the administrative structures.

## 2. MAIN CHALLENGES AND OPPORTUNITIES

Romania's successful accession to the European Union will depend, among other factors, on achieving a sustainable high rate of economic growth, as well as ensuring social cohesion and improvements in environment quality. The main opportunities and challenges for EU Cohesion Policy in 2007-2013 are as follows:

- a) to ensure macroeconomic stabilization;
- b) to strengthen the institutional framework;
- c) to improve human capital utilization;
- d) to provide comprehensive incentives for research and development activities;
- e) to facilitate adequate capital accumulation; and
- f) to achieve well-balanced regional development.

### 2.1 Levels of GDP per capita and economic growth

#### 2.1.1 GDP Evolution

In the last 15 years, Romania's economic evolution has been strongly influenced by external changes and the EU accession process. The implementation of market economy rules and other external shocks triggered a first phase of structural change, as in all the central European economies. In the 1990-92 recession, the level of real aggregate GDP fell by 25.9 per cent compared to the level in 1989, due to a reduction in domestic consumption (-12.8 per cent) and net exports (-9.0 per cent). Between 1993 and 1996, however, the level of GDP increased by 17.4 per cent, with economic growth in 1993-94 fuelled mainly by a rise in net exports (not least due to increased exports of intermediate goods to Western Europe) and in 1995-96 by growth in domestic demand. However, the process of industrial restructuring was postponed during this period of economic growth and this led to a deterioration in prospects for ongoing development. Hence, the economy faced a second phase of structural change with the 1996-99 recession, when the level of GDP decreased by 11.7 per cent. In this period, gross fixed capital formation fell (-11.7 per cent), as did final consumption (-4.2 per cent), although net exports remained positive. Since 1999, there has been continuous real GDP growth, with annual rates of between 4.9 per cent and 8.1 per cent. Thus 2004 was the first year when the real level of GDP was higher (by 0.2 per cent) than the 1989 level. The main contributor to economic growth in 1999-2002 was gross capital formation (+10.5 per cent),<sup>1</sup> but since 2003 growth has mainly been fuelled by domestic consumption, leading to an increase in the trade deficit.

GDP per capita has increased more rapidly than the level of aggregate GDP due to a continuous fall in population, as a consequence of a clear change in demographic behaviour. The level of GDP per

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<sup>1</sup> Update of computations by F. M. Pavelescu - Correlation between domestic demand and exports dynamics, in *Romanian Revue of Economics no.2/2003* (in Romanian)



capita in 1992 stood at 76.2 per cent of the 1989 average, rising to 90.2 per cent in 1996, before falling again to 79.7 per cent in 1999, and rising to 98.4 per cent in 2003. Despite this trend, the level of GDP per capita in Romania is only around 32 per cent of the EU average in purchasing power parities. Compared to the other candidate countries, the level of GDP per capita in Romania in 2004 was higher than in Bulgaria (30 per cent) and Turkey (29 per cent) and lower than in Croatia (46 per cent).<sup>2</sup> The gap vis-à-vis EU Member States, however, is considerable, with Romania's GDP per capita 7 times lower than in Luxembourg, 3.5 times lower than in France, 3 times lower than in Spain, 2.5 times lower than in Greece and 1.5 times lower than in Lithuania.

In conclusion, we can note that Romania's economy has demonstrated potential for economic growth under the conditions of a market economy and international openness to trade. In general, there is a good basis for ongoing growth in coming years, although there are potential risk factors relating to the size and growth of the trade and current account deficits.

### ***2.1.2 Inflation and internal deficits***

The past fifteen years of structural economic change have been characterised by persistent inflation and budgetary deficits. Inflation rates (measured by the annual consumer price index) have varied, depending on the characteristics of the reform process. In 1990, consumer prices grew by 5.1 per cent, but in the following four years inflation rose to three digit figures. In 1995 and 1996 inflationary pressures decreased significantly, but there was a further price shock in 1997, partly due to the last stage of price liberalization. This led to an annual inflation rate of three digits (154.8 per cent). Since then, the consumer price index has decreased continuously, but remains the highest estimated to be around 8 per cent in 2005.

While price liberalization was one factor that fuelled inflation, others were internal and external deficits. The general government balance showed a surplus only in 1990 and 1991 and since then the State budget has shown moderate but continuous deficits, ranging from 0.4 per cent of GDP in 1993 to 4.6 per cent in 1992. In contrast, the current account deficit has tended to increase annually but was at its maximum (relative to GDP) in 1990 when it stood at 8.7 per cent of national GDP. The National Bank has aimed to reduce inflationary pressures during the process of price liberalization but has also endeavoured to provide conditions conducive to economic growth, particularly when inflationary pressures have diminished significantly.

## **2.2 Labour markets, human capital and employment**

The introduction of free market rules has led to significant changes in the economy. One important effect has been a continuous decrease in employment (from 10,945 million people at the end of 1989 to 8,306 million at the end of 2003), mainly due to industrial restructuring. Moreover, the reduction in domestic demand between 1990 and 2000 reduced the capacity of the service sector to create new employment. The process of land restitution has meant that the agricultural sector has provided employment opportunities and low qualified jobs for many people who lost their jobs in industry. By

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<sup>2</sup> Source: EUROSTAT News Release No.75/2005

the end of 2000 the number of people employed in agriculture was 3,570 million, representing 41.4 per cent of total civil employment.

New employment trends have emerged since 2000, when the number of workers in agriculture started to fall, reaching 2,884 million at the end of 2003. However, the share of agriculture in total employment remains very high at 34.8 per cent, and represents an important challenge for Romania in light of future accession to the EU. Significant industrial growth in 2000-03 has led to the creation of significant numbers of new jobs – although other jobs continue to be lost in industry, so that its share in total employment in 2003 was 24.7 per cent. New jobs have also been created in the construction and service sectors. The percentage of total employment in the construction sector grew from 4.1 per cent in 2000 to 4.8 per cent in 2003, while the share of employment in services increased from 31.3 per cent in 2000 to 35.7 per cent in 2003. Employment in the sub-sectors of producer services and real estate has increased continuously. However, employment in services remains low in comparison with other European countries. The excessive weight of agriculture in total employment significantly influences the professional structure and is a key reason, for example, for the low level of people employed in non-manual professions (white collar) - only 31.1 per cent of total employment according to the Labour Force Survey for 2003.

An analysis of the education level of workers reveals that 10.4 per cent of people had tertiary level education in 2003; 4.3 per cent had specialized post high school or technical foreman education; 30.5 per cent had high school education; 24.7 per cent had vocational or apprenticeship education; and 21.2 per cent had secondary school education. The educational structure of the employed population varies significantly by age group. A comparison between the age groups of 25-34 year olds, 35-49 year olds, and 50-64 year olds shows that the proportion of employed persons with at least high school education increases in younger age groups. This is a consequence of the clear increase in the number of universities and students since 1990, leading to notable improvements in the quality of human capital. Moreover, 2005 has seen the beginning of a reform of the higher education system aimed at ensuring compliance with European trends. Some problems still remain in relation to the training system, not least the need to provide a life-long-learning system.

The constant decrease in the number of employed people has not led to an increase in the unemployment rate, especially in the last 5 years.<sup>3</sup> Since 1999, the male unemployment rate has been higher than the female unemployment rate due to strong industrial restructuring in 1997-1999, as well as a reorientation of labour demand, with increased demand for workers in professions where women are more strongly represented. At the same time, there has been a strong decrease in labour supply due mainly to the growth of the inactive population and an increase in external migration to EU countries. As a result, the participation rate decreased from 63.4 per cent in 1999 to 54.8 per cent in 2003 – well below the target set in the European Employment Strategy.

### **2.3 Upgrading physical infrastructure**

Crises in the centrally planned economy meant that the process of structural change that has occurred since the late 1980s has taken place in a context of obsolete physical infrastructure. As

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<sup>3</sup> The registered unemployment rate at the end of the year was 11.6 per cent in 1999 but fell constantly to 6.8 per cent in 2003 (calculated from the Statistical Yearbook of Romania 2004).

compared to other European countries there was and still is a clear gap in terms of the length and quality of public roads, motorways, environmental infrastructure etc. One of main targets of government economic policy (supported by various EU programmes) is to modernize physical infrastructure, leading to a 7.8 per cent rise in the length of public roads in 1998-2003. Compared to EU Member States, Romania's transport infrastructure is insufficiently developed to meet current needs. For example, Romania will have to build 1,100 Km of TEN-motorways at a cost of around €23 billion. To this should be added the rehabilitation of 9,500 Km of national and county roads at a cost of around €7 billion.

The length of railways rose by 67 km between 1998 and 2003. In 2003, electrified railways represented 35.8 per cent of total track length. Normal gauge lines represented 98.8 per cent of total length, of which 72.0 per cent was single-track and 26.8 per cent was double-track.

Some positive evolutions were recorded in relation to distribution networks for natural gas and drinking water. The number of localities provided with natural gas supply increased from 993 in 1999 to 1,221 in 2003, while the length of natural gas distribution pipelines grew from 20331 km at the end of 1999 to 23,917 km at the end of 2003. The number of localities with drinking water supply networks stood at 2,997 at the end of 1999 and at 3,375 at the end of 2003, while the simple length of drinking water supply network was 37,417km at the end of 1999 and 42,263 km at the end of 2003.

With respect to power consumption, this increased from 1,621 tones of oil equivalent per inhabitant in 1999 to 1,796 tones of oil equivalent per inhabitant in 2003, that is by 10.3 per cent. If we take into account the increase of 23.4 per cent in the level of GDP per capita in the same period, this implies a significant decrease in energy intensity, due to industrial restructuring and measures aimed at rationalizing power consumption.

By the end of 2004, there were 20.2 fixed phone lines per 100 inhabitants, while the digitalization rate had risen to 77.2 per cent. The number of fixed phone users was 4,389 millions, around three quarters of whom were in urban areas. The market for fixed phone lines was privatized in 1998 and this market has now been liberalized, although it is still dominated de facto by the ex-state operator (ROMTELECOM) which owns 98.8 per cent of contracts. In 2004 the number of subscribers to alternative fixed line providers increased from 9,000 to 67,000.

The mobile phone market saw rapid dynamic development between 2001 and 2004, so that at the end of 2004 the number of users was 10.2 million. There are now four operators but the market is dominated by 2 firms (Mobifon and Orange), each of which has a market-quota of 48 per cent. Although the number of mobile phone lines users is more than three times higher than that of fixed phone lines users, the fixed phone system accounts for 57.4 per cent of total traffic.<sup>4</sup>

There are four PCs per 100 inhabitants (compared to 13 in Central and Eastern Europe). A programme has been set up to establish information centres that allow citizens to gain access to ICT. Statistical analysis shows that 69 per cent of PCs are used in the public administration, banks, insurance societies, financial services, and in industry, while the remainder are used in private households.

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<sup>4</sup> National Agency for Radio-communications. Statistical Report for 2004.

In the field of environmental protection Romania has more difficulties to overcome than some other Central and Eastern European countries. According to a study by the World Bank, around €29.7 billion is needed to implement the EU's 17 environmental directives. Thus the task of identifying financial sources for environmental investment has become one of the main targets of the public authorities.<sup>5</sup>

International experience in both from developed and developing countries, as well as studies based on endogenous economic growth models, demonstrate that in a context conditioned by the use of new information technologies, adequate infrastructure is a prerequisite for long-run economic development. In Romania, higher investment in infrastructure would stimulate a better use of indigenous capacities in economic sectors such as construction, create new job opportunities and enhance the efficiency of communications between economic agents.<sup>6</sup> Moreover, infrastructure upgrades would create the basis for a positive stimulus on the supply-side, by facilitating an upward shift on the learning curve in the field of technological and organisational change. In other words infrastructure upgrading is needed to achieve gains in total factor productivity.<sup>7</sup>

## 2.4 Research, technological development and innovation

The process of structural change has had negative consequences for the national research system, technological development and innovation especially in the early 1990s. Industrial restructuring in 1996-1999 also had negative effects on R&D because business demand for research products and services declined sharply. The recovery of economic activity since 1999 has not led to an increase in total R&D expenditure, which as remained around 0.4 per cent of GDP. Business R&D expenditure was 0.3 per cent of GDP in 1999 and 0.23 per cent in 2003, governmental R&D expenditure was 0.07 per cent in 1999 and 0.13 per cent in 2003. The level of R&D expenditure relative to GDP is lower than in all EU Member States except Cyprus (0.32 per cent).<sup>8</sup>

The number of employees in the R&D sector fell from 148,513 in 1990 to 37,241 in 2000, although employment has since risen slightly to 39,985 in 2003 (or 0.48 per cent of total employment).<sup>9</sup> Despite their small numbers, these workers are important for Romania's ongoing development because of their high levels of skills. The evolution of R&D activities in the near future could be hampered by the

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5 The World Bank study estimated the following investment needs in 2004-2015: water sector = €8.022 billion; air quality = €2.78 billion; waste management = €7.16 billion; industrial pollution prevention = €4.15 billion; other = €3.34 billion. Romania is aiming to manage these costs by mobilising investment from diverse external and internal sources, and has also been granted temporary derogations from the urban water quality directive (Council Directive 91/271/EEC).

6 Public investment in infrastructure should also stimulate indirectly capital accumulation through two channels a) a shift in business expectations on the effects of increasing the share of gross fixed capital formation in GDP and b) increasing public saving. The IMF Country Report No.03/12 (January 2003) stated that: "Given Romania's prolonged capital scarcity, capital accumulation could become the major driving force of growth...(and)...Restructuring in the public sector and public investments in infrastructure in preparation for EU accession should consolidate investment growth and narrow the gap between Romania's investment rate and that of other more advanced transition countries."

7 S. Syrett - Local development - Avebury Ashate Publishing, Limited, Adershot, 1995, cited in F. Pavelescu-Transformation of economy and labour market disequilibria, IRLI Publishing House, Bucharest, 2003 (in Romanian).

8 Data published by EUROSTAT (Statistics in focus-Science and Technology No.6/2005) show clear regional disparities in R&D expenditure because funds tend to focus on economic clusters and on the most developed regions of different countries.

9 Compared to an EU average of 1.44 per cent.

ageing of research staff, so that efforts are needed to attract younger university graduates into the R&D sector, in order to maintain its contribution to the innovation process in industry and services.

In 2000-2002, 16.9 per cent of businesses were classified as innovative. Most innovation expenditure is allocated to equipment and apparatus acquisition (53 per cent of the total in 2002), with a further 25 per cent on R&D activities 25%, seven per cent on knowledge acquisition from outside units, and the remaining 15 per cent on staff training, introduction to the market of innovated products, design and other preparatory activities. About 60 per cent of the total number of innovative firms adopted strategic or organizational changes for innovation.<sup>10</sup> At the same time, 22 per cent of the total firms were involved in different form of cooperation.

## **2.5 Business, trade and FDI**

### ***2.5.1 The increasing role of small and medium sized enterprises***

The shift to a market economy system not only led to changes in sectoral structure but also in the size of economic agents. Small and medium sized companies increased their role in the economy, partly due to the restructuring of many large industrial enterprises which led to the emergence of firms that could be classified as medium-sized. Moreover new firms were created as the result of entrepreneurial initiative.

Consequently, in 2002 small and medium-sized enterprises employed 51 per cent of the total number of employees, and generated 43.8 per cent of value-added at factor cost, 39.8 per cent of gross investment, 56.1 per cent of total turnover and 24.5 per cent of direct exports. The importance of this type of firm is increasing as private initiative responds to improvements in the business environment. As compared to the situation in countries with consolidated market economies, the small and medium-sized firm sector in Romania seems to be more fragile, hence the importance of coherent support from Cohesion policy. Public investment in support infrastructure for entrepreneurial initiative and technology transfer could stimulate the innovative potential of SMEs.

Among many factors supporting rapid SME development is the growth in access to and use of Internet facilities. Although broadband and ISDN connections have grown at an impressive rate (to 52 per cent of businesses in 2004, compared to the EU average of 89 per cent), the proportion of enterprises currently using the Internet lags significantly behind the EU average. There are clear differences depending on firm size, with only 50 per cent of SMEs but 90 per cent of large firms using the Internet (compared to the EU average rates of 89 per cent and 99 per cent respectively).<sup>11</sup> At the same time the number of Internet connections practically doubled in 2004, with broadband connections showing more rapid growth than narrow band connections. This evolution indicates further potential demand for information technology use in households and businesses alike. In recent years small IT companies have emerged, which suggests that there are real opportunities for the take-off of the ICT sector in Romania, that could reduce the gap vis-à-vis the most advanced EU countries.

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<sup>10</sup> Calculated from the Statistical Yearbook of Romania 2004).

<sup>11</sup> Internet usage by individuals and enterprises, EUROSTAT Statistics in focus no18/2005.

### **2.5.2 Foreign direct investment**

The recovery of the Romanian economy in the last five years has taken place in conditions of increased foreign investment flows. In the first eleven months of 2004 the volume of foreign investment in Romania was 2,158 million euro, which is 40 per cent higher than in the whole year of 2003. As a result, the total stock of foreign direct investment was around 10 billion euro by the end of 2004. In terms of sectors, 53 per cent of foreign direct investment is in industry, 17.9 per cent in services, 8.9 per cent in wholesale trade, 7.8 per cent in transport, 7.2 per cent in retail trade, 2.0 per cent in tourism, 2.0 per cent in construction and 0.9 per cent in agriculture.

The Romanian public authorities aim to attract foreign investors mainly by means of two approaches: a) improving the business environment by granting special facilities for investment projects over 10 million euro and simplifying red tape related to the registration and operation of economic agents and b) improving the marketing of Romania's advantages and opportunities for inward investors.

## **2.6 Geography**

Romania is situated at the Eastern extremity of the EU and this peripheral position, exacerbated by poor transport infrastructure, has led to difficulties in accessing EU markets, as well as higher transport costs for exported goods. Nevertheless, there is potential for the harbour of Constanta and the Danube–Black Sea channel to create a direct connection from the North Sea to the Black Sea.

There are some developmental differences between Romania's eight regions (see Table 1). Region 8 was the only one that showed a positive growth rate (+4.34 per cent); all other regions, except Central and West Region, recorded negative growth rates in the period 1993-2002. Region Central and West recorded very small growth rates.

The gap between the Bucharest-Ifov region and the other regions is underpinned by clear sectoral differences (i.e. a dependence on services and manufacturing rather than agriculture), as well as differences in endowments of physical and human capital. In 1993-2002, the hierarchy between regions with respect to GDP per capita did not change significantly. The regions with a relatively low level of GDP per capita have a "fragile" economic structure and are the hardest hit during recessions, yet do not have the capacity to catch up during phases of economic recovery.

**Table 1. Level of GDP per capita at the regional level in comparison with the national average (1993-2002)**

REGION	GDP per capita - National average = 100 per cent -				Percentage change	Annual growth rate
	1993	1996	1999	2002	2002/1993	per cent
1. NORTH-EAST	80.5	80.0	73.9	71.5	89	-1,18
2. SOUTH-EAST	99.4	100.9	92.7	85.8	86	-1,46
3. SOUTH	103.9	91.7	83.3	80.0	77	-2,58
4. SOUTH- WEST	82.0	89.5	89.8	79.9	97	-0,26
5. WEST	106.5	105.7	115.5	108.3	102	0,17
6. NORTH- WEST	97.1	92.8	96.1	94.1	97	-0,31
7. CENTRAL	104.2	112.3	106.9	108.0	104	0,36
8. BUCHAREST- ILFOV	136.2	142.6	170.7	208.2	153	4,34

Notes: Regional GDP data were revised in 1993 and 1996.

Source: Romanian Yearbook of Statistics. 1999-2004

If these trends continue, some “islands” of relative prosperity could emerge, close to areas facing difficulties in assimilating the technological capacities and social capital needed for sustained economic growth. This should be taken into account in the Cohesion policy strategy.

At national level, GDP has grown continuously since the recession of 1996-1999. This level has been exceeded in Bucharest-Ilfov region (Table 2), while the Central Region has had a GDP annual growth rate that has been close to the national average<sup>12</sup>. In the other regions the economic activity recovery has been slower. Compared to the 1999 level, the level of GDP in 2002 was 9 per cent higher in the North-East Region, South Region and North-West Region, but less than 6 per cent higher in the South-East Region, South-West Region and West Region.

<sup>12</sup> In 1999-2002, the GDP growth rate was 4.34 per cent at national level, 3.57 per cent in North-East Region, 1.9 per cent in South-East Region, 2.97 per cent in South Region, 0.43 per cent in South-West Region 1.57 per cent in West Region, 4.37 per cent in Centre Region and 11.29 per cent in Bucharest-Ilfov Region.

**Table 2. Indices of GDP, employment and labour productivity at national and regional level in Romania in the period 1999-2002**

**1999 = 100**

Region	GDP index	Employment index	Labour productivity index
Romania	113.6	98.9	114.8
North-East Region	111.1	94.6	117.4
South-East Region	105.8	95.2	111.1
South Region	109.2	94.3	115.8
South-West Region	101.3	92.0	110.1
West Region	104.8	104.5	100.3
North-West Region	110.8	98.8	112.1
Central Region	113.7	98.1	115.9
Bucharest-Ilfov Region	137.9	125.6	109.8

Source: Romanian Yearbook of Statistics. 1999-2004

In terms of employment dynamics, there has been jobless growth at national and NUTS-2 level, especially in the North-East, South-East, South and South-West regions. The exceptions are represented by the two most developed regions (Bucharest-Ilfov and West) where labour demand increased. As a result, labour productivity registered the most impressive growth in the North-East, South, and Central regions.

These evolutions have had some consequences for relative labour productivity at NUTS-2 level (Table 3). The value of this indicator grew only in the North-East and Centre regions. So, the ratio between the highest and lowest regional values in terms of labour productivity decreased from 268.2 per cent in 1999 at 248.2 per cent in 2002. Also, it is important to mention that, excluding Bucharest-Ilfov Region only the Central region had a level of labour productivity that was above the national average.



**Table 3. Relative labour productivity at NUTS-2 level in Romania in 1999 and 2002 (%)**

<b>Region</b>	<b>1999</b>	<b>2002</b>
North-East Region	75.7	78.2
South-East Region	95.2	92.2
South Region	83.9	84.6
South-West Region	84.8	81.4
West Region	113.7	99.3
North-West Region	89.5	87.5
Central Region	100.0	101.0
Bucharest-Ilfov Region	203.0	194.2
Ratio Maximum/Minimum	268.2	248.2

Note: Data show the level of regional labour productivity relative to the national average in 1999 and 2002. The final row shows the level of labour productivity in the region with the highest level as a percentage of labour productivity in the region with the lowest level.

Source: Romanian Yearbook of Statistics. 1999-2004

As a conclusion, Bucharest-Ilfov Region and, to an extent, the Central Region have represented the major growth engines in recent years while other regions have experienced a slower pace in growth or even negative growth. The structural weaknesses of the other regions impede the creation of the basic conditions for strong aggregate economic growth at this stage of Romania's development.

### **3. RANKING AND SEQUENCING COHESION POLICY INVESTMENT**

The effectiveness of Cohesion policy support will depend inter alia on the ranking and sequencing of funding between spending categories. Romania has significant needs in all four main categories of expenditure, which means that the choices needed on the allocation of funds are challenging. Please see Annex 2 for details of our proposal for the allocation of Cohesion policy funding in 2007-2013.

In our view, a significant percentage of EU funds (around 67 per cent) should be allocated to infrastructure, and around 15 per cent to each of human capital and business support. In order to upgrade the institutional capacity we propose an allocation of 3 per cent of total funds.

We recommend a strong emphasis on infrastructure due to the need to give a decisive impulse for solving a long-lasting problem of Romanian economy, namely the obsolescence of infrastructure. The preceding chapter argued that a sustained strategy for infrastructure development could bring significant benefits. It should also be mentioned that the floods of summer 2005 created considerable damage to physical infrastructure, and this will increase pressure for spending on infrastructure.

In contrast, human resources development has benefited from various financing schemes over the last 15 years. Moreover, the level of labour force skill in Romania is now relatively good when compared with that of more developed Member States of the European Union. This implies that the sums allocated to human resources from Cohesion policy could be smaller in relative terms.

The investment mix proposed takes into account the experience accumulated in Romania in recent years. Although there are still some distortions in the use of pre-accession instruments<sup>13</sup> such as ISPA and SAPARD, there is evidence of positive learning in these fields which should continue as interventions are extended. We have also taken into account the development of social dialogue and public-private partnerships at national and local levels which should enhance absorption capacity for EU funds. Romania has also made progress in relation to a range of EU policies e.g. on the environment, educational system reform, active labour market policies, support for small and medium enterprises, and the strategy for informational and communicational technologies development. The experience gained and improvements made in these policy fields will have a positive impact on the efficiency of financial assistance granted in the framework of Cohesion policy.

#### **3.1 Ranking different policy goals**

The clear GDP per capita gap between Romania and EU Member States means that the main objective of economic policy in coming years must be to achieve sustained economic growth, in order to facilitate Romania's integration into the EU economy. If this process is successful, it will bring benefits not only for Romania but also for the EU as a whole, as it would reduce many problems generated by poverty, illegal migration and the underground economy.

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<sup>13</sup> In some cases, the need for ISPA projects was overestimated in the rush to EU funding. This practice created unnecessary burdens for local budgets and higher tariffs than needed for services provided (in fields such as waste management, water supply, etc.).

It will, however, take a relatively long time to reduce the gap between Romania and most EU countries. A sustained strong growth rate in Romania will depend on a vigorous push on the supply side. In the context of current technological changes linked to the information and knowledge society, there is a need for investment in infrastructure modernisation in order to achieve steady long-run economic growth by enhancing access to Western markets and reducing transport costs. In Romania's case infrastructure needs are serious, and include the "classical" aspect of infrastructure (roads and railways, wastewater treatment), the "modern" aspect (telecommunication networks, broadband networks, local loop) and the "social" aspect (building schools and hospitals, environment).

One of the most important targets of economic policy has to be to facilitate an increase in the competitiveness of Romanian firms. A stronger export performance would help to limit the expansion of the current account deficit in the face of import growth stimulated by domestic demand. A consistent increase in business competitiveness would create a virtuous circle involving employment growth, a decrease in the inflation rate, and a reduction in external deficits.

Efforts are also needed to manage State budget deficits. Modernization and EU accession imply the need to upgrade physical and social infrastructure, and this in turn places significant pressures on government expenditure, thus potentially leading to budget deficit increases. Moreover, reductions in the tax burden could potentially enhance the competitiveness of economic agents. Public authorities need to identify a taxation level that does not hamper business competitiveness and, at the same time, allows for sufficient public investment in infrastructure and spending on social cohesion. Finally, in order to maintain inflation at an acceptable level, it is important to evaluate public spending choices as development proceeds. Public-private partnerships may help in achieving targets on physical and social infrastructure development.

A clear improvement in environmental quality should be a major concern for public authorities in Romania. The adoption of the *acquis communautaire* in this field brings high costs and in the short run may impede the competitiveness of firms. These expenditures could initially be financed by Cohesion policy. Later, the creation of adequate conditions for different types of public-private partnerships could represent important opportunities for business development in this field.

Attention should also be paid to the long run operation of the labour market. There is a need, first, to increase the participation rate of the working-age population, and second to ensure a clear improvement in the quality of "classical" training systems and new forms of education and training such as long life learning.

A further goal should be to keep regional imbalances at a low level. The experience of recent decades has shown that economic restructuring does not have neutral effects across all regions. The most successful regions are those with stronger entrepreneurial traditions and more flexible economic structures. The most difficult situations are encountered in areas with mono-industrial structures and high dependency on subsistence agriculture. As a consequence, regional development policy needs to be flexible depending on the area which is addressed. Also it is important to ensure a balance between actions that stimulate economic growth and the development of entrepreneurial culture on the one hand, and those promoting social inclusion on the other hand. The success of these policies would strongly depend on a visible improvement of administrative capacity at all levels.

### 3.2 The investment mix needed to maximise benefits relative to costs

Our proposals on the investment mix take into account the particularities of the Romanian economic situation and the results of Cohesion policy in existing European Union Member States. The main principle underlying these allocations is to ensure the basis for long-run sustained economic growth, while also avoiding significant regional imbalances and higher social inclusion.

More than two thirds of EU funds should go towards infrastructure upgrading, including:

- water and waste water infrastructure – 16 per cent;
- waste management – 15 per cent;
- TEN – 11 per cent (with 6 per cent for roads, 3 per cent for rail and 2 per cent for energy);
- other road and rail infrastructure – 15 per cent (with 7 per cent for roads and 8 per cent for rail);
- 3 per cent should be allocated for upgrading the border check points and,
- 2 per cent for education infrastructure, health infrastructure, local infrastructure.

The main problem to be solved is the selection of specific priorities and the sequencing of the investment process over time. Prioritization will depend on the availability of appropriate projects and plans<sup>14</sup> and on the scale of allocations from EU funds. Funds should first be focused on developing the TEN and later on other transport connections. For the environment, the existing strategy states that investment in water and waste systems should start in large towns (more than 250,000 inhabitants) and later on smaller towns. Special attention should be paid to improve border crossing points, ports and airports in order to reduce costs for exporters and facilitate trade.

We recognise that a strong increase in public investment could generate short run inflationary pressures, either by stimulating wage inflation in the construction sector, or by leading to increased budgetary deficits or tax rises. This risk must, however, be balanced against the need to raise the quality of Romania's infrastructure in order to facilitate its economic integration with the EU. Various steps could be taken to manage inflationary pressures, including sequencing infrastructure construction projects over time, balancing the spatial distribution of large infrastructure projects and, in the case of inflation generated by fiscal pressures, greater to develop and implement public-private partnerships.

Finally, it will be important to ensure that the allocation of infrastructure investment is efficient and corresponds to market demand. A coherent method should be used for selecting projects (for instance, cost benefit analysis) in order to take into account of local conditions and to avoid carrying out projects that would have been better located elsewhere.

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<sup>14</sup> E.g. the Brasov–Arad section of the Corridor IV has no plan for its design or construction but has EBRD agreement for co-financing; the corridor Brasov-Bors has a design but has no external co-financing.

The proposed allocations for human resources development are first divided on a ratio of 3:2 between skill upgrading and active labour market policy. Under skill upgrading, we used a scale of between 1 per cent and 3 per cent in considering the importance of each priority and propose allocating 3 per cent to life long learning, 2 per cent to higher education and to education/training of researchers and 1 per cent to secondary education and to State aid for training in business. Under active labour market policies we propose allocating 3 per cent for general active labour policies, 2 per cent for training unemployed adults and 1 per cent for training young unemployed people.

In the sphere of business support, equal allocations of 3 per cent are proposed for each of the following: State aid for RDTI, aid to raise environmental sustainability in business, technology transfer and diffusion, Information Society support for business and 'Other services' for firms. Funds should be focused on projects that are expected to show the strongest effects.

The proposed share of funding for building institutional capabilities is 2 per cent focused on raising the quality of human resources in the public administration, and support for the information society.

For other environmental interventions it is recommended to allocate 1 per cent of total funding.

In conclusion, the proposed allocation of Cohesion policy funding places special importance on infrastructure development and environmental protection. These are the factors hampering Romania's economic growth in the long run and investment needs in these fields of activity are huge. So Cohesion policy interventions would represent a good opportunity to create a strong stimulus for investment that could relax the constraints on economic growth. However, investment needs are considerable. It is estimated, for example, that expenditure needs for the year 2007 alone to meet only the costs of implementing the EU acquis in the field of environmental protection to be 4035 millions EUR<sup>15</sup>, which is around 4 per cent of annual GDP (according to the autumn 2005 projections of the Romanian National Forecast Commission<sup>16</sup>). For the whole period of 2007-2013 the amount needed for environmental investment is estimated<sup>17</sup> at 22 billion<sup>18</sup> EUR. For these reasons it is proposed that 35 of funds should be allocated to environmental interventions.

Given the extensive needs in other areas of infrastructure (notably transport), as well as the high costs of infrastructure projects, it is proposed that a further 36 per cent of funds be allocated to other types of infrastructure development, excluding environmental protection.

Funding for human resources development and business support are needed in order to sustain supply-side changes and long-run economic growth. It is important to note the respective sums would

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<sup>15</sup> Source: ROMANIA. RESTRUCTURING FOR EU INTEGRATION- THE POLICY AGENDA .Country Economic Memorandum. Vol.2 Main Report and Annexes, World Bank June 2004.

<sup>16</sup> Source: [www.cnp.ro](http://www.cnp.ro), Evolution of main macroeconomic indicators in the period 2005-2009; preliminary Autumn 2005 forecast

<sup>17</sup> Source: ROMANIA. RESTRUCTURING FOR EU INTEGRATION- THE POLICY AGENDA .Country Economic Memorandum. Vol.2 Main Report and Annexes, World Bank June 2004

<sup>18</sup> Estimate of demand for environment investment was carried out in a less careful manner. There are neither alternatives considered nor cheaper solution taken into account. EU funding was considered as granted so no attention was paid to low cost solutions. This is very damaging situation especially for industry and local authorities that did not fully participated at the exercise of cost estimating. Finding low cost solutions to comply with EU acquis will be very important owing to the fact that money saved in this way will be available for other environmental projects and the burden on industry and local authorities will be lower.

improve the quality of training system and active labour market policy. The proposed allocation for business support would be focused on fields that could stimulate entrepreneurial spirit and production system restructuring and upgrading, making it compatible with the informational technologies era.

## 4. POLICY INTERACTIONS, SYNERGIES AND TRADE-OFFS

In the 1990s policy efforts were focused on achieving economic recovery, accelerating the privatisation process and restructuring the economy. Now, however, policy-makers have started to develop a more coherent and coordinated strategy for economic and social development, taking into account better balance between the goals of economic growth, social inclusion and environmental sustainability. Several coordinated policy units have been created, but they have not succeeded in bringing ad-hoc policies together into a coherent framework.<sup>19</sup> Some policies have been developed on the basis of the OECD report, but much remains to be done. The main obstacle relates to the capacity to achieve expected effects. Even if, theoretically speaking, policy measures seem appropriate, the economic impact is often less or other than expected, as in the case of the recent introduction of a flat tax rate.

### 4.1 Limits and constraints on policy interaction

Annex 3 provides further information on our views of potential interactions between interventions within the future Cohesion policy strategy in Romania. We believe that a number of issues limit positive interactions between spending categories.

First, there is often a lack of global long-term vision with respect to the focus of interventions and expected targets/results. This lack of guidance can be seen in various policy fields at local, regional and national levels, as in the delayed road transport infrastructure programme in the last 15 years.

Second, there is a lack of continuity, with frequent reassessments, shifts in policy direction, temporary halts and/or backward steps, or even radical changes in substance. This may be seen, for instance, in the reform of pensions, of the personal income tax system, and of fiscal policy.

Third, there is sometimes a tendency to overestimate existing opportunities and potential. Some policies may be correct and necessary in principle, but may generate practical problems or lead to unexpectedly weak or adverse effects.

Finally – and perhaps of utmost importance in Romania - the implementation of policies has often lacked coherent co-ordination at national level, leading to inconsistency between reforms in different policy fields. For example, social policies are not supportive of the structural reform process, while reforms in the business environment do not provide the necessary incentives for the workforce to adopt a proactive attitude towards new forms of private health and pension insurance.

### 4.2 Strengthening positive interactions

Despite all these difficulties, Romania has moved from a phase of very weak policy coordination to some degree of positive interaction. The need to comply with the *acquis communautaire* has led to increased emphasis on policy coordination. For example, Romania's Strategy for Sustainable Development (developed in 2003-2004 but not yet finalized) combines the goals of economic growth and macroeconomic stability with environmental protection and social inclusion. Emphasis is also

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<sup>19</sup> OECD Economic Surveys – Romania; Volume 2002/17 – October 2002

placed on the need for intra- and intergenerational balance (for instance, in the pensions' recalculation in 2004–2005) in order to ensure an equitable approach to the costs and benefits of transition and reform.

Efforts are being made to improve cooperation and coordination between institutions. This has been lacking in the past, leading to policy changes whose implications have not always been fully and adequately assessed. In 2005 a multi-annual programme has been developed that takes into consideration to a larger extent the provisions of the National Development Plan, the Pre-Accession Programme and other relevant strategies and has thus improved coordination between them. A further important step has been the designation of the Ministry of Finance as the general financial coordinating institution of all external funds for development. Coordination between institutions and departments will be of particular importance to the Cohesion policy strategy. For instance, the stated intention of the Ministry of Transport to develop an investment programme for road infrastructure implies a huge (financial and human) effort which will require close coordination between all relevant partners.

There are also important interdependencies between different policy fields. For example, policies on business competitiveness depend on effective intervention in relation to education, training and labour legislation. It has long been recognised in Romania that there is a need to improve interactions between the education system and labour demand as voiced by businesses. The education system does not train young people for the needs of the contemporary labour market, while active labour market policies mainly take the form of temporary adjustment measures rather than step-changes in skills and attitudes. Similarly, improvements in initial education and continuous vocational training would facilitate R&D absorption. Finally, labour legislation needs to provide sufficient safeguards to workers while also ensuring good conditions for business competitiveness and efforts are needed to ensure that the socio-economic partners cooperate effectively in this regard.



## 5. THE GEOGRAPHICAL FOCUS OF THE STRATEGY

### 5.1 Tensions between national goals and balanced regional development

In Romania there are eight NUTS 2 regions, seven of which are predominantly agrarian and one region (Bucuresti-Ilfov) that is a large urban agglomeration. Apart from the Bucuresti-Ilfov region, differences in terms of GDP per capita between the seven regions are limited. Bucuresti-Ilfov is a quasi-metropolitan area with relatively developed infrastructure and industrial traditions and thus acts as a magnet for foreign investment and other sources of economic growth. Annex 4 provides an overview of our assessment of the ways in which the Cohesion policy strategy could potentially contribute to different geographical goals in Romania.

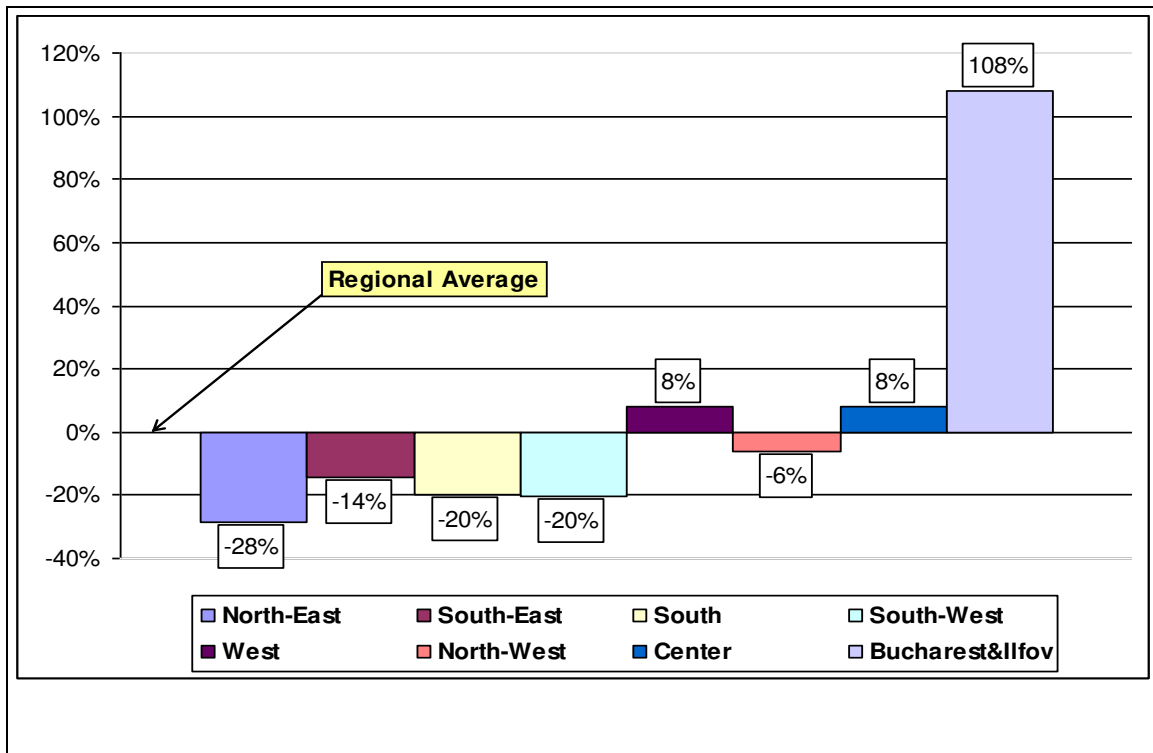


Figure 5-1. Regional GDP/head compared with the regional average (2002)

Few indicators show significant regional disparities, apart from FDI stock. Some areas, however, have particular problems, both rural and mining/urban areas. There are some regional differences on poverty indicators,<sup>20</sup> although the relatively better performance in Bucuresti may in part be due to its higher nominal wage level which is offset by higher nominal living costs. The north-east region has the highest poverty rate and the lowest level on the human development index (4 percentage points below the national average). High poverty rates are also to be found in the south-east region, the south and south-west. In 2002-2004, GDP registered a significant increase so that the poverty rate decreased, but the hierarchy of regions did not change much (Table 4).

**Table 4. Poverty rate and Human Development Index at regional level (2002)**

Development Regions	Poverty Rate	Human Development Index
	per cent	
<b>Romania</b>	<b>28.9</b>	<b>100</b>
Region 1, North-East	40.7	96
Region 2, South-East	33.2	97
Region 3, South	30.4	96
Region 4, South West	32.4	98
Region 5, West	24.5	100
Region 6, North-West	26.6	98
Region 7, Central	24.8	100
Region 8, Bucharest	15.0	110

Source: Romania 2004 - Human Development Report, UNDP 2004

## 5.2 Business competitiveness: FDI, innovation and training

FDI is concentrated in three regions (Bucuresti – Ifov, South-East and South) which together account for 73.1 per cent of the total. This is partly due to the weak transport infrastructure of some area which means that their accessibility is poor, while the development of the telecommunications

<sup>20</sup> According to the Government Commission on Poverty Alleviation and Social Inclusion Program (CASPI), around one per cent of the population lives in extreme poverty (on less than US\$1 at the purchase power parities); around 12 per cent lives in severe poverty (i.e. in large and persistent want that prevents people from functioning normally in society); 17 per cent lives in poverty (with a lack of resources needed for a decent minimum living standard); up to one third might live in relative poverty (as a result of the transition crisis); and nearly 17 per cent has a relatively low income (less than 60 per cent of median income).

network is also geographically uneven. It is important to note, however, that data are distorted by the fact that in many cases investments are carried out in various sites across the country but the headquarters are located and registered in Bucuresti, where taxes and duties are also paid. This practice tends to lead to an over-estimation of the degree to which FDI activities are spatially concentrated.

**Table 5. Foreign investment stock in Romania, by regions (cumulated 1990-2003)**

<b>Regions</b>	<b>Value Million €</b>	<b>per cent of Total</b>
TOTAL Romania, of which:	10159,6	100.0
- Bucureşti – Ilfov	5471.1	53.9
- South-East	1107.7	10.9
- South	846.1	8.3
- West	751.9	7.4
- North-West	676.9	6.7
- Central	644.6	6.3
- South-West	360.5	3.5
- North-East	300.8	3.0

Source: BANCA NAȚIONALĂ A ROMÂNIEI și INSTITUTUL NAȚIONAL DE STATISTICĂ., Rezultatele cercetării statistice pentru determinarea investițiilor străine directe în România în anul 2003

Business competitiveness also depends on efforts are to upgrade the universities and research centres located in the main cities. These universities and research centres could be the source of technological change via educated personnel and material inputs to the research and development process. Finally, all regions need investment in secondary technical education and vocational training, as an important input to business activities of all kinds.

### 5.3 Accessibility: transport and communications infrastructure

Differences in access to international transport networks are among factors that influence disparities between and within regions. Regions that benefit from good transport infrastructure connections to EU markets are generally western regions, including Bucharest–Ilfov, the Centre and the South. The Bucharest–Ilfov Region is also home to the main international and national airports. The Central Region has some important railway junctions that link Romania to Western and Central Europe. The Southern Region has the most developed and modernized part of the national road network, as it is intersected by four international roads and has good access to national and international road networks. In contrast, certain counties in the north-east and south-west have particularly poor transport infrastructure. In the North–East’s Botosani County, 18.7 per cent of roads are unpaved, while the region’s railway network is also under-developed in terms of length and quality. The counties of Caras-Severin and Mehedinti in the south-west are characterised by poor accessibility in part due to weak connections with Serbia. In some areas the local transport network is poorly developed (notably in the Danube Delta and Apuseni Mountains), with negative consequences for economic development.

Romania is crossed by three TEN corridors: the two land corridors IV (Berlin-Istanbul) and IX (Helsinki-Alexandropolis), plus the river corridor VII linking the Danube River to the Black Sea. These corridors cross the entire country except the north-west and central regions. In the recent past Corridor VII was blocked<sup>21</sup> due to the war in the former Yugoslavia, thus creating enormous losses for Romanian river transport companies and significant road congestion. This corridor is particularly important because it is the cheapest and most direct way to connect Romania with Central Europe. Improving the TEN should not only improve access to Western Europe but should also increase connections between main cities in Romania. The rail TEN should help to remove from roads a significant share of commercial transport.

It is likely that priority will be given to Corridor IV (Arad - Timisoara-Sibiu – Bucuresti - Constanta) in order to link to the Hungarian TEN and facilitate access to Western Europe. However, this could mean slower progress on Corridor IX that aims to improve North-South links and improve connections to eastern areas of Romania.

Another important aspect relates to cross-border cooperation that can assist areas that are isolated due to a lack of connections with neighbouring countries (such as Botosani and Maramures near the border with Ukraine and Caras-Severin and Mehedinti near the border with Serbia). Significant improvements are needed in transport connections across borders with Hungary and Bulgaria, for example via the new bridge across the Danube at Nicopole-Turnu Severin on Corridor IV.

Investment is also needed to address traffic congestion in the main cities, particularly because most transit traffic goes through towns rather than bypassing them. This is the case for cities such as Bucuresti,<sup>22</sup> Constanta, Bacau, Cluj, Pitesti and Timisoara. In many cases, there is a need to build ring roads that could significantly improve transport links and reduce air pollution in the major urban agglomerations. Traffic congestion could also be reduced via improvements to urban public transport

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<sup>21</sup> Last year this corridor was opened for traffic but not at full capacity.

<sup>22</sup> In Bucuresti the existing ring road is undergoing a massive repair programme.

systems by investing in light rail systems, trams and trolleybuses.

Finally, investment is needed to improve transport links between the main cities and surrounding areas, which could assist the agricultural sector, tourism, and access to sea and river ports. Such efforts are especially needed in the north-east, south-east and southern regions where business is hampered by the lack of infrastructure. Transport links should be complemented by the development of the telecommunications, notably broad band internet.

#### **5.4 Environment: biodiversity and infrastructure**

Romania is home to some wild species that have disappeared in Central and Western Europe. Moreover, the Danube Delta is a biosphere reservation with an enormous number of faunae, birds, fishes and flora. These wild fauna and flora are an important asset that Romania will bring to the EU. In order to preserve this rich legacy, steps are needed to extend and maintain natural parks and biosphere reserves and to ensure that important species and areas are not neglected.

Environmental infrastructure in Romania is underdeveloped but there are no significant disparities among regions. The most important discrepancy is between rural and urban areas in terms of drinking water supply and sewage plants and waste management facilities.

#### **5.5 Locations with particularly acute problems**

These include former and existing mining areas, as well as areas characterised by extreme poverty (notably in the north-east on the border with Moldova, in Southern regions along the Danube and around Bucuresti), as well as those rural areas with severe weaknesses in terms of basic infrastructure. However the future Plan should draft strategies and plans according on the basis of existing regional structures and not attempt – as earlier versions of the NDP have – to introduce new concepts such as “priority areas” “traditionally underdeveloped areas”, “areas with declining industry” and “areas with weak economic structures”, “disfavoured areas”, or “development axes”.

##### ***5.5.1 Mining areas and urban decline***

Mining areas are still characterised by severe economic, social and environmental problems, especially in the Jiul Valley and the Apuseni Mountains. In 1997, there were over 175,000 miners but by 2005 this number has dropped to 57,000, and the trend is continuing. By the end of 2006, up to 50 non-profitable mines will be added to the 400 that have already been closed, and another 16,000 miners will be out of a job. The closures are the result of the government's policy of eliminating subsidies; aid for lignite, ferrous, and non-ferrous ores will end in 2007 and aid for pit-coal will be gradually eliminated by 2010. The State has spent \$5.7 billion in subsidies to the mining industry since 1989.

The restructuring strategy will continue in coming years. About 30 mines - mostly situated in Central and Northern Romania - are scheduled for closure in 2005-2006, leading to the loss of a further 7,600 jobs. The government hopes to ease the social impact with a \$120m loan from the World Bank to be used for compensation payments, for creating new small businesses and for environmental regeneration. It will, however, be a serious challenge to encourage economic development in these

mono-industrial with few other employment opportunities. Cohesion policy funds could help by financing water supply and modern heating systems, as well as improving urban waste management systems and eliminating large scale mining waste. Re-training and advisory programmes are needed for laid-off miners, as well as investment in facilities that could assist some former mining areas to attract tourists.

More generally, efforts are needed to reverse urban decline, as many towns are seeing migration both to rural areas and to the capital. In the long run, the objective should be to maintain the current share of the working-age population in urban centres with fewer than 150.000 inhabitants. While some urban centres may continue to decline, others should register population growth and in-migration. An integrated multi-pronged strategy is needed, combining public investment in infrastructure, direct support to enterprises and incentives for business development.

### **5.5.2 Rural areas**

The urban-rural gap has widened since 1989, with rural areas now clearly showing weaknesses in terms of basic infrastructure, such as access to sanitation services, health care and education. The number of persons per physician in rural areas is more than five times higher than in urban areas (1689 persons/doctor compared with 306 persons in 1999), while infant mortality is also higher in rural areas (21.5 per cent in rural areas compared to 15.2 per cent in urban areas<sup>23</sup>). Local roads in rural areas are poorly developed, with some even being impassable during certain periods of the year. Access to sanitation is also limited.

## **5.6 Ranking and sequencing**

In terms of the geographical dimension of the future Cohesion policy strategy, there are two main priorities. First, Romania needs to find a way to combine the goals of national convergence and balanced development across all regions. In the current situation the main policy emphasis should be on the goal of GDP growth (for instance using growth poles that exist in each region). GDP growth could create a solid basis for reducing disparities, alleviating urban-rural gaps and diminishing poverty. Second, vertical measures are needed to address acute regional problems (such as those of the mining areas in the Jiul Valley, and poverty in the north-east region). These should complement horizontal measures aimed at creating a better economic environment by means of infrastructure development, labour market reforms and capacity building.

As to the structure of future programmes, consideration needs to be given to the relative balance between regional and sectoral operational programmes. In 2007-2013, a considerable share of funds should be allocated to sectoral programmes. Romania will not be able to adopt a fully regionalised approach immediately due to a lack of institutional capacity and experience. However, while a regional approach would not play a major role at the beginning, its function should increase over time in conjunction with the absorption and co-financing capacities of regional actors.

As to the distribution of funds between any regional programmes, we propose a similar distribution of funds in all regions except Bucharest-Ilfov (see Annex 5). In practice, the factors determining the

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<sup>23</sup> See NHDR 2003-20044

volume and structure of financial allocations are the priorities set by public authorities, local labour market characteristics, domestic co-financing capabilities and other factors affecting absorption capacities (such as policy-makers' ability to comply with complex rules and experience in project generation). A different approach is probably needed in Bucuresti-Ilfov because its sectoral structure and endowments of physical and human capital differ from those of other regions.

As to the allocation of funds between regions, one option would be to use a weighted index, incorporating indicators such as GDP per capita; population and unemployment rate; density of roads and density of railways; drinking water network and of sewerage network; and poverty rate. However, funding allocations should also take account of differences in absorption capacity and demand between regions. If some regions show weak absorption capacity, one option would be to reallocate funds to other regions with a lack of EU co-financing for projects.

## 6. THE DOMESTIC POLICY AND INSTITUTIONAL CONTEXT

There are links between domestic policy and EU Cohesion policy strategies in terms of their overall objectives, as reflected in coordinated statements, programmes and strategies. However, frequent changes in political power have affected the consistency of these plans. In addition, problems and delays in the adoption and, in particular, the application of some elements of the *acquis communautaire* have also caused problems. Another major problem has been the lack of public resources for public investments. The volatility of the domestic policy and legal framework means that developing EU programmes with reference to domestic policy could be problematic, although the *acquis communautaire* and EU programmes could potentially provide the basis for a more coherent policy structure.

Future domestic policy in Romania aims to achieve real economic convergence with the European Union. This goal is being integrated into domestic strategies through measures set out in the country's Pre-Accession Programme and National Development Plan. In order to promote positive linkages between domestic policies and EU Cohesion Policy strategies the Government should address a range of issues, relating to macroeconomic policies, labour market conditions and the business context.

### 6.1 Macroeconomic policy and domestic co-financing

The main goal must be to ensure that macroeconomic policies provide a favourable basis for sustained economic growth. There is a need to consolidate the budget deficit at an appropriate level and to reduce overall levels of public debt. Further gradual reductions in the inflation rate are also needed, in order to meet the EU's nominal convergence criteria. Incomes policy should contribute to the disinflation process, by strictly relating wage increases to economic performance. A macroeconomic context that is conducive to business investment and activity should contribute to stronger exports and also maintain or raise Romania's attractiveness to FDI, both of which should help to ensure a sustainable external balance.

As well as ensuring broadly business-friendly macroeconomic policies, a specific need in relation to Cohesion policy concerns the availability of domestic co-financing for Cohesion policy programme and projects. At a general level, the macroeconomic environment is favourable for gradually building up the capacity to participate in and co-finance EU programmes and projects. However, there are still some important obstacles to providing the necessary environment for both successful accession and the efficient use of EU funds

The main problem is likely to be insufficient domestic resources for co-financing projects. Generally speaking, the availability of domestic financing, especially the availability of private, domestic funds for investment in business, is limited in Romania. It is also important to take into account the challenge of weak capital inflows in the country, which could impact negatively on the ability to co-finance projects. Legal regulations have been proposed to cut tax on profits which are reinvested. However, there is still an extremely low level of financial support for, for example staff training, which would help the long term development of firms.

Thematic strategies are mainly developed at a national level and much of the co-financing will depend on central government budgets. However, it is also important to take into account the situation at



regional and local levels which are generally regarded as the 'weak link' in policy implementation and in their ability to co-finance projects. Compounding the problem is a lack of foresight and ability to attract and draw down funds, due to a lack of experience in project development and application procedures, and project management. Additionally, local business communities, territorial administrative structures and civil society are unevenly developed across the regions and cooperation between the relevant regional actors is extremely weak.

It is expected that there will be important inflows of Cohesion policy funding from 2007 and that a significant percentage will be spent on infrastructure projects. This is likely to affect the supply side, especially in construction and engineering fields, as is evidenced in the increased number of students in these fields. There are also likely to be demand side effects. The price of construction materials has already risen, with prices for construction materials in 2000-2003 rising by 4.6 percentage points more than the prices of industrial goods and 7.5 points more than the prices of manufactured goods. It is likely that this trend will continue. It should also be noted that numerous skilled engineering and construction workers from Romania are currently working abroad (in Spain, Italy, Germany etc) so the availability of specialised staff will be limited in the future. This could lead to strong nominal wage increases in the construction sector, as demand for such staff increases.

Inflation has been falling steadily and is expected to continue, although it remains a concern for the Romanian authorities. In 2005, the National Bank announced an inflation target of 8 per cent and for 2006 the target is around 5 per cent. However, since 1990, no inflation target announced by the National Bank has been achieved so there is some scepticism over these new targets. In late 2004 and in 2005 the National Bank policy was to strengthen the Romanian currency against the euro and US dollar. As a result, the exchange rate has fallen by more than 10 per cent in a very short period of time. This abrupt strengthening of the LEU (RoL) has had a very hard impact of all EU co-financed projects. When projects were drafted, the expectations were for RoL to devalue so funding for all projects in 2004 and 2005 was calculated on the basis of an exchange rate of 42-45,000 RoL/€. Since then, the exchange rate has instead shifted to 33-34,000 RoL/€, and the difference in RoL that has resulted has had to be covered by the project beneficiaries. In many cases projects have not been finished because local authorities have not had the extra money needed to cover the difference.

The authors have not found any evidence that EU support has led to the crowding-out of private investment. In the future, when the scale of Cohesion policy funding increases and co-financing needs will also rise, such a crowding-out mechanism might, however, be seen. This implies the need for the Romanian authorities to consider carefully the main investment needs (which are seen especially in the environmental field) and to find least-cost solutions. In this process will be important to involve those actors responsible for undertaking projects (industry and local authorities) and not only the Ministry of Environment that does not directly undertake projects.

At the moment other pressures are being seen on the project beneficiaries, notably because they have to spend money in advance and then claim a reimbursement of expenditure from EU sources. The only source of such funding is the banking sector, which implies that project beneficiaries have to pay interest on sums borrowed.

EU co-financing rates under Cohesion policy can be up to 75 per cent for Structural Funds interventions under the Convergence Objective, and up to 85 per cent in the case of the Cohesion Fund. Although there are some concerns that inflows of EU funding could constrain domestic public

expenditure decisions (due to the need to provide domestic co-financing), these inflows should allow for an increase in development-oriented categories of public expenditure. If different EU co-financing rates are applied between different categories of Cohesion policy intervention, the authors consider that projects with higher EU co-financing rates are likely to be preferred to those projects with lower EU co-financing rates.

## **6.2 Regulation of product, service and capital markets**

A first need is to improve business regulation in order to enhance the operation of markets, for example via an active competition policy, restrictions on state aid, transparent rules for public acquisitions and reductions in administrative barriers to business. Efforts are also needed to finalise privatisation and restructuring processes, as well as to continue to clarify rights to private property. At present, the State allows State enterprises to benefit from postponements in debt repayments, thus introducing distortions to competition in the productive sector, and does not ensure the effective strategic development of these enterprises. Improvements are also required to the regulation of financial and capital markets in order to ensure ongoing liberalisation, while also enhancing the sector's stability.

Another aspect of the domestic policy context that could condition the effectiveness of Cohesion Policy is the business culture of domestic firms. There are weaknesses in terms of the levels of professionalism and a lack of maturity in business relations. The main problems are weaknesses in setting contracts, the quality of work, and complying with contract terms. These problems reduce the confidence of investors and mean that insurance levels are high and levels of trust are low. Systems to limit the participation on unreliable firms in project bids would help to improve the business environment as far as Cohesion policy programmes are concerned.

Further problems relate to the administrative burden on business, the unpredictability of the legal framework, and ongoing inefficiency and even corruption in the public administration. The country's weak business environment continues to represent an important obstacle for addressing labour market problems. After infrastructure investment, the need to create an open and business-friendly climate should form a key element of the country's strategy to sustain and develop employment and the economy.

### **6.2.1 The administrative burden on business**

The administrative burden on private companies can be shown in relation to the administrative demands of the tax system places.

First, businesses must make monthly declarations to various different State bodies, such as the Financial Administration, the Labour Administration, other State funds and the Unemployment Authority. Declarations have to be submitted either directly or by mail. A common problem with those sent by mail is that they simply do not arrive, which means that the company becomes liable for penalties for non-payment. An additional complication is that the forms and procedures for various declarations change regularly, a few times a year in some cases.

Second, there are overlaps between the tax declarations required by different institutions. In some cases (for example on employment) the same information has to be registered directly with a number

of different State bodies, such as the Chamber of Commerce, the Labour Office, the Unemployment fund, the Handicapped Persons Fund etc.

Third, tax payers need to administer their own paperwork, in order to compensate for the lack of communication between State institutions. The institutions administering special funds do not communicate with each other and each operates its own individual systems and databases. Also, the Fiscal Authority's database is not connected to other institutions that administer and collect tax declarations. Tax payers themselves therefore face the administrative challenge of having to correct and compensate for these inefficient systems.

Finally, there are asymmetries between the State institutions and private companies and individuals. It is almost impossible for an individual to challenge a State body, or to hold it accountable for inaccuracies either through complaints procedures or through the courts. This gives State institutions considerable power over private enterprises or individuals. It is also very difficult for private companies to claim back tax that they may be entitled to.

### **6.2.2 Unpredictable and unstable legal framework**

The unstable and unpredictable legal frameworks for business have been long-standing problems in the country. Legislation<sup>24</sup> continues to be prepared without sufficient attention to detail or consultations with stakeholders. Recently, some improvements have been made. For instance, draft laws must now be made available on the internet, in order to facilitate consultation with interested parties, e.g. the business community and trade unions. However, it is not uncommon for this requirement not to be observed<sup>25</sup>.

The recent proliferation of new legislation and legislative changes has also created difficulties for business. The combination of laws and other legal documents, such as Emergency Ordinances issued by Government, have created an extremely complex legal system and business environment. The legal system is overburdened, making it difficult to settle cases such as bankruptcy proceedings. In terms of the overall business environment, in particular, it is difficult for small businesses to comply with all legal requirements without specific legal advice. For instance, constant changes to taxation regulations<sup>26</sup> and alterations to incentives to investors make it very difficult for enterprises to draft medium-term business plans or to prepare feasibility studies. As a broad illustration of the complexity of the legal framework for business, the following figure charts the volume of new legislation.

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24 In Romania is used a French inspired legalistic approach to policies. Laws tend to be detailed, covering a long range of situations, and later on so called *methodological norms* are needed to apply the law.

25 The most recent case of such behavior took place in February 2005 when the Ministry of Finance promulgated a new Fiscal Code without any consultation and without making public in advance the main provisions.

26 For instance, in February 2005, the rate of tax on profits was reduced to 16 per cent. In order to compensate for the reduction in revenues due to this change, a further 12 new taxes and charges were introduced in the Fiscal Code.

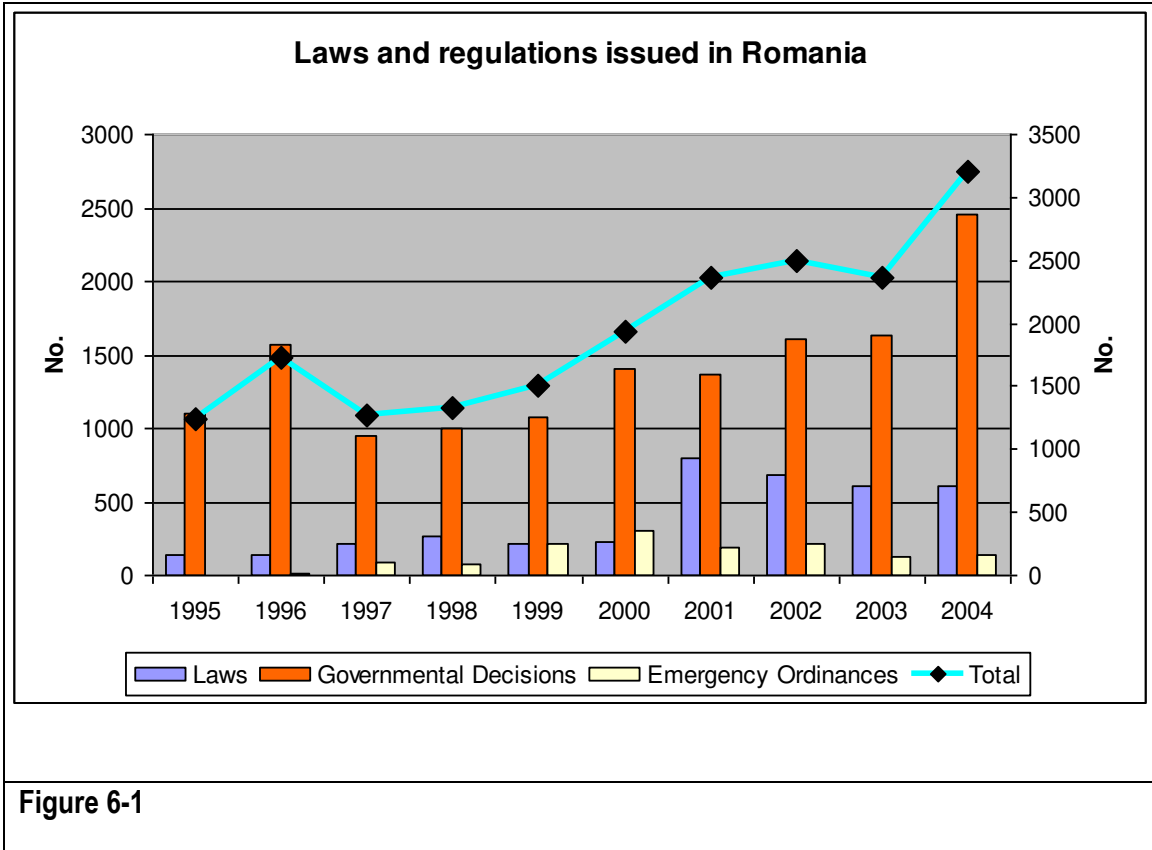


Figure 6-1

Source: Collection of “Legislatia Romaniei 1995-2004”, ISSN 1214 -1221 Bucuresti 2005

### 6.2.3 Administrative inefficiency and corruption

Numerous studies<sup>27</sup> identify corruption as one of the major factors deterring FDI and, as a consequence, reducing economic growth in the country. Corruption has become a high profile issue on the agenda of international organisations and national governments, yet indices produced by organisations such as Transparency International suggest that corruption is still a wide spread phenomenon.

In Romania, corruption is seen as an important issue both by domestic actors and the international community. Various public opinion polls show that the population perceives corruption to be a major concern. Compounding the problem is the level of confidence in the courts and parliament. Transparency International publishes regular Corruption Indexes; in 2000 Romania ranked in 68<sup>th</sup> place out of 90 countries. Transparency International’s Global Corruption Barometer compared perceptions of a range of different institutions in various countries and showed that Romania’s political parties were perceived as the most corrupt institution, while the courts also scored badly.

<sup>27</sup> As for example see the paper *Corruption and Composition of Foreign Direct Investment: Firm-Level Evidence*; Beata K. Smarzynska and Shang-Jin Wei., World Bank 2000

**Table 6. Perceptions of corruption among Romanian citizens with regard to different institutions**

	Political Parties	Courts	Business licensing	Medical services	Tax authority	Police	Other
<b>per cent</b>	24.3	20.2	15.1	12.6	9.3	6.4	12.1

Source: Transparency International Global Corruption Barometer, 3<sup>rd</sup> July 2003

### **6.2.4 State owned enterprises**

The State still owns numerous enterprises, not only in the network industries but also in manufacturing. Many of these enterprises operate at a loss and, although direct subsidies have been cut, such enterprises continue to benefit from payment offsets and arrears, for example via non-payment of utility bills and taxes.<sup>28</sup> Institutional weaknesses and weak competition means that these enterprises are not forced to face a hard budget constraint, with negative systemic effects through the wider economy. The government has taken some steps to address this issue but further action is needed to enforce payments in relation to utilities and taxes and to encourage enterprise restructuring. The difficulty, however, is that further restructuring will clearly be painful, not least in terms of additional job losses and social dislocation.

Some of the most serious problems are in enterprises in the mining, rail, energy and heating sectors, which account for a large share of arrears (in addition to other public funding and subsidies granted to these providers of public services). Further efforts are needed to design and implement effective restructuring strategies in all these sectors, in order to reduce indebtedness and improve the efficiency and quality of services.

This situation poses serious difficulties for choices in relation to the allocation of Cohesion policy funds to sectors such as mining, rail, energy and heating. As these enterprises are generally loss-making and in debt, levels of investment are likely to be low, and pressure for EU funding may be high. However, it does not seem appropriate to allocate Cohesion policy funding in ways that would allow highly indebted enterprises to avoid introducing the necessary restructuring strategies.

## **6.3 Labour markets**

### **6.3.1 The functioning of the labour market**

A further key area of domestic policies that relates to Cohesion policy concerns the labour market where there is evidence of structural problems. There are high levels of long-term unemployment and youth unemployment, as well as higher unemployment rates among people with lower skills levels or only vocational education. Similarly, disparities in unemployment and employment rates between regions also suggest that there may be insufficient labour mobility. Although there have

<sup>28</sup> IMF (2004) Romania: Selected issues and statistical appendix. Washington DC. IMF Country Report No.04/220.

already been significant job losses in industry and construction, the process of industrial and agricultural restructuring does not seem to be complete, so that further reductions in employment can be expected, not least in loss-making State-owned enterprises.

Labour market regulation is relatively flexible<sup>29</sup>. There are wage bargaining mechanisms at national, sectoral and enterprise levels and, in practice, allow for sufficient differentiation in the private sector. This may not, however, apply to all State-owned enterprises, with potential distorting effects in the wider labour market. A further problem is the relatively high tax burden on labour (including social security contributions), although the authorities have taken steps to reduce the tax burden. Moreover, an appropriate balance is needed between the goals of reducing the tax burden, limiting public indebtedness and ensuring sufficient public resources for investment and social policies.

### **6.3.2 Human and knowledge capital**

Current efforts and financial resources in relation to human and knowledge capital are not adequate, despite their importance for Romania's long-run development. More attention has recently been paid to labour market issues, via a National Employment Plan and a Continuing Vocational Training National Plan. However, further efforts are needed to develop human capital and improve labour market mechanisms, as well as to promote labour force mobility and intensify employment measures. Additionally, adjusting education and training systems to local, national and European labour market needs is an important requirement for increasing labour force and occupational flexibility. A lack of well-paid, attractive jobs means that high-skilled young employees are finding more attractive jobs abroad. Migration, even if is only for temporary, poorly skilled work, often proves to be a more attractive option than underpaid jobs in Romania.

The relative advantages that the country enjoyed at the beginning of the 1990s with respect to basic education and vocational training have now been lost for some trades and professions. The current basic education system does not meet current labour market demands and, even less, future ones. Moreover the availability of opportunities for continuing professional development and vocational training is extremely limited. Only 11 per cent of companies implement training programmes, compared to an average of 70 per cent in the EU. SMEs are particularly weak in this area, taking a very short-term view of their employees' needs. Similarly, active labour market policies such as training programmes are extremely weak and not adjusted to market demands.

Further needs relate to Romania's still relatively slow transition to a "knowledge-based economy" and information society. Efforts by both public and private sectors are needed to stimulate scientific research and to invest in education, technology transfer and innovation. Improvements are also needed in mechanisms that facilitate the transfer of outputs from scientific research and innovation into the economy, in order to increase the contribution from national R&D activities and improve productive and human resource development. Finally, there is a need to ensure the more widespread use of information and communication technologies, not least with the aim of improving the performance of the public administration, by means of more coherent implementation and use of integrated information systems.

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<sup>29</sup> IMF (2003) Romania: Selected issues and statistical appendix. Washington DC. IMF Country Report No.03/12.

## **7. THE EFFICIENCY OF THE PUBLIC SECTOR**

The issue of public sector efficiency is complex and particularly difficult to accurately estimate due to the lack of systematic data collection and analysis, and the lack of institutional stability. A further difficulty concerns weakness in the implementation of policies, even when their design is adequate.

In Romania there are no systematic surveys or analyses of the efficiency of the public sector. There are also very few analyses of how exactly institutional issues influence economic development. Regarding the existence of data, there are no indicators to show the efficiency of the public sector and no records that show trends and tendencies. Additionally, there is no culture of auditing public institutions.

Estimations of institutional efficiency are also hampered by institutional instability which has been a particular issue, even at central government level. Realistically, the 'life' of a central government institution (ministry or agency) tends to be no longer than two years. After each parliamentary election new ministries and agencies are created, while later on, during the mid-term of the government, the structure of the government is frequently restructured, with existing institutions being merged or split up. The lack of analysis and, in particular, the persistent institutional instability is extremely damaging to the morale and professional development of public servants and to the quality of public policy-making. A key issue is therefore the need to achieve stable institutions, which themselves do not suffer from the loss of skilled staff after training and which have greater independence from political influence.

It is also important to take into account how domestic policies are implemented. The strategies that have been developed are mainly legal instruments that are implemented and enforced by additional governmental resolutions, ordinances, emergency ordinances, etc. A number of domestic policies have been implemented by special act, such as a new Labour Code requiring annual vocational training plans to be drawn up for employees. However, the impact that domestic policy plans and regulations can have is limited by problems in their implementation. The plans etc. are not always realistic or even 'anchored in reality', which makes them hard to implement. Others may be well-constructed but implementation mechanisms are not available. In terms of the institutions and actors involved in implementation, avoidance or inertia are common problems, i.e. where possible institutions will avoid the additional administrative burden of implementing programmes. This problem has significant implications for achieving the objectives of strategic documents, particularly in the medium term. Inconsistency in the application and sequencing of programmes is another problem.

### **7.1 Instability of central institutions**

The instability of the central level institutional structures is a key issue. The EU accession and integration processes have created the demand for new institutions. However, frequent modifications and changes have created delays in the EU integration process, have created weak institutions and have contributed to high levels of staff turnover. This instability has been constantly criticised by the EU in their annual regular reports on Romania's progress towards accession. Two examples illustrate some of the problems faced.

In 1997, as a result of a PHARE project, the Romanian authorities set up the National Agency for Regional Development (NARD) to act as a central executive body in the management of Structural

Funds and eight Regional Development Agencies. This arrangement lasted for four years. In 2001, NARD was incorporated into a newly formed Ministry, the Ministry of Development and Prognosis (MDP). In 2003, MDP was dissolved and its Department for Regional Development was incorporated into the Ministry for of EU Integration (MIE). Debates about the most appropriate structures for regional policy in the country remain on-going. With respect to environment, the Ministry of Water, Forestry and Environment (MWFE) some competencies were transferred to the Ministry of Agriculture 2001. In 2003 the two ministries were merged into a single Ministry called the Min. of Agriculture, Forestry, Waters and Environment. In 2004, as result of criticism from EU and other international institutions, the Ministry of Environment and Water Management was recreated. In both cases, each change created substantial disruption and cost. In particular, it affected staff, many of which left the public sector, and undermined training provision and support offered by EU pre-accession programmes.

As previously mentioned, in contrast to the central level, at county and local level existing institutions are more stable. However, lack of resources is a major problem. First, low salaries mean that local councils are not able to hire suitably qualified persons, particularly in the areas of environment, finance, management, urban planning. Constant pressures to reduce expenditure and cut staff runs contrary to the increasingly complex tasks that the local administrations are expected to undertake. An additional burden is the relative lack of information about the new responsibilities of the local administration and how these should be fulfilled. Lack of experience and training is also a problem. Training for local authority staff is required by law, but the high turnover of staff means that expertise is not being built up.

## **7.2 Lack of resources allocated to local level institutions**

The situation at region, county and village levels is a direct contrast to the situation at central level. At the sub-national level institutions tend to be stable for long periods. However, at these levels, the main problem is the lack of resources that are allocated to the local public administrations. This problem has become particularly pronounced as de-centralisation has transferred increased responsibilities to local authorities without the required resources. As a result, staff are overworked and underpaid. In these circumstances it is very difficult to retain qualified personnel that could help to, for instance, prepare good quality projects.

It should also be recalled that almost 99 per cent of EU funded technical assistance and support is at present allocated to central Ministries rather than sub-national authorities. Even when funding is nominally allocated to sub-national levels, it is usually centrally managed, sometimes with questionable results. The twinning projects have been the only case of decentralised projects but these have received very limited financial inputs; for example, the current regional projects have a budget of 600,000 euro for 24 months.

Another problem is that lack of resources and under funding of local budgets has made it very difficult to co-finance EU projects, particularly larger-scale infrastructure projects. Local authorities have the right to borrow money up to 20 per cent of the local budget in order to fund projects. However, if one major ISPA application is granted this usually takes up all the regions co-financing resources, making other, smaller projects impossible to pursue.



Looking to the future, Cohesion policy could contribute to some dimensions of institutional change, by supporting:

- Administrative efficiency at central, regional and local level. At central level stability is needed to build up the experience and training of staff in key institutions. At regional and county level, where there is greater stability, more resources are needed to attract qualified persons and to train them to fulfil their new and complex duties.
- Computerization. In recent years, the Romanian Government, with help from EU funded programmes, has made significant efforts to computerize the administration at central level. On a wider scale, the e-government project is also meant to help people and businesses to fulfil some administrative tasks via the internet (as fiscal payments and reporting). The area where more effort is needed, and where the Cohesion fund could contribute, is at the regional and county level where computerization and software skills are still lacking.
- Public procurement. The country has a special law which sets out how public procurement should be arranged. At central level, the procurement system now operates via the internet. It is important that this system is extended to the regional and county levels, which could be supported by Cohesion policy.

The question has been raised, 'do some dimensions of institutional change or capacity building instead require regulatory or organisational changes rather than additional public investment?' In Romania, there is now a need for institutional stability as opposed to change. If institutional changes continue at the current rate, resources will continue to be wasted in reorganizing the institutions. However, one change that could be considered, that has particular relevance for Cohesion policy, is the National Agency for Regional Development could be re-established as the coordinating body in the field of Economic and Social Cohesion policy<sup>30</sup>.

Building institutional capacity remains a key concern. Many of the capacity issues that are raised in the preceding paragraphs could also be addressed by domestic policy and institutions, which could reinforce and complement the support available from EU funds. Particular areas of concern are the need for additional investments to train staff, the creation of regional computerized networks for better communication, data base creation and improved reporting.

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<sup>30</sup> In the last four years Min. of EU Integration was in charge with Cohesion Policy.

## **8. INSTITUTIONAL AND ADMINISTRATIVE ASPECTS OF COHESION POLICY**

### **8.1 The current situation**

In order to channel funds a structure has been created that combines existing public bodies, which have been new responsibilities and some new institutions that were created as offices or directorates within the existing ministries or agencies.<sup>31</sup> In 2004, the institutional framework for the coordination, implementation and management of structural instruments was established. The managing and paying authorities, as well as the intermediate bodies for the different Operational Programmes have now been identified, along with the bodies responsible for managing the the Cohesion Fund.

In 2004 a National Committee<sup>32</sup> was established for the coordination and preparation for managing structural instruments. The Committee is responsible for preparing an institutional framework necessary for the implementation of structural instruments. Committee members are state secretaries or the heads of the institutions that are involved in that process, including representatives of the institutions that are designated as Managing Authorities. The Minister of Public Finance is the president of the National Committee and the Ministry acts as a Secretariat. The main attributions of the Committee are:

- a) defining the strategy and planning the actions that required by the preparation process of the institutional framework, necessary for the management and implementation of structural instruments;
- b) monitoring the preparation process of the institutional and legal framework, as well as of the procedures that are required for managing and implementing structural instruments;
- c) coordination of the inter-institutional relationships between the structures that are involved in the management and implementation of structural instruments;
- d) assessment of the preparation process and of functioning of the institutional and legal framework, as well as of the necessary procedures for managing and implementing structural instruments;
- e) reporting to the Romanian Government and submitting proposals regarding the priority measures required by the preparation process and for the functioning of the institutional framework.

The issue of whether the institutional and administrative preconditions are in place for the effective design and implementation of the Cohesion policy are in place is a complex one. It is particularly difficult to assess the capacity of institutions in the Romanian case, as many of the relevant institutions are relatively new; some are no more than six months old. As previously mentioned

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<sup>31</sup> Although building the legal and institutional frameworks for EU funds started in the second half of the nineties, the development of instruments, policies and the allocation of responsibilities were undertaken in parallel with pre-accession aid programmes, Phare, ISPA and SAPARD, which due to their differing requirements has lead to some complications.

<sup>32</sup> The GD no. 1200/29.07.2004 (OJ No. 702/4.08.2004).

developing institutional consistency and stability is important for future, as opposed to an additional raft of institutional reform. In terms of regulatory changes, a mechanism is necessary to solve disputes between the public bodies, institutions and beneficiaries. An additional reform consideration should be developing systems and methodologies for evaluation and monitoring and evaluation, and building up expertise in this area.

### **8.1.1 Strategy building**

So far there has been a tendency to draft strategies in a hurry, in order to comply with accession deadlines. Time pressures have meant that decision-makers have not always examined the full range of possibilities or developed the most cost effective or efficient programme. This has created a lot of problems and led to a number of mistakes as issues are either ignored or addressed in an ad-hoc manner. Another problem has been a lack of coordination between policy strategies.

In terms of preparing for the next programming period, the central State has developed a number of drafts of the NDP, which are based on different approaches. The most recent draft - NDP 2007-2013 – manages to take into account past mistakes and meets more of the EU's criteria and standards. Regional Plans have also been drafted. However, these have not been well-integrated into the NDP, due to the heavily centralised approach to planning strategies, with only implementation taking place at regional level.

Strategic capacities at sub-national level remain very weak and there is still a need for extensive work to develop capabilities for strategic development and planning at regional and county levels. One possibility is that Operational Programmes should be based on regional strategies that would be prepared under the coordination of the Regional Development Boards, in collaboration with relevant Ministries.

### **8.1.2 Project preparation**

Project design is the responsibility of the 'project-owner', who usually hires a specialist company to develop the project. The work is undertaken in accordance with EU rules on eligibility, financial conditions etc. In project preparations there have been problems due to time pressures. For example, the introduction of ISPA implied the need to prepare a number of different and more complicated projects in the field of transport and the environment within a short period of time. In the space of four years, many projects with an accumulated value of more than €2 billion had to be prepared. Particular pressures were felt in the environmental sectors where there was a lack of expertise. Project development difficulties were exacerbated by the lack of the necessary engineering and design experts<sup>33</sup>.

Central State authorities have comparatively well-qualified staff and expertise in drafting large and complex projects. However, expertise is lacking at the local levels, where much project development work is expected to take place. Project development is complicated and pressures on the local levels are increased by the fact that, according to Romanian legislation, each public investment project

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<sup>33</sup> Many institutes of engineering had been closed down due to the shortage of new investment projects in the early 1990s.

should have a feasibility study prepared in line with a legally-specified methodology, which does not link with the EU's requirements for cost-benefit analyses<sup>34</sup>. In future, the Romanian legal requirements for preparing public investment projects should be adapted to EU requirements – as is already the case, for example, in relation to environmental impact assessments, where the relevant EU directive was transposed into national legislation in 2004.

### **8.1.3 Project selection and implementation**

Project selection is usually undertaken by independent Commissions, as stated in the Calls for Proposals, either at regional or national level. However, the decision making process has sometimes been undermined by a lack of time.

In other cases, the implementation of projects has been delayed. For instance, in the case of some ISPA projects, where funds had been awarded, it turned out that the land was the subject of legal disputes, so a new location had to be identified and projects redesigned. In other cases, there was a lack of necessary expertise in relevant field to adequately assess the projects.

Absorption capacity appears to be relatively good across the main sectoral interventions. Central government bodies have been able to use expertise from national institutes with experience in designing projects, which has help then to develop good projects. From the financial point of view, central bodies have also been able to co-finance projects, either from the central State budget, or by drawing on external financing (such as loans from international markets), within the limits on public sector indebtedness agreed with the IMF.

However, at regional and local level the capacity to develop projects and finance projects is considerably weaker. From the technical viewpoint, there is a requirement of increased expertise in applying for and using resources. From the financial point of view, co-financing is not limited by law but low resources limit their participation.

Local ownership of projects is an indispensable element for achieving objectives. One option currently under discussion as a replacement for the Regional Boards is for central programming by line Ministries with the Prime Minister's office selecting projects. However, any structure would require a genuine partnership framework involving sub-national actors.

As regards implementation, Regional Development Agencies at present have around 400 employees. (In comparison, the Ministry of Labour has 200 employees in Bucharest and plans to assign 70 people to Structural Funds implementation.) RDA staff have achieved wide experience in all sorts of projects (small and medium, in almost all domains covered by the Structural Funds). A key question would be as follows: assuming that all Ministries would hypothetically wish to have the RDAs as Intermediate Bodies or Implementing Agencies, how much of the available funds would the RDAs be able to process? The authors believe that, if the RDAs are relieved of major involvement in the selection process, and if all concerned bodies go ahead with recruitment as planned in the Chapter 21 planning documents, then the RDAs could process up to 40 per cent of the funds. That

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<sup>34</sup> So far the local public authority that is beneficiary of a EU grant should draft a dossier according to Romania legislation and another according to EU requirements; this practice usually increased the complexity and cost of application

means that they could support the implementation of SOP Competitiveness and SOP Human Resources, in addition to the ROP. To this end, the selection process could be undertaken by the Managing Authorities, and the remaining work (contracting, control, processing payment claims, monitoring) could be assigned to the RDAs. This “remaining work” requires much experience in managing the audit trail, it is voluminous, time consuming etc. and most of the current Ministerial structures and Governmental Bodies appointed as Intermediate Bodies have not so far undertaken these tasks, whereas the RDAs do have expertise in this work.

#### **8.1.4 Monitoring and evaluating outputs, results and impacts**

Monitoring and evaluation are usually tasks of the central and regional authority such as: the Ministry of EU integration, the Agency for SMEs, the Ministry of Education, the Ministry of Health, other central bodies and Regional Development Agencies. Standardised systems of evaluation and monitoring are weak. There is a need to establish and to make functional a National Evaluation System which could allow lessons to be drawn from past experience of previous EU programmes and help to identify potential bottlenecks for future support. Evaluation practices are not only needed for EU assistance but also for national intervention measures at central and local level.

Progress towards setting up monitoring and evaluation systems for EU programmes has been slow. However, a computerised system of data exchange<sup>35</sup> for monitoring the regional development programmers/projects (IRIS) was recently installed at MEI and in RDAs, as result of the EU assistance. At the moment, it is impossible to evaluate results and impacts of Cohesion Policy. Nevertheless monitoring and independent evaluation structures should be in place in order to perform ex-ante, mid term and ex-post evaluation.

#### **8.1.5 Partnership**

At present, civil society involvement is lower than expected, particularly stakeholders at local level. There is a lack of local/regional organisations with multiple partners. Where they do exist, such institutions tend to have little impact, for example the tripartite institution with responsibilities for industrial relations and social dialogue at local level.

Local governments and their regional associations (called Regional Development Boards) are key partners at NUTS II level. The Comprehensive Monitoring Report for 2005 highlights the issue that regional partners are not involved in programming. Perhaps this happens because the regional partners are weak in terms of their capacities for policy formulation but, as it has been stated, Ministries are also weak in policy formulation. In our view, though time-consuming, difficult, etc. partnership should be made to function, and should be at a political level as well as at a technical level (i.e. technical discussions should not replace political ones).

Our recommendation would be, therefore, that Regional Development Agencies should also be involved in the implementation of SOP Competitiveness and SOP Human Resources as Implementing Agencies. They should also be Intermediate Bodies for the ROP, but should not be responsible for project selection. This would be possible because there is no specific definition of

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<sup>35</sup> This application is made in PHP technology (interface) / PostgreSQL (for databases).

what an Intermediate Body should do and it would be possible for there to be more than one Intermediate Body for each Operational Programme.

## **8.2 How EU funding could help build capacity**

In Romania there is a need for investment to upgrade the quality of Public Administration bodies that are directly responsible for Cohesion Policy. With this in mind, it is important to take into account the diverse needs involved.

At central level the Ministry for EU integration, Ministry of Finance, Ministry of Transportation and other central bodies act as managing authorities and monitoring bodies. In each institution there is a need for adequate training and provisions for new staff. For instance, the instance Ministry for EU integration has recently hired more than 200 people who require specialist training.

At the level of the Intermediate Bodies, none have experience in the administration of Cohesion policy, except Regional Development Agencies. In the case of the Regional Development Agencies, the expertise is substantial, but it still needs improved. They also need to be better resourced, some even lack appropriate offices, furniture, etc. In the case of Regional Development Agencies, EU has made significant efforts to provide of training and computers. However in many cases, the domestic input, provision of office space and furniture, etc, did not match the EU contribution.

At the level of beneficiaries, a special effort is needed to help in improving projects. For instance, seminars, training sessions, manuals etc. could be developed. For the future more efforts should be made to enhance the demand side through improving projects' quality and better identification of regional needs.

Our recommendation would be that regional level partnerships and structures should be supported before and after accession with dedicated decentralised technical assistance / twinning / twinning light programmes. These programmes should not be managed by State Ministries but directly by the EU Commission<sup>36</sup>.

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<sup>36</sup> The current twinning projects are signed by RDAs and the Commission with disbursement managed by the CFCU

## 9. CONCLUSIONS

The main challenges for Romania from the viewpoint of human capital utilisation are: a) high proportion of persons employed in agriculture; b) relatively low activity rate for the whole working-age population. The main advantage of this production factor is the relatively high educational level and mobility of the younger fraction of labour supply.

Despite of some progresses made in infrastructure upgrading, efforts are still necessary to modernize it and to reduce significantly the gap with more developed European countries. In this manner, the premises could be ensured for sustained economic growth in the short and long run. For this reason it appears necessary that the most important part of allocations of Cohesion policy funding (in our opinion about two thirds) should be allocated to infrastructure development.

The recent economic growth tended to increase the gap with respect to the development level between the eight Romanian regions, the GDP growth being more and more conditioned at national and regional level by strengthening the SME sector and the rise of FDI flows.

The volatility of the legal framework and the incongruence of national policies on average term (more than a legislature) cannot warrant to the necessary extent the support for cohesive strategies. The institutional building oriented on creating compatibility with the *acquis communautaire* represents a real support element for developing a cohesive policy.

The frailty of the business climate will (still) represent an important restriction in adjusting the labour market to the internal labour demand. The Lisbon Strategy sets out only employment objectives/target, but the activity fields pertain to the specialization of national economies. Within this framework, Romania has not yet (re)defined its sustainability position/clusters on the international market.

At the time being there are no high tensions between the goals of national convergence and balanced development across all regions; among Romanian regions there are no significant disparities except some sectors as FDI. Bucuresti-Ifov region induces GDP unbalance among regions but on the whole Romania would be covered by Objective 1 (GDP lower than 75 per cent of the EU average); it is important to understand the existing negative trend and to put in place measures to prevent or reduce it.

In Romania there are some weaknesses in the institutional context or the public administration which constrain economic development; some of them are: institutional instability, unpredictable legal framework, lack of evaluation culture etc.

The institutional structures and the legal framework are at the beginning; there is no experience there are shortages and gaps in dealing with Cohesion policy but progress is obvious. In order to increase the absorption rate of Cohesion policy funding it is important to improve the demand side in several areas: strategy-building; project preparation (including technical and environmental assessments), design and selection; financial management; monitoring results and evaluating outputs and impacts.

As well, it is important to strengthen the technical assistance directed to the local and regional levels without interference of the central ministries.

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