No. 26

FINANCIAL TRANSFERS FOR INVESTMENT TO LOCAL GOVERNMENTS

– Three case studies –

Sorin Ioniţă

Csilla Kajtár

Sorin Ioniţă, *executive director of SAR, associated lecturer at the National School of Government (SNSPA), Bucharest.*

Csilla Kajtár, *policy analyst at SAR, PhD candidate in Public Policy at Indiana University, Bloomington.*

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ROMANIAN ACADEMIC SOCIETY (SAR)

15 Petöfi Sándor, Bucharest 1
tel/fax (4021) 222 1868
office@sar.org.ro
www.sar.org.ro

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BUCHAREST 2004

IN ROMANIA

General Budgetary Framework

Some aspects of intergovernmental finance, such as the systems of tax sharing and equalization, have been reasonably well documented and discussed in Romania so far. By contrast, the situation with the transfers for investment coming from line ministries, special funds or the general budget is much less clear. Currently there is little in the way of criteria governing the allocation of these funds in territory, by local government tier or unit, though the sums vehiculated are substantial. Instead, money comes on an ad hoc basis to take care of "special needs and local situations", or in response to political pressure. Special funds are usually insulated from the general budget and are enacted, funded, and disbursed on their own ambiguous and non-transparent rules. However when the special funds are dismantled the situation may gets even worse, since then even the total pool of funds to be earmarked for a certain service becomes unpredictable (as it happened with the Special Fund for Roads in 2003).

The policy consequences of this kind of arrangements are easy to anticipate:

- These are the least transparent elements of the revenue allocation process, and as a result likely to encourage political clientelism and rent seeking.
- Since the distribution tends to be discretionary, the process may create informal hierarchical relations between the tiers of state administration, even when the law says that there should be no such thing. Central ministries or county councils, lacking more modern instruments to pursue wider policy goals, are tempted to use pressure instead of incentives in order to ensure localities' compliance.
- The link between the patterns of distribution and national strategies is often not apparent. The logic of regional development often clashes with the practice of sectoral allocation, in an environment where cross-departmental communication is very difficult.
- Special funds and investment transfers, whether part of the general budget or not, may function as **strong counter-equalizers**, and hence make the whole effort to design a good equalization system irrelevant. The lack of feed-back channels in the Romanian process of policy-making, as well as the shortage of analytic capacity in central and local governments, make it difficult to discern and understand such social effects when they appear.

The current practices and policies governing the interaction of localities, counties and the central government create obstacles for all parties. The use of inappropriate tools by the county council impairs the autonomy of the localities, especially rural communes. In turn, the counties lack appropriate tools to address countywide needs and priorities. This is exacerbated by a

tendency for one on one interaction between localities and the county council to pursue individual needs and priorities, which is unavoidable when there are no general rules that may apply to all. The same observations are true regarding the relationship between the central government and counties.

Three important policy areas with substantial intergovernmental financial transfers are analyzed in this material. They are: **(i) Residential District Heating; (ii) Housing; (iii) Roads**. They all imply a substantial capital investment component and are financed through a combination of money flows coming from different sources. Local governments (LGs) are free to contribute with their own funds to any of these functions (some contributions for 3 are mandatory anyway), but the bulk of the spending is done with funds received from the central budget through transfers.

	Items in Fig. A	**Obs.**
(i) Roads	18, 19 20 (partially)	Roads Special Fund was abolished in 2003 and money come directly from the Ministry of Transp. Rehabilitation of rural roads is also financed from item 20
(ii) Housing	21 a, b, c, d	Direct transfers Direct financing by the Min of Transp of a local function (and property) = implicit transfer; some money may be counted twice in 21 / and a, b, c, d – Min Trasp's budget is not clear
(iii) Residential heating	3 (partially) 8, 9 24, 25, 26	Direct (user) subsidy Indirect (price) subsidy Grants for the rehabilitation of local utilities

Fig. A below is an attempt to disentangle and map all the current intergovernmental financial transfers in Romania, to the extent that this is possible, and organize the functionally by service and source. The data comes from: the Ministry of Finance, which centralizes a set of financial info from all LGs (both tiers); the annual budget laws and executions from the respective years; and data collected directly from relevant line ministries and agencies. The analysis is still preliminary, as some cells are still to be filled in and some allocation procedures to be confirmed. However, even in this form we believe the table can serve as an useful guide for understanding intergovernmental transfers in Romania in general. The following correspondence exists between the three policy areas selected and the financial flows identified in Fig. A.

Fig. A. The system of intergovernmental transfers in Romania

Item no.				bn RoI	2001	2002	2003	2004*
(1)	PIT	**Shares ("cote") (36.5 / 10 / 16%) quasi-own**			**25,252**	**27,414**	**37,269**	**40,900**
			PIT (100%)		*37,244*	*43,863*	*59,154*	*64,921*
	PIT	**Lump sums ("sume defalcate")**						
(2)		**"Equalization"**			**4,000**	**9,278**	**15,717**	**21,650**
(3)			Social welfare (income, heating – direct subsidy) L416		-	4,375	7,727	8,526
(4)			Child protection		-	-	1,926	3,226
(5)			Culture, art		-	595	814	921
(6)		*Eq. proper*	Own, counties		1,020	1,092	1,336	8,977
(7)		*Eq. proper*	Localities		2,980	3,216	3,914	
(8)		**Price subsidy (indirect), heating**			**2,524**	**3,044**	**3,597**	-
(9)	VAT	**Price subsidy, heating**			**-**	**-**	**-**	**7,647**
(10)		**Education prim+sec**			**21,463**	**27,382**	**33,991**	**37,960**
(11)			County (special needs)		932	1,190	2,664	3,619
(12)			Localities		20,531	26,192	31,327	34,341
(13)		**Kindergartens**			**103**	**169**	**203**	**235**
(14)		**Counties: agro-consultancies**			**94**	**131**	**157**	**182**
(15)		**Counties: child protection**			**-**	**1,668**	**-**	**-**
(16)		**Handicapped protection**			**-**	**1,869**	**-**	**-**
			TVA (100%)		*71,517*	*93,382*	*124,572*	*156,189*

(17)	**General budget - other earmarked funds**			**3,964**	**4,327**	**7,366**	**7,900**
(18)	**Roads**		**Special fund**	**1,900**	**1,966**	-	-
(19)	Roads		Ministry of Transp.	-	-	2,288	2,495
(20)	Rural water / roads (Min Transp)			402	420	400	420
(21)	Housing funds (Min Transp)				357	385	404
(22)	Other (Min Transp)				106	159	70
(23)	**Total grants from Min Transp**				***883***	***3,232***	***3,389***
(a)	***National housing programs (Min Transp)***				***2,709***	***3,460***	***4,038***
(b)	*Finalize apts. begun before '90 (OG 19/94)*				*299*	*294*	*309*
(c)	*Social housing (L114/96)*				*30*	*36*	*38*
(d)	*Houses for the youth*				*2,380*	*3,130*	*3,691*
(24)	**Grants for restructuring local heating providers**		Special energy fund	25	50	-	-
(25)			MAI	-	-	55	59
(26)			Ministry of Economy	-	97	373	235
(27)	**Subsidies for cofinancing foreign loans**			**945**	**734**	**900**	**1,800**

Funds are not all transferred to LGs; may overlap with (21)

**** 2004 data based on the provisions of the State Budget Law***

Not included:
National Fund for Regional Development

Investments of public companies / utilities into the local infrastructure (esp. by extending the water / gas / electricity grid), which are off-budget local investments influenced by decisions taken at the central level

Arrows show changes in the structure of transfers

1. RESIDENTIAL DISTRICT HEATING POLICY

Summary of problems

- *Residential district heating (DH) is currently financed through a complicated combination of financial flows, involving several separate ministries at the central level and both tiers of local government, without any of them having full resposibility (or data) for the whole policy. Therefore not only management becomes difficult, but even constructing a complete picture of the system is a dauting task.*
- *Two policy goals cohabitate uneasily: investment in rehabilitation and social protection through subsidization. Currently the latter tends to prevail (especially in the form of an indirect – price – subsidy) which means the system is biased towards status quo. In the same time a process of self-selection occurs among clients, with the most well-off disconnecting from the system due to poor service quality and thus aggravating the problems of solvability of the operators.*
- *Investment in DH rehabilitation falls significantly short when compared with the government's own targets (the 2001 Strategy). Local crises tend to be solved by tampering with other distribution mechanisms that are supposed to be formula-based (such as the equalization grants).*

1. 1. Overview, supply, regulation, costs

About 90% of the block of flats in Romania, mostly built after 1960, are connected to district heating systems (DH). As the 2002 census data show, about 2/3 of the urban residential units (35% nationwide) use this system. The supply of DH goes mostly to households (90% of the total in 2002) as the commercial users have gradually moved towards more efficient and flexible solutions. Therefore, after 1989 the generation and delivery of heating have become less and less, on its client side, an issue of industrial restructuring, but one linked with the general social protection policies of the state. And since social protection has been increasingly redefined as a local mandate, the burden of reshaping this policy has also been passed on the shoulders of local authorities. The process culminated in 2001, when a substantial part of the heating supply was transferred to LGs, in the form of 18 power generation units previously belonging to the national public company Termoelectrica (accounting for 40% of the heat production and 10% electricity production of the company). Later on five more units were passed to local governments, so that the total number became 23. In 2003, the heating for the population and other industrial users is supplied by[1]:

[1] *Data from Analysis of District Heating Sector in Romania, 2000-2002*. Daniel Aizic, World Bank, 2003.

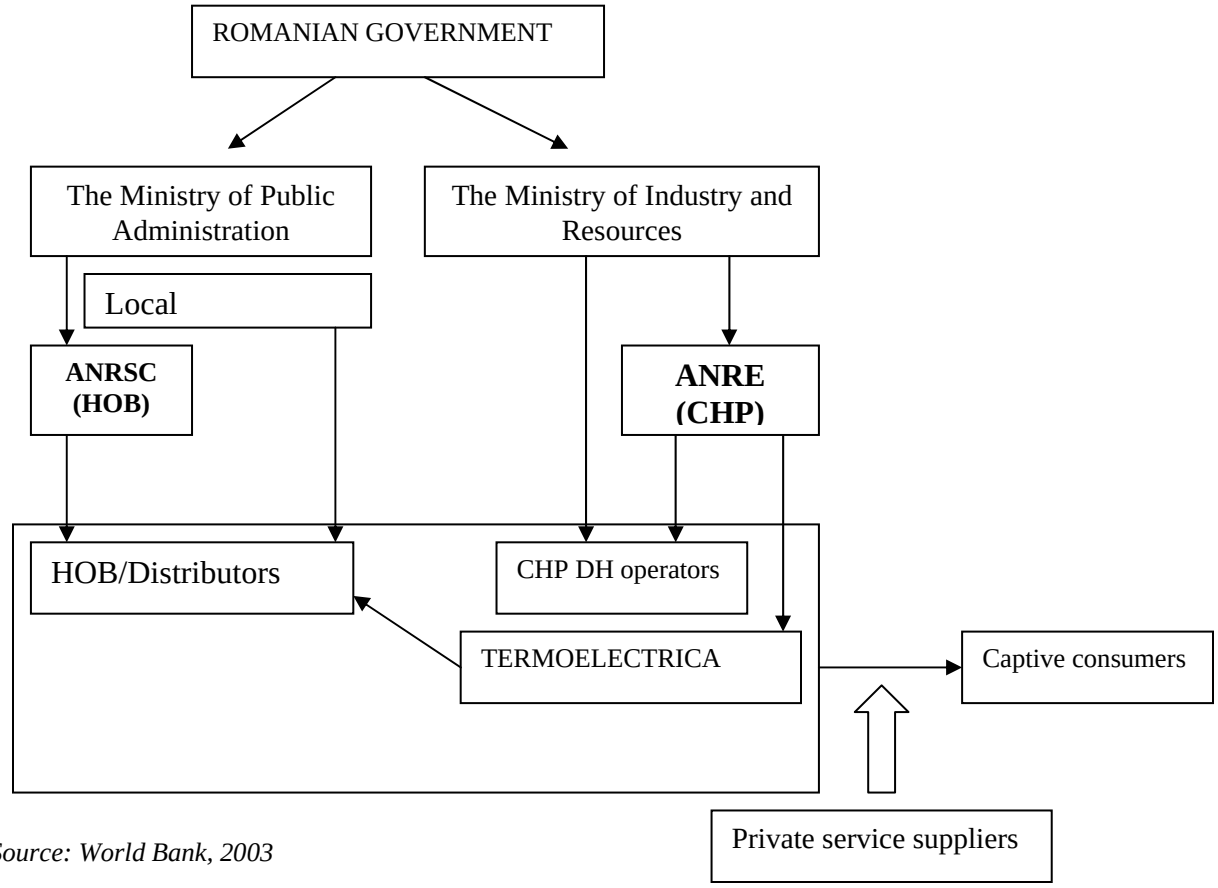
- the national company Termoelectrica (about 30% of total)
- local power plants owned by LGs or other parties (about 70%)

The power plants are of two types:

- With cogeneration (CHP) – they produce both electricity and heating and thus are on average more efficient; this is the case with the 18 units externalized by Termoelectrica in 2001
- Heating producers only (HOB)

The CHP plants, whether they are owned by Termoelectrica, LGs or other entities, are put under the authority of the National Agency for Energy Regulation (ANRE) which is empowered to monitor supply, approve price levels and profit margins, and in general ensure the quality of the output. The local heating distributors and the HOB producers owned by LGs are regulated, together with other local services, since 2002 by the newly created National Agency for Regulating Communal Services (ANRSC – OG373/2002). More than one year after it has been set up ANRSC is still a fledgling agency in the process of developing capacity. The fine details of the cooperation between the two regulatory bodies are still to be worked out in practice. Fig. 2 below shows how the supply system functions.

Fig. 2. The structure of supply and regulation



Source: World Bank, 2003

Local government has played a more substantial role after the passing of Law 326/2001 on Local public services, since their responsibility was emphasized in managing local utility services (including DH, but excluding CHP), water supply and sewage, cleaning, public transportation, and public domain. LGs have now exclusive competence in establishing, organizing, coordinating, monitoring and controlling public utility services. DH system assets are public and/or private domain of local administrations. Two main types of utility services management will be possible: *direct management* commissioned through specialized departments of the local administration; and *indirect management* (concession) whereby the local administration concludes management contracts with private companies.

Local administrations, however, preserve the rights:

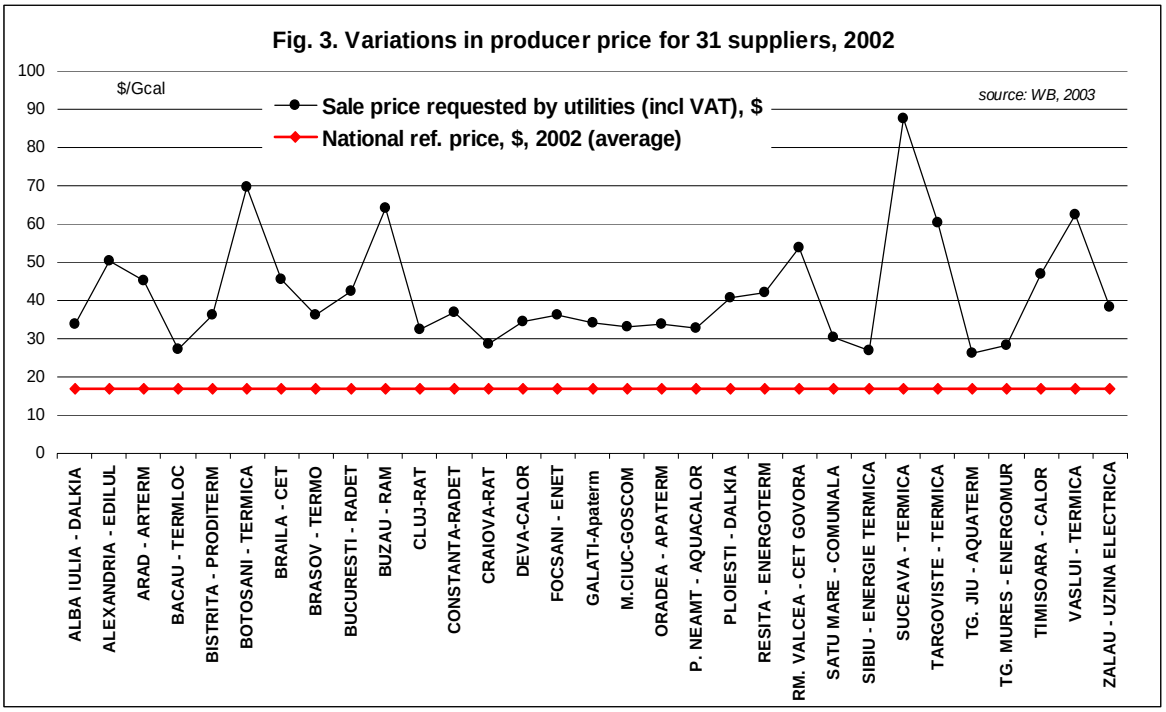
- to adopt policies and strategies for development of the utility services;
- to monitor, control, and supervise the compliance with the contractual obligations, the quality of services and the parameters of services of the operators; the administration and management of the public systems from the infrastructure handled over by concession;
- to determine or validate prices for local public services.

The Government provides technical and financial assistance to the local administration in establishing and organizing local public services.
The technical condition of the plants producing heating for local communities varies a lot, depending on the age of the equipment, technical solution and quality of maintenance. The combinations of fuel used also vary. The effect is that producer costs are very different from one place to another, thus posing acute problems of management and social policy, both at the national and local level. For example, when the 23 plants were transferred from Termoelectrica, LGs were in general very reluctant to take over, raising objections as to the lack of financial resources to maintain operations and commission investments, and the lack of technical and managerial skills to supervise activities of the plants.

They also knew these were the most inefficient plants of Termoelectrica, with an average production cost of 31$/Gcal, above the company average of 18$/Gcal, and the most burdened with arrears: their outstanding receivables were about 40% of the turnover at that moment. Since then the government has tried to help the new owners (LGs), either with subsidies (items 3, 8, 9 in Fig. A above) or targeted investment programs (items 24-26), but the sheer magnitude of the problem makes it difficult to find a solution in such a short time.

Fig. 3 offers an image of the wide variation in costs and prices charged by local utilities. Data were collected by the World Bank (2003) from a sample of 31 power plants in large cities. Together they supply about 2/3 of the total residential heating consumed in Romania and cover about 70% of the households relying on DH. As the data show, disparities are high: both the operational costs and the final price range roughly between 1:3 (with 54$/Gcal the highest cost, in Suceava). The quantity of heat lost in the

system (producer+distributor) also varies a lot, between 4 and 40%, usually the highest leaks plaguing the most inefficient producers, which increases their break-even price even higher.



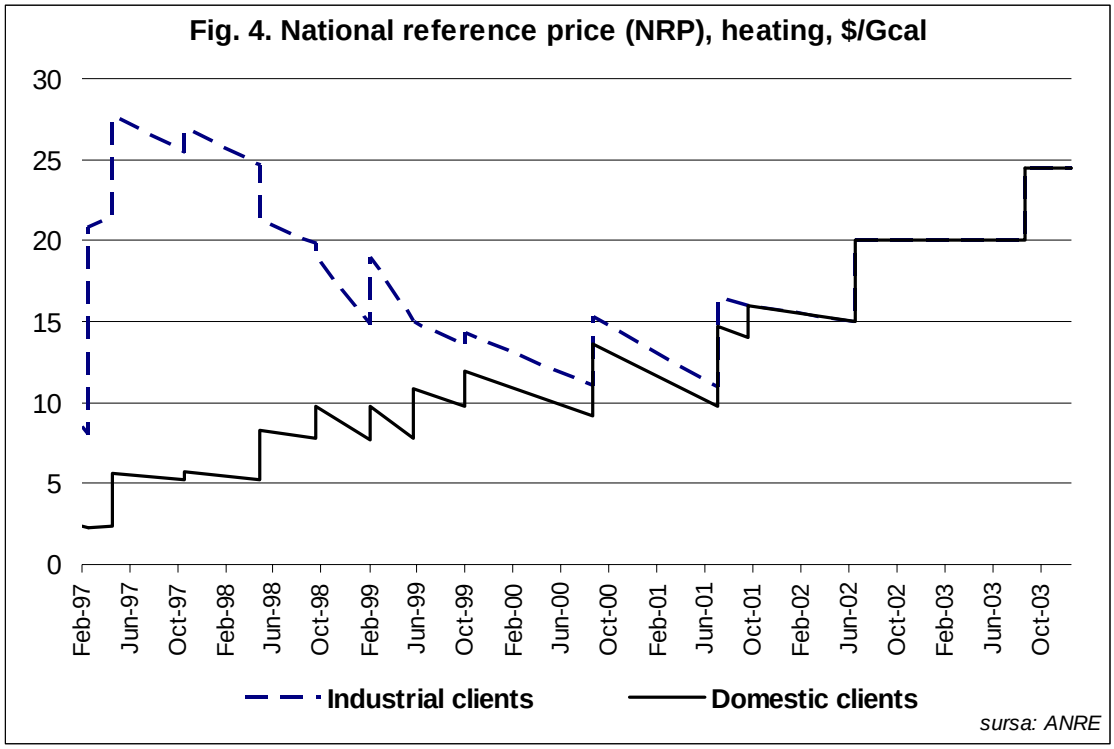
1.2. Social policy

In order to cope with these discrepancies a social policy was gradually put in place with two components: **direct (user)** and **indirect (producer) subsidization** of the heating price. A National Reference Price (NRP) was introduced as an element of national policy which is set and periodically adjusted by ANRE. The evolution over time of the NRP is shown in Fig. 4.

The DH consumers pay only the NRP (and VAT on it starting with 2000). Until the fall of 2003 the difference between the local price and NRP was covered by the **indirect (producer) subsidy** with funds coming:

- 45% from the national budget
- 55% from the local budget

Starting with Oct 2003 the formula was dropped (OU 81/2003), and while the intergovernmental transfer is still operational there is no legal requirement anymore that it should amount to exactly the 45% share of the indirect subsidy. In exchange, the LGs have got the right to deviate up from the NRP, and as a result have the residents of a particular city pay more per Gcal if the local council decides they want to pay less indirect subsidy.



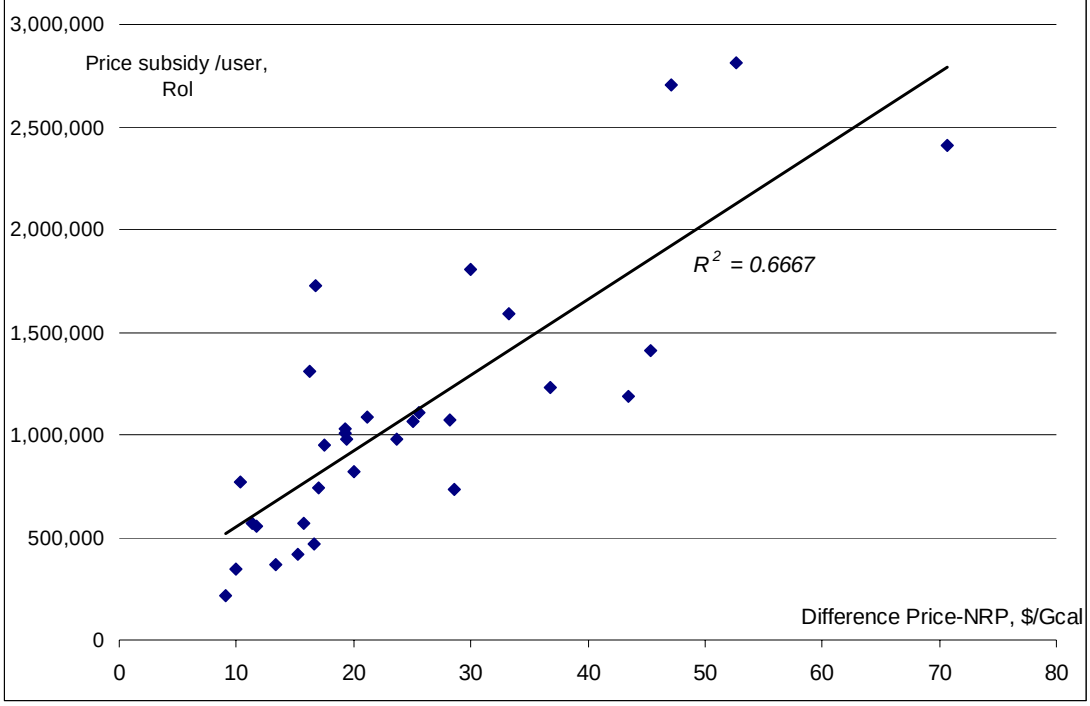
In addition, a **direct (user) subsidy** is paid by local governments to the poorest urban dwellers based on means-testing, for a period of five winter months. The schedule of subsidization has six income brackets also specified by national laws and updated regularly (currently OU 81/2003), as part of a uniform and mandatory national policy. As a result, there are **three streams of funds** which define the social policy in the area of residential heating:

A. *An indirect subsidy from the central government*: an intergovernmental transfer specified in the Annual Budget Law in the form of a lump sum allocated by county. The County Councils subsequently pass the money down to localities, which in turn give it to the heating producers. Until Oct 2003 it (presumably) covered 45% of the difference between local price and NRP; after that there is no such requirement. *This component is displayed as budget item (8-9) in Fig. A above.* The allocation of this transfer seems to function more or less as specified: for the same sample of 31 producers we find a robust correlation between the need for subsidization (big difference local price / NRP) and the money actually transferred to the respective LGs as they are reported to the Ministry of Finance (Fig. 5). This is good news, since it happens often that counties interfere with financial transfers destined to the lower tier and alter their original allocation patterns.

B. *An indirect subsidy from the local government*: money paid by the LG from its own sources of revenue, on top of A. Until Oct 2003 it was supposed to cover the remaining 55% of the difference between local price and NRP.

C. *A direct subsidy to the poorest users.* Here too the central government finances partially this mandate, though there is no reliable estimate of its aggregated cost to LGs and therefore no way to tell, from data currently available in the public domain what fraction is covered by the transfer nationwide[2]. *The transfer item (3) in Fig. A* is meant to finance both the heating allowance and the minimum income policy, as well as a number of other social functions (protection of handicapped persons, etc), and as a result it cannot be broken down by functional categories. Moreover, the LGs have to contribute money from their own revenues to fulfilling these social functions, and the total amount of this contribution is again something impossible to asses at the national level based on the currently existing data, because the reporting structure does not contain such breakdowns. In 2002 the scope of this subsidy was broadened, allowing households who use natural gas and solid fuel for heating to apply for support from LGs. The same principle of means-testing applies in their case.

Fig. 5. Correlation between local need and price subsidy, 2002



What we do know from anecdotal evidence, however, is that LGs have experienced severe financial strains after they received the new social policy mandates. In many places they are not able to pay their 55% share of indirect subsidy – but the same seem to be true about the central

[2] Although officials in the national government – especially the Ministry of Administration and Interior – usually claim that they keep tabs on C, they have not yet produced the data in the public domain to prove it.

government, since the transfer grant has never reached its legal target of 45% (Fig. 6). Thus both central and local governments are generators of arrears in the energy sector, though probably the latter play a larger role.

Fig. 6. The fraction of the indirect subsidy actually covered by the transfer

	2001	2002	2003
Total indirect subsidy (central+local), bn Rol	**6,176**	**7,260**	**8,288**
Indirect subsidy, central, bn Rol	2,524	3,044	3,597
Indirect subsidy, central, %	40.9%	41.9%	43.4%

Source: ANRE, MoF

1.3. Case study: Galaţi

In order to make up for this shortage of data we focused on just one municipality from where we have collected data first-hand: Galaţi city, in the eastern part of Romania, size about 300,000. Fig. 7 and the data in the table below presents the situation of DH in general and the details of the subsidization on all three components (A, B, C), allowing for a more refined discussion about what the residential heating policy means for a typical Romanian city where the local utility is not an outlayer in terms of price and efficiency (see Fig. 3).

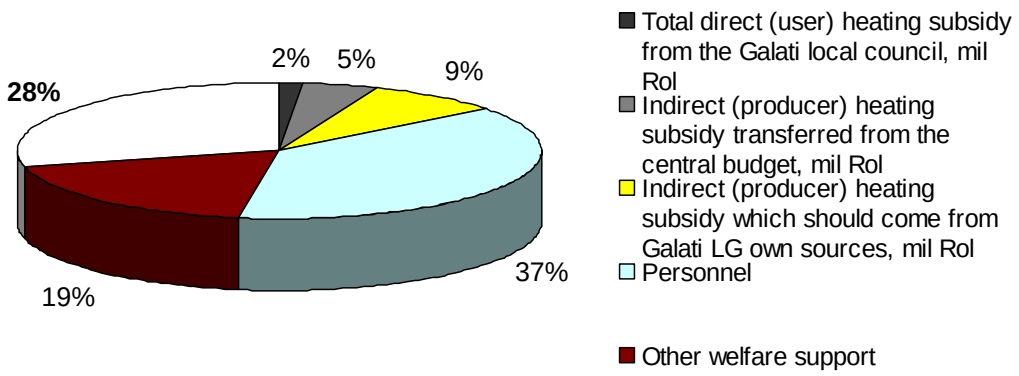
A number of interesting developments become now apparent which confirm those few data available at the aggregate level.

- The indirect (producer) subsidy is still dominant by far, in spite of the stated national policy to shift towards direct subsidization of users. The indirect subsidy (own sources and the grant) amounts to 12% of the local budget, the direct subsidy to just 1%. In other words, a lot of resources are put into a general subsidy going to households that may not necessarily need it, while those who really need subsidization get trivial amounts of money: on average 1.1 mil Rol/household for the current 5 winter months (about 30$).
- Component A represents only about 35% of the difference between the producer price and NRP, instead of the legal 45%. On the other hand the LG also generates arrears of payment, with outstanding debts of about 4% of the local budget. The unpredictable way in which this new mandate was created two years ago created a lot of financial difficulties for LG and made their budget even more rigid: when, as in the case of Galati, about half of it has to be spent on salaries and part on the rest on other mandates (such as income support), there is little else left to finance true local priorities.

Galaţi municipality, the winter 2003-04

(a)	Number of households connected to DH	87,000	87%	of total
(a)	Number of households connected to DH applying for heating allowance (direct subsidy)	21,000	24.1%	of connected
(a)	Total heating allowance to be distributed this winter (5 months), mil RoI	23,600		
(a)	Average sum/household, 5 months, mil RoI	1.12		
(b)	Number of households using gas who apply for heating allowance	2,736		
(b)	Total heating allowance to be distributed this winter (5 months), mil RoI	930		
(b)	Average sum/household, 5 months, mil RoI	0.34		
(C)	Number of households using solid fuel who get support from the local council	550		
(c)	Total heating allowance to be distributed this winter (5 months), mil RoI	134		
(c)	Average sum/household, 5 months, mil RoI	0.24		
	Galati LG budget	1,675,939		
	Total direct (user) heating subsidy from the Galati local council, mil RoI	24,664	1.47%	of budget
	Total energy bill (estimate), 5 months, mil RoI	816,000		
	Difference to be covered (local price - NRP), bn RoI	212,900		
	Indirect (producer) heating subsidy transferred from the central budget, mil RoI	74,000	34.8%	of the need
	Indirect (producer) heating subsidy which should come from Galati LG own sources, mil RoI	138,900	65.2%	of the need
	Indirect (producer) heating subsidy which should come from Galati LG own sources, % in local budget		8.29%	of budget
	Total spending by Galati LG on direct and indirect heating subsidies, 5 months, mil RoI	163,564	9.76%	of budget
	Overdue debts by the population, cumulative, mil RoI	800,000	about 1 year production	
	Number of households with overdue bills, estimate	15,600	17.9%	of total
	Overdue debts by the LG, cumulative, mil RoI (estimate)	65,000	3.88%	of budget

Fig. 7. Heating subsidies in the Galati local budget



- The biggest debtor to the local utility is however the population, with outstanding debts of 800,000 bn Rol, ie about ½ of the total local budget or the value of heating production for the whole year 2003. The situation cannot be unrelated to the first point above: better targeting the funds, by shifting them towards direct subsidization, will also allow an increase in per-family allocations. This may be also important for the producer: the 18% of consumers who have arrears of payment (outstanding bills older that 3 months) are probably to be found among the 24% of households who apply for support from LG.
- In Galaţi, 95% or more of the direct subsidy go to DH users; while the share of support for the households using gas and solid fuel remains trivial. In other localities, especially small ones, the situation may be different.
- For social and political reasons LG are reluctant to raise price above NRP, as they authorized to do, especially in an electoral year. They need more incentives to do that – such as allowing them to shift funds among A-B-C components – or otherwise the flexibilization of the system introduced in 2003 would look more like the central government throwing the hot potato in their lap: since prices have to be raised anyway, let LGs pay the political costs for that.
- Although the bulk of arrears appear to be generated by households, there are reasons to believe that at least some overdue debts of local public institutions are not recorded and reported accurately. Most likely, they are underestimated, since (i) penalties for late payments are not applied (following a controversial instruction from the Court of Accounts), or (ii) deferred payments for which a rescheduling was negotiated with the

supplier are not considered arrears in the sense these are defined by OU 81/2003[3].

1.4. Preliminary conclusions

- Heating provision in local communities is a cross-cutting area of policy where the priorities in three domains have to be carefully balanced: sound decentralization based on clear rules and local autonomy; the reforming of the energy sector; and social protection considerations. So far, the need to increase nominally the cost-effectiveness of the centrally-controlled energy sector seems to have prevailed when some of the most inefficient power generators were handed over to LGs in the fall of 2002. The 45-55% formula for dividing the indirect subsidy between center and localities was an attempt to align the motivations of the two tiers of government, but it also created a lot of financial distress at the local level by making the LG budgets even more rigid than they were before.
- An element of flexibility was introduced in 2003 when the 45-55% formula was dropped, and the LGs were authorized to raise the heating price to consumers above the NRP. However, this also created uncertainty in the system, in spite of the informal pledge of the government that its support will remain more or less the same in absolute terms. Moreover, under the current structure of transfers and responsibilities the LGs have no real incentive to pay the political price of increasing the price/Gcal, since whoever does this will receive less funds the following year in the form of price subsidy grants (component A). The fact that 2004 is a year with local and national elections only complicates the problem.
- The current emphasis on the indirect subsidy, out of which an unspecified amount is used for investments in rehabilitation, represents a misallocation of resources – an indirect transfer towards the majority who may be able to pay a higher price from a minority of consumers (20-25% in the case of Galaţi) who are not able to pay. Since the direct support they receive is rather small, they keep accumulating arrears and magnify the problems in the energy sector.
- Compared to the total amount of the indirect subsidy (7,640 bn Rol in 2004) the special earmarked grants for rehabilitation projects (less than 300 bn Rol in 2004) are a pittance.
- Trying to solve the problem in one area by destroying mechanisms that function well in others is poor policy. This is the case of OU 81/2003, which attempts to deal with the arrears of payments generated by LGs, which allegedly do not pay their share of the indirect subsidy, by making the transfer of the equalization grants and the PIT shares (items 7 and 1 in Fig. A) conditional upon the disbursing of money to utilities. Not only is

[3] But sometimes they can also be over-estimated by mistake, as it happens in Giurgiu county where some heating bills of schools are counted twice (*DFID Report on Arrears in Decentralized Finance and Management Project*, December 2003).

this questionable from the legal point of view, but it also creates informal subordination between tiers of LG, since it authorizes county council presidents to make direct decisions on localities' budgets.

- The current high level of indirect subsidization also distorts the market by blocking entry and locking in the inefficient status quo. Moreover, asking permission from the monopolist to disconnect from the service, as the current rules request, is not exactly a competitive arrangement. This highly subsidized status quo prevents the searching for better / more flexible alternatives for those households who could otherwise afford them. It is an illusion that keeping the better-off households captive in the system – as the government is tempted to do, by gradually erecting administrative obstacles for those who want to disconnect themselves – will help cross-subsidize the least well-off. In the current structure everybody is subsidized in a very inefficient way.

And a policy agenda:

- The role of each tier of government, primarily central and local, have to be better defined, and the responsibilities more clearly spelled out. This goes from reaching a workable *modus vivendi* between the two regulatory authorities (ANRE and ANRSC), to the clarification of the intergovernmental financial flows which have to be put on a more predictable, formulaic basis. Ideally, the DH section of the *National Strategy for Decentralization* (if there's ever going to be one, and whatever its name) should clarify the possible roles to be played by each government tier: owners / operators / beneficiaries / regulators. Even if reforms are urgent – and in the energy sector more than anywhere – these reforms should not be implemented at the expense of the still-fragile LGs.
- Social subsidies (A, B, C) have to be unified into one pool of funds and allocated in a way that is fair and transparent, but also stimulates LGs to make their own decisions on policy trade-offs, and creates incentives to economize at the local level. The emphasis will have to change anyway from indirect to direct (user) subsidization, and LGs will have to be allowed to experiment various social protections schemes. The administrative costs of implementing national mandates, to the extent that they exist, should also be assessed (for example, given the trivial amount of resources distributed to users of gas and solid fuel, does it make sense to continue with them?).
- In any case, social subsidies will have to be clearly separated from the investments programs in the rehabilitation of utilities. Right now, the indirect subsidy (A and B) is a little bit of both. The funds available in the national budget for upgrading the generation plants (items 24-26 in Fig. A) will have to become more visible and predictable, as part of a long-term national strategy.
- The current window of opportunity should not be squandared – substantial restructuring in the financing mechanisms are probably easier

to implement now, when fuel is relatively cheap due to a devalued USD, than it was three years ago or may be three years from now.

- However, money for these rehabilitation programs should not be spread thinly across the board. There should not be massive investment in systems which are going to be dismantled sooner or later, as they have no chance to break even due to high costs (Fig. 3). In fact, the situations vary a lot from one place to the other, and probably there is no general solution which can be applied overall. Solutions working for CHP suppliers may not work in the case of HOB. Alternatives will have to be explored – including the radical one: getting rid of the DH system altogether (like in Baia Mare city). The central government should attempt to remain as financially neutral as possible towards all viable forms of provision.
- Technical problems and trade-offs have to be clearly spelled out and debated, not merely hinted at indirectly in press statements when a new regulation is announced. It is a pity that the government has not yet produced a policy paper on such an important subject, since they do have some data and analytic capacities in the central agencies which are not accessible to the wider public.
- Good policies are based on good knowledge and analysis, and these presuppose at least a minimum of data that describe the situation at the national level / or split by tier of government / components of financing, etc. Such data are largely absent now. A systematic revision is necessary of the information flows pertaining to residential heating policy, in order to organize and supplement them. It is unacceptable when an important policy that implies substantial amount of funds, and in which mandates are created and changed all the time, is lacking even the most rudimentary measuring and evaluation instruments. At a minimum, a database should exist with info about all the LGs regarding all the heating subsidies they receive or pay, and all the investment grants they have access to, separate from other LG functions. The database should be accessible to all interested parties and facilitate informed discussion before legislation is initiated – not after. DH reform will not succeed if policy-makers will continue to grope around in the dark.

2. HOUSING POLICY

Summary of problems

- *Housing seems to be the domain where the assignment of responsibilities by tiers of government is less clear among the three policy areas discussed in this material. It is the one where the instruments of public intervention were created rather late, in the second half of the last decade. And also the one which is by far the least likely to meet its overambitious objectives.*
- *There has been considerable confusion and policy drift in terms of the main goals of intervention: commercially-based operations of the National Housing Agency (ANL) are not clearly separated from the social components, or other prestige projects unrelated with housing. A significant shift of resources has taken place from the first component towards the others.*
- *Even the success of the commercially-based component is under question, as there is some evidence that ANL has developed the type of residential houses that would have been built by the private sector anyway (up-market), while it did little to respond to the unmet demand on the lower-middle segment. The implicit social reallocation through explicit and implicit subsidization is morally questionable – and since the subsidy is large the system tends to create strong incentives for rent-seeking. Private business associations have estimated the subsidy to the ANL clients from each Romanian family at about 120 Euro/year.*
- *Local governments were affected in many ways by this policy pursued mostly by default, as there has been little consultation with them by the central government when plans were initiated or changed. For example, the bolstering of the social component creates a lot of municipal residential property which has to be managed professionally, while most LGs are unprepared for this mandated task. The rules for deciding where and how to build are unclear. Both the commercial and social components of the housing policy presuppose significant indirect subsidization by local governments, much beyond their current ability to spend, and its magnitude and social effects have never been seriously assessed.*

2.1. Inherited situation: high demand and low supply of houses on the market

Construction has been one of the most dynamic sectors of the economy in Romania after 1990, as many individuals and organizations – but mostly private operators – have rushed to improve or renew their property, following decades of underinvestment and decay under Communism. Today, after more than ten years, the diversification of real estate property is

impressive, reflecting the changing economic conditions and aspirations of various social groups. While low income strata, especially in urban areas, are trapped in the high-rise project houses (block of flats) built ages ago under Communism, the emerging upper middle classes have started to move out into newly built or renovated detached houses.

But even Communist-time condominiums have begun to differentiate, the attractiveness (and hence, price) of a flat being influenced much more significantly than before by the quality of the neighborhood and the capacity of the "associations of owners" to raise funds in order to rehabilitate the building. As a result, the real estate market in most Romanian cities and towns is nowadays dual:

- with a thin upper tier which enables a number of well-off people to move into new houses built and sold at prices close to the Western level per sqm;
- and a heavy bottom of mass transactions through which ownership in existing houses, and especially flats in condominiums, is rationalized, passing from those who own more than they need to those who are able to outbid current owners

The problem is, only the first component adds to the existing housing stock, which on average is old and of low quality[4]. But so far even these additions were rather drops in an ocean. There is a significant demand for reasonably priced, mid-quality new houses, and for various reasons – such as the low interest of developers and construction companies, who find the margin of profit too low on this segment – the market is slow to meet this kind of demand.

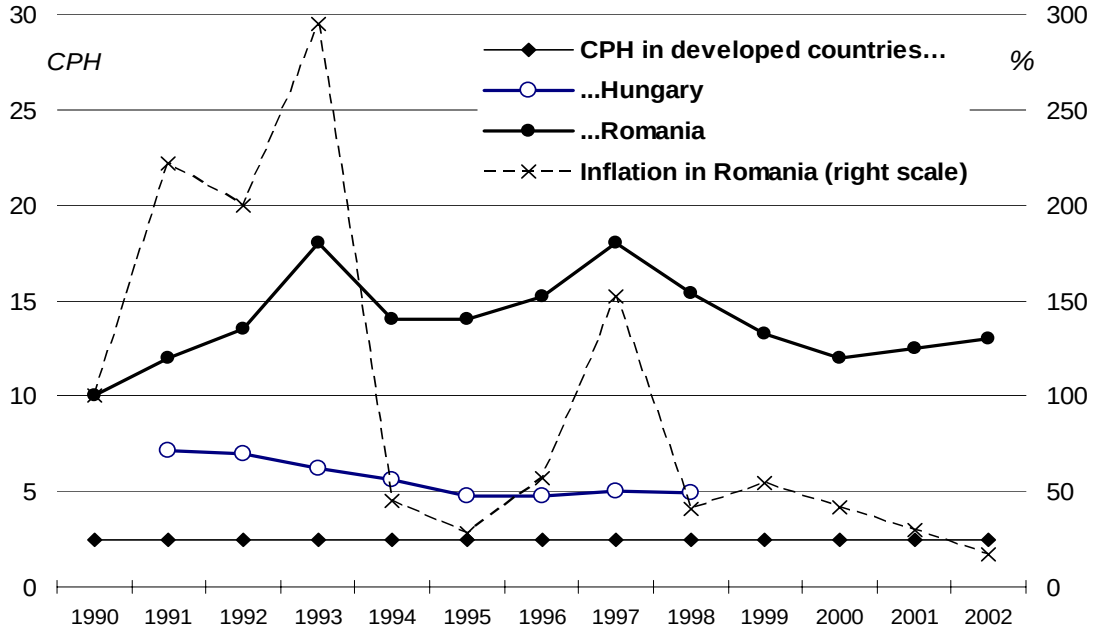
Moreover, the mass privatization of flats that took place in 1990-91 was a big lost opportunity to initiate a sustainable housing policy. Back then, most property built during communist times was sold to tenants at "social prices" – i.e. sums ranging between the average salary for three months and a bus ticket price – in an unprecedented one-off transfer of residential property. More than one million housing units have been privatized this way. Unfortunately, this move did little to change the attitudes entrenched in the post-Communist societies and make people feel that from now on "the state" would not give people houses any more. What is more, the possibility was forgone to set more realistic prices for the public property given away, which people would pay in installments over the long run, and thus create a rolling fund to finance new investments. How important this could have been it would become apparent in 1999-2000, when the cash-strapped center-right coalition struggled hard to find money to set up the National Housing Agency (ANL – more on it below).

[4] According to an estimate 56% of the residential buildings in Romania have fully recovered the initial investment, in other words they have reached the end of their functional life – *Country Profiles on the Housing Sector. Romania.* UN, NY and Geneva, 2001.

Fig. 1 summarizes all these elements and shows that a new house is still beyond the reach of most Romanians. Most affected by the situation presented above are the younger families who do not happen to inherit a property and must raise cash to buy it, some tenants evicted from buildings restituted to old owners, and the social vulnerable groups who have never owned their own residence. With the average price of a new, 100 sqm flat at the level of the total average salary for more than 10 years, it is practically impossible to save / or repay the loan / out of a normal income. The high inflation of the last decade – both an effect and cause of economic uncertainty – delayed the appearance of a truly mortgage loan market until two-three years ago, and even now the costs of borrowing are still high.

The poor instruments for urban management and securing property rights were also part of the Communist legacy. Many localities in Romania still do not have General Zoning Plans (PUZ) and the institution of land cadastre is in its infancy. Municipal inspectorates for constructions are weak and the offices issuing of building permits are regarded as one of the most corrupt local services.

Fig. 1. Capacity to purchase a house
(CPH = price of a 100 sqm new flat / yearly salary)



Source: Ministry of Public Works, 1999

2.2. Addressing the problem after 1990: housing policy in Romania

Given the magnitude of the problem the idea has always been present that state intervention is necessary, though the details and the instruments of intervention were never clearly spelled out. It was only in 1994 and,

especially, at the end of 1996, with the adoption of a Law of Housing, that the first explicit elements of active social policy were introduced:

- first, buildings under construction in December 1989 were to be completed and allocated "preferably" to young people who had never had a property of their own;
- and second, a stock of social houses would be created to be administered by the municipalities and rented to the most urgent social cases in their communities

However, these programs could hardly make a difference. While the total solvable demand for houses was estimated at about 200,000 in 1999[5], the total output of the two programs since 1997 is around 10-11,000 units. What is more, roughly 90% of them come from the first component, which means they were completed at substantially lower costs. As the stock of residential buildings begun before 1989 and left unfinished runs out, the cost of putting new apartments on the market shoots up and the pace of construction slows down (Fig. 2).

In an attempt to deal with these problems a **National Housing Agency (ANL)** was set up in 1999 with the aim to bolster the mortgage credit in Romania and improve the situation of the existing housing stock, by the construction of new residential areas in cities. A pool of funds was to be created through transfers from the general budget and international loans, while the cooperation of local governments was important because they would have to provide the land free of charge and finance the extension of the local infrastructure to the new neighborhoods. On top of that, the new owners would be exempt from paying property tax until they repay the loan.

Fig. 2. Components of the housing policy: number of units completed

	1997	1998	1999	2000	2001-02
Program for Youth (unfinished buildings)	3,257	2,096	2,271	1,187	-
Social Housing		10	215	444	464
National Housing Agency (ANL), mortgage loans				389	711
ANL, units to let to young married					1,880
Social Housing (unfinished buildings)					1,807

Sursă: Ministry of Transportation and Public Works, 2003

N. Noica, 2003. Politici de locuire în România. Editura Maşina de Scris. Nicolae Noica was Minister for Public Works between 1997 and 2000.

As it was initially defined, the main goal of ANL was to create a growing owner-occupied housing stock of European standards through construction financed by mortgage loans. In operational terms ANL's main task was to facilitate financial agreements and manage financial resources for the construction, purchase, rehabilitation, consolidation and extension of residential units. The loans were made in extremely favorable terms, given the adverse conditions on the Romanian financial market in 1999-00: downpayment was 20% of the total price of the house, and the loans were truly long term spanning over 20 to 25 years.

Plans were ambitious, as 6-7,000 new units were planned to be built in the first few years. Both ANL and the Ministry of Transportation and Public Works (MTPW) – which de facto supervises the Agency's operations – would thus become involved into designing and implementing a number of large-scale urban projects, some of which included the construction of privately owned housing units financed by mortgages. These projects were located in Bucharest (Băneasa district and several other areas), Cluj (Floreşti district), Constanţa (Palagu Mare district) and Braşov (Săcele district).

In addition, though the main focus of central government's housing policy was supposed to be the strengthening of private property through encouraging and subsidizing mortgage loans (ANL), the Ministry also made a commitment that it would continue and scale up its contribution to the social housing policy. Through an international loan contracted in 1998 the Ministry initiated a scheme to build 2,000 new apartments which would be transferred to local governments and used for social emergencies. Thus the central government would contribute substantially to the financing of an important mandate it had created for local governments in the previous years.

The combination of housing policies pursued by the central government through the Ministry of Transportation and Public Works since 1996 can be summarized by distinguishing between its two main components.

A. ANL was launched in 1999-2000 under the previous center-right government as a **commercial-type scheme** of housing mortgage loans. Nostalgia played a role, as the scheme was explicitly supposed to materialize the similar plans designed by the historical parties in the interwar period[6].

- interest revolving around market level, with some subsidization that the "government may grant" depending on projects
- firm prices at the time of contract: re-evaluations would occur only when inflation is greater than 20%
- all the new houses would become private property

The state initiated the scheme with a transfer of about 300 bil Rol (about 20 mil USD in 1999); today we are in the range of 450 bil Rol/year. The prices

[6] The Minister of Public Works between 1997-2000 was a Christian-Democrat coming from a family with strong roots in the interwar democratic politics.

with building contractors were firmly negotiated and included in the contract. For a typical flat, the final price revolved around 200 $/sqm. The estimated rate of profit for contractors was around 8-10%.

Local governments play an important role in this scheme, as they are supposed to contribute with the land, exempt the owners of property tax until they repay the loan to ANL, pay for extending the roads infrastructure and utility grids to the new neighborhoods, and subsidize/facilitate the building operations in various other ways (for example, by providing some free of charge certain documents and licenses for which other private actors have to pay a fee).

B. Apart from ANL operations, MTPW also runs additional **social housing schemes** such as the ones shown in Fig. 2.

- "Ordinance 19/1994" – houses (mostly apartments in buildings which were unfinished in December 1989) built (or completed) with money 80% from the state budget and 20% local budget and sold to young people, recently married, etc (see criteria in the ordinance). About 9,000 apartments completed by now (see Fig. 2), but mostly in early years of transition. As it was mentioned above, the stock of unfinished houses where the building started before 1989 has by and large ran out, so that this program has naturally shrunk. It is hard to determine the total size of the operations in this program and the implicit subsidy per unit, since the buildings were in various stages of completion. But it would be safe to assume that the total sum coming from the central & local budgets was in the range of 100-150 million USD.
- The social housing project launched by the MTPW with a 60 mil USD private credit contract with a British company, which was also the building contractor (Mivan Kier JV Ltd). These new houses were to be built and transferred to local governments to be used for social emergency cases. Initiated in late '98, the loan contract was signed in March 2000 and covered the building of 2,000 apartments.

Like in the case of the mortgage loans scheme, local governments are supposed to contribute with land, new infrastructure and connection to utilities – or even to contribute cash from their housing development budget lines, when they have it.

After the new PSD government came to power in **2001** a number of **changes** were made. First, everything was put under the same roof – that of ANL. Thus the Agency ceased to be only the administrator of a commercially-oriented public mortgage fund, and incorporated a significant social mandate. As it turned out, this change would prove to be more difficult than initially planned. Second, component B (social) was re-emphasized at the expense of A (commercially-based operation). Since the resources were not earmarked to each of them in the first place, it is difficult to document this with financial

data. But the physical output figures discussed in the next section give a strong hint in this direction. An additional private loan of 100 mil USD was contracted from the Development Bank of Europe to meet the high targets the government has set for itself in the electoral campaign with the B component.

Third, prices to the beneficiaries were raised on component A form 200 USD/sqm to about 350-450 USD/sqm, depending on the type of building. The current government blames the previous one for setting prices included in contracts unrealistically low, which may have caused the quality problems signaled by beneficiaries (see also Fig. 5 below). On the other hand previous government's officials blame the current administrations for raising prices too much. They say this may have happened both intentionally, in order to siphon off funds, or as a result of shifting from condominiums to detached houses; or unintentionally – higher prices reflects the costs of uncertainty to the contractor, as the downpayment from clients was reduced from 30% to 10%, and the builder gets less money upfront having to rely on more numerous installments from ANL. Briefly, the pressure on contracting companies to extend more commercial credit to ANL has made the houses more expensive.

2.3. Financing the housing policy

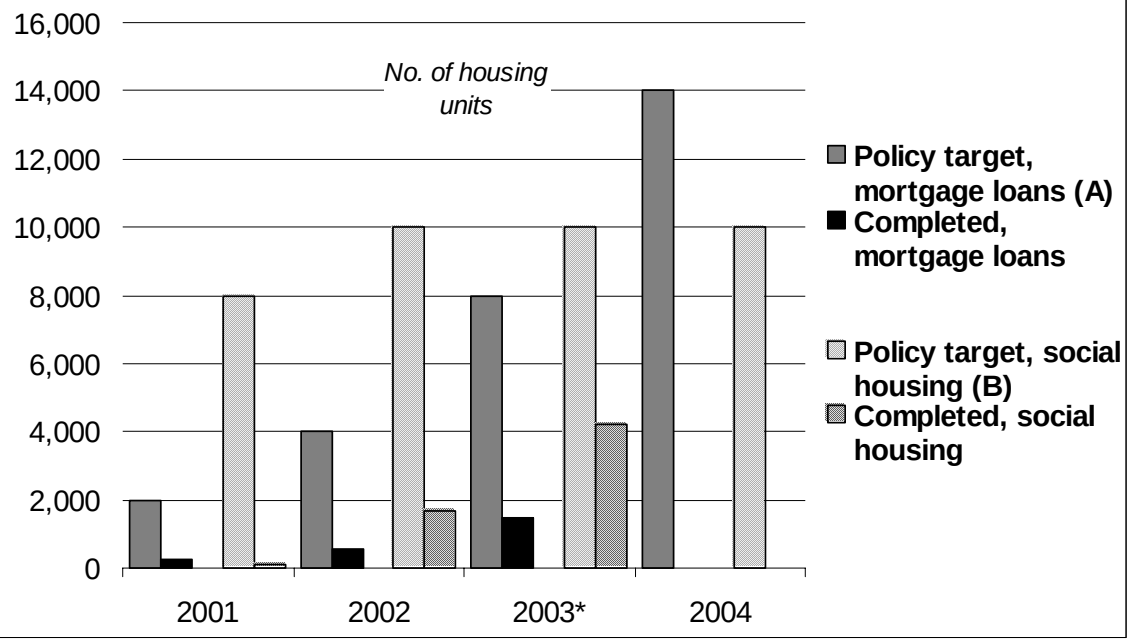
However, the most visible change introduced in 2001 was the significant overall scaling up of the operations compared to what the previous government had attempted, almost by an order of magnitude. The target for the 2001-04 mandate was set at 28,000 new units in the component A (mortgage loans) and 38,000 in component B (social housing to be leased out, mostly to young families). This was an extremely ambitious goal – probably too ambitious, as Fig. 3 shows.

There were many difficulties which contributed to the rather spectacular failure of the housing policy, and they will be discussed in the next section. But the most important was probably the initial miscalculation of resources available. If in 1999 when the social housing program was launched, the initial loan of 60 mil USD was meant to finance the building of 2,000 apartments, at an average cost of 30,000 USD per unit. When the whole operation was scaled up in 2001, the government failed to explain where they would find more than 1 bil USD to finance the 38,000 units promised. What is more, the picture became murkier since the current government also promised it would build 400 school sporthalls during this mandate. Though formally they are not ANL's responsibility, there is anecdotal evidence that the effort to complete these sporthalls is making a dent in the resources which would otherwise be devoted to the housing schemes.

There is no surprise therefore that ANL faced serious financial problems when it tried to implement the two schemes. First, as the price per sqm of units built with mortgage loans went up, the prospect of putting affordable, mid-level houses on the market became increasingly remote. Instead ANL was naturally pushed towards developing more expensive, up-market property

such as the new neighborhoods of detached houses launched in 2002-03. The typical example is "Henri Coandă" project in Bucharest – a lot of about 1,100 units for which the estimated final price will be in the range of 400-500 USD/sqm[7]. And even this price will include a lot of implicit and explicit subsidies, since the common property will be developed mostly at the local government's expense and the purchasing contracts are VAT exempt.

Fig. 3. Policy targets and accomplishments in the housing policy (A: 20,000 units; B: 38,000 units)



** Rough estimates for 2003 since MTPW and ANL have not produced clear and consistent reports regarding the finalized units*

The situation is even more dramatic on component B – social housing – where the central and local governments have to bear the full cost of the program. So far money could be found to cover only about 35-40% of the costs of the proposed policy between 2001-04. In a last minute attempt to find additional resources and close the financing gap for component B (and the school sporthalls informally attached to it) the government tried in March this year to circumvent banking regulations and take a credit of about 200 mil USD from CEC, the savings bank which is still state-owned. The move was met with harsh criticism from the Central Bank, IMF and the media and it had to be abandoned. Currently there are signs that MTPW attempts to find some 100 mil USD in the state budget to make up for the shortfall. Under these circumstances it is obvious that reaching even half of the announced target would be a great success. Most likely, the government will struggle to

[7] These are just estimates, however. The new contracts are less firm as far as the final price is concerned than the first ones concluded in 2000, thus introducing an additional element of uncertainty to the clients.

put on the market about a quarter of the 38,000 social housing units by the end of 2004.

Fig. 4. The cost vs. available resources for the two components, 2001-04 – a yawning gap

Component	Estimated cost, USD	Sources of funds	Available, USD	Deficit, USD
A. Mortgage loans: 20,000 units	**140-160 mil***	State budget/local budgets	about 100 mil	**40-60 mil**
B. Social housing: 38,000 units	**1,150 mil**	State budget**	300 mil	**650-700 mil**
		International loan	100 mil	
		Local governments***	50-100 mil	

** Meant to cover subsidy to the credit, various fees, land viabilization, infrastructure, connection to utilities (average 8,000-10,000 USD/unit); it does not include the price of land*

*** Item (a) in Fig. A at the beginning of this material*

**** From own revenues and the housing fund allocated by MTPW (item 21 in Fig. A at the beginning of this material – 35 mil USD between 2001-04)*

The role of the local governments in the housing policy has become less and less clear as the targets became more ambitious and the goals more numerous. Though in principle they should be happy to bring new investments in their community, the reality on the ground is more complex. First, LGs enthusiasm to cooperate in A-type operations (commercial mortgage loans) has cooled down once they saw there are substantial costs to the local budget associated to the scheme. In many localities it is really difficult to find appropriate plots of land which would be attractive enough for clients so that they are willing to pay the substantial price per sqm presupposed by a commercial loan. Second, especially in cities where mayors belong to opposition parties, they do not want to make what they regard as an open-ended commitment of resources to a national policy for which the central government is likely to take all the political credit. As a result local governments were in general slow to contribute from their own resources to the investment policies of the MTPW, especially to the social housing part. When they did, they relied mostly on special grants and transfers received from the same central government (such as item 21 in Fig. A at the beginning of this material).

The in-kind subsidy mentioned above, in the form of free land, building permits, utility connection and VAT exemption can be substantial. Save for the VAT exemption it is covered by the local governments, so it is likely to function as a strong deterrent for LGs to engage in cooperation with ANL. The

average subsidy can be inferred as a difference between the price paid by the beneficiaries on their contracts with ANL and the price they have got on the free market when they sold their new property. As the law did not ban the selling of property in any way, some apartments have already entered the real estate market one or two years after completion. The analysis in Fig. 5 below refers to an average 100 sqm apartment in a condominium begun in 2000 and completed in 2002 in Bucharest. The subsidy can be substantially higher in the case of detached houses projects initiated after 2001.

Fig. 5. Case study: implicit subsidy for property built on ANL mortgage loan

USD	Price paid to ANL	Additional private investment by client*	Price for which it was sold	Implicit subsidy
100 sqm apartment in condominium, Bucharest	20,000	7-8,000	38,000	***10,000***

** To remedy the poor quality of work*

Since only 1,500-1,800 housing units were completed in the component A until now, the total implicit subsidy from local governments to the new owners extrapolated from the case in Fig. 5 may be the range of 15-20 mil USD. But if we go back again to the government plan to build 20,000 such units between 2001 and 2004, the total implicit subsidy would be around 200 mil USD. This is almost a third of the combined budget of the large cities which is earmarked for housing and public services, which includes the component B and all other utilities rehabilitation & maintenance. It is unlikely that local governments will be ever able to come up with such a substantial contribution in land and cash.

There are also significant costs to the local governments in the long run. Having the new owners of new houses built on mortgage loans exempt from property tax (the main source of local own revenues) may not be a problem while their number is still insignificant – for the time being, this is just a questionable by minor social reallocation. More important is the new mandate created for the local authorities by the social housing component: the new condominiums are leased out to families (mostly young, first-time owners) at very low rates which are unlikely to cover the costs of maintaining the property: between 5-10 USD/month. Not only is the management of the new municipal assets a difficult task for which most LGs are unprepared, but based on previous experience with publicly-owned residential property a quick deterioration of the housing stock is likely to occur, at least in some buildings, and the authorities will struggle financially to keep them from depreciating.

2.4. Conclusions and policy issues

- There has been confusion regarding the ultimate intentions of the housing policy, especially after 2001. If the emphasis is put on social housing (with a positive discrimination for young, first-time owners), and less on the commercial mortgage loans, this means the whole housing policy is diverted from its original stated goal when ANL was created – i.e. to stimulate the mortgage credit market, very weak back in 1999-2000, by reducing the transaction costs between the three private partners: developers, clients and the credit institutions. In other words, initially the policy was meant to encourage the *development of private property*. Later on the emphasis was shifted towards *(re)creating new public property*, as social units are not supposed to be sold to tenants (though the possibility cannot be completely ruled out, especially if the new municipal units become a political liability in the future), with all the typical problems attached to managing it. Moreover, this strategic decision, which is a *reversal of the privatization trend of the early '90s*, was never discussed in these terms and assumed explicitly. Before such a strategic decision is made – as minister Mitrea implied when he announced recently in a press conference that ANL may completely withdraw from mortgage lending (component A) in 3-4 years – it would be good to launch a proper public debate.
- Even the original plan of stimulating the development of private residential property, as it was defined by the previous center-right government, had its weaknesses. The mortgage credit scheme implies subsidies in various points, the magnitude of which has never been assessed explicitly. Evidence shows that the subsidy can go as high as 20-30% of the market price of property (see Fig. 5 above). This may be acceptable as long as ANL focuses on developing affordable houses for the lower-middle social categories. However, once ANL starts to engage in up-market projects in trendy areas of the main cities, the high subsidization from the rest of the community become a moral problem. Private construction business associations have estimated that each Romanian family pays an average of 120 Euro/year on subsidies to the "privileged clients of ANL"[8].
- Private developers and construction companies also claim that subsidized ANL contracts create unfair competition and crowd-out private investment. The precise effects are hard to pin down but there is some evidence to back their allegations. In 2003, as the ANL schemes gained speed (Fig. 3), the number of housing units completed in Romania with private funds went down by 4.3%, for the first time in the last fours years. In the same time the number of units built with public funds more than doubled. This is a question hard to answer, but worth asking: is ANL really stimulating the development of private property? or it merely

"Concurenţa ANL a diminuat livrările de locuinţe în sectorul privat", *Ziarul Financiar*, 20 martie 2004.

substitutes private investments with publicly subsidized schemes, building houses that would have been built on the private market anyway? It would be useful to explore this issue empirically in a more coherent manner and give an informed input into the decision-making process.

- The changes introduced in 2001 have added new layers of complications, as the government has raised the stakes, gave new social mandates to ANL and in the same time embarked on a series of prestige projects unrelated to the housing policy but which are likely to piggyback on the same pool of resources (such as the 400-some school sporthalls). Not only that this has made the policy targets more difficult to accomplish, but it also became more difficult to distinguish between the commercially-oriented (subsidized) operation and the pure social schemes. There is a permanent tendency of the policy-makers to avoid clear commitments and figures in the official reports and play hide-and-seek with the policy targets which are shifted from one component to the other. Some cross-subsidization may also take place between components, though this is also difficult to demonstrate based on the data currently available.
- The criteria and mechanisms of decision and allocation of resources remain by and large discretionary and obscure, for all the components of the housing policy. The County Councils "centralize the needs coming from territory" and pass the information up to MTPW. Then resources are passed down to counties following no clear rules or guidelines – "proportionately" as some public officials claim. One element may be that "the more advanced investments are served first", which is in itself a controversial principle to distribute funds.
- The general problem of intergovernmental transfers in Romania is present here too: County Councils intermediate the money flows and decide on allocations even if they have no formal attribution in this policy area. This complicates unnecessarily the relations between tiers of government and opens the possibility for them to interfere with the housing funds; or to make other earmarked or non-earmarked grants conditional upon cooperation in this particular domain. Many budgetary items have been recently defined by the government more flexibly precisely in response to the financing crisis in the housing sector (for example, money for roads can now be used to finance infrastructure for the new ANL projects). Therefore the ministry or the county councils can use them now as instruments for inducing discipline and a more cooperative behavior in local governments, who otherwise have little incentive to participate in such costly schemes.
- The capacity of local governments to administer the new stock of public residential property should be a factor to be considered when decisions are made where and how much to build. The natural propensity to cut as many ribbons as possible should be tempered by the shortage of managerial expertise and maintenance funds. Problems of over-investment have already begun to appear in the case of the new sporthalls built by MTPW: maintaining and paying utilities for them,

especially in winter time, is beyond the possibility of many small or medium-sized local governments already sunk in arrears. Without proper planning there is a risk that similar problems will appear in the case of the expending municipal residential property, especially the one developed through social housing schemes for which the rent does not cover maintenance costs.

- One important aspect related to institutional capacity is the allocation of houses according to strict formal criteria. This is important on both components of the policy, because in both cases the benefits accruing to clients are substantial – an implicit subsidy worth the average salary for 3-4 years on component A; or rent at trivial levels (50-100 USD/year) virtually in perpetuity. As a result the pressure is high on both ANL and the local governments from would-be clients to get access to such contracts. The decision-makers would be well-advised to have a second look at the fundamental parameters of the housing policy, and the network of weak institutions which are mandated to implement it. Even if in theory such a public policy may work, the matter remains open whether in the current context the Romanian central and local authorities will manage to prevent its transformation into a case study in rent-seeking.

3. ROADS POLICY

Summary of problems

- *The Romanian roads sector is chronically underfinanced. Considering the resources in the last years, overall, the roads infrastructure is degrading faster than it is maintained and upgraded.*
- *The limited funding is allocated through political decisions for projects of questionable priority and low economic efficiency, but of great visibility and prestige, (as highways or bridges with no traffic). Allocation of funds towards counties is also done in a discretionary manner, ignoring the criteria stipulated by law.*
- *Lack of monitoring, control and transparency leads to great differences in costs per kilometer for similar works executed in different regions with different contractors.*
- *Due to lack of transparence, the Romanian public is aware only of partial and superficial aspects of the national roads policy, lacking a global view of priorities and the way these are implemented. As a result, the real public debate is lacking in the sector which will involve the larges public investments in the near future.*

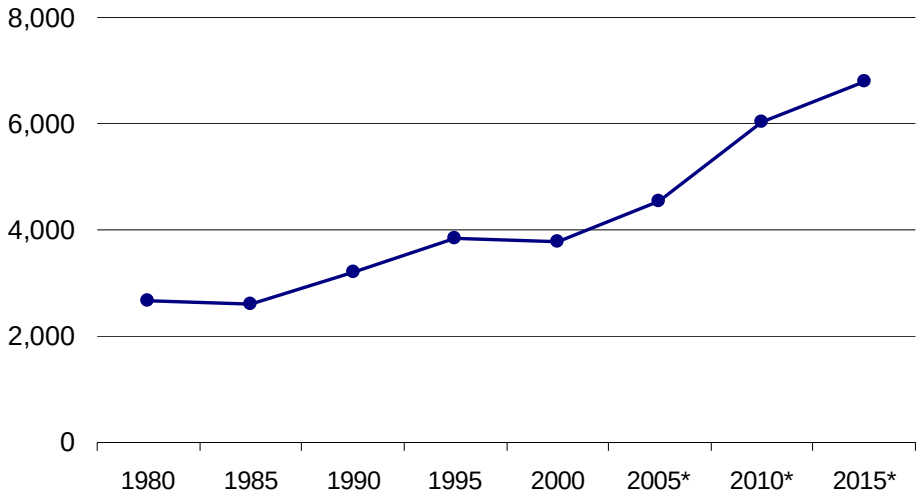
The infrastructure represents vital lubrication for any economic machinery, thus addressing the problem of public roads in Romania, including administration and public finance for the sector, is of extreme importance. Well built, maintained and safe roads network can contribute with value added of 3 to 5% of GDP, as the World Bank estimates. Also, following the same figures, transport commonly accounts for 5 to 8% of total paid employment, and public investment in transport typically accounts for between 2 and 2.5% of GDP and may rise as high as 3.5% in countries that are modernizing outdated transport infrastructure or building new transport infrastructure[9]. In Romania the transport sector contributes 4.8% of the GDP and accounts for 5% of the country's employment. But the public investment in the sector is only about 1% of the GDP, half of what is the minimum standard of 2% in Western countries.

Unfortunately, while transport has the potential to account for economic growth, in Romania the total annual loss due to road traffic accidents has been estimated to be about 2.5% of the GDP. In 2002 there have been a number of 2,398 fatalities on roads (46% pedestrians), and a total of 8175 persons who have suffered accidents. Thus if loss of one human life were

[9] The World Bank, http://wbln0018.worldbank.org/ECA/Transport.nsf/Countries/Romania?Opendocument

estimated at €1 million[10], the total loss in the economy from accidents on roads is as high as €2 billion. The main causes for this are poor road infrastructure, poor technical state of vehicles, limited effectiveness and penetration of traffic management and law enforcement. Not yet so pregnant, and neither accounted for in Romania, are the health costs from pollution by automobiles. However, considering the constant increase in traffic (see Fig.1) this can also become a problem that will need future consideration.

Fig. 1. Increase in annual average daily traffic: vehicles/24h



Source: National Administration of Roads

In Romania the general factors that influence the transport sector are: (1) globalization of trade, that greatly expanded the scope for international trade in goods and services, (2) congestion and pollution growing particularly in cities, (3) transport sector deficits, namely, poorly managed public transport services that impose a heavy burden on public budget, and (4) expenditure needs required to maintain and modernize existing transport infrastructure (currently needed around $450 million per year accounting for about 4.5% of the state budget). With problems ranging from under-financing, to poor administration, lack of quality control, lack of a comprehensive and feasible national strategy, the public officials at national level are in the position to consider trade-offs such as the followings.

1.1. Trade-offs

The public roads system cannot be treated separately from its functions – that of keeping the population and the goods moving within the country and abroad efficiently, thus improving the economic performance and the welfare of the population. A national policy for roads can be designed only by

[10] In 1996 the World bank estimated one fatality at a price of $130 000

explicitly delimitating feasible options and priorities. Inevitably, the options are political, as the technicians can only contribute at formulating the right questions. There will always be conflicting interests and for this reason a transparent debate process should be followed. A strategy for developing and maintaining the national roads system should be flexibly integrated with other national strategies for economic development, human resources development, or tourism.

In conditions of scarce financial resources, at national level decision makers need to choose from a series of options to establish priorities and design such a strategy. The public debate should focus around the following options:

- Local autonomy versus national uniform system of roads. One also needs to decide at what level the local autonomy should occur.
- What activities can remain public, what is being contracted out, and what can be entirely privatized? In this context, several activities, especially the non-capital intensive ones (such as maintenance), are harder to contract out. Who will undertake those activities? Also, who is to oversee and ensure quality control, in relationship with the contractors for the entire national roads system and works carried out.
- Time trade-off: should a shorter-term view be kept in mind, to cover the needs for the next nears, or should one chose expensive solutions for the longer term (ex: four-lane national roads vs. highways)
- Spatial trade-off: build roads where there is traffic already (i.e. development); or build roads in order to trigger development, to answer needs to reduce isolation of the population.
- Have a rigid fund for roads or a flexible allocation through the national budget, with allocation based on a multi-annual strategy.
- Have the transfers to the local governments made based on formulas, criteria, or flexibly decided, case by case by the national government (for counties), and by the county councils (for localities)

Based on answers to the first three points, we can define the national policy, priorities and allocation of attributions on center-regional-local levels, and the degree of local autonomy for roads. Based on the answers to the last three points we can define the policy for allocation of funds, based on the criteria incorporated in laws. However, before drawing conclusions, we will present a short overview of the status of transport in Romania.

1.2. Short overview of the Road Transport in Romania

In Romania, due to insufficient investment, maintenance and repair, the transport infrastructure does not meet current needs of a market economy and lags behind Western Europe. The existing infrastructure, built on the organic pattern of old roads connecting localities, with no city by-passes, is extremely inefficient in terms of safety and speed limits. Several past programs – national or international donor-financed – aimed to strengthen

institutional capacity, reorganize the roads administration, and improve road maintenance and rehabilitation, but severe problems still persist.

The road network totals approx. 78,601 km, of which 20% are national roads carrying 60% of the traffic. Road density, with regard to both population and land area, is the lowest among all CEE countries and, thus, pollution is not yet an issue but in major cities. Transport infrastructure, according to the Romanian Constitution is public property of the State. These assets are administered by national entities, or companies or corporations under the jurisdiction or the monitoring of the Ministry of Transportation – which may award these assets for concession[11].

As far as road transportation is concerned, the Ministry of Transportation is in charge of setting up the general transport strategy and policy, defining the needs in terms of networks development, dealing with international organizations and organizing the transport operation through licensing of operators and setting up rules and regulations for the transport sector. The national roads are managed by the National Company of Roads (NCR; previously the National Administration of Roads, NAR) – an autonomous entity under the Ministry of Transportation, in process of being privatized since 2003. They represent approximately 15,093 km of national roads. Because of the difficulties faced by the railway companies and the natural advantages of the road transportation, the latter is playing an increasing role all over the region.

Public roads in Romania (excluding street networks) are classified in a three-tier system: national (main) roads (14,696 km), district (county) roads (36,020 km), and communal roads (27,781 km). In addition there are approximately 30,000 km village roads serving the rural villages' needs, and farming related activities (Fig.2 and 3). All roads are often re-classified, and for this reason, the exact length in each category varies greatly from year to year.

If the national roads are administered and managed by the National Company of Roads, the district (county) roads are administered by the County Council and managed by the County's technical department. The communal roads are administered and managed by the village councils aided by the County council's technical office. Construction, maintenance and administration of the national road network are also the responsibility of National Company of Roads, secondary account holder, after the MoT. NCR is at present dependent on the budget for almost all its resources (only some revenue is derived directly from bridge tolls, transit permits and overloading charges levied at the frontier posts). The field organization consists of 7 directorates (Bucuresti, Craiova, Timisoara, Cluj, Brasov, Iasi and Constanta) further divided into 41 sections, their borders coinciding with those of administrative districts (*counties*). Each section is divided into 4-6 districts

[11] Transport Infrastructure Regional Study (TIRS) in the Balkans/ Final report, Louis Berger SA, 2000

for routine and winter maintenance. In addition, there are some 140 'formations' for periodic resurfacing and strengthening, each equipped with one asphalt plant and the corresponding transport and paving equipment.

Fig.2 Network by type

Description	Road Network*				
	Paved		Gravel	Earth	Total
National Roads - NR	14,462	98%	221	-	221
Districts Roads - DR	18,111	67%	7,718	1,138	26,967
Communal Roads - CR	4,951	16%	18,686	7,529	31,166
Total	37,524		26,625	8,667	72,816
%	*51%*		*37%*	*12%*	*100%*

**(Excluding street networks) Source: The World Bank, 1997*

Fig.3 Network by type and administration

Description	Administration	Length (km)
Motorways		114
National Roads - NR	NCR	15,093
District Roads - DR	County Councils	36,010
Communal Roads - CR	Local Councils	27,781
TOTAL		**78,998**
Streets	Local Councils	22,328
Streets in Rural Settlements	Municipalities, Cities and Communes	97,660

Source: National Administration of Roads, 2004

Traffic of all types has been adversely affected by the large downturn and the restructuring of the economy away from heavy industry which was traditionally a large user of transport. Road traffic grew rapidly in the 70s but stagnated in the 80s as it was suppressed by physical control and regulation. Car traffic increased dramatically in 1990, but fell back thereafter as fuel prices were adjusted to reflect world market prices. Currently, both in absolute numbers and percentage increases, traffic is on the rise compared to previous measurement (once every 5 years). In spite of this increase, Romania still does not have very heavy traffic (Fig 4). For a distribution of the traffic on length of roads, figures from 1990 and 1995 show that less than 20% of the network had traffic levels in excess of 6,000 vehicles per day (VPD) and only around 5% 10,000 VPD (Fig.5).

Also, all traffic from the Western borders towards East combined is approximated at no more than 35,000 VPD (vehicles per day, annual average) – corresponding to the capacity of one four-lane highway. Even from this perspective only, two West-East highways are highly unlikely to be a profitable investment.

Fig.4. Vehicles Per Day - National Annual Average 2000			
Type of Roads	**National Roads**	**District Roads**	**Communal Roads**
VPD - 2000	3776	1327	621

Fig. 5. Traffic in VPD	1990 (km)	1995 (km)
<1,000	1,796	1,575
1,000 to 3,000	6,353	5,294
3,000 to 6,000	4,407	4,547
6,000 to 10,000	1,136	1,910
> 10,000	347	718
TOTAL*	**14,039**	**14,044**

** excludes length through municipalities, Source: The World Bank*

Engineering for the road system has generally been prepared by the institutes of the MoT. Private engineering consultants have emerged, often in joint-venture with foreign consultants. Road design standards became more appropriate to traffic flows and physical characteristics, but there are still several technical mistakes made, as often no proper financial and feasibility analysis are carried out prior to project implementation. For example, widening the existing locality-connecting network is an expensive exercise – for the state, localities and users – while it does not solve the problem of speed limits and traffic safety in localities. Costs are similar or even higher than building new roads, on shorter routes, not crossing localities.

1.3. Financing roads

In Romania the level of public finance for roads is low at around 1% of GDP in 2003 compared to the minimum of 2% in Western countries. In 2004 the forecast budget for roads is at around US$ 758 mil (about 1.38% of the GDP) but this amount includes the service of all the credits taken for past and current projects. In 2002 NCR's budget amounted to around US$ 308 million (without the payable debts), while the 2004 budget will be approximately US$ 680 (including payable credits, etc.). Starting 2004, the NCR budget does not comprise the funds to be transferred towards local governments.

In the past, expenditure for roads has been fairly constant fluctuating between US$260 to 300 million per year (Fig.6). If until 1996 the distribution of funds between the national roads and the rest of the network has been stable at 50:50, with the introduction of the Road Fund this ratio changed to 65:35, roughly reflecting traffic flows. Capital expenditures have mostly gone to improving and strengthening existing roads rather than new construction – even if the latter are necessary for safety and efficiency (eg. city by-passes, crossroads, etc). Priority has been given to basic repairs and keeping the road surface in as good condition as possible at the least cost.

Fig. 6. Roads Expenditures (US$ mil)

	National Roads			District and Communal roads			Total
	recurrent costs	capital costs	total	recurrent costs	capital costs	total	USD - Million
1989	104	35	140	129	36	164	304
1992	72	6	78	94	13	107	185
1995	215*	68	283	98	30	128	411

** The amounts include the rehabilitation costs*

Fig. 7. Projection of the revenues from the Road Fund, US$ mil, 1996 value

Years	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Road Fund Revenues	0	0	0	151	156	160	165	170	174	181
Total road sector revenues	262	251	350	445	459	415	431	339	345	353

Source: The World Bank

In terms of revenues, until 1996 road user charges consisted in: annual vehicle license fees; vehicle registration fees, a 5% tax on the ex-refinery price of fuel and various fees and tolls. Taxation level was low and total revenues amounted to some US$ 63 million in 1992, half of it from fuel taxes. Also, fuel tax revenues did not increase in parallel with traffic and fuel consumption (as price of fuel was gradually reduced in real terms). Revenues from tolls and transit fees almost doubled since 1992

For increasing and stabilizing revenues, Law 118 was passed in October 1996 for establishing a Road Fund, which was scheduled to function until 2003. This was fed from 25% charge on ex-refinery prices (exclusive of excises) of fuels and 10% of charge on ex-factory prices (excluding excises) of vehicles. The Fund generated around US$ 200 million per annum starting in 1997. It grew with traffic and vehicle purchases, and did better than projected. Other fees and tolls generated around US$ 35 million per year. These two sources would cover the variable costs of the network but fell short of covering total roads costs estimated at US$ 400-450 million per year. This Fund was shared between the national roads (65%) and county roads (35%). The road fund income covered the administrative expenses, routine maintenance, loan service payments, and limited rehabilitation costs of the national roads. It also covered most costs of county roads' rehabilitation and maintenance.

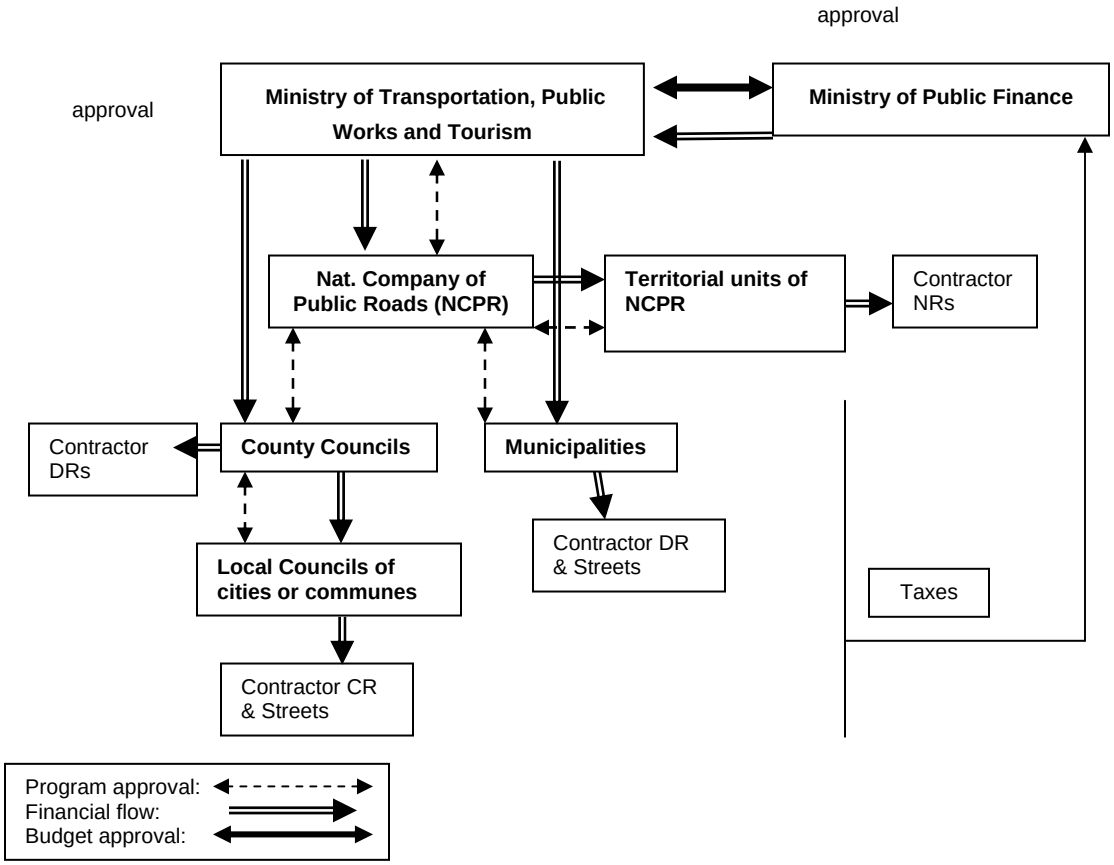
1.4. Financing and administration of District and Communal Roads

In 1990 the process for transforming the state owned companies, whatever their managerial body, into autonomous or commercial companies, was started (Law 15/1990). In 1997 the district roads, previously patrimony of the central state, were transferred to the County Governments through Urgency Ordinance 43/1997. The Economic Departments at the level of

County Councils were transformed in autonomous entities (RAs) - a step towards privatization of public services. Also, through Law of local administration 215/2001 a new entity with juridical personality, subordinated to the County Council and called *Directia pentru Administrarea Drumurilor si Podurilor Judetene* (County Level Roads and Bridges Administration) was created with the task of developing and maintaining the road network (that under its direct jurisdiction and the communal roads).

County Councils perform an assessment of the technical status of all the roads in the county, even if not all under county administration, and establish the total need of works and funding. The findings and proposed projects are then submitted for approval to the Ministry of Transportation, through the National Company of Roads (which oversees the process and offers technical expertise if the case). The communes submit all program proposals through the County Councils for review, from where the programs are sent to the Ministry of Transportation through the National Company of Roads. The Municipalities can request funds directly from the 35%, not being obliged to run their requested amounts through a program of the County Council (see Fig. 8). Theoretically, these funds should be for financing district roads crossing Municipalities, but in practice this is not verified when the programs and transfers are approved.

Fig.8 The process of program proposal and financing of roads



If approved, the programs are financed from own sources and/or from special funds (or in 2003-2004, earmarked sums from the national budget). After approval from the Ministry, the programs are divided in quarterly sections and funds allocated on a monthly basis through credit requests one month in advance of the operations being carried out. Until 2002 the Counties would benefit of 35% of the Road Fund (which passed through the NCR). Currently, the funds transferable to counties appear as a separate line in the state budget, amounting to approx. US$ 77 mil, representing only 10.3% of the total budget for roads that appears in the state budget for 2004. Also, these funds will not be disbursed by NCR, as they used to be, but directly by MTPW.

Law 118/1996 established a formula to be used for allocating funds among counties, that takes into account the length of district roads, traffic, and technical status:

K1 = L1 * vpd/L * VPD

K = K1 * K2

L1 – total length of DRs in the county
Vpd – annual average of vehicles per day (vehicle/24h) in the county
L – total length of DRs in Romania
VPD – the annual average of vehicles per day on DRs in Romania
K2 – is an indicator of the technical quality of the roads and the County priorities established

In practice it was never certain if and how this formula was used. Of their 35% share the County Councils have the obligation to allocate funds for communal roads and, lately, for streets connecting the new neighborhoods built under the national housing program (ANL -- see the next section of this report). The County Councils have (or take) the freedom of allocating these funds, theoretically on a program basis, on criteria established at County level. For example, in 2003 in Timiş County a program of ROL 100 billion (US$ 3.01 million) was proposed and a financing of ROL 30 billion (US$ 0.9 million) was approved for 2003. The criteria – not really quantifiable and more like goals – used for further allocation within the county were:

- maintenance and repairs of roads for safe traffic
- isolated activities
- follow the strategy of the County Councils for arranging the access towards the center of communes, and access to the county capital city.
- improving the technical quality of the road connections for some isolated localities.
- repairing main district roads.

Law 118/1996 was abolished by OG 3/2003. New methodological norms appeared but the formula for allocating the 35% among beneficiaries is in principle the same.

The Special Fund for Rural Roads

Unlike the Road Fund, the Special Fund for Laying Gravel on Communal and Village Roads (Law 577/1997) was maintained. This Special fund is fed from the Ministry of Transportation and Tourism. The program for graveling started slowly as there were no funds available. The procedure for including roads in the program and financing is similar to the one for communal roads. Programs are approved according to the annex of the law. Between 1999 and 2003 the program was extremely slow. In 2003 there have been no new projects introduced – all were continuations of the ones started in previous years. The ordinance 60/2002 stipulates that it is mandatory to have a representative of the Ministry of Transportation at the gravel laying operations.

Of the around 60,000 km of earth roads and streets in rural areas, the program only covered 11,000 km. For example, in 2003 in Timis County ROL 4.5 billion (US$ 135,542) were allocated and 1.5 km built. Usually the cost is ROL 2.5 – 3 billion /km. (US$ 75,301 – 90,361) the operations carried out being: 1) ballasting, 2) laying gravel, and/or 3) treatment. Interestingly, interviews at County Council level revealed that the program administrators are more satisfied with this poorly financed but steady and predictable program than with the turmoil going on yearly around the funds for public roads finance. Thus, in all likelihood more transparence and predictability helps the local administrators to plan their interventions better, which can not happen in present circumstances in the case of district and communal roads.

1.5. Specific problems

The problem regarding Romania's public roads is manifold:

(1) low level of funding overall, which reflects the low priority attached to this sector in the general budget process (NCR's budgetary cycle has closed in 2002 with surplus of about 20-25% of the total – which shows that it was used as a buffer for controlling the total government deficit, while in fact NCR has large arrears).

(2) unclear allocation rules for the fraction of the money distributed to local governments (both tiers)

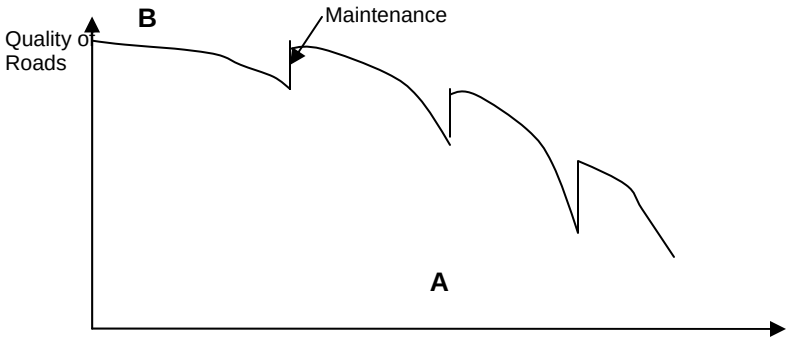
(3) low level of technical and administrative capacity in many local / county governments

These aspects can only be addressed simultaneously, because for example it does not make sense to pump additional resources into a system which is opaque and does not function according to proper criteria. For example, even when capacity exists, the motivation for efficient, transparent and coordinated approach for repairing and maintaining the national roads network is missing. There are no appropriate levers for holding accountable the responsible entities (if anyone ever knew who these were) for the extra costs of an inefficient and hazardous roads system.

1.5.1. Low financial and administrative capacity

The constant low level of finance – at 1% of GDP and barely covering maintenance -- combined with local economic pressure leads to allocations being made in discretionary and political manner, rather than based on needs. After years of continuous decay currently the roads network is in its worse shape (at point A on Fig.9). Though it is often argued about, overall, each county has the road network in bad condition. To repair the entire system (bring it to point B in Fig.9) Romania would need about US$ 1.2 billion per annum for at least two years. These funds should be used only for investment in roads, with around US$ 360 million per year for maintenance and US$ 120 million per year for traffic safety measures.

Fig 9. Struggling to keep pace with the degradation of infrastructure



Partly this bad management at all levels was caused by the rushed and untimely privatization – when District and Communal roads were transferred to the patrimony of County councils, and, respectively, Communes. Even if Counties had some expertise regarding road maintenance and building, there was no practice, and arguably no interest, regarding program development, contracting out, organizing proper tender procedures, and supervising the works carried out by private firms. Moreover, this new situation with no proper legal levers for quality control, but new funds being transferred to local levels led to twisted incentives and continuous decay of the patrimony. As previously mentioned, the funds are not extremely significant, but they are significant enough to be used as political capital shaping power relations at local level as much as between local and central government levels.

Even if lately major administrative reorganization took place in the sector, responsibilities are not clear (or rather not respected) at different levels. The commercial activities, such as investments, constructions, upgrading, volume maintenance, are contracted out. Seven enterprises (SAs) of roads and bridges were created, with majority state capital, and to be sold in 2003. However, even if some progress has been made, a comparison of the average cost of applying a 5 cm overlay reflects the system's inefficiency (data are from 1999, but current data are likely to be worse as more materials are imported).

Fig.10. Comparative average costs for applying 5 cm of overlay

Country - US$/m2	
Belarus	8.0
Brazil	8.2
Estonia	4.6
Finland	5.2
Romania	9.2
Russia	6.7
USA	5.0

(Source: The World Bank - compiled from figures available in 1999)

Activities currently managed by the local governments can be placed in two categories: unprofitable and profitable. The first category refers activities that are cheap, but time consuming and requiring extensive labor (current repair works, database collecting and administration, inspections) and are more difficult to contract and manage. These are left for direct delivery from the County councils, under diverse forms of institutional organization (departments, compartments) or entirely left for the autonomous service providers (RAs). The second category refers to larger works, with more capital involved (development of road structures) the only activity that is of interest and appropriate for privatization/ easily contracted out. However in conditions of low management capacity, contracting out does not represent necessarily a silver bullet because it is still the County that needs to supervise and administer contractors.

The effects of bad management and little funds at county level are exacerbated by the lack of coordination at national level, or at least at regional level among counties. So far, at local level there are neither clear incentives nor capacity to coordinate works. Currently, counties do not even know the level of funding each of them receives, and even less about the projects proposed by neighboring districts as this data is not easily available and understandable. In these conditions, by law NCR has the duty to set standards, norms and coordinate programs. The only (and obviously not very effective) way NCR does this is through the approval of programs that Counties and Municipalities propose.

Another major fault in the system is the possibility for County Councils to request NCR and obtain reclassification of district roads to national ones. This usually happens not because the roads are of national interest (fulfilling traffic and positioning criteria) but rather because counties wish not to administer and fund them. Since transfer levels for roads do not correlate in practice with the length of district roads, the incentive is strong for Counties to discard these roads. Unfortunately, reclassification only leads to further decay, because NCR is unlikely to invest in a road (be that called national) if the traffic on it is low and its positioning is not important.

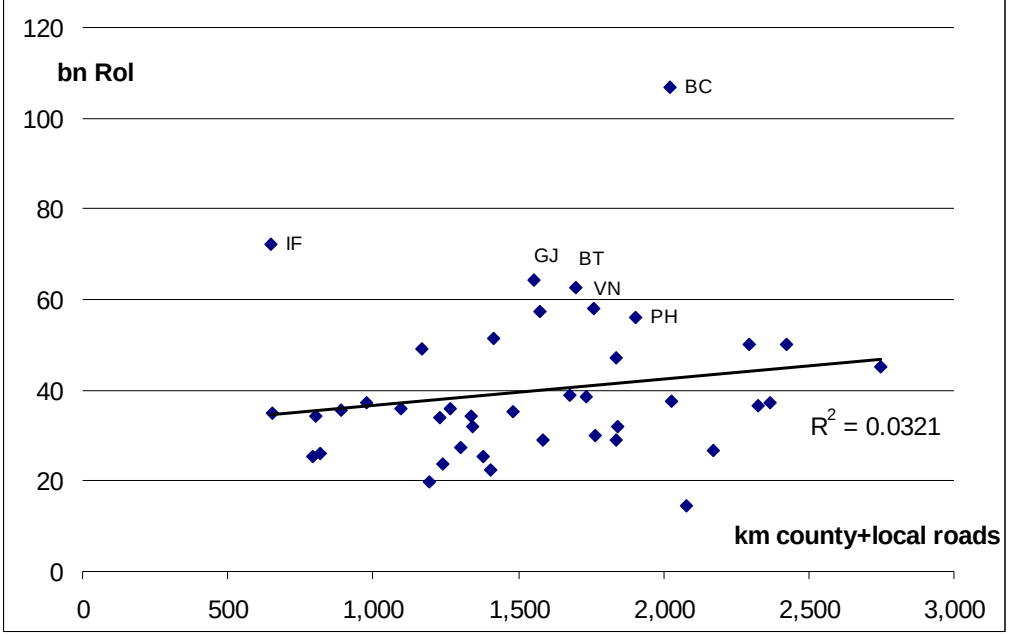
1.5.2. Opaque and inconsistent financing procedures

Establishing a Road Fund was welcome in 1996 in conditions of a severely underfunded road network. The international donor organizations, such as the World Bank or EBRD pushed for this solution as a step in reorganizing the system. Unfortunately, the results of abolishing the Fund – basically done for increasing transparency – are clearly not those expected. If last year, at least the total amount of funding existing for roads was clear, in 2003 the exact amount of taxes linked to roads is not known. These allocated funds, seemingly more opaque than the fund, were leaving room for discretionary allocation.

The following graphs come to prove that even when the distribution mechanism among the counties was established by a formula incorporating criteria as length of roads, the technical quality, and traffic, the funds actually transferred were not correlated with the mentioned criteria. Fig 11-1 reveals that actual allocation of funds does not correlate with the length of District and County roads.

Moreover, at county level the information about how much was allocated to any of the other counties is not available, except informally. For example, it is believed that Timis County, with 130,000 registered vehicles and one of the longest roads network, should receive quite a large chunk of the funds, but there is no possibility for checking how and if the criteria for traffic and length of roads were respected. Traffic data from NCR shows that Timiş has an annual average traffic of 721 vehicles per day on district roads – rather low and close to the average among counties – but this statistics is not clear at County Level, leaving room for interpretation.

Fig. 11-1. Allocation analysis 1: by length



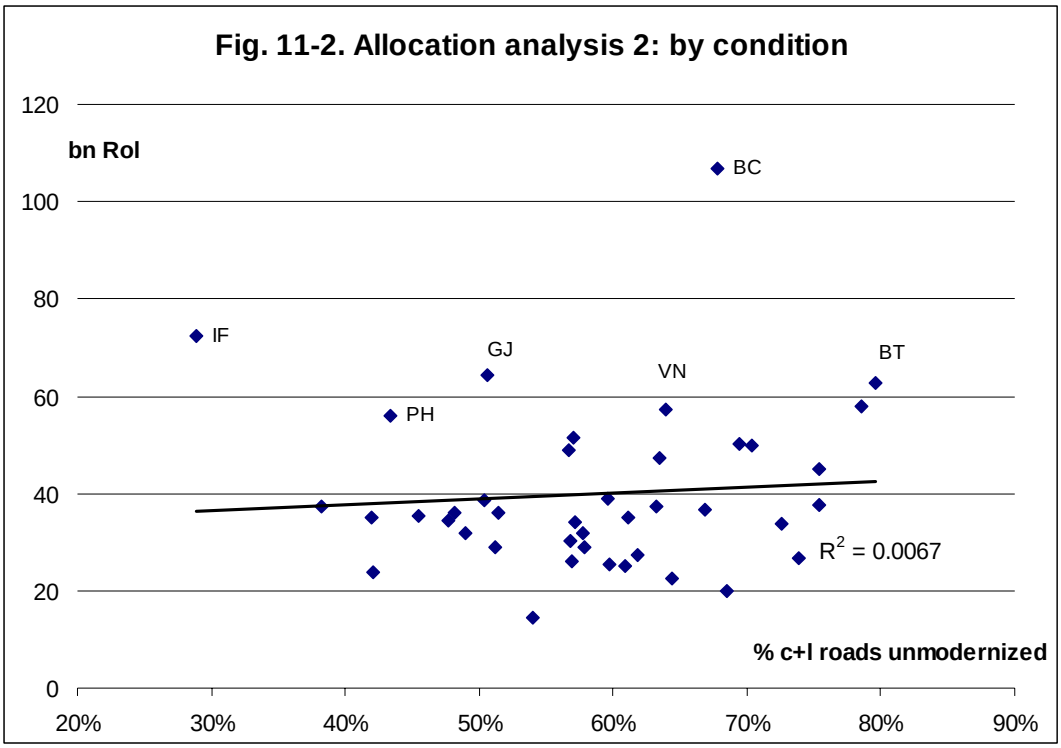


Fig. 11-2. Allocation analysis 2: by condition
bn RoI
120
100
80
60
40
20
0
BC
IF
GJ
VN
BT
PH
R2 = 0.0067
% c+l roads unmodernized
20%
30%
40%
50%
60%
70%
80%
90%

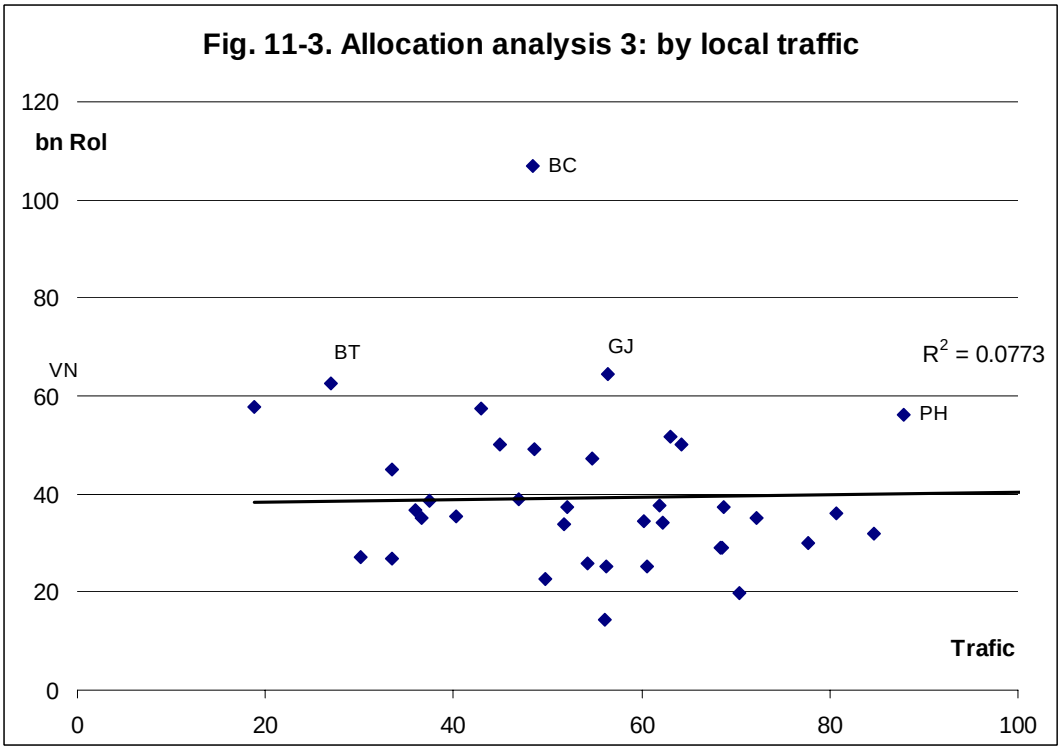
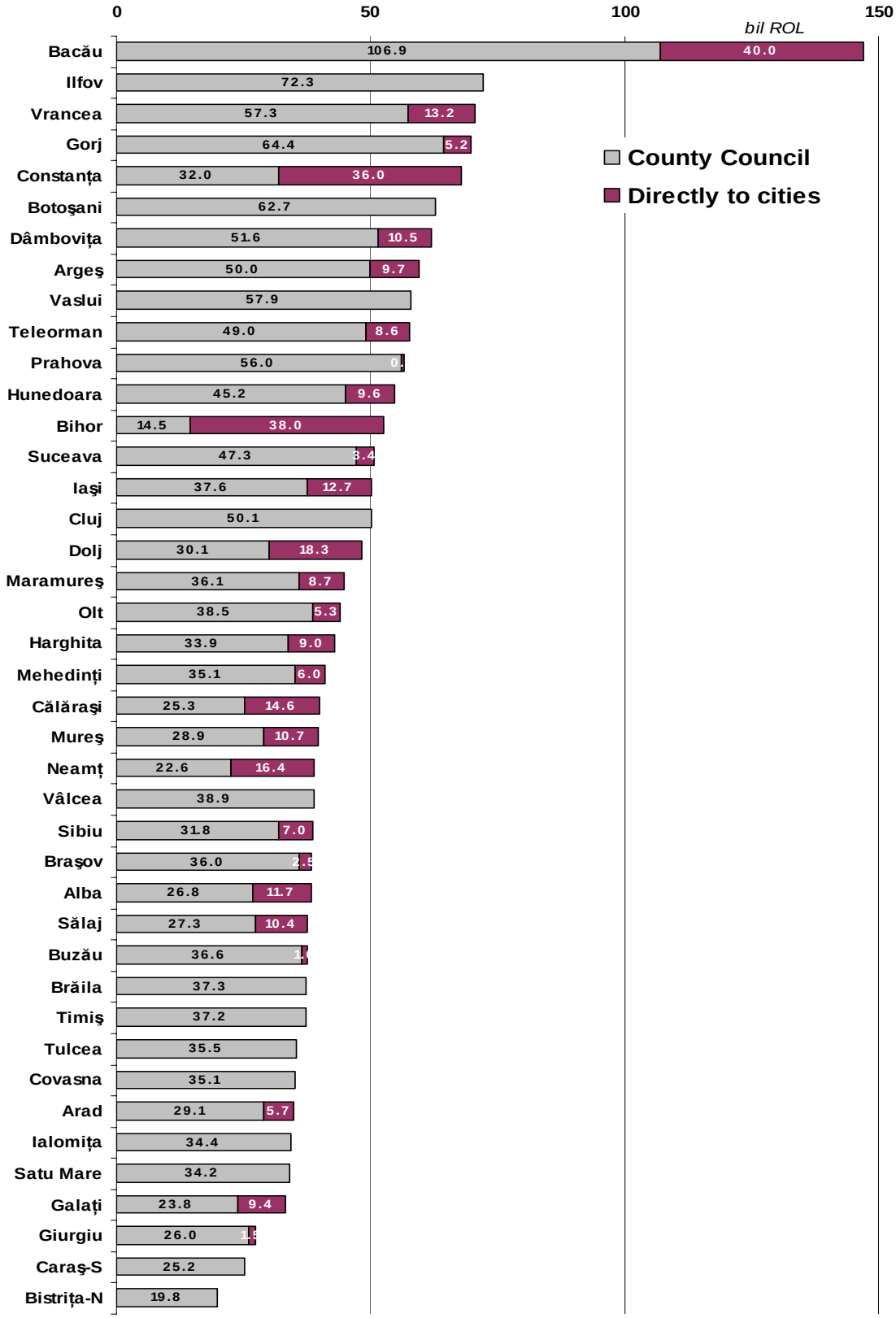


Fig. 11-3. Allocation analysis 3: by local traffic
bn RoI
120
100
80
60
40
20
0
BC
BT
GJ
VN
PH
R2 = 0.0773
Trafic
0
20
40
60
80
100

Fig. 12. Grants to counties from the National Roads Fund in 2002 – questionable criteria



The quality of roads is also a criterion that is unclear and can be subjectively interpreted. In our analysis we used a proxy considering the ration between un-modernized and modernized roads. The correlation is not statistically significant (Fig. 11-2). For traffic we created another proxy, dividing the number of registered vehicles in a county with the total length of district and communal roads. As Fig 11-3 reveals, correlation is not significant in this case either. Fig. 12 displays the overall effect of the discretionary allocations by county operated in 2002.

Abolishing of the Road Fund may create different problems because the current sources of funding for roads are not likely to cover the needs. Public roads will be mainly financed with a 25% tax on fuel which is included in the excise, and tax from automobile sales, also included in the state budget. It is planned that a new *vigneta* (Eurovigneta) will represent the main source of income for the National Roads Company. However, the problem that might appear is that through sales of Eurovigneta only €150 million can be collected (with an estimate for 2003 of €250 million), all this while the annual budget of NCR for 2004 is US$681 million (including payable loans, grants, etc.). The balance will have to be covered from the state budget.

Abolishing the Road Fund only created more insecurity and administrative burden in a situation in which the administrative capacity of NCR does still not match the needs for coordination, management encountered in the sector. Also, from the current state budget it seems that the counties receive even less funding than from the Road Fund (around 10% compared to the previous 35%).

The Government does have in its plan the 'reclassification if road network and associated changes in administration management and financing in roads, and increased efficiency of road works through privatization and development of domestic construction industry' – it remains to be seen how this is going to be done.

1.6. Traffic safety

The National Company of Roads has the central responsibility for traffic and safety. Law 118/1996 established that NCR allocate 10-15% of the funds for safety. Unfortunately, it is not transparent and certain if these sums are allocated at central, and even less at local level. Currently, the company cannot be sued if proven that it did not fulfill its role stipulated through law.

Nighttime driving causes 50% of fatalities, as US experience reveals, while only 25% of vehicle miles take place by night. In this situation, investments in nighttime visibility measures worth it both to reduce fatalities but also for side benefits such as civic beautification and reduction of crime. A report of the Federal Highway Administration in the United States pointed out that installing lighting has the highest benefit-cost ratio of all safety improvements.

While traffic accidents cause important losses to the economy, and also road improvement without safety measures in place increases the number of

accidents due to speeding, there are no legal or other levers to impose safety measures. Even more than providing roads, traffic safety should be a public good provided by the state, but it is not done so, causing losses of 2.5% of GDP per annum.

1.7. Conclusions – what should/could be done

Important institutional and financial constrains limit growth in the transport sector. Reform is unfinished and chaotic. The system, together with the NCR, has been reorganized but its organization, management and technology need further support. Maintenance needs a special attention from the state, as it is not a profitable and visible activity. Transport should be safe, efficient, ensure mobility of labor force and trade, and coordinate with European networks. International experience reveals that in the sector of roads infrastructure, where such large investment opportunities are at stake, any strategy or policy needs to be politically attractive in order to become truly feasible. Economists and researchers need to permanently produce analyses and participate in public debate with informed opinions, such that they reveal policy alternatives that are equally economically suitable and politically attractive. In this context, public funding for research and development would be justified. Also, strategies need to be flexible in responding to socio-economic and demographic changes.

Setting the stage for a real public debate could increase transparency and circulation of information in the sector. In Romania, the transporter's unions, or associations are not vocal enough in lobbying for better roads that would decrease their losses due to delays when accidents occur or bad roads increase transportation time. Equally, civil society representation is weak and uninformed. Citizen groups interested in government spending in infrastructure should be formed to hold the local and national governments accountable for spending decisions.

It is international practice to pursue technologically sophisticated projects as they are a source of pride despite their expense. However, for Romania these are too costly and not necessary at an annual average daily traffic of 3,776 vehicles per day (VPD) on national roads. A motorway would be feasible only if in concession of a private firm. Even if the traffic is not high enough to make the investment profitable for a private company, the government could subsidize the difference, recuperate costs in 20-25 years, and leave administration to the company. This would be feasible in the current situation when local administrative capacity for a highway is not in place.

The current legislation might also need some revision since it seems to be producing twisted incentives at county level for a race for obtaining national funding for projects. At times it is possible that at local level cheaper projects, more efficient and with higher social benefits could be designed and implemented if only the right incentives were in place.

Priority should be a better management of funds through coordination and increased safety. Also, the network should be used for increasing the mobility

of Romania's rather inert labor force. There is a general tendency in the sector for taking on capital intensive projects, thus building new roads, instead of investing in projects for efficient management with better long-run results. Priorities should be changed towards organizational measures, optimal financing systems, and thus overall reducing the need for new infrastructure. These types of projects would have a much higher benefit-cost ratio.

When funding is insufficient or cut-backs occur these are usually done on the maintenance activities and less on capital investment - more visible and politically sensitive. As a result, it is important to establish a predictable and politically acceptable road maintenance formula. Latvian experience shows that roads maintenance is funded with 40% of what it would need and rural roads are allocated only 20% of what is needed. Maintenance of highways or national roads can be easier, bud district and rural roads have extreme length. Financing maintenance requires special attention because it is not an attractive enough activity to survive political debates on public expenditures. In this context, relying on taxes might have disadvantages. User charges, collected separately from the government budget are regarded as a best way to ensure optimal and sustainable budgets. The followings constitute brief ideas for consideration by policymakers:

- **Coordinate activities** – national and local level to attain efficiency with the limited resources available. Creating regional administrative bodies that can coordinate at least at that level (similar to the metropolitan area transport authorities) and ensure services that reduce negative as much as positive externalities resulted from lack of coordination. Municipalities should also coordinate with Counties.
- **Establish levels of expertise** and based on those distribute tasks, and allocate corresponding funding.
- **Create levers - legal or else** – to hold responsible the entities at various levels. Currently, the legislation establishes more or less clearly who are the owners, administrators, managers, and suppliers for the roads, but there are no clear means for accountability. The problem of roads should be brought into public debate in an accessible manner rather than using sophisticated and technical terminology, and thus the population could hold the Counties accountable for low safety and poor quality of roads.
- Create a **simple formula** for allocation of funds, and apply it in a **transparent** manner. Anecdotic evidence should be substituted with systematic data analysis.
- Increase **administrative capacity** and create **incentives** for applying good practices criteria at all levels.
- **Create nationally available and accessible data base**. Future volume, pattern and demand of transport should be correctly evaluated and decisions taken upon those facts; the national data should be reliable,

publicly available, coherent at country level, accessible from district level so that the system can be coordinated

- Place **priority on safety issues** such as city by-passes, intersections, marking, lighting, or modernizing roads. Create levers for suing responsible administrators for road accidents.