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Economic Policy Reform for Sustainable Development in Romania

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Economic Policy Reform for Sustainable Development in Romania

Summary of a discussion held at
the Harvard Institute for International Development (HIID)
on April 28-31, 1997

Harvard Institute for International Development
Cambridge, Massachusetts, U.S.A.

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SUMMARY OF THE DISCUSSION

Monday, April 28

Welcome and General Overview

Jeffrey Sachs welcomed all participants, particularly the visitors from Romania. He saw the workshop as an opportunity to brainstorm about Romania's economic problems and opportunities.

Sachs saw as Romania's most important task the attainment of high rates of economic growth to make up for lost time. To an outsider, Romania appears to be one of several countries that have recently experienced a rapid growth spurt only to be followed by a sudden crash. All countries, he continued, can learn from the experiences of others. It is useful to know the key factors that are associated with high-growth countries and the policies and strategies they followed.

In all high-growth cases in recent decades, the export sector has been the key propellant. This raises the question of where Romania's export profitability lies. Fortunately, Romania is favored by geography: it is a relatively low wage country with low transport costs to the world's largest prospective open market, i.e. most of Europe. Poland has a similar advantage and has become a successful export-led growth model.

When one asks what policies should be followed, the answer lies in setting priorities so that there is the right mix of market forces and government policies. Sachs identified factors to which any government should pay attention when identifying appropriate policies and setting priorities:

- ***Openness of the economy*** - This involves the need to work backwards from goals to figuring out which policies should be implemented to facilitate access to the goal.

- ***Low tariffs/duties for exporters*** - Exporters cannot compete effectively, he said, if they must pay high tariffs and duties on machinery/inputs/capital goods imports.

- ***Fiscal policy*** - If budgets are too expansionary, the exchange rate will be overvalued, and domestic prices will increase sharply. If government spending is too large relative to GNP, tax rates must be higher to make up for it, thus chasing away foreign investment.

Sachs observed a tendency in Eastern Europe to compare itself to Western Europe. But this is not a good standard, he explained, because Western Europe does not need high growth rates to maintain adequate levels of social spending by government. They became rich first and then raised social spending. It cannot be done the other way around.

- ***Rule of law*** - Among other things, this requires a low level of corruption, independent judicial review, objective law enforcement, and enforcement of contracts.

- ***Financial stability*** - High inflation, bank failures, and political instability destroy the confidence the public must have in banking institutions if they are to save there. Politicization of banks provoked panic in Bulgaria, he observed, resulting in the banking system's loss of credibility and a precipitous drop in confidence in government. A strong currency board, he contended, does not deal with the root problem. To strengthen confidence in the banking system, deposits must be protected, foreign competition and mergers allowed, and violators of banking laws jailed.

Sachs concluded his remarks by suggesting that HIID might help the Romanian delegation in these discussions by:

- Calling on international experience to offer comparisons and benchmarks.
- Accounting for the different policy and institutional techniques employed elsewhere and their results.
- Facilitating conversation among the visiting Romanians to help them coordinate their strategies, think about priorities, and assess timetables and sequences for policy and other reform initiatives.
- Identifying problems and issues that call for deeper study or research.

Policy Reform and Growth: Cross-Country Evidence

Andrew Warner then presented a summary of research he conducted on economic growth in more than 70 countries. His data demonstrated that:

- Poor countries grow faster than rich countries.
- Open economies grow faster than closed economies.
- Poor, open economies linked into the global trading system grow faster than rich, open economies.
- Open economies are more susceptible to external shocks, but the growth rate of open economies over several decades has been much higher than that of closed economies.

Overview of the Romanian Situation by the Romanian Delegation

Laurentiu Tachiciu presented an evaluation of the current situation in Romania as well as the blueprint of the reform program of the new government. He noted that the latter is the second attempt to restructure the Romanian economy in line with the principles of a free market after the fall of communism in Romania.

The main components of the current radical reform program are:

- ***Macroeconomic stabilization*** through a tight fiscal policy (e.g., a 10% reduction of the government bureaucracy; reduction of health and R&D budgets; an increase in government revenues through an increase in certain taxes); and a monetary policy which allows the leu to float freely.

- ***Creation of efficient markets.*** In agriculture, for example, a land market and a market for agricultural services are lacking. The capital market is small and fragmented.

- ***Sectoral reform.***

- ***State-owned enterprises (SOEs).*** The main solution must be quick privatization. Restructuring public monopolies such as energy and water is far more difficult because it is difficult to assure competition in these sectors. A major problem is inter-enterprise arrears.

- ***Agriculture.*** It remains the main subsidized sector. Reduction of subsidies cannot happen in the near future, partly because of non-existent agricultural markets.

- ***Banking.*** Part of the banking system has performed well, although failure of two banks revealed weaknesses in bank regulation.

This reform program, Tachiciu continued, is complemented by a program of social protection to avoid social unrest and ensure the success of the reforms. Unfortunately, he pointed out, his government lacks a long-term perspective. He hoped that these discussions would help him and his colleagues move in that direction.

He concluded with the observation that a successful reform program must go hand in hand with reform of the public administration. Decentralization is the main objective in this area.

Dan Radu Rusanu then identified the main objectives of the public finance program administered by the Ministry of Finance:

- Reduction in subsidies (currently at 17%, down from 48% in 1990 and 36% in 1993).
- Development of agriculture and small and medium enterprises.
- Autonomy of local governments.
- Identification of non-inflationary sources of finance.
- Reduction of the budget deficit.

One of the main worries of the Ministry, Rusanu observed, is that payroll taxes still make up a larger share of revenues than profit taxes. Future priorities are the reduction of payroll taxes from a maximum of 60% to a maximum of 40%; reduction of taxes on profits from 38% to 30%; and design of strategies to discourage fiscal evasion and to promote foreign investment (by allowing free transfer of profits abroad and adopting new legislation).

Daniel Daianu identified three causes of the present economic situation:

- A tremendous gap between consumption and production.
- With regard to the balance of payments, large macroeconomic imbalances reflect a trade deficit and few capital inflows.
- Stimulation of the economy in the year before the recent elections.

It is these factors, he explained, which make the situation in Romania so tough now. The current program must make the necessary corrections, but this will lead to a contraction of the economy (estimated growth -2% this year). A primary concern is the attraction of capital inflows which will not occur without privatization. Romania has a legacy of poor allocation of resources: that's why it cannot follow the Asian example. Dealing with corporate governance and building institutions are also major challenges.

In the field of monetary policy, the National Bank of Romania (NBR) follows an exchange rate policy that attempts to avoid overvaluation. Now, NBR cannot intervene to defend the leu and is trying to build up reserves. Another problem is the difficulty of dealing with the Ministry of Finance.

Bogdan Baltazar began his remarks on the Romanian situation by pointing out that there is a role for government in policy making because the market cannot be allowed to make all decisions in certain sectors (e.g., mining). Unfortunately, the government has yet to frame a strategy that encourages export-led growth. Mr. Baltazar is proud of the national consensus on reform, but in his view, the structural adjustments have yet to start.

As far as privatization is concerned, only 15% of the promised 50% of enterprises went into private hands. Privatization under the former government was politically driven, resulting in non-transparent transfers of some of Romania's best enterprises. Currently, the State Ownership Fund (SOF) is trying to simplify the bureaucratic procedures of privatization. Baltazar also observed that the mass-privatization program created 15 million Romanian shareholders without putting into place the corresponding corporate governance mechanisms. A major challenge is to find a balance between strategic investors (i.e., those who come to produce solely for the Romanian market) and those investors who produce primarily for exports. **Daianu** countered that investors come to Romania for low wages, rather than the internal market.

Ioan Oltean then described the main priorities of the Ministry of Water, Forests and Environmental Protection. They are:

- Passage of environmental legislation, which did not exist before 1990.
- Harmonization of Romania's environmental legislation with European Union (EU) legislation and adoption of international standards of environmental protection.
- Creation of the institutional framework to implement the legislation.
- Education of the public with respect to environmental matters.
- Creation of incentives for investment in non-polluting equipment.

Oltean concluded his presentation by reminding the audience that economic reform cannot be separated from environmental issues.

Nicolae Staiculescu addressed the problems of the oil-refining and mining sectors. He estimated the capacity of Romania's oil-refining sector at 34 million tons per year in excess of internal needs (14 million tons). The dilemma faced by the government is whether to close down some plants, leaving only as many as necessary to cover internal needs, or to keep all plants working through exports.

The mining sector receives large subsidies. It is, however, very difficult, he claimed, to close down mines because of the social costs involved.

Iuliu Bara listed several issues of concern. He began his remarks by citing a lack of coherence in the coordination of the different ministries of the government. Another major problem he identified is the nonexistence of a real labor market. Old mentalities toward work are still widely in place, he lamented. The status of the civil servant is also a problem. He noted that the existing bureaucracy makes it hard to implement the political will of the current government.

The government lacks adequate internal channels of communication, according to **Lia Trandafir.** This situation contributes to the image of an incoherent and amorphous government.

After thanking the Romanian delegation for their presentations, **Sachs** ventured the impression that a change in the structure of the Romanian economy has yet to begin. The reality of economic life, he observed, is that some parts of some sectors should be closed, and the government must have some confidence in what will follow. Without a sense of the future, governments tend to avoid looking for a way out of the crisis. He believes that the Romanian government should promote the new, rather than spend too much time preserving the old. It is Sachs' view that governments cannot re-train. The government should focus on attracting foreign investment. The problem of luring strategic investors is critical for the upcoming discussions. Sachs ended his remarks by urging that every effort be made to seek out foreign investors for the money, technology, access to markets, and ability to upgrade and restructure that they bring.

Privatization

Eytan Sheshinski began the discussion of privatization with his impressions of where the process now stands in Romania. The process has had two steps (in 1992 and 1996) and has met with some success, notably in the area of small enterprises. Claiming that 2/3 of all state owned enterprises (SOEs) were still unprivatized (**Baltazar** corrected him with the figure of 1/3), Sheshinski stated that privatization in Romania still faces some large challenges.

If the ultimate goal is to restructure the current system, then bringing the largest of the SOEs into private hands becomes critically important. This can only be achieved by acknowledging that their value is what the market will pay rather than some "expert valuation." The latter is not objective pricing.

Sheshinski identified the complicated institutional processes for privatization as problematic. Private Ownership Funds (POFs) are not allowed to invest more than 10% in firms, or to play a role in their restructuring. Even more serious for the prospects of privatization, Sheshinski asserted, is the fact that Article 5 postulates that SOFs should have a "golden share" that would be activated in times of "national interest." He argued that such ambiguous wording discourages investment. Clearer legislation is essential.

He invoked the Czech Republic as a example where unrestricted bank involvement in privatization caused a problem in the entire process and stressed the need for establishing strict and credible regulations before privatization.

On the topic of restructuring firms prior to sale, Sheshinski argued that investors purchase based on their valuation of firms, and then restructure. The government gains nothing by restructuring.

Finally, Sheshinski asked about the Romanian government's plans for the revenues from privatization. He suggested following the Bolivian example where the revenues capitalized a fully funded social security system.

Baltazar then made three points about the state of privatization in Romania:

- The political will for privatization now exists.
- SOF procedures have been streamlined.
- In an attempt to make the bidding process easier, there has been a change in the scoring sheets.

The overall effect of these changes, he believes, has been to increase commitments to investment and eliminate the "social" requirements that previously were enforced.

Commenting on previous investment ventures in Romania, Baltazar noted that the "Daewoo deal was bad from the beginning" and was an example of "how not to invest." Investors with only financial interests, and without diversification, would be detrimental to Romania. He then returned to the question of industrial policy, citing the "qwerty" theory which, based on the configuration of the typewriter keyboard, says that if everyone is used to something, even though it may not be the best method available, it's wise not to change. Insisting that America has a <u>de facto</u> industrial policy (citing the luring of BMW to California), he expressed hope that such a policy in Romania would look toward the future, rather than being explicitly about targets. Baltazar also contended that restructuring prior to sale is often required by the circumstances. He concluded that some entities that need to be privatized (e.g., hospitals, universities) will simply not sell unless they are improved before going on the selling block.

Moving onward, Baltazar expressed wonder that SOFs bothered Sheshinski. Drawing a diagram of the percentage of firms privatized, he noted that ownership of 51% of strategic firms is kept by government. Regarding the golden share, he said that the law is a framework and not a prescription, leaving areas open for negotiation. He also dismissed the Czech example, noting that the problem there was that the banks were "too powerful."

Turning to Sheshinski's question about the destination of revenues from the sale of enterprises, Baltazar noted that 20% would go into regional development funds, with 60% going back to the enterprise in the form of rebate to lure investors. There ensued a heated debate about the desirability of a 60% rebate, and why it was necessary at all. **Sachs** noted that if someone wants to buy a firm, he'll buy it; the rebate is irrelevant for that decision. Why not just sell the firm at a price 60% lower? Sachs asked. He also criticized the non-transparency of this policy.

Tachiciu intervened at this point, explaining that the 20% of revenue destined for regional development is intended to make Romania's regional structure similar to the EU's, so as to expedite integration. **Sachs** responded that regional development policy was the least successful of all EU policies. If it had already existed in Romania, the International Monetary Fund (IMF) would have made its removal mandatory before giving aid. By trying simply to emulate the EU, Romania would be adopting some of its faults. Sachs concluded by stressing the need for a prioritization of enterprises to be privatized, rather than an adherence to target numbers such as those set by the World Bank.

Iuliu Bara pointed to the need for retraining workers in areas that would be hardest hit with privatization, such as the mining industry. **Sachs** noted that mining is a "great tragedy for all nations in the 20th century," and it would be impossible to save the region. Spending money to do so would be a waste. Instead of worrying about the past, Romania should focus on the future.

Returning to the discussion of privatization, **Tachiciu** noted that there are about 100 sectoral strategies, but there is great political danger in undertaking this course. **Sachs** repeated at several junctures that politicians should not be expected to take the blame for what happens in privatizing; the market should be seen as the impersonal means of adjustment. It's not the politician's job, he insisted, to decide which firms should close; that is the job of the market.

Tachiciu made the observation that Professor Sachs did not live in a former communist country, and that there are many inter- and intra-sectoral linkages that make an exclusively market strategy dangerous. **Sachs** countered that if one sector fails, the same goods or services can be found on the world market. **Daianu** asserted that corruption was a large problem in carrying out government managed privatization in Romania, but **Baltazar** dissented, saying that the problem in the past was a lack of political will. **Clifford Zinnes** noted that Romanian laws need to be applied evenly in order to attract investment, otherwise they act as a tax on foreign investment.

Katharina Pistor then introduced the topic of privatization and corporate governance. She began with the flat observation that mass privatization will not work in Romania. She cautioned that regulations must be in place before banks are privatized, so as to forestall the danger of state re-intervention (as happened in Russia). **Rusanu** noted that the state is the worst administrator and will continue to be so. Privatization is thus a point gained. Sachs agreed, adding that the vast majority of enterprises to be privatized will not need a regulatory environment. **Sheshinski** concluded that by removing the barriers to entry, the market would act as a more effective regulatory environment than the state ever could.

Tuesday, April 29

Economic Reform and Agriculture

Richard Goldman presented a short overview of the world agricultural economy and its changing features that are important to Romania and Eastern Europe. Goldman identified the following structural features of that economy:

- A growing demand for livestock products (mainly from middle income countries) and therefore a growing demand for cereals (e.g., wheat, corn), while demand for cereals for direct consumption remains fairly stable. In Eastern Europe demand for livestock has been falling recently. The growing demand for cereals in the world could be a potential export opportunity for Eastern European countries.

- An era in the world agricultural economy where large inventories of cereals have been built up seems to be ending, mainly because price supports are declining in the U.S. and Western Europe. These inventories stabilized world cereal prices. Because support policies are being dismantled, price shocks due to bad weather are expected to be larger in the future. Therefore, the world market for cereals is likely to be less stable in the future.

- The world is entering an era of increased economic integration in agriculture as import duties are eliminated and consumers and producers are forced to adjust quantities in response to prices. This broadening of the cost of adjustment will have a stabilizing effect on the world agricultural market. However, in Goldman's view the destabilizing trend seems to be dominant.

- The trend price for cereals in the world market is falling. Whether this trend will continue is the subject of an intensive debate. Although the World Watch Institute predicts that prices will rise by 20-30%, the FAO and the World Bank are not forecasting such large price increases. Goldman concluded that the future is quite uncertain regarding world cereal prices.

- As a result of the reduction in food subsidies for meat and dairy products, the demand for grain for livestock decreased in Eastern Europe and the former Soviet Union. However, the yield levels in Eastern Europe are very low compared to Western Europe. There is therefore a possibility for large increases in production in this region, especially with increasing demand from Western Europe.

Daianu observed that yields in Romania are low even when compared with Hungary or Poland, thereby making the marginal benefit from increased production in Romania tremendous. He also mentioned his concern that in a world of low inflation and increased variability of world agricultural prices, shocks for a poor country like Romania could be a major challenge.

Tachiciu then offered a list of problems particular to Romania's agricultural sector:

- The rural population is aging and as of today there are no incentives for younger people to remain in the countryside.

- A shortage of skilled labor has emerged as younger people have lost the knowledge of how to farm.

- Rural infrastructure is in deplorable shape. Spending for land rehabilitation and irrigation has declined during the past couple of years.

- Although 90% of land is in private hands, holdings are small (averaging 2.5 hectares) and farmers face many constraints (e.g., lack of equipment, capital, etc.).

- Until recently, agricultural services were offered primarily by state-owned companies. Even though the companies have now been split, and to a large degree privatized, equipment and machinery are outdated, services are bad, and prices are not affordable to private farmers.

- In the final analysis, the main problems facing agricultural growth are the absence of effective distribution markets and the almost nonexistent land market.

Tachiciu concluded by summarizing the government's agriculture program for this year. Legislation has been proposed to facilitate development of a land market and to privatize distribution companies. The government is also looking for ways to solve the financing problems of agriculture because direct credits did not reach agriculture. Subsidies this year will be 60% of last year's.

In response, **Goldman** noted that Romania's aging rural population is a phenomenon that is widespread throughout the world. In this context, he pointed out, a land market becomes critically important because it is the only mechanism through which young entrepreneurs can obtain access to extensive amounts of land in order to create farms. He also stressed that rental agreements can be a very successful way to create farms, as the experience in the U.S. shows. Goldman asked whether there is thinking about the rehabilitation of certain regions rather than a nation-wide policy. **Tachiciu** expressed his belief that agricultural reform has to be part of a regional/local development strategy, but admitted that there are no policies in place at this moment.

At this point **Oltean** offered more data on Romania's agriculture and pointed out that two relevant laws were recently passed. The first increases the maximum amount of land a person can own to 200 hectares (to help create large farms); the second is the sharecropping law, which allows even state land to be given out for sharecropping.

Robert Vogel, who would speak at a later session on the subject, interjected that the Agricultural Bank has had a harmful effect on the creation of sustainable rural financing mechanisms and expressed the view that credit cooperatives can play an important role in Romanian agriculture. He stressed that overcoming the difficulties Romania faces in financing internal trade is critical to agriculture. **Goldman** agreed, noting that the biggest problem of farmers worldwide is their inability to sell their crops and the biggest problem facing traders is lack of a credit line.

The discussion then shifted when **Baltazar** asked why Eastern Europeans are asked to abolish official credit and let the market decide, while the U.S. and Western European governments are involved in their countries' agricultural sectors. **Goldman** agreed in principle that agriculture is in some sense part of the public sector and that there should be a role for government intervention. He added that in the U.S. and Western Europe the agricultural systems have evolved without a great deal of public subsidy until recently when the number of farmers became relatively small. He cautioned, however, that interventions are not always efficient or even essential for growth. According to Goldman, careful intervention seems to be the right direction.

Concluding the discussion of agriculture, **Daianu** noted that controls on fertilizer and marginal prices have been lifted, and **Tachiciu** observed that tariffs for agricultural products have been lowered by one half (the average for agricultural products is now 27% with a maximum of 60%). He also noted that tariffs are a hotly debated issue in Romania because under current circumstances its products compete with subsidized products from Western Europe.

Economic Reform and Environmental Policy

Jeffrey Vincent began the discussion by stating that the transition to a market economy should be good for the environment in the short run. Profit-maximization by private firms and subsidy reduction should lead to more efficient processing. In addition, the short-term contraction in output in all of Eastern Europe contributes to a decrease in environmental damage.

In the long run, however, one cannot be so optimistic. The development of Asia today and the development of the U.S. and Western Europe in the 1950s and 1960s show that in the absence or ineffectiveness of environmental policies, rapid economic growth can lead to severe environmental degradation. The fact that until high income levels are achieved, income and environmental quality do not rise together is also problematic.

Vincent offered a few examples of environmental damage that cause severe economic costs in Asia, in Volvograd (air pollution) and in Russian municipalities (water pollution). In addition to reducing economic costs, environmental policies can promote economic growth by promoting tax reform that charges fair market value for use of natural resources (a negative example is the low price of timber in Romania, which leads to wasteful use of this natural resource). Environmental policies can also promote investment by addressing environmental liability issues. Survey evidence from Russia shows that concern for the environment is very high among foreign investors but low among local politicians.

The World Economic Forum's 1997 Executive Survey, he continued, shows that managers generally do not believe that environmental regulations have a major impact on company profitability and foreign direct investment decisions. Furthermore, environmental costs turn out not to be very large when compared to labor costs.

Vincent then turned to the critical issue of environmental regulation design. He raised two main issues: efficiency (meaning which economically justified environmental objectives should be selected) and cost-effectiveness. He stressed the need for flexible, transparent, and stable regulations. Vincent criticized U.S. environmental regulations as being too stringent and having the wrong focus because they do not let companies decide how to reduce pollution in a way that is most convenient for them.

Finishing his presentation, Vincent outlined three reasons for Romania and other transition economies to implement effective environmental policies now:

- Environmental damage is currently reducing growth and welfare.
- Investment decisions that will shape the future economy and determine future environmental impacts are being made now.
- Clean-up is vastly more expensive than prevention.

Economic Reform and Environmental Policy

Clifford Zinnes followed with remarks on environmental policy problems in Romania. He opened by urging that Romania not grow and develop first and wait for the implementation of environmental laws later. The environment, he stressed, is a major source of wealth for Romania, and an environmental policy can help the country get the most value out of its resources.

Furthermore, Zinnes pointed out, one important role of environmental policy is to reduce investor risk. Generally investors don't mind cleaning up but they fear the uncertainty of 'when' and 'how much' they have to clean up if legislation is unclear and non-transparent.

He then summarized some of the steps Romania has taken to create a legal and institutional framework for sustainable development:

- A transparent system for evaluating environmental performance of enterprises has been introduced, so that trading in shares can be conducted efficiently. Also, the process of privatizing state-owned entities carries with it a system for establishing environmental liability.

- When enterprises are restructured, the environmental law requires that compliance schedules be put in place which specify what has to be done when and by whom.

- Efforts are under way to harmonize Romanian legislation with EU standards, because for the latter environmental criteria are crucial for European integration.

- A new institution in the water sector has achieved three important goals: fiscal decentralization, democratization, and sustainable resource management.

- The gradual creation of a vibrant environmental service sector has been made possible by environmental legislation.

Zinnes concluded with a detailed description of the procedures in Romania that address environmental obligations. In order to deal with the complex issue of environmental liability, the current privatization program minimizes investors' future profitability risk and maximizes the government's credibility as a serious seller committed both to privatization and to resolving environmental issues. The key feature of the system is a pre-sale environmental audit intended to establish two types of liability:

- *Quantifiable liability* identifies those environmental obligations known at the time of sale which relate to both past damages and future compliance. These are handled by specifying minimum acceptable goals (MAGs) in the tender documents and sales contract. The costs are fully assumed by the investor.

- *Contingent liability* identifies potential sources of environmental liabilities whose costs cannot be known with precision. If the investor is making a substantial additional investment commitment, the investor may negotiate to share with the government the contingent liability categories (CLCs) in exchange for a reduction in the price of sale.

To **Oltean's** question about creating an off-budget environmental fund, **Vincent** responded that one has to think carefully before establishing these funds. In a country like the U.S., for example, the bulk of the resources for environmental protection come from companies and private individuals instead of the state budget. He further advised Romania not to copy U.S. regulation, but rather to specify performance standards and leave the decision process to the companies.

Rusanu argued that environmental regulations in Romania are harsh and constitute a handicap to attracting foreign investors. **Vincent** repeated the main findings of the 1997 Executive Survey (see above) and stressed that investors are quite fearful of uncertainty and random enforcement. They prefer stable and clear regulations. In response to a question from **Oltean**, **Zinnes** said that tax breaks are an extremely inefficient way to encourage environmental investments. They are preferred by governments because they are easier to implement than regulations are to enforce. However, the enforcement of regulation is more efficient, according to Zinnes.

Bara concluded the discussion of environmental policy by observing that by reducing uncertainty, clear and transparent environmental regulations complement other facilities that are needed to attract foreign investors.

Health Care

Sherry Glied outlined some of the trade-offs in health care while making it clear that there is no single means of doing things right. She identified four basic issues that the government must address:

- How to divide responsibilities between the public and private sectors.
- How to finance the system.
- How the public sector can control costs.
- How the private sector will be managed.

In Glied's view the government must play a role in the provision of public health (e.g., vaccination against infectious diseases, sewage, sanitation, health education); the provision of health care to poor people; and the regulation of the health insurance market (to make sure that the healthy are not favored at the expense of the sick).

The main health care financing issue, she believes, is that patients tend to over-consume health services when they do not pay the full cost. This leads to rapidly rising costs in the health care system. Costs can be kept in check in two ways:

- Government provision of health care goods. Three methods can be used:

    - Rationing quantity (which is effective but not very efficient).
    - Letting providers pay for it (by allocating budgets to doctors for each of their patients).
    - Contracting with hospitals under managed care plans (to regulate the provision of services).

- Full or partial payment by employers and/or patients.

Tachiciu explained that each Romanian citizen has free access to health care but the quality is poor. Today, Romania must decide whether to increase the quality of care for some at the expense of poorer segments of society. **Glied** responded that such a trade-off is universal. One solution might be to offer somewhat higher quality care for everybody, while making even higher quality services available for those able to afford it. **Zinnes**, speaking from personal experience in Romania, mentioned the widely practiced use of side payments (bribes) to doctors, which makes it hard for some of the poorest to afford health care. In response, **Tachiciu** admitted that bribes are widely used, but did not agree that the present system leaves poor people without health care.

Members of the Romanian delegation offered pros and cons for the different financing models of health care. **Glied** concluded her presentation by suggesting that managing a balance between private and public systems is crucial. While private systems can provide additional quality for those who can afford it, public systems must be available for the poor who otherwise could not afford health care.

Fiscal Federalism

Roy Kelly's presentation covered the following topics:

- Fiscal decentralization, focussing on administrative aspects.
- Issues surrounding devolution to improve accountability and empowerment of the people.
- Ways to reshape the tax service and think about it functionally.

Wherever it has been tried, fiscal decentralization has faced an array of issues, of which the following are the most common:

- *Assignment of expenditure responsibility:* What is the role of local government?
- *Assignment of revenue sources:* Tax-sharing arrangements, set tax rates, amount of flexibility.
- *Assignment of intergovernmental transfers:* How to equalize output, capacity?
- *Regional/local borrowing:* Who pays? Central or local government?
- *Central government lending:* If the central government lends, what should its role be so that there are no problems?
- *Social programs:* If the central government does not lend, what is the fate of social programs?
- *Financial management:* For example, does bankruptcy law exist for local/central governments?
- *Legal structure:* In the constitution? In law? What legitimacy is there to ensure that local/central governments have accountability/are held accountable?

Kelly stated that three important conclusions should guide any government decentralization initiatives:

- Fiscal decentralization is the core of reform.
- Fiscal decentralization is a system, a package of reforms that need to go together.
- Fiscal decentralization is a process which will continue to move, takes time, and needs to be institutionalized as a process.

He warned that there is no ideal fiscal decentralization system. To fashion an appropriate one, problems that have emerged elsewhere must be recognized:

- *Fiscal imbalances:* Vertical and Horizontal.
    - *Vertical:* i.e. It is desirable to collect certain types of taxes (e.g., VAT, personal income, trade taxes) via a centralized system. But on the expenditures side, this should be performed locally, in order to be close to the people. If expenditure is controlled centrally, central government passes off costs to local government, or central government passes off revenues to local government, which bankrupts central government (this is typically done to get funds as close to the people as possible).
    - *Horizontal:* Some local governments are richer than others; the central government needs to equalize this difference.

- *Coordination vs. competition*.

- *Problems of context and process.*
  - Unclear goals
  - Inadequate control
  - Inadequate flexibility
  - Inadequate local flexibility
  - Inadequate design

According to Kelly, the most convincing reasons for decentralization are to:

- Move government closer to people and increase accountability of governments. If there is no tension between "top down" and "bottom up" approaches, there is no reason for decentralization.

  - Top down: Does the local government do what the central government wants?
  - Bottom up: Does the local government do what the people want?

- Improve efficiency in allocation of resources.
- Improve revenue mobilization: people are more willing to pay.
- Allow for interregional competition and innovation to improve costs.

He also presented some of the arguments for fiscal centralization:

- Macroeconomic control and stabilization.
- Equalization potential: What will happen to poor regions if local governments are autonomous? Central government needs to "equalize."

Two financing models have emerged for fiscal decentralization:

- *Tax sharing model* (Germany)
  - Grants, categorical grants for equalization
  - Shared taxes (most of money comes from here)
  - Minor local taxes
- *Assignment model* (U.S.)
  - Grants
  - Shared taxes
  - Significant taxes – can set rates (autonomous)
  - Loans
  - User charges

Kelly concluded by listing the "10 commandments" he has developed to govern fiscal decentralization:

- Don't hurry because haste can be damaging. Organizational change takes time.
- Start where you are.
- Strong central government is essential to monitor the process.
- What local and central people want are different.
- One size does not fit all. One model will not necessarily be applicable to rural and urban areas.
- Start with expenditures, then revenues.
- Link expenditures and revenues (transparency, accountability, and flexibility).
- User charges and property taxes, then other revenue sources, including transfers.
- A fiscal decentralization strategy and process are needed.
- Simplify system.

Rusanu began the discussion of Kelly's remarks by stating that he has served in both local and central government. Depending on which seat he was in, he would defend different positions.

The Ministry of Finance, he noted, is criticized for high taxes. However, ministries, as well as localities, are interested in raising money for themselves. Everyone wants a reduction in taxes, but they also want preferential treatment for their own ministries or their own locales. The government is urged to implement a global tax, but the 10 commandments say "don't hurry."

What does it mean to have a global tax? The tax enforcement agencies can only control around 25% of the population; Romania would need four times more enforcement than it now has. The government cannot track down all the taxpayers. Therefore, given the mentality of the people, the global tax shouldn't be introduced for another 10 years because there is a lack of updated/computerized data processing systems.

We should be aware of some of Romania's tax collection problems:

- Romania collects more via payroll tax than from the profit tax.
- How to punish people who do not pay taxes? And how do you recalculate their tax given the high inflation?
- Inflation increases and decreases are all over the place. How to value 1 million leu now versus later?
- Should the retailer pay a tax when the product is delivered or when the product is sold? Currently, the former rule applies, leading to the decapitalization of enterprises.

Tachiciu insisted that lack of fiscal reform is a major burden and problem. The capacity of local authorities to manage reforms depends on their staff, not their number of terms in office. Here lies the responsibility of central and local government: to train local staff.

Commenting on Rusanu's remarks, **Kelly** observed that "hurry" is a relative concept. It does not mean that reform should be postponed. What it does mean is that some reforms can be undertaken now, and others later. For example, a hard budget constraint should never be postponed because it is an effective way of holding local governments accountable to their people. Whenever central government bails out local government, reform is set back because local governments are not accountable. Strategy should not be postponement, but implementation.

Baltazar agreed that laws must be in place to empower local governments and to enforce and encourage their reform and accountability. There is a nationalistic/patriotic legacy of trusting central government more than local government which he finds troubling. Local government officials are known for their connections with central government rather than with their electorate.

Pension Reform

Laurence Kotlikoff announced that his presentation on pension reform would be divided into two parts:

- *Economics of social security reform:* What it means to privatize social security.
- *The "right" way to do it*: Issues/details of how pension reform should be done.

***Economics of social security reform* -** The best way to analyze pension reform is with the government's intertemporal budget constraint.

Either current generations pay for what the government spends, or future generations will. He advocates using generational accounting to determine the size of future tax liability facing future generations. The burden on future generations can be estimated by comparing their projected net taxes to their projected labor income. In the U.S., for every $1 earned by each person in the future, $0.84 will go towards recovering past debt.

A burden of this size on future generations is clearly unbearable. To avoid it, there is a need to increase taxes paid by current generations so that future generations will be better off. How can this be done? Currently, 15% of people's wages go to fund the pensions of today's old people. Instead, Kotlikoff argued, if people's wages are invested in the economy, then the economy's capital stock grows, leading to more productive workers, thereby increasing the tax base. It is possible, he argued, to increase per capita output in the long run by 10-15% if privatizing is done correctly.

***The "right" way to do it* -** Kotlikoff then turned to ways of privatizing. An efficient and effective approach, he stated, should have the following characteristics:

- Worker contributions put into private accounts.
- Consumption tax pays for those social security benefits accrued under the old system.
- Earnings sharing gives caretakers security. For example, if the primary earner is male, the portion of his salary going to the pension is divided into two accounts, one for him, one for his spouse.
- Government provides matching contributions for low earners (redistribution) so that minimum wage workers have adequate funds when they retire.

An important question, he continued, is how these funds are invested.
Kotlikoff recommends:

- Investing in a single international diversified fund (i.e., stocks and bonds),

Daianu responded that capital movement is dangerous in a country like Romania because it destabilizes the exchange rate. Romania needs national savings invested in the country, not transferred abroad.

Kotlikoff countered that when currency is convertible and Romanians invest abroad, foreigners will invest in Romania.

A series of comments were made by the Romanian participants. To an expression of uneasiness about pension funds being invested abroad, a participant countered that it is done by Romanians all the time. It was also argued that Romania cannot play the market with retirement funds; it must be certain that the funds are available when needed.

Kotlikoff then summarized a plan which he has proposed to the U.S. government and which he now proposes to Romania:

- Introduce a consumption tax as the mechanism to finance accrued benefits under the old system.
- Protect secondary earners with earnings sharing.
- Make the system progressive using a progressive government contribution match.

- Internationally diversify invested funds.
- Annuitize privatized account balances on a cohort specific basis.
- Lower transaction costs—one portfolio.

Baltazar observed that psychological ties to the state lead people to trust the state more than those who promote privatization. **Daianu** contended that people will be weaned off of these psychological ties only in extreme situations, such as repeated high inflation rates. **Bara** confessed that the proposed system, although complex, is interesting. The question remains, however, how can it be implemented in Romania given its current difficult situation?

Kotlikoff concluded by announcing that a program that would conduct generational accounting calculations is available for free. He does not think the proposed system is as complex as it might appear. The World Bank could help implement the program. The Romanians should model themselves after the U.S. by letting the exchange rate float, which will lead to a lot of capital inflow into Romania.

April 30, 1997

Reform of the Financial System

Robert Vogel's presentation was in three parts:

- *The banking system*
- *Bank supervision*
- *Securities markets*

Banking system - Vogel began by focussing on examples from agricultural finance and the agricultural bank. Agricultural finance is critical to Romania's future growth, he observed, but the agricultural bank is the country's most egregious example of an insolvent bank. It is not an unusual example of what often happens with state-owned banks.

He explained that the bank's insolvency created a fiscal burden for the government. It also hindered financial market development by crowding out potential development of other institutions. These problems occurred for political reasons, resulting in major management problems and inappropriate staffing.

Actually, Vogel went on, the rural areas of Romania have a good basic financial structure. There is the Post Bank, which is innovative and provides important deposit services; the Cooperative Bank, which is aggressive in opening up branches in rural areas, offers good interest rates, and accommodates depositors well; and the credit and consumer cooperatives. It is important, he contended, to separate credit and consumer cooperatives.

Consumer cooperatives seem to be in bad shape in rural Romania, while the credit coops are doing well.

Also within the structure of rural finance is the Savings Bank. Although it has no history as a lender, it has considerable potential for direct lending because clients like to borrow and deposit in the same institution. Its potential lies in a large network of rural and urban offices throughout Romania and a large reserve of deposits.

What the rural areas most lack is crop credit through informal finance, such as traders. Currently, the manner in which subsidies are injected into the system through marketing agents does not leave farmers and distributors free to develop commercial trade and credit relationships as rapidly as they should.

Banking supervision - Vogel's assessment of the present system is that its examination capabilities are inadequate; its legal capabilities are seriously deficient; the technical capabilities for managing, merging, or liquidating banks are not developed; and the political support necessary for effective supervision is wanting.

Among the remedies he would recommend are:

- *Monitoring of insider lending*. Currently, loans may go to bank owners/managers, because they are politically connected. This is not easy to monitor, but it is important to do so.

- *Intermediate steps.* When a bank has a serious problem, intermediate steps are needed between no remediation and closing the bank down.

- *Increased technical capability* must be developed to manage, merge, or liquidate. It is not only necessary to deal with problem loans, but also to work with problem banks in a short turn-around time.

- *Genuine political support* is needed in order to recognize losses (someone must pay the bill) and to remove owners and managers who are either colluding in or are just not handling well enough problems of the bank.

- *Deposit insurance.* These remedies must precede deposit insurance since depositors will no longer care which banks are problem banks.

Securities markets - Vogel recommended five actions that will assist in developing a market for securities transactions in Romania:

- Establishment of a legal infrastructure for instruments, contracts, etc.

- Establishment of an accounting infrastructure for generation of essential information. Clear rules are needed about the content of the balance sheet and the income statement. Consistency is essential.

- Measures to disseminate timely, relevant, and accurate information to all participants in the market.

- Measures to protect minority interests. Small investors will not buy securities if the government holds a "golden share."

- An infrastructure for conducting transactions. Clearing and payments must appear to the investor to be as low risk as possible. Depositories and custodians must operate under transparent rules backed up by the force of law. Government has an appropriate and important role in assuring the reliability and credibility of the system.

Legal Reform

Katharina Pistor introduced her presentation on legal reform by noting that economists increasingly look to law to "solve" problems that economists cannot. In transition economies where there is no tradition of private ownership of enterprises, an area that concerns them a great deal is corporate governance, for which there are two outstanding, broad models: the "German" system, which is a very regulated, statutory system, and the "American" system, which leaves more rights to corporate contracts and has been in flux for many years. Pistor cautioned strongly against simply transporting one legal system to another legal environment.

She urged countries such as Romania to move toward a self-enforcing model of corporate law. It is her view that if the situation is one where shareholder rights are not well enforced and product competition markets are not well defined, as in transition economies, it is important for the legal system to allocate as many rights to private parties as possible.

Trandafir, referring to the modernizing needs of the Romanian legal structure, expressed the view that passing almost 100 laws is not something that should be alarming because they are needed to streamline the legal process. There is no common law system in Romania, so legislation is the only way to change the law. **Oltean** insisted that legal reform is needed before banking reform. Following the 1990 constitution, all laws must be consistent with it. Some of the 100 proposed laws are amplifications of articles in the constitution and refer more to procedure than to substance, so this is not alarming. In recommending going slowly, **Pistor** said she was not necessarily promoting bottom up law. She cautioned that a legal system cannot be designed that does not have internal contradictions. It was not her intention, she said, to compare the Romanian legal system with the American or German. Her advice is simply that changes be considered within a local institutional perspective.

Baltazar interjected the view that the biggest legal problem in Romania is the lack of law enforcement. This is what deters foreign investors. Courts in Romania are not taken seriously, he said. Judges are young, ignorant, or subject to bribery, and do not know much about the economic principles on which most of the commercial cases are based.

Oltean disagreed with what Baltazar said about judges. He pointed out that he is a lawyer by profession and he knows the court system inside and out. Oltean admitted that judges may be young or inexperienced, but so is any young professional, whether he or she be a banker, economist, or whatever. He reminded his colleagues that judges are also very poorly paid and are not supposed to receive funds from elsewhere. So they are susceptible to bribes. This is something that needs to change. **Baltazar** said that is probably true, but he reminded others that the agricultural bank was the main conduit through which subsidies were supposed to be dispersed but the money never reached the peasant. The legal system, he charged, has led to the fall of many private banks.

The Role of Contracts in Foreign Investment

David Smith forecast an increasing role for lawyers in Romania as investments increase. Lawyers will be needed to deal with the complex foreign investment contracts that will be coming along.

Smith said he would discuss two different types of contracts:

- Contracts between foreign investors and local companies (state-owned or private).
- Contracts awarded by the government to local or foreign investors (concession agreements, such as in the field of development of natural resources).

One generic form of contracting, he continued, is the Build-Operate-Transfer (BOT) model. BOT is a concession-based financing structure. The main agreement is the concession contract (Project Agreement) between the government agency and the project company. In addition to the concession contract, the project company usually enters into:

- Credit agreements with lenders (very important).
- Purchase agreement ("off-take" or "take or pay" agreement) with the government agency.
- Escrow agreement with lenders/government agency.
- Construction contract with contractors.
- Operation and maintenance contract with the operator.
- Shareholders agreement with its own shareholders.
- Insurance policies with insurers.

Baltazar interjected that usually the shareholders of the project company are also operators and contractors, as they are trying to obtain as much profit as possible. **Zinnes** warned that the government needs to signal its seriousness in these contractual agreements if it wants a deal concluded successfully. **Baltazar** responded by saying that Romania has never defaulted in its debt obligations. Responding to an earlier concern of Baltazar's, **Smith** said that government can avoid being overcharged for inputs when shareholders and contractors are the same by including a provision in the contract requiring purchase of inputs at world market prices.

The discussion turned to what local shareholders have to be aware of in a joint venture contract. **Baltazar** warned about overvaluation of the know-how and equipment that are brought in. **Daianu** suggested that an agreement should be reached on the size of exports.

Smith continued his presentation by pointing out that contracts are an exercise to allocate risks, control, revenues, and responsibilities.

He then explained the basic functioning of franchise agreements and acknowledged that, in principle, the franchisee must assume considerable risk without having much control. **Daianu** also expressed his concern about the protection of local franchisees and warned the Ministry of Finance to be concerned with excessive outflows of capital by the franchiser. **Baltazar** disagreed with this opinion, and said that as long as franchisers pay their taxes, the government should not be worried about capital flows abroad.

Referring to Vogel's presentation on the banking sector in Romania, **Rusanu** tried to correct what he thought was an incorrect impression about credit and consumer cooperatives. Even though both types of cooperatives are led at the center by Centrocoop, the credit and consumer cooperatives are independent of each other in the regions, he said, with different boards of directors. Consumer cooperatives are not allowed to lend money derived from credit cooperatives.

Public Expenditure Reform

Lester Gordon identified the stimulation of discussion about the practical problems of expenditure management as the purpose of this session.

The problems of expenditure management are universal, he said, but in transition economies they take on a particular twist: In these former command economies financial instruments were not key tools for allocating resources. Control was through the movement of resources. Thus processes for developing financial plans that control the flow of resources and the actual expenditure of funds were neglected. This makes expenditure control, particularly in a highly inflationary situation, he said, an especially vexing management problem.

Transition economies in an inflationary crisis typically are indecisive in adopting measures to control expenditures. In addition to the political problems they face, decision makers are also confronted with dated and inaccurate information on actual expenditures. Non-inflationary budgets are normally not the solution because systems for implementation are not in place. Emphasis should first be placed on enforcing timely and accurate expenditure reporting. An extreme measure, but one that is often necessary, is to resort to a cash budget (i.e., allowing no more expenditure than there is cash in the bank).

Gordon observed that expenditure management can be complicated further by inherited organizational structure. Often, a system for setting national and sectoral budget priorities is lacking because of the structure of government, not to mention staffs better trained in bookkeeping rather than budget program analysis and modern accounting.

Commenting on the situation in Romania, **Rusanu** said that the Ministry of Finance uses a cash budget and has good statistics about the revenues and expenditures. The main problem in his view is that the Ministry of Finance is cash strapped.

Openness and Growth: Policies to Encourage Exports

Steven Radelet began his presentation by stressing the importance of exports, especially manufacturing, in growth. He also noted many misunderstandings about why manufacturing is important. The presentation was based on his research on the Asian economies.

Radelet concludes that there is a direct connection between countries that are successful in manufacturing exports and in economic growth. He reported that there are very few exceptions to this pattern. Out of a group of 78 developing countries for which data are available, 11 of 13 fast-growing economies recorded rapid growth in manufactured exports. Of the 65 slow-growing economies, 64 also recorded slow growth in manufactured exports.

Radelet found that successful countries met a variety of conditions:

- The right macroeconomic policies were followed.

- An exchange rate that did not penalize exporters was adopted. (The exchange rate was a critical dimension.)

- Inflation was under control. When it is high, manufacturing firms can not compete because of production and labor costs.

- The importance of import policies for exports was recognized. For exporters to be successful, they must be able to obtain imports quickly and cheaply. Customs clearance must be fast. Even a small increase in import costs can wipe out the exporter's profit margin, since imports make up around 85% of production costs. Import duties on them can really wipe out profits.

- Tariff rates in east Asia are quite low and very high in south Asia, where growth has been poor. The share of imports covered by quantitative restrictions is low in east and southeast Asia and very high in south Asia.

Radelet then turned to the problem of how high tariffs can be reduced for exporters. In addition to across-the-board cuts in tariffs, three types of facilities enable exporters to import without duty:

- *Export processing zones:* Geographic areas outside the country's customs barriers where firms can locate themselves. Provide good infrastructure for the exporters: roads, electricity, and access to ports. They have a mixed record around the world: not successful in Africa, South Asia, Latin America, and the Caribbean, but very successful in East Asia, especially Malaysia, because the governments were truly committed to making it work and to making exports profitable.

- *Bonded warehouses*: Like export processing zones, but a firm can be located anywhere because a customs official is present all the time. Advantage in letting firms locate wherever they choose, but difficult to administer because of dispersed locations. Firms must post a bond at a bank, which is the value of the duties that they would normally pay.

- *Duty drawback systems*: Firms can be located anywhere they want. After they export, duties are refunded.

Each of the successful Asian countries, Radelet observed, had a mix of these three systems.

Tachiciu asked what the difference is between drawback systems and bonded warehouses. **Radelet** responded that at a bonded warehouse, a customs official is located full time at the firm. Under a drawback system, no customs official is present. Firms pay import duties and present evidence of duty payment when seeking reimbursement for exports.

Tachiciu then asked what criteria are used to allow firms to be beneficiaries. **Radelet** replied that traditional exporters qualify themselves for drawbacks. Others who export from time to time usually must be above a certain size. **Daianu** wondered whether this could be a level playing field. **Radelet** responded that industrial targeting occurred in Taiwan and Korea, but the evidence on whether the chosen firms were the most successful is mixed. In Malaysia and other South East Asian countries industrial targeting has generally failed.

Romanian Prospects and European Integration

Andrew Warner distributed some graphs on the economic performances of European Union countries and the transition economies, from which he drew the following conclusions:

- Among transition economies, those that reformed fastest grew fastest.
- It is unrealistic to expect growth from the state sector. (Those firms not from the state sector grow the fastest.) One simple predictor of growth rates is the share of the economy in the private sector.
- Comparing levels of income in transitional economies with those in the European Union, Romania's $4,000 average per capita income is 24% of that of average per capita incomes in the EU.
- What level of economic growth is necessary? (**Baltazar** expressed the view that Warner's estimates for Romania are “misleadingly nice.”) To close the income gap between EU countries and transition economies, the latter would have to grow at a quite high rate over time.
- Looking at data that relate savings and an index of liberalization to growth rates, Warner concluded that a lot of action happens from the liberalization variable.

Georges de Menil agreed with the general thrust of the two previous presentations. He recommended reducing tariffs and breaking up monopolies as being more beneficial to growth than increasing savings. (The same point was stressed by **McPherson** later.)

Both **Pistor** and **de Menil** reminded the Romanians that the likely integration of Romania into the European Union will make a big difference for the country's exports.

Baltazar responded that in the event of a take-off of Romania's exports, access to Western European markets would still be limited because of the restrictions imposed by the EU.

Monetary Management

James Duesenberry opened the discussion by stating that his remarks would address four topics:

- *Banking structure*
- *Money market instruments*
- *Supervision*
- *Monetary policy, disinflation, and the exchange rate*

Noting that financial structures were in flux, Duesenberry explained that the real issue for the development of banking in Romania was the need for well-trained loan officers and credit evaluators as well as managers capable of making effective portfolios to diversify risk. Supervisors need to be capable of early action, before a bank is brought to the brink of closure, by utilizing such instruments as cease and desist orders or through memoranda of understanding. Directors need to exercise real responsibility, and becoming "suable" would help them to be so. In order to ensure a competitive banking system, other lending institutions such as leasing companies, merchant banks, and insurance agencies are needed to fill gaps in services and help to provide further competition.

Moving on to market instruments, Duesenberry noted that these also include the short-term instruments to be used by the Central Bank. They include T-bills issued directly to the public, and short-term debt obligations that can be resold in the market.

Duesenberry then addressed the state of inflation in Romania today. He asserted that more austerity is called for to bring it down from last year's 60%. The longer inflation exists, the more it becomes entrenched and harder to get rid of, negatively impacting foreign direct investment. Government expenditures have been driving inflation, he concluded, placing the Central Bank in a fix: It could either raise interest rates to astronomical levels or ration credit, neither of which is desirable. Duesenberry insisted that a prudent fiscal policy must involve both the Bank and the government, requiring a significant slowdown of monetary velocity and austere policies.

Baltazar interjected that the high rates of inflation that occurred in Romania previously were corrective, needed to adjust prices to equilibrium. **Duesenberry** agreed to some extent, but noted that the exchange rate would also act as a corrective mechanism. Unfortunately, the exchange rate appreciation would lead to a "crisis of renewed confidence," where appreciation would feed back negatively on exports. Duesenberry argued that a fixed exchange rate would be the worst possible solution, as fluctuations in the rate would help relieve inflationary pressure. As a policy suggestion, it would be better to have a team of people who have direct contact with the ministers, working together on outlook and issues, just to get the numbers right. This would undoubtedly help with coordination.

The discussion shifted a bit at this point, as **Zinnes** noted that banks levy an implicit tax on small businesses through service charges, and these need to be eliminated in order to foster growth. **Tachiciu** brought up the problem of full convertibility. **Duesenberry** dismissed out of hand the idea of capital controls, stating that if capital wants to flow, it will. Intervention in portfolios will only harm foreign investors, and capital controls, once in place, will be hard to get rid of because of the vested bureaucratic interest they create.

Malcolm McPherson intervened at this point, emphasizing the inefficacy of capital controls and stressing that convertibility worked as a disciplinary measure for macro policy in Indonesia. Worrying about convertibility was really a "waste of time," as full convertibility had been achieved in South Africa without any adverse consequences. **Baltazar** agreed, saying that he had money in non-Romania banks and wouldn't bring it home until full convertibility had been achieved.

McPherson then launched into the heart of his presentation with the following main points:

- Adjustment is never easy; there are always winners and losers.
- Politics always intrudes on stabilization, but the successful countries (such as Indonesia) can isolate their technical teams from political pressures.
- No country has gained by delaying adjustment.

In light of the foregoing, McPherson concluded that Romania's current economic program "does not really add up." He insisted that the program was not consistent with a projected budget deficit of 3.5%/GDP and would lead to a crisis of credibility.

Daianu chimed in at this point, wondering why credibility was at stake if the primary budget was in surplus. Transparency was a key of the new government.

McPherson continued, cautioning the Romanians to seriously consider compression of the budget deficit. Reduction of subsidies was a step in the right direction, as was the cutting of indexation. What was needed, however, was foresight about what would happen next year, if such austerity measures were not taken. Would the pain be taken in one big hit or spread out over years? Inflation could be made to drop like a stone, as it had in Zambia. **Duesenberry** re-entered the discussion at this point, arguing that hard constraints needed to be applied to enterprises in order to ascertain how much credit could be afforded. **Daianu** noted that 21-22% of GDP was in arrears from the public sector of which 4-5% of GDP where net arrears (losses).

McPherson then summarized his argument:

- When macro imbalances exist, one must either finance them or adjust.

- There exists a confusion between financial and “real” responses.

- There also exists a perception that there can be no limits on fiscal and monetary policy of a government, which is false because of the operation of global markets. Romania should start with international relationships and work backward.

- Government self-restraint is needed first and foremost for stabilization. The government needs to stop running deficits.

- For Romania, the long run is already here. Phasing in just some of these changes would not work, so there has to be a full liberalization of markets, closing of all “value subtracting” industries, elimination of subsidies, and a deindexation of wages and benefits.

April 31, 1997

Creating a Hospitable Climate for Foreign Investment

Louis Wells commenced the discussion by clarifying the difference between foreign direct investments (FDI) and portfolio investments. He also stressed that figures of FDI in the world are less encouraging than the rhetoric suggests and foreign investments play an important role only in 10 countries which receive over 2/3 of the total amount. FDI is a form of debt that finances current account deficits. After this rather pessimistic start, Wells turned to the good news about FDI: In order to encourage it, the same types of reforms have to be implemented that encourage local savings and investments. FDI also brings with it technology, access to foreign markets, and skilled management.

Wells went on to explain that with the exception of China (unusual because of its large market), promotion efforts need to accompany the reforms. Ireland is a good example of a country with an effective promotion effort that is now widely copied. Singapore, a tiny undemocratic city state, and Costa Rica, also with a small market, are other examples of countries that attracted a lot of foreign investment.

Wells then described three different kinds of investors:

- Investors in manufacturing plants for the domestic market are easiest to attract if there is a fairly large market.

- Manufacturers for export markets are hardest to attract because they have a choice of where to go. They are concerned with labor flexibility, a strike-free environment, a predictable environment, and duty-free access to imported materials and components.

- Investors in the sectors of raw material extraction are easy to attract and they are usually more willing to deal with uncertainty and regulation.

Discouragingly for many countries, Wells continued, the first wave of foreign investors are not the ones mentioned above but rather investors who operate hotels, consulting firms, or service providers. Eastern Europe usually gets two additional kinds of investors: investment firms and members of the diaspora.

Wells went on to list five mistakes commonly made by countries that try to attract foreign investments:

- Heavy reliance on tax incentives. Studies have shown that these tax incentives play a minor role in investment decisions.

- Establishment of an investment center (so-called one-stop investment center). These institutions have been successful in few cases, in part because they often lack power, causing investors to go to the Ministry of Finance for help.

- Promotion of foreign investments too early, before the environment is sufficiently reformed. Investors are usually hard to bring back if initially disappointed.

- Failure to target specific areas for investment. Because promotion is expensive, certain types of investors need to be targeted.

- Provision of poor investment services. The best way to promote investments is to give examples of success stories in your country. It is also extremely important to treat potential investors well on their visits (e.g., waiting for them at the airport; giving them a chance to meet "happy" investors; showing them residential areas, schools, etc.).

Baltazar gave a short overview of Romania's experience with foreign investors in the last five years. He pointed out that the first investors from abroad were mainly students from Africa and the Middle East studying in Romania. Many of them engaged in custom and fiscal fraud, thereby giving foreign investors a bad reputation. On the positive side, big name companies have also invested in Romania (e.g., Siemens, Alcatel). Unfortunately, their investments are rather small to date. Baltazar again mentioned his disappointment with the Daewoo deal in Romania. Nonetheless, he is committed to making it a success in order to attract other investors. He also expressed his disappointment with the low interest shown by European and American investors so far. He hopes that one day Romania will become a second Ireland.

Wells ended the final session by warning that Europeans might want to buy local companies in order to ensure that these are not exporting to their markets.

Concluding Remarks

Sachs then offered some final remarks on the entire workshop. After thanking the Romanian delegation for participating, he expressed his hope that this workshop was useful not only for HIID, but also for its guests. He noted that HIID is interested and ready to help Romania with advice and implementation issues in a few areas. He repeated the need for a strategy for long-term growth. Programs such as those implemented by the IMF are very short-term oriented and do not assure entry onto a path of high long-term growth rates.

On behalf of the Romanian delegation, **Tachiciu** thanked Sachs and HIID for the very useful workshop and hoped that these sessions were just the beginning of long-term cooperation between HIID and the Romanian government.