3. RESTRUCTURING THE ENTERPRISE SECTOR

3.1 In the last few years, Romania has made some progress in enterprise reform including carrying out privatization to strategic investors. However, in no other area, has the legacy of the socialist years weighted so heavily in Romania as in enterprise reform and private sector development. The slow and inefficient enterprise reform of the past has left Romania with a larger number of enterprises to be privatized or liquidated than in all of the other CEECs combined. Public enterprises are the core of the un-restructured part of the economy. As discussed in the previous chapters, there are also dynamic private businesses, which are leading Romania’s solid trade performance in the EU and world markets. Their scope of action, however, is limited to a few activities operating around the un-restructured enterprise sector. Furthermore, the expansion of these internationally competitive private firms is hampered by the sizable un-restructured public enterprises and the soft budget constraints that keep unviable enterprises from exiting. This chapter is divided into three sections. Section A described early transition reform efforts, as compared to those undertaken by other countries. Section B documents their effects on economic growth. Section C suggests some dimensions of the remaining reform agenda.

Figure 3.1: Many new enterprises enter, few exit (1993-2002 average)


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63 This chapter was prepared by Simeon Djankov (CICMA), the World Bank Group. Juan Carlos Ginarte prepared the section on nonpayment and accumulation of arrears, and Stella Ilieva prepared the analysis of total factor productivity; both Economists ECSPE, the World Bank.
A. Economic Restructuring Reforms: Romania in a Regional Perspective

3.2 The main thesis of this chapter is that the Romanian enterprise sector is characterized by a vibrant and expanding fringe of successful private businesses, which operates around a slowly-shrinking core of non-competitive state owned enterprises. The competitive sector finds opportunities in some domestic markets: services, construction, and light manufacturing; and has accounted for almost all of the recent boom in exports. Many new firms have started operations in the last few years (Figure 2.1) and these entrepreneurs make good use of existing institutions. However, their expansion is hampered by the continued existence of a non-competitive core of enterprises, which crowd out opportunities for external financing and sales. This effect is apparent in the difference in the share of new entries and exits as a share of economic activity. In the typical market economy, these numbers go hand in hand. In Romania, exit rarely happens.

3.3 The result is an unstable business environment in dealings between private and state-owned companies. Market economy institutions are sometimes obviated by non-competitive practices in tolerance of arrears to utilities and the tax office. This sends a signal to entrepreneurs that perhaps they, too, can escape payments to suppliers in the state sector. In contrast, business between private companies is performed on market principles. The significance of this dual system is diminished over time, but the slow progress retards the further development of a business-friendly environment.

3.4 The first ten years of enterprise reform in Romania were characterized by slowly unfolding privatization, with a large number of enterprises – between 1,500 and 2,000 – remaining fully or partially in state hands. Recently, the government has carried out a number of successful privatizations to strategic investors, including Siderurgica Hunedoara, Tractorul, Roman Brasov, and ARO Campulung. Still, no other economy in Central and Eastern Europe has such a large remaining privatization agenda.

3.5 The prevalent methods of privatization in the 1990s—insider privatization and mass privatization—resulted in weak corporate governance. Only recently have sales to strategic outsiders and hence boosted economic growth. Lackadaisical privatization was accompanied by soft budget constraints, resulting in large arrears to the government, the utilities, and the financial sector. Many unviable enterprises have been kept in operation. Even profitable enterprises benefited from accumulating arrears, reducing their incentives to restructure. Finally, domestic competition and labor reallocation opportunities has been hampered by the slow exit of unviable firms, explained both by the presence of soft budgets, the dysfunctional insolvency system, and labor market rigidities.

A.1. Privatization Unfolds Slowly, Far from Finished

3.6 The 1990s were a period of transformation of ownership in Central and Eastern European Countries (CEECs). In Hungary, companies were sold to outsiders, mainly foreigners, based on the strategy that foreign technology is needed to boost productivity. In the Czech Republic, mass privatization was implemented in 1992-1994, and in the following five years a rapid concentration of shares in the hands of strategic investors took place. By 1998, an estimated 85 percent of companies had a strategic owner. Foreign investors flowed in, buying both the remaining large state owned companies and many already privatized enterprises. By the end of
2003, a third of the enterprise sector has significant foreign ownership. The Slovak Republic also started with mass privatization, but cancelled it in 1994 and instead reverted to direct sales, mainly to domestic investors. However, large enterprises, primarily in the heavy machinery, automotive, and financial sectors, went directly to strategic foreign investors. Since 1999, the Slovak Republic has been the favorite destination of foreign investors in the region, with about 40 percent of value added now produced in foreign-owned companies. Poland initially privatized all small companies and allowed for new entry, while weighing options in the privatization of large enterprises. In 1995, mass privatization started in earnest while banks and other financial institutions attracted foreign investors. Finally, Bulgaria toyed with mass privatization but, like the Slovak Republic and Poland, changed course mid-way and engaged in sales-for-cash that brought in much needed foreign currency. By the end of 2003, more than 80 percent of productive assets in these economies were in private hands (Figure 3.2). More importantly, nearly all had strategic owners.

Figure 3.2 Private Sector Share in GDP, end-2002

<table>
<thead>
<tr>
<th></th>
<th>Bulgaria</th>
<th>Czech Republic</th>
<th>Estonia</th>
<th>Hungary</th>
<th>Poland</th>
<th>Romania</th>
<th>Slovak Republic</th>
<th>Slovenia</th>
</tr>
</thead>
<tbody>
<tr>
<td>Source:</td>
<td>EBRD and World Bank.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

3.7 In the meantime, Romania experimented with various alternatives. Those took considerable time to develop, and after 10 years of transition Romania had privatized only 40 percent of its large enterprises, and about two-thirds of its medium-size enterprises (Table 3.1). By end-2003, there were still approximately 1,300 state-owned enterprises in Romania, including in manufacturing and services; and another 600 enterprises that were de facto in state control. This is a larger number than in the rest of CEECs combined.

Table 3.1 Privatization in Romania, 1993-2002

<table>
<thead>
<tr>
<th></th>
<th>Companies for privatization</th>
<th>Companies privatized (share of total)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Large</td>
<td>708</td>
<td>288 (40)</td>
</tr>
<tr>
<td>Medium</td>
<td>2549</td>
<td>1582 (62)</td>
</tr>
<tr>
<td>Total</td>
<td>3257</td>
<td>1870 (57)</td>
</tr>
</tbody>
</table>

Source: The Romanian Authority for Privatization and Management of State Ownership
3.8 The goal of the isolation program was to bring companies back to health or, if this proved difficult, to privatize or liquidate them. However, managers remained in place, and were reluctant to take drastic measures since they were either elected by the workers or their appointment was approved by the union. Instead, they focused their energies into vying for access to Romania’s own “Structural Funds”, and giving explanations of their inability to pay various obligations to the government.

3.9 Not surprisingly, little restructuring took place, with most of the funds used instead to maintain employment. At the time of closing the program in February 1997, only four firms graduated into profitability, two were privatized, and two were liquidated, out of the 147 companies that entered the isolation program. Had the government used the resources of the Structural Funds to offer generous separation packages to workers, the amount used during the life of the isolation program would have been sufficient to give 30 monthly wages to every employee. A generous package that would have been difficult to reject. The program instead served to delay privatization and when it became clear that there was no other route, many enterprises were already too troubled to be worth resuscitating.

3.10 The State Ownership Fund. The protracted approach to enterprise restructuring was set from the start. In 1991, the government carried out a legal conversion state-owned enterprises (SOEs) were divided into two groups: remaining SOEs and commercial companies. The former group was smaller in number but included all strategic companies, about 400 in total, which accounted for nearly half of productive assets.64 A number of those were entered the isolation program, others were deemed too strategic to do so. In contrast, the commercial companies were slated for privatization, albeit of an unusual kind. Their shares were placed in a newly established State Ownership Fund (SOF) and one of five Private Ownership Funds (POFs), in a ratio of 70:30 percent. The management of the SOF was identical to that of State Property Funds in every other transition economy. However, unlike privatization funds in any other country, the Romanian POFs remained state-managed, their boards of directors appointed by government and approved by Parliament. Their nominal owners, about 18 million Romanian citizens who received shares through mass privatization, received no control.

3.11 Thus the mass privatization program in Romania was unique in its design. In every other country that distributed vouchers to citizens—Bulgaria, the Czech Republic, Poland, and the Slovak Republic—the privatization funds were privately owned and operated. This created incentives for the new owners to establish profitable operations or liquidate the companies in distress and sell their assets. Also, it resulted in rapid concentration of ownership in the hands of strategic owners, either a privatization fund or another legal entity that bought the controlling package. For example, by the end of 1997, or within 3-4 years after mass privatization, over 70 percent of mass-privatized companies in the Czech Republic had a majority owner.65 In Bulgaria, by 1999 nearly 85 percent of mass-privatized companies has a majority owner.66 In both cases, the concentration took place in secondary-market trading as owners were interested in consolidation of stakes and improved governance. In sharp contrast, by end-1998, the largest

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64 Romanian Development Agency (1997).
65 Claessens and Djankov (1999).
66 Djankov (2002).
private owner in mass-privatized companies in Romania had on average a 24 percent stake.\footnote{Earle and Telegdy (2002).} This made it difficult to make strategic decisions and commit to long-term restructuring.

### 3.12 The other major privatization method employed in Romania was management employee buy outs (MEBOs). These started before the mass-privatization program (its heyday in 1995-1996) and developed into 1997, when the practice largely ceased. By the end of 1998, about a third of all industrial firms in the SOF portfolio has insider owners. Two features of the process made it unique.

- **First**, the ownership share that went to insiders was very large—65 percent on average, with a median of 71 percent.\footnote{Earle and Telegdy (2002).} To the extent that there was any outside ownership, mostly through residual mass-privatization shares, it could play no effect in corporate governance; and
- **Secondly**, usually the entire stake was transferred to employees, so the method should really be deemed employee buy-outs.

### 3.13 MEBOs also took place in Russia and the countries of former Yugoslavia, especially in Croatia and Slovenia. In Russia, managers of state-owned enterprises provided the backbone of the resurgent Communist party and Yeltsin offered them ownership stakes in exchange for support in the 1996 elections.\footnote{Shleifer and Treisman (2001).} Employees also gained some shares, but had no power over the decisions of the companies. In effect, these were management buy-outs. By 2001-2001, about three-quarters of these companies had changed ownership (and management), taken over by large conglomerates or being sold to outside (primarily domestic) investors. Similar developments, with much smaller magnitudes, took place in Hungary and later in Poland. In Croatia and Slovenia, the worker councils traditionally had a large role in company management and successfully retained power in the transition period. As a result, restructuring of these companies has been slow and only since 2002 have they experienced any significant interest from foreign investors. Today, many Croatian and Slovenian companies face similar issues as do Romanian companies. However, a major difference is the higher level of competition in the domestic market, as former Yugoslavia had historically been more open to imports from Europe.

### 3.14 Privatization to strategic investors. Since 1998, sales for cash gained momentum in Romania. Some of these companies were too troubled to be of interest to insider owners, other profitable companies were offered to foreign strategic investors following the Hungarian experience of direct sales. By 2002, about two-thirds of GDP was produced in private companies. However, 33 percent was still in state hands, 24 percent was insider-controlled, 19 percent had strategic outsider investors, 13 percent was controlled by shares obtained in the mass-privatization, with the remainder in the hands of privatization funds and dispersed owners (Figure 3.3).
A.2. Privatization Modes Affect Outcomes

3.15 Transition economies, in Central and Eastern Europe and further east, have privatized over a quarter million enterprises in the last decade. Various privatization methods have been tried, successes varied, and privatization strategies were revised as the evidence accumulated. By now, there is sufficient empirical evidence and analyses that show that:

- Privatization in almost any form resulted in better productivity and more employment opportunities than state ownership; and

- There were different effects of different types of new private owners.\(^7^0\)

3.16 Privatization to strategic outside investors is associated with nearly six times higher productivity growth than privatization to insiders (Figure 3.4). In Central and Eastern Europe, privatization to employees made enterprises worse off than keeping commercialized state ownership. Privatization to managers-insiders also worsen performance. Foreign ownership was particularly beneficial, and this result is supported by the experience in every country.

3.17 Figure 3.4, one can associate the apparent success of various transition economies with the privatization mode. Estonia and Hungary went for outsider privatization, mostly to foreigners. So did Bulgaria, Latvia and the Slovak Republic, after initial delays and hesitation. The Czech Republic, Lithuania, and Poland had a mixed strategy, but in the end ownership quickly concentrated in the hands of outside investors. Unique among its peers, Romania ended up with privatization that often made things worse, not better. Romania today is at par with Georgia and Ukraine, far behind the rest of CEECs. Only recently has Romania carried out privatization to outside investors and subsequent increase in foreign investment.

\(^7^0\) Djankov and Murrell (2002).
Figure 3.4 The Benefits of Outsider Ownership in Central and Eastern Europe (in percentage average annual productivity growth)

Note: Insiders does not simply add the analyses for employees and managers as some studies do not distinguish among the two groups. Similarly, Outsiders does not simply add the various groups of outsider investors. In some cases, these are reported and analyzed together. The two categories—Insiders and Outsiders—should only be compared to each other.


A.3. Hard Budget Constraints, Yet to Come

3.18 Most CEECs have had to deal with loss-making financially unviable enterprises. However, in most cases distressed assets were isolated under state fund management and sold off or liquidated. Unlike most other CEECs, nonpayment and arrears in the state-enterprise transactions in Romania is common—both financially unviable and viable companies rely on nonpayment to finance their operations. In 2002, arrears amounted to nearly 4.5 percent of GDP. For example, tax arrears amounted to a third of total assets of SOEs; excluding payments to utilities. Wages also grew at a very fast pace, at nearly 9 percent in real terms. Energy utilities also continued to tolerate arrears, allowing unviable firms to survive and preventing market exit. In contrast, this practice is nearly absent in private-to-private transactions in Romania. The challenge is to extend hard budget constraints observed in private-to-private transaction interface to the state-private transaction interface.

3.19 Other transition economies have faced similar issues but the arrears phenomenon is virtually unknown there. In all cases, distressed assets were isolated under state fund management and sold off or liquidated. With few exceptions, as in Polish mines and shipyards, has this issue resulted in significant budgetary allocations. And as many utilities were privatized early on, non-payment usually resulted in delivery stoppage. Unviable enterprises were forced to cease operations. Also unique in Romania, as the banking sector remained in state hands longer
than in any other Central and Eastern European country, enterprises also continued to receive bank credit to fill the shortfall. In short, through social security and tax arrears, through the banking sector and the utilities, Romania has delayed the sale or liquidation of many unviable companies.

3.20 More worrisome is the fact that many profitable private companies have been allowed to accumulate arrears too. In 2002, profitable tax arrears of private companies as a percentage of their total assets averaged over 10 percent, a share that is similar to the tax arrears share in companies in minority state ownership, at 11.5 percent.

3.21 When both unviable and viable companies face soft budget constraints, there is little incentive for productivity improvements. This behavior of government agencies is particularly puzzling, as the main rationale for the slowness of privatization was declared to be the financial betterment of companies. This would take place in the context of hardened budgets. Indeed, the evidence from other transition economies show that hardened budgets are the second most important determinant of enterprise restructuring (Figure 3.5). Absent that, and in the absence of outsider privatization until recently, without enterprise restructuring, Romania’s competitiveness has been limited.

Figure 3.5 Hardened Budgets Increase Productivity Growth in Transition Economies (in percentage average annual productivity growth)

![Graph showing productivity growth](image)

Source: Adapted from Djankov and Murrell (2002).

3.22 Strengthening financial discipline of the enterprise sector is also fundamental to maintaining macroeconomic stability. If enterprises operate profitably without dependence on either direct or implicit government subsidy, their financial difficulties will not significantly affect government budgets. Financial imbalances in the economy will not meaningfully pose a threat to the stability of the fiscal accounts, and the central bank will be able to maintain control

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71 Coricelli and Djankov (2002).
72 Fennema and Schaffer (2003).
over monetary policy. To the extent that much of the public enterprise sector is unprofitable and un-restructured, however, companies will depend on budgetary assistance and quasi-fiscal subsidies to continue operating. These are a risk to sustaining macroeconomic stability. In addition, subsidization distorts resource allocation, crowds out profitable firms from the credit markets, and limits growth prospects. Large loss-making entities that are subsidized by the government will be able to block the entry of efficient competitors, including foreign companies. Under these circumstances, resources that could have been used to invest in new projects, and which could have led to faster job creation, are instead used to finance wasteful activities.

3.23 Furthermore, without restructuring public enterprises these will remain a source of inflationary pressure and low competitiveness since historically they have been a source of rapid wage increases. The wages of state enterprises are used as reference for wage adjustment throughout the economy, including private enterprises and the state administration, and increases have often not been justified by productivity growth. Rapid real wage growth was partly responsible for the strong real appreciation and consequent sharp exchange rate devaluation of 1998 and 1999 needed to restore current account sustainability.

3.24 Table 3.2 presents estimates of the amount of budgetary subsidization of the enterprise sector. Direct subsidies have declined from 2.6 percent of GDP in 2001 to 2.2 percent of GDP in 2002. This is primarily due to a decline in agricultural subsidies as a result of improved harvests since 2000 and increased opportunity for export. Energy and transport subsidies have remained largely unchanged in 2001 and 2002.

3.25 However, explicit budgetary subsidies are not the only public resources transferred to enterprises. In Romania, there are a variety of implicit subsidies provided to both state-owned and private companies. The transfers include budgetary credits, accumulation of tax arrears, transfers from off-budget funds, and government payment of guaranteed loans. In total, these implicit non-energy subsidies have increased from 4.1 percent of GDP in 2001 to 5.5 percent of GDP in 2002. In addition, there are significant implicit subsidies from the energy sector to non-energy producers and households, of which about two-thirds accrue to firms. In 2002, these subsidies were 1.1 percent of GDP in 2002.

73 According to its Pre-Accession Economic Program, the GoR aims to limit wage growth in the budgetary sector to the sum of CPI inflation and growth of GDP. For the public enterprises, wages increases are to be limited to the sum of CPI inflation and productivity growth.

74 The Russian financial crisis of 1998 also triggered a decline of confidence in Romania and necessitated external adjustment.

75 Until the late 1990s, state-owned enterprises in Romania depended heavily on directed bank credits to finance losses and inter-enterprise arrears, which often were driven by rapid wage increases. As the loans were seldom repaid, the financial imbalances were effectively "monetized." As a result, monetary policy could not be reconciled with the strategy of using the exchange rate as a nominal anchor to control inflation. After 1997, soft-budget constraints were no longer financed by the central bank. Firms also began to impose hard-budget constraints on each other. Today, because the enterprises remain largely un-restructured, continuing losses have been financed with direct budget subsidy, tax arrears, unserviceable foreign loans that repaid by the government, and cheap sources of energy.

76 Energy sector subsidies have been estimated by the IMF. See the September 2003 Staff Report for the Fourth Review Under the Stand-By Arrangement and Request for Waivers of Performance Criteria. These estimates exclude the district heating companies that were not spun away from Termoelectrica. The estimate of the allocation
Table 3.2 Subsidization of the Enterprise Sector

<table>
<thead>
<tr>
<th></th>
<th>2001 (billions of lei)</th>
<th>2002 (billions of lei)</th>
<th>2001 (% of GDP)</th>
<th>2002 (% of GDP)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct Subsidies 1/</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Energy</td>
<td>30923</td>
<td>32772</td>
<td>2.6</td>
<td>2.2</td>
</tr>
<tr>
<td>o/w local government</td>
<td>9633</td>
<td>12372</td>
<td>0.8</td>
<td>0.8</td>
</tr>
<tr>
<td>Transportation</td>
<td>3841</td>
<td>4564</td>
<td>0.3</td>
<td>0.3</td>
</tr>
<tr>
<td>o/w local government</td>
<td>7765</td>
<td>8620</td>
<td>0.7</td>
<td>0.6</td>
</tr>
<tr>
<td>Agriculture 1/</td>
<td>2808</td>
<td>2875</td>
<td>0.5</td>
<td>0.2</td>
</tr>
<tr>
<td>Other</td>
<td>6280</td>
<td>2581</td>
<td>0.6</td>
<td>0.6</td>
</tr>
<tr>
<td>Implicit Subsidies</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Budgetary credits, net</td>
<td>7245</td>
<td>9199</td>
<td>0.1</td>
<td>0.1</td>
</tr>
<tr>
<td>Tax debt</td>
<td>26901</td>
<td>63423</td>
<td>4.1</td>
<td>5.5</td>
</tr>
<tr>
<td>Change in end of year stocks</td>
<td>8516</td>
<td>1610</td>
<td>0.7</td>
<td>0.1</td>
</tr>
<tr>
<td>CANCELLED INTEREST AND PENALTIES</td>
<td>3068</td>
<td>4175</td>
<td>0.3</td>
<td>0.3</td>
</tr>
<tr>
<td>ENERGY FUND</td>
<td>8013</td>
<td>13492</td>
<td>0.7</td>
<td>0.9</td>
</tr>
<tr>
<td>Loan guarantees paid</td>
<td>7435</td>
<td>6050</td>
<td>0.6</td>
<td>0.4</td>
</tr>
<tr>
<td>o/w energy sector</td>
<td>39027</td>
<td>25554</td>
<td>3.3</td>
<td>1.7</td>
</tr>
<tr>
<td>Quasi-Fiscal Energy Subsidies 2/</td>
<td>31763</td>
<td>22304</td>
<td>2.7</td>
<td>1.5</td>
</tr>
<tr>
<td>Low tariffs</td>
<td>7264</td>
<td>3250</td>
<td>0.6</td>
<td>0.2</td>
</tr>
<tr>
<td>Non-payments</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Memorandum:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total tax arrears (eop stock)</td>
<td>126587</td>
<td>190010</td>
<td>10.8</td>
<td>12.6</td>
</tr>
<tr>
<td>o/w arrears of 76 large loss makers</td>
<td>46944</td>
<td>68274</td>
<td>4.0</td>
<td>4.5</td>
</tr>
<tr>
<td>rescheduled arrears</td>
<td>6259</td>
<td>5019</td>
<td>0.5</td>
<td>0.3</td>
</tr>
</tbody>
</table>

Notes: 1/ Includes items classified in the state budget as transfers to mining and agriculture. 2/ Based on IMF estimated of the allocation of subsidies between households and firms in 2001.

Source: Ministry of Finance; Ministry of Industry and Resources; WB staff estimates.

3.26 The two principal types of implicit non-energy subsidies are tax arrears and loan guarantees, both strong indicators of widespread weaknesses in corporate financial discipline. In 2002, subsidization via tax arrears, including cancelled interest and penalties, was 4.3 percent of GDP. This includes debt to the state budget, social insurance funds, and local government. It includes 4.2 percent of GDP in new arrears, which itself includes an estimated 2.0 percent of GDP in new interest and penalties on previously overdue obligations, and 0.1 percent of GDP in cancelled interest and penalties. The rate of implicit subsidization from tax debt is 1.4 percentage points of GDP higher in 2002 than in 2001. However, these numbers include cancelled arrears. New arrears actually increased 1.9 percentage points of GDP.

3.27 Activated loan guarantees increased to 0.9 percent of GDP in 2002 from 0.7 percent of GDP the previous year. This form of subsidization, in fact, has become increasingly important. In 1995, outlays were just US$ 1.6 million. Between 1995 and 2000, they grew at an average annual rate of US$ 40 million, while in each of the last two consecutive years the growth has
nearly doubled. In 2002, outlays for loan guarantees reached US$ 408 million, nearly half of which pertained to energy companies.\textsuperscript{78}

3.28 Romania has tried to reduce the financial pressure on the state enterprises by rescheduling and canceling some arrears. Rescheduled arrears totaled 0.5 percent of GDP in 2001 and 0.3 percent of GDP in 2002. Cancellation of interest and penalties were 0.7 percent and 0.1 percent of GDP, respectively. As demonstrated by the rise in new tax arrears, these operations ultimately do not restore financial stability. They can only encourage financial indiscipline and retard the restructuring needed to profitable business operation. As such, they pose a threat to macroeconomic stability and promote wasteful use of scarce resources.

3.29 This type of subsidization is widespread in Romania. Both public and private enterprises use tax arrears to finance themselves. Neither loss-making nor profitable companies are excluded, though the degree of use of tax arrears is inversely related with profitability. As shown in Table 3.3, majority and minority state-owned companies have had the largest tax debts as a percentage of total assets during the last two years, averaging 30 percent and 7 percent, respectively. Of these companies which had losses in both 2001 and 2002, the arrears averaged, respectively, 37 and 11 percent of assets. For private companies, persistent loss-makers averaged more 30 percent of assets in tax debt, while profitable entities owed the equivalent of 2 percent of assets. Furthermore, the distribution by type of arrear tends to be about the same irrespective of the level of profitability, with debts to the state budget, social insurance funds, and local and special fund on average accounting for, respectively, 51 percent, 37 percent, and 12 percent of the total amount owed.

3.30 Eliminating this financing option is key to strengthening the financial discipline of the enterprise sector. In fact, firms largely impose hard-budget constraints on each other: the scale of overdue trade credit among enterprises in Romania is in the range found in western Europe.\textsuperscript{79} In terms of overdue debt service to banks, there is indeed a large stock of outstanding liabilities, though mostly specific to state-owned companies. However, this appears to be a stock problem rather than a flow problem, as the outstanding debts were mainly accumulated prior to 2002 and banks now are generally imposing hard-budget constraints on enterprises better than before.

\textsuperscript{78} Under the current IMF program, total contracting or guaranteeing of external loans is capped at US$600 million, or 1.3 percent of GDP, for loans with one- to three-year maturities, and US$3.6 billion for loans with a maturity greater than one year.

Table 3.3 Tax Arrears (% of total assets)

<table>
<thead>
<tr>
<th></th>
<th>Large Losses in both 2001 and 2002</th>
<th>Losses in at Least One Year</th>
<th>Profitable in both years</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Regie Autonomes</td>
<td></td>
<td></td>
<td>3.7</td>
<td>3.6</td>
</tr>
<tr>
<td>State-owned</td>
<td>69.4</td>
<td>74.6</td>
<td>30.7</td>
<td>6.1</td>
</tr>
<tr>
<td>Majority state</td>
<td>32.6</td>
<td>40.7</td>
<td>25.1</td>
<td>28.8</td>
</tr>
<tr>
<td>Minority state</td>
<td>11.7</td>
<td>10.5</td>
<td>10.3</td>
<td>11.4</td>
</tr>
<tr>
<td>Private</td>
<td>31.1</td>
<td>36.1</td>
<td>7.9</td>
<td>10.4</td>
</tr>
<tr>
<td>Cooperative</td>
<td>44.5</td>
<td>76.9</td>
<td>18.9</td>
<td>18.7</td>
</tr>
<tr>
<td>Total</td>
<td>27.9</td>
<td>32.4</td>
<td>9.5</td>
<td>10.7</td>
</tr>
<tr>
<td>o/w state budget</td>
<td>13.7</td>
<td>14.7</td>
<td>5.2</td>
<td>6.1</td>
</tr>
<tr>
<td>social security</td>
<td>11.2</td>
<td>14.2</td>
<td>3.0</td>
<td>2.7</td>
</tr>
<tr>
<td>local gov. &amp; spec. funds</td>
<td>3.1</td>
<td>3.5</td>
<td>1.3</td>
<td>1.9</td>
</tr>
</tbody>
</table>


A.4. Domestic Competition Slow to Come

3.31 There are examples of countries which have been unwilling to have rapid privatization and still have reaped the benefits of markets. China comes to mind, as well as Poland and the Slovak Republic in the early transition period. In both cases, the main policy was to ensure the entry of new firms and the use of unviable assets in these new operations, through liquidation, leases, or asset stripping. It is more difficult to point to examples where restructuring has taken place in the absence on both strategic privatization and hardened budget constraints. One can perhaps characterize the dual nature of Chinese restructuring in this way, with some sectors and regions being subject to both private (and foreign) ownership and strong competition from new entrants, while other sectors remaining protected and the recipients of state transfers. With the exception of Belarus and several central Asian countries, no one has tried to restructure without the benefits of both hardened budget constraints and increased domestic competition. This is what Romania has tried for some time.

3.32 As shown in Figure 3.6, increased domestic competition is associated, in the context of transition, with faster enterprise restructuring than import competition. The main reason is that new domestic entrants can easily find their comparative advantage and fill these market niches. In contrast, foreign companies typically have global or regional strategies and try to complement their operations abroad. Rarely do they know where the gaps in the local market are.

3.33 Increasing domestic competition is the easiest of all transition reforms. First, allow for the registration of many new firms, by making the process free of administrative burdens. Second, push unviable incumbent companies into liquidation, so that their assets can be used in new ventures. The latter feature is more important in countries with underdeveloped financial markets, like Romania, where buying new assets on credit is nearly impossible and instead entrepreneurs need to recycle second-hand assets.

3.34 Starting a new company in Romania is not too difficult, although a lot can be improved (Figure 3.6). In particular, the commercial registry is one of the least efficient in the region,
taking on average three weeks to issue a company identification number. The use of notaries in the registration process also makes it unnecessarily complex.\textsuperscript{80}

**Figure 3.6 Room for Improvement in Entry Regulation, 2004**
(number of days to legally start operations of a new business)

![Bar chart showing the number of days required to legally start operations of a new business in different countries.](image)


3.35 Moreover, exit rarely happens and by the time it does, assets are often obsolete. Romania's bankruptcy law has the weakest protection of creditors of any transition economy (Figure 3.7). Once a company is in distress, its management dictates the terms of the insolvency process. The result is an unwilling use of formal insolvency by creditors, coupled with the general stance of government to allow arrears to accumulate. Assets stay unused for years.

**Figure 3.7 Creditor Rights in Insolvency Index (varies from 0 to 4, high is better protection)**

![Bar chart showing the creditor rights in insolvency index for different countries.](image)


\textsuperscript{80} World Bank (2004).
3.36 Not only do new companies have trouble getting such assets, but their managers also have trouble distinguishing themselves from other companies. Private banks are unwilling to lend long-term credit, as recovery is difficult. The government has attempted to address this issue with the establishment of a public credit registry in the year 2000. The idea behind it is to provide would-be creditors with sufficient knowledge of the credit histories of companies and their owners so they can distinguish between good and bad risk. As work in progress, the registry has already had some impact, with much to be done.

B. GROWTH IN THE ENTERPRISE SECTOR

B.1. Sales Growth of Enterprises

3.37 The issues summarized here resulted in the shrinking of the Romanian economy in the 1990s, with growth taking place only in the last four years. Table 3.4 compares the sales growth performance of the Romanian enterprise sector with that in other six transition economies. Romania has the sharpest declines in production in 1992-95 and 1996-1999. Bulgaria is the only other country that records declines in both periods. Since the year 2000, Romania has rebounded strongly, with average annual growth of over 5 percent. However, similar growth has been recorded in Bulgaria, and the Slovak Republic, which suggests that transition laggards are in part catching up with early reformers.

<table>
<thead>
<tr>
<th>Year Period</th>
<th>Bulgaria</th>
<th>Czech Rep</th>
<th>Hungary</th>
<th>Poland</th>
<th>Romania</th>
<th>Slovakia</th>
<th>Slovenia</th>
</tr>
</thead>
<tbody>
<tr>
<td>1992-1995</td>
<td>-11.1</td>
<td>1.4</td>
<td>0.8</td>
<td>1.1</td>
<td>-13.7</td>
<td>-6.1</td>
<td>3.6</td>
</tr>
<tr>
<td>1996-1999</td>
<td>-5.2</td>
<td>1.1</td>
<td>3.6</td>
<td>6.9</td>
<td>-5.8</td>
<td>6.4</td>
<td>3.8</td>
</tr>
<tr>
<td>2000-2002</td>
<td>5.1</td>
<td>3.4</td>
<td>4.6</td>
<td>2.4</td>
<td>5.2</td>
<td>4.9</td>
<td>2.7</td>
</tr>
</tbody>
</table>

Source: Private Sector Vice Presidency, World Bank Group.

3.38 Another heartening feature of recent growth in Romanian enterprises is that it is accompanied by some adjustments in the labor force. This has resulted in even higher labor productivity growth, at over 7 percent on average since the year 2000. Only the Slovak Republic rivals this growth.

3.39 Still, the missed opportunities in the early transition years put Romania at real GDP equivalent to 87 percent of its 1989 level. This is the lowest level of any central and eastern European economy, bar Bulgaria (Figure 3.9).

3.40 In the 1990s total factor productivity (TFP) growth has accounted for nearly all of economic expansion. Between 1991 and 2002 the contribution from labor was negative as a result of labor shedding. Due to periods of contracting investment followed by weak capital accumulation, on average there was no contribution from capital. Growth was entirely due to more efficient use of labor and capital, with average TFP growth of 2 percent over the whole

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81 TFP growth is measured as a residual source of growth once labor and capital contributions have been accounted for. Generally speaking, the size of the physical capital stock is especially difficult to quantify. In the case of Romania there is also a large informal economy which may lead to inaccurate estimates of output and labor and capital input. TFP estimates, therefore, can be highly sensitive to measurement error.
period. This is less than half of the TFP growth experienced in central Europe: the Czech Republic, Hungary, Poland, and the Slovak Republic recorded TFP growth of close to 4.5 percent over the same period.\textsuperscript{82} Again, this growth was largely explained by shedding excess employment but since the mid-1990s new fixed investment started coming in as well.

**Figure 3.9 2002 GDP Relative to the 1989 GDP Level**

\[\text{Figure showing GDP relative to 1989 levels for selected countries.} \]

\textit{Source: EBRD (2004).}

**B.2. Total Factor Productivity**

3.41 TFP growth in the Romanian enterprise sector has risen to 3.3 percent in more recent times—1999 to 2002—but still trails all transition economies but Croatia and Slovenia (Table 3.5). Whether productivity growth can accelerate depends on faster investment growth, particularly FDI. In the long-run, efficiency can only increase from the adoption of new technologies, including managerial techniques and advanced capital goods. To achieve this, the incentive structure of the economy needs to be changed to encourage greater domestic and foreign investment. This will also require reforms that encourage more domestic savings and further financial restructuring and a business climate that attracts more long-term foreign capital to improve the intermediation between savers and investors. This will lead to a reallocation of resources to the most productive sectors of the economy. The example of other transition economies—first Hungary in 1991-1995, then the Czech Republic in 1994-1998, and recently the Slovak Republic—shows that investment can increase significantly in a very short period, if the business environment improves.

\textsuperscript{82} Djankov and Murrell (2002).
Table 3.5 Accounting for Economic Growth

<table>
<thead>
<tr>
<th></th>
<th>Average annual growth rates (percentages)</th>
<th>Contributions to growth (percentages)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>GDP</td>
<td>Labor</td>
</tr>
<tr>
<td>1999-2002</td>
<td>4.1</td>
<td>-0.5</td>
</tr>
<tr>
<td>1991-1998</td>
<td>-0.5</td>
<td>-1.8</td>
</tr>
<tr>
<td>1991-2002</td>
<td>0.7</td>
<td>-1.5</td>
</tr>
</tbody>
</table>

Source: World Bank staff estimates.

C. THE REFORM AGENDA

C.1. Privatizing to Outside Strategic Investors

3.42 Privatizing the enterprise sector and imposing hard budget constraints is central to Romania's economic restructuring. The best mode of privatization is to outside strategic investors. Recently, Romania started to move in this direction. Pace of reforms needs to be accelerated since the protracted enterprise reforms and failed privatization methods of the past have left a legacy of a large reform agenda going forward. This process needs to be carried out decisively and in a transparent framework.

C.2. Licensing Regimes

3.43 In mid-2003, the government introduced the silent consent rule that had immediate impact on 480 licenses. The new rule allows companies to undertake activities if the relevant government authority has not responded within 30 days. Also, new legislation is to be accompanied by a regulatory impact assessment, in line with OECD standards. Finally, statutory limits on the processing of licensing requests have been mandated. All these changes will undoubtedly reduce the administrative burden on business. Much remains to be done. Businesses continue to complain from burdensome regulation (Figure 3.10).

Figure 3.10 A Quarter of Businesses Identify Licenses as a Major Problem (% of businesses that say business licensing is a moderate to major obstacle)

Source: BEEPS 2002 survey.
3.44 Regulatory reform in this area is not difficult and yet in Romania this regulatory reform is wanting. Several other EU accession countries have recently revised their regulation to allow quick entry, Hungary in 2002, Slovakia in 2004. In 2003, Turkey reduced the number of procedures necessary to start business operations from 13 to 6, and the number of days from 38 to 7. Reform is also taking place in the registration processes of many European Union countries, including Finland, Greece, Italy, Netherlands, and Portugal. Italy, for example, has removed business registration from its courts and placed it in administrative units. In all cases, these reforms have lowered the current and expected time needed to register new businesses. A recent study for the European Commission found that “Considerable progress has been made in improving the process of administering business start-ups.” In particular, many EU Member States have:

- Improved the administrative efficiency of current procedures by introducing statutory response times (“silence is consent” rules). This reform has been undertaken in Romania although business surveys do not uniformly register its effects.
- Introduced Internet sites to provide information, improvements in the availability of information for entrepreneurs; the mapping of all procedures and licenses; the provision of information electronically; and consolidation of information into a single source. None of these steps are taken in Romania.
- Reduced the scale and complexity of the documents required to establish new businesses by using single registration numbers, and notification and self-certification rather than authorization. This has been stalled on numerous occasions in Romania, with no results in sight.

3.45 If reform is revitalized and Romania implements these reforms, it should not stop here. Registration should be made into a purely administrative process and available as an electronic service. The current organization of Romania’s registration system is low in efficiency. Its location in the courts and involvement by judges in individual registration decisions are contrary to good European practices. This also damages economic growth by reducing the capacities of the commercial courts to deal with legal disputes. A better option is an expert registration agency. The national registry database should be publicly accessible, updated continually, and eventually accessible by Internet.

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84 For example, the main recommendations relating to the European Union’s First Directive on company law consists partly of the need to accelerate the filing and disclosure of company documents and particulars by the use of modern technology.
3.46 Regulatory reforms are indeed a first step towards a more competitive business environment. However, reforms need to be sustained to provide a business environment of entry and exit.

C.4. Labor Regulations

3.47 Romania has revised its socialist-era Labor Code, making it in many areas more restrictive than the original. Especially burdensome is the area of conditions of employment, where firms in Romania are at a significant disadvantage relative to their peers in eastern Europe (Figure 3.11).

Figure 3.11 Employment Regulation Index (varies between 0 and 100, higher values for more rigid regulation)

![Employment Regulation Index Graph]


3.48 Businesses report that rigid employment laws are a significant obstacle to their performance. In cross country comparisons, Romania has some of the most rigid conditions of employment, with tight restrictions on hours worked, night and holiday work, and a relatively high minimum wage. Several details in the labor regulations create perverse incentives for workers. For example, one business interviewed reported that labor regulations create problems in managing absenteeism.

3.49 Another example is the regulation requiring periodic automatic increases in wages by years worked, so that salaries are in effect based on seniority, not productivity. This is a significant problem in labor-intensive industries like textiles, where a very low turnover of workers and salaries continually creep up.

3.50 Rigid labor regulations encourage informality. A common practice in order to avoid social security payments and taxes is to pay official wages at the minimum wage threshold, and
to pay additional cash wages directly to employees. This practice was prevalent in the late 1990s, when an estimated 50 percent of the workforce in private business was paid in this manner.

**C.5. Bankruptcy**

3.51 Lenders also face problems with bankruptcy laws. In a good case scenario it takes four years and costs around 8 percent of the value of the estate to close a business through bankruptcy proceedings. Interviews with insolvency practitioners suggest that it takes five years to resolve bankruptcy when the main creditor is a private bank or company. This makes Romania the second least efficient country among all central and eastern European economies, trailing only the Czech Republic (where it takes over eight years). As a result most banks report that they foreclose before bankruptcy—all stated that bankruptcy was rarely used to enforce on default. About 90 percent of the bankruptcy cases that reach the courts—an estimated 4,000 cases a year—are brought forward by the state as a means to collect on overdue taxes.

3.52 Revisions to the bankruptcy law were proposed by the government in early 2003, but have yet to be adopted by Parliament in full. Government Ordinance 38/2003 introduced some minor revisions, most importantly an article that stays management during the insolvency process. This is a setback from a creditor rights perspective as the incumbent managers have more opportunity to strip assets in cases where liquidation is the most likely outcome.

3.53 A draft law has been proposed to parliament and will have significant beneficial effects on improving creditor rights in Romania if passed. Among the most salient features are a reduction of the period of appeals—from 30 to 10 days; the introduction of subpoena for creditors published in newspapers, which will reduce the time of notification; removing the requirement for the presence of a court clerk during the creditors’ meeting; and a provision for out-of-court restructuring. All these features would undoubtedly make lending in Romania a less risky proposition.

3.54 Two other areas of judicial reform merit consideration. First, the application fee for entering bankruptcy is the highest of any country in Europe, at 5,000 euro. It is unclear what the rationale for such a fee is. Second, under the current structure of the Romanian judiciary, one can become a bankruptcy judge fresh out of law school, at 23 years of age and with no experience in either insolvency practice or management and accounting. In contrast, Italy and France, the two countries used as the origin of the current judicial system, have both implemented reforms that ensures that judge shave some experience in handling commercial matters prior to taking the bench. Such reform would take time to develop and is likely to have a large positive effect on the quality of judgments.

**C.6. Efficiency and Predictability of Commercial Contracts**

3.55 Enforcement of contracts in Romania faces more serious challenges than it may first appear. As described in Section 1, judiciary reform is high in the agenda in Romania’s process towards EU accession. In late 2003, important initial steps have been taken including adopting Judicial Reform Strategy 2003-2007 and adopting constitutional amendments overhauling the
legal framework for judicial reform. Regulatory and organizational changes have to be fleshed out and more importantly actions need to be taken to develop a functional, transparent, independent judiciary system. These changes will improve enforcement of contracts. There is evidence that deficiencies in the judiciary are significant.\footnote{Romania: A Public Expenditure Review, 2002, The World Bank and Regular Reports on Romania by the EC, 2002 and 2003} A recent World Bank study reports that these deficiencies have for the most part discourage business to resolve disputes through litigation.\footnote{Building Market Institutions in South Eastern Europe: comparative prospects for investment and private sector development, forthcoming in 2004, The World Bank.} Only very large enterprises seem to be more litigious compared to medium and small business. In addition, the large and dominant presence of public enterprises combined with the practice of barter settlement further reinforces these findings since firms have these alternative mechanisms to settle disputes. Hence, the low number of days of 240 days to enforce a simple debt contract in Romania, compared with an average of 252 in CEEC reflects deficiencies rather than strengths since only large companies use the courts to settle disputes and the judiciary lacks transparency (Chapter 3). Furthermore, in 2003 the Emergency Ordinance 58/2003 reintroduced two levels of appeals for all types of commercial disputes and hence represents a step backwards in the efficiency of commercial cases. Data of January 2004, indicate that debt collection cases now can take on average one year to resolve. In addition deficiencies in the enforcement of contracts protecting property rights on land in agriculture is a major stumbling block for agricultural transformation discussed in the next section (Section 4).\footnote{See Chapter 4 in Volume 2 of this report.}

Clearly judiciary reform is central. Recognizing these deficiencies, the government has put judiciary reform high on the agenda in Romania’s process towards EU accession. In late 2003, important initial steps were taken, including the adoption of Judicial Reform Strategy 2003-2007 and constitutional amendments overhauling the legal framework for judicial reform. Regulatory and organizational changes have to be fleshed out and more importantly actions need to be taken to develop a functional, transparent, independent judiciary system. Implementing these reforms are essential to improve enforcement of contracts, and thus for growth and competitiveness prospects. In addition, further streamlining of contract enforcement is also needed. Four successful reforms in other countries are of particular relevance for Romania:

- Establishing information systems on caseload and judicial statistics, as in the Slovak Republic can help identify the courts primary users and the biggest bottlenecks.

- Taking out of the courts transactions that are not disputes—in particular the registering of new business entities—will free up resources for commercial litigation. Because such reform will require new legislation, in the meantime government can reorganize the workflow in the courts so that clerks, not judges, are responsible for company registration.

- Simplifying procedures. The priority is to reduce opportunities for defendant appeal and delay. Reducing reliance on written procedures and legal justification are also necessary. More extensive reforms include introducing summary proceedings to alleviate court congestion (as has recently been introduced in Mexico). Default
judgments—automatic if the defendant does not appear in court—will also significantly cut delays.

3.57 Reforming the enforcement of judgments. Currently, judicial enforcers in Romania are highly regulated, and the service is an expensive part of the commercial dispute resolution process. The minimum fee is ROL 3 million, and it rises steeply with the amount of the case.