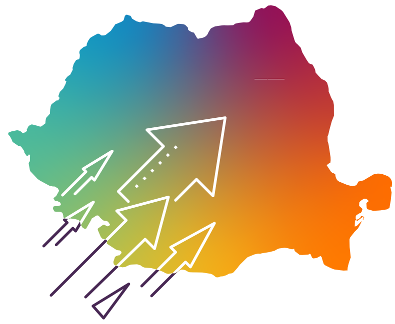
Romania in the OECD

A comparative analysis of the 'key' points in the OECD economic reports for Romania (2022-2024). Significant developments and directions of action to support the accession process.

Foreign Investors Council



INTRODUCTION

Increasing Romania's attractiveness for Foreign Direct Investment (FDI) has been a constant priority for the Foreign Investors Council (FIC) in its more than 25 years of activity. An essential element in attracting foreign investment is Romania's accession to international structures. Both NATO membership and later EU membership were events that spurred FDI growth in Central and Eastern European states.

In the case of Romania, if we consider the last 2 decades, we can see that the share of FDI stocks as a percentage of GDP (21% in 2003 before the country joined NATO) almost doubled and reach 39% of GDP by 2022 according to UNCTAD[1] data. Equally importantly, if we look at the share of foreign capital inflows in the Romanian economy each year, they have made a significant contribution to growth and investment, representing in the last 9 years (excluding the 2020 pandemic year) between 10% and 15% of gross national fixed capital formation.

Romania's accession to the Organisation for Economic Cooperation and Development (OECD) would represent another important step in attracting foreign investment to Romania, as we can see from examples of countries in the region, according to UN and World Bank statistics. The Czech Republic became a member in 1995 and registered an increase in FDI stock from 12% to 70% of GDP. Hungary joined in 1996 and we can see an increase in the share of FDI stock in GDP from approximately 24% at the time of OECD accession to 59% in 2022. Similarly, in Poland, the stock of FDI increased from 7% in 1996, when the country obtained OECD membership, to 40% of GDP. Estonia joined in 2010 and currently has approximately a 79% share of FDI stocks in GDP, having reached a maximum of 96% of GDP in 2020. Latvia joined in 2016, and in just 5 years, the share of FDI stock in GDP increased from 54% to 59%.

The OECD guidelines are also aligned with the FIC's vision for the sustainable development of Romania for the next 20 years. Under the umbrella of the project Va Urma (https://vaurma.ro/) developed by the FIC, we discussed with the Government, with representatives of Parliament, and with international structures a series of measures that will support convergence with the standards that our country must meet in order to be able to join the OECD. Both specialist studies and Va Urma show that structural reforms in key areas implemented in OECD countries, such as in education, taxation, state-owned companies, and administrative capacity can increase the annual GDP growth rate by up to 1 percentage point.

Romania can obtain the international recognition that comes from joining the OECD, especially the possibility of attracting Foreign Direct Investment (FDI) with added value that would reduce the pressure on the state budget. For some companies, OECD membership is one of the necessary conditions to invest in a particular country, as this is seen as a guarantee of high economic and legislative standards. Consequently, there is a need for a more coherent and strategic approach by Romania to FDI.

1 UNCTADstat - General Profile

CONTEXT

In January 2022, Romania was officially invited to start the process of joining the OECD, the powerful organisation that currently brings together 38 states with an average and high level of economic development, 70% of global production and trade, and 90% of global direct foreign investment. The organisation has among its central objectives designing policies and directions of action to help members, and society as a whole, thrive within a framework of sustainable economic development, equality, and a balanced spread of well-being.

Accession to the OECD is a strategic goal for Romania and a capital landmark in the future development of the country, after joining NATO and the European Union. The importance of the path towards joining the organisation is underlined by the establishment of an accession council, under the patronage of the Romanian Prime Minister, which brings together the main state institutions and organisations able to respond to requests from OECD sectoral specialist committees.

In assessing candidate countries, the OECD takes into account the following factors:

OECD

Structural reform, as a basis for strong, sustainable, green and inclusive growth;

Trade and investment, from the perspective of an open, competitive, sustainable, and transparent market, based on clear rules, avoiding protectionism, fostering good conditions for international competition, dismantling unnecessary barriers to trade, all in order to increase the benefits of consumers and encourage innovation;

Sustainable and inclusive development, based on the principle of equal opportunities;

Governance: strengthening public governance, integrity and fighting corruption;

Environment, biodiversity and climate;

Digitalisation: promoting the digital economy;

Infrastructure: developing it in a transparent, accountable, and inclusive manner

Since the announcement of Romania's invitation to begin the accession process and the related dialogue, our country has been the subject of two economic reports compiled by the OECD. One was published in 2022, and the second in March 2024. This document and its conclusions start with a comparative analysis of the two reports, to identify recurrent themes and new topics, to assess the OECD's perception of the progress made by Romania in terms of the accession process, as well as in terms of the evolution of the economy and society. The aim is to identify the key topics where the focus of Romania's actions is expected to support the accession process and healthy and sustainable development of the economy and society as a whole.

After a general comparative analysis of the two reports, two important observations are drawn from the point of view of the concentration of efforts:

01 There is a core of 2-3 common themes in the reports, for each of the 4-5 major directions pursued in the analysis, with the important observation that the outlook in each report is different. At the beginning of 2022, after the most difficult period of the Covid pandemic, some of the action directions were aimed at reducing future risks in similar situations, i.e. the effective implementation of the National Recovery and Resilience Plan (NRRP). Now, in 2024, in the post pandemic situation, the focus is more on new challenges which have emerged, such as geopolitical tensions and the inflationary environment of the last 2 years. Consequently, attention has shifted to areas which, although considered important in the 2022 report, received less attention then in terms of recommendations for clear measures to tackle them, i.e.: **fiscal sustainability (with related reforms), energy security and mitigation of environmental issues.**

02 As could be expected, in terms of external/ generic risks, the Covid threat and the perspective generated by that situation have been replaced by the effects of Russian aggression in Ukraine (within the broader context of other geopolitical tensions: Israel-Palestine, difficulties in the relationship between the West and China, logistical disruptions generated by Somali pirates, etc.). However, given that the situation in Ukraine is likely to remain uncertain for longer than previously expected, the „corridor" to Ukraine is only treated tangentially in the proposed action plan.

PRIORITY TOPICS

European funds – the importance of absorption and developing the administrative capacity to attract and implement projects, especially in the context of the NRRP, is further emphassed, to provide additional funding opportunities for key projects.

Inflation, which must be curbed, and the prudent monetary policy of the National Bank of Romania (NBR) is also a common point in the two reports.

Perennial issues affecting the business environment: bureaucracy, continued weak digitalisation in some state institutions, corruption, poor governance in state-owned companies, and inefficient allocation of budgetary resources to areas that help the business environment. The still weak transport infrastructure is another issue, and is emphasised more in the 2024 report, even though investment in the field has actually increaed. Both documents refer to the need to finance small and medium-sized enterprises (SMEs) as an important element in developing the business environment. Companies or investments which are seen as less „bankable" are soon to be supported by the Development and Investment Bank.

MACROECONOMIC AND SOCIAL INDICATORS

In terms of the main macroeconomic and social indicators, where Romania still remains far from the OECD average, minor improvements can be observed over the last 2 years (between the two OECD reports analysed). Differences compared to the level of OECD economies have generated public debates on Romania's preparedness to join the organisation, with many economists concluding that the country still has progress to make on the economic front, and that certain short term issues need to be resolved before accession is feasible. We point out some areas where Romania still has work to do to align with the level of the organisation:

- **Budget revenue of 34% of GDP is 5-6 percentage points below the OECD average,** which means that increasing tax compliance and fighting tax evasion is critically important. Moreover, the VAT gap, most recently estimated at around 35% (considerably higher than the EU average of 5.4%), is probably the weakest point of the Romanian tax system. Moreover, the neighbouring states and in the region (e.g. Bulgaria, Slovakia, and Hungary) have significantly improved their performance in this area, through measures which were easy to implement.
- **The share of GDP allocated to public expenditure on health and education** (approximately 1-1.5%) **is lower in Romania than the OECD average.** In absolute terms, based on Romania's current level of GDP, this means 4-5 billion euros for each area, which leaves the health and education sectors with limied resources, hence reducing the quality of life and impeding economic growth.
- **The current account deficit, and the trade deficit, are each 8-9 percentage points below the OECD average.** Romania has one of the largest trade deficits of the countries of Central and Eastern Europe (CEE), so there is a need for investment in production facilities in sectors with imbalances between imports and exports, to enable more local demand to be satisfied by domestic production.
- **The budget deficit**, is a serious problem. It currently stands at close to 7% of GDP, with no prospect for it to be kept under control without structural reforms in the administration. If Romania were now an OECD member, it would have the largest budget deficit of the member states, and one of the highest inflation rates.
- In terms of education, **there are major differences between Romania's results at the latest PISA tests and OECD averages (approx. 430 vs. approx. 470);** Investing in education is one of the main recommendations of the OECD reports.
- **GDP per capita in terms of purchasing power is barely 75% of the OECD average.**

Other chapters where Romania is below the OECD average include life expectancy (difference of approx. 5 years), population employment indicators (**there is a worryingly high percentage of young people aged 15-24 who are not involved in the formal labour market; approx. 23% in Romania compared to the OECD average of 11%),** as well as the percentage of **GDP allocated to research and development** (**0.5% in Romania compared to the OECD average of almost 3%**),

Romania scores better in terms of public debt, which is around 50% of GDP, compared to the OECD average of approximately. 105%. However, OECD observers are concerned that the debt is nevertheless increasing, and the costs of financing it are high.

This comparative analysis of the reports and of the indicators for Romania compared to the OECD average, is not exhaustive, but it aims to capture the key messages of the organisation for Romania, in terms of the areas which the country needs to focus on to achieve OECD accession.

DIRECTIONS OF ACTION AND NECESSARY MEASURES

We believe that the 2024 report sets out more clearly than in the past the steps which Romania needs to take to join the OECD, and hence gives a useful roadmap. The key issues identified are as follows:

The risks of the budgetary imbalance,

are treated much more comprehensively, bearing in mind that, in Romania, the budget deficit has continued to deepen even after the Covid pandemic period, when unprecedented spending was made by governments throughout Europe and in most of the world. .To address this major issue, we have identified various proposed directions and measures, many of which are interconnected. These include: improving tax collection (reducing evasion, increasing the VAT base, suspension of income tax exemptions - some steps have already been taken in this respect), fiscal reform supported by impact analysis (and then reinforced by fiscal stability), reforming the pension system (together with improving the level of participation in the workforce through support for re-qualification, increasing the retirement age for women, as well as stimulating the return of women to work after birth by improving the childcare system through support for nurseries, kindergartens etc.).

Energy and environment

as expected, in the context of the regulations related to the "Green Deal" in the EU, there is a sharp focus on these topics in the 2024 report compared to the previous one, especially due to major fluctuations in energy prices after the Russian invasion of Ukraine in 2022. On the one hand, the OECD has recorded progress in the last 10-20 years by Romania in terms of the reduction of industrial pollution, as well as increased investments in renewable capacities. On the other hand, the 2024 OECD report warns that these capacities (wind and solar) are still largely theoretical, as the energy grid cannot absorb them, and hence there is only partial benefit from their development. A number of other issues are mentioned in the report in relation to this topic, two of which we consider especially important: 1. Public transport : The report notes that public transport use is decreasing,while personal car transport is growing and hence emphasises the need for an integrated urban mobility system and the transition to "green" vehicles and 2. The need for a financing program for building renovations. The report highlights the need for measures to improve energy efficiency in older housing, bearing in mind that from the point of view of the energy consumption of buildings, Romania is far behind the OECD average.

Weaknesses in the education system, with effects on the labour market:

The report highlights the poor school dropout rate, insufficient development of dual and vocational education, the high proportion of young people who do not participate in the labour market, as well as the weaknesses of the formal labour market and the effects of the «grey» informal economy, which is non-fiscalised (progress here would also help improve the budget deficit).

In addition to these major themes, which have increased their importance for the OECD, **the 2024 report also sets out in a more detailed way what the impact would be of measures to reduce imbalances.** So while the 2022 report suggested that a 2.5% increase in GDP could be generated by measures to increase tax compliance, the 2024 report is more specific and focuses more closely on the areas where the largest impact could be made. For example, it suggests that increasing the VAT base would lead to a 0.75% - 1.5% increase in GDP, and the cancellation of the sectoral exceptions on the application of income tax would generate a 0.4% - 0.6% rise in GDP. So the OECD message seems stronger than in the past, as Romania is evaluated and improves its performance.

Comparative analysis has also identified some issues which have been identified as important in the past, but which receive less emphasis in the 2024 report: **the risk of non-performing loans, the insolvency regime regime** (although the 2024 report points out that nothing concrete has been done and the involvement of the courts remains excessive), **the start-up landscape** (here perhaps the perception of the OECD has improved, because the Romanian startup ecosystem is developing, and it is supported by financiers and investors through various programmes, business incubators etc.).

As is clear from this document, the benefits of belonging to the OECD are apparent and are understood by the authorities. Although the OECD's primary focus is economic, membership also brings wider benefits (social, environmental, etc.).

The accession process involves the achievement of standards, so ultimately it requires states to reform, to reach various milestones proposed by the OECD's specialist committees. Membership demonstrates acheivement of these standards, and hence makes it easier to attract large investments, including strategic investment funds.

Membership also demonstrates the real progress that the new member state has made in terms of the state of its economy, as well as in terms of the welfare of its citizens. It helps the country's rating, which ultimately contributes to the reduction of the costs of financing public debt, further stimulating investment in the economy..

Therefore, based on the main messages of the OECD from the two analysed reports and taking into account the changes in perspective in the most recent report, i.e. the progress already achieved by Romania, but also the attention drawn to areas where progress is still slow, we believe that the main directions of action to support the process of joining the OECD should be grouped on 3 axes: **improving budget revenue; a healthy business environment based on a well-motivated and active workforce; energy efficiency**. The interconnected actions that we consider most relevant are summarised below:

Reducing the budget deficit by increasing **collection, reducing the VAT "gap"**, and boosting compliance, along with reforming the public administration to reduce unnecessary and inefficient public spending. Increased collection means higher income, which means more space for increased investment in **education**, which in the medium and long term will correct imbalances in the **labour market**.

A package of measures that **will encourage the business environment to create more added value in Romania:** coherent investments in **transport infrastructure**, reducing bureaucracy, digitalising the administration, and encouraging the internationalization of Romanian businesses.

Efficiency of energy consumption through optimal rehabilitation of the **building stock, urban mobility**, systems, and transformation of the theoretical capacity of green energy into real production in the network, benefiting both industrial consumers (cheap energy will increase competitiveness) and household consumers.

In conclusion, we bring back into the discussion a very important topic for the development of Romania, which is currently not widely dealt with in the OECD analysis, i.e. the need for the revitalisation and development of the military and defense industry. The OECD has noted the resilience of the Romanian economy to the shocks generated by the war in Ukraine and has pointed out its effects on the social and economic life of Romania. For example, the influx of refugees in 2022 helped consumption (although not significantly, because only a small number of Ukrainians remained on Romanian territory, and the vast majority moved on to the west). The report also noted the aid offered by Romania to Ukraine (humanitarian, military, etc.). However, the development of the defense industry in Romania is another necessary chapter to strengthen national security and this would also have a positive effect on economic growth. The modernisation of the local defence industry is vital both to strengthen the Romanian armed forces and also to facilitate export opportunities.