EXECUTIVE SUMMARY

This year's SAR Annual Policy Analysis and Forecast Report addresses two major issues:

– How close is Romania to real convergence with the European Union, how much the recent growth has helped towards that goal and what else there is left to do before the country is able to join the Euro zone.

– What are the public policies that need to be put in place so that performance can increase more smoothly and more efficiently.

The Forecast highlights the above-average GDP growth, that surpassed expectations for the second year in a row: 2014 brought another 2,9% to Romania's GDP – according to provisional data available from the statistics office – and could be called the first year of post-crisis growth, after 2013 had barely equaled the GDP of 2008.

Exports were the driving contributor to this growth, with another historic peak last year, of Eur 50 bn., up almost 50% as compared to 2008, while internal

Inflation is at an historical low, the 1,1 percent at year-end being in line with the more developed economies in Europe. The unemployment rate (5,29%) is nearer to the most optimistic of last year's expectations as well, even after the increase in minimum wage generated worries that there may be additional job losses.

However, the panel of experts questioned by SAR are still cautious about whether this is a confirmed trend or just the result of a fortunate conjecture, therefore the average of estimates is still rather modest, with an average forecast for GDP growth in 2015 of 2,4%, and a low of 1,5%. Rock-solid stability of the currency is still expected, with large consensus on the 4,5 RON/EUR, both average and year-end.

The stock exchange and real estate market are also expected to confirm their previous growth, based on the positive adjustment of historical imbalances.

Technically, Romania is ready to enter the 2-year ERM2 Euro-zone accession mechanism at any point, as it fulfills or is able to fulfill all five Maastricht criteria. However, real convergence of the economy is still far, with uncertainties at both ends of the risk spectrum: either be proved unable to keep up with the core speed or be overwhelmed by the cheap credit and pushed into a new bubble.

Therefore, more steps need to be taken in order to prepare the economy for accession. Mostly, it's about adjusting taxation and public spending in order to give more leeway to free enterprise, but also about strengthening the legal framework so that the playing field becomes better leveled for market competitors.

Agriculture and energy are the most prominent examples of sectors where law-making and law-enforcement could bring plenty of additional economic growth, but we dare say that good governance is key to summing all components of development into a solid course of long-term development.

For 2015, SAR is issuing 12 detailed recommendations for things that the government should do in order for the country to become better prepared for the Euro.

1

Job creation by tax simplification

Romania has one of the highest levels of taxation in the EU, with the third highest VAT (24%) and a total tax burden on labor (42,5%) that places the country in the top 10. However, the rate of tax revenues as compared to GDP is one of the lowest, at only 31,5%, the result of poor collection and tax evasion, amounting to an estimate of more than 15% of GDP. Not only is taxation high, but the procedures themselves are burdensome, with no less than ten different public contributions for each wage paid by an employer. Taxation is especially high for low wages, starting at almost 40%, it peaks at 43% for above-average wages and then is becomes regressive, going as low as 35% for high-earners. As a result of this facts, only 4,5 million Romanians work on a regular employment contract, while by comparing to the EU averages we see a potential of 7-8 million.

We recommend first the simplification of tax procedures, followed by a gradual schedule of tax cuts, up the point when both revenue levels and voluntary compliance become satisfactory. For the long term, we recommend the integration of all contributions in a single flat tax – higher than the current 16% income tax but lower than the 42,5% total burden – divided in two pseudo-brackets: social contributions up to a sum and income tax for whatever exceeds it.

2

Better governance key to economic success

Romania ranks among last in Europe regarding the ease and transparency of public procedures, placing itself tightly on an axis of correlation with corruption control indexes: the more predictable and responsive a country's public sector is, the less corruption; hence the better development, as state capture is estimated to hamper half of the potential economic growth. Especially obvious is the correlation between the control of corruption and the level of online availability of public data, this also being one of the easier goals that could be achieved in the short term.

We recommend an increase of public online services offered to tax-payers, the mandatory requirement that all public institutions create an online public expense tracking system to be assembled on one national portal and the current yearly budget is replaced with a multiannual transparent one minimizing discretionary spending left out.

3

Improvement of the public procurement system

Public procurement levels are relatively high in Romania, with 16 billion euros in 2013 which stands for almost a third of total public spending. However the procurement system is so primitive that no cost-efficiency or cost-benefit benchmarks could be derived. This chapter shows how the system is intentionally left lacking, so there can be more leeway left for fraud. Even a mere search in the database brings up partial or erroneous results, while the public commitments to transparency that led to the creation of the data.gov.ro only translates in moving the same useless data in a centralized server.

We recommend mandatory compliance with data-management standards, including but not limited to judicial responsibility for lack of mandatory fields or, as it happens often, completely deleted contracts. Amendment of the freedom of information law is also needed to explicitly allow for digital data to be released, as right now government officials sometimes refuse access to such data as "it's not in the law". Also, a reputation record should be kept and made public on bidders that didn't fulfill past contracts or were not up to the standards, so they can be excluded from future procurement, thus limiting the number of incidents and the opportunities for corruption.

4

More profitable returns and financial autonomy for anticorruption

The number of convictions for corruptions rose dramatically in the latter years, however public coffers rarely see any of the stolen money back. Therefore, the society Is rightfully worried that the criminals will go back to their untouched fortunes as soon as they finish their jail terms. On the other hand, it's mostly impossible for the authorities to find the money in the darkness of offshore financial centers and secret bank accounts, while the convicted have little incentive to give up any of it.

For this reason, we recommend the use of real stimuli in order to better recover the losses, by adding even more flexibility to a legal framework that is already in place: the trade between jail-time and money given back. Te practice can be put in place even at an earlier stage of the trial, before the conviction, if the accused agrees to admit the charges and fully reimburse the damages done. This way, the burden on courts can be diminished and money can be spent for public purposes sooner rather than never. On the other hand, the spectrum of extended confiscation should also be used at its full possible length, as further source of revenue and deterrence method.

We recommend adjustment of the legal and procedural framework so that more negotiating power be given to prosecutors, subject to final judicial review. We also recommend that part of the recovered sums become revenue for the DNA, as a way to provide financial autonomy.

5

Asymmetric decentralization with flexible geometry

Romania has an administrative structure dating almost 50 years back, specifically tailored to strengthen the powers of the communist leaders back then. Not only is it excessively centralized, but it has proven inefficiencies, conflicts of jurisdiction or lack of legitimate political representation. Some 80% of communes are unable to even finance their council wages from tax revenue, with discretionary income expected from the higher levels of administration and discretionary further redistribution among constituent villages. Informal administrative centers emerged, but with no direct possibility of political feedback from the citizens.

Just as well, half of the counties (județe) are unable to make ends meet, nor can they satisfactory provide their citizens with some of the services required: universities, hospitals or airports.

We recommend that unsustainable communes are merged with larger neighboring administrative towns and for the rest the three tier structure is preserved with some changes. Municipalities with higher administrative performance should benefit from further fiscal decentralization; counties should see their powers curtailed and regions should become the default level for administrative control and anticorruption to compensate for the absence in poor areas of civil society and free media.

6

Highway development roadmap needs by consensus

Romania now has 646 Km of highway, but no full border-to-border connection, as segments crossing the mountains – the hardest – were left last. Part of the blame lays with politicians who tried to elude European priorities and procurement rules, ending up with almost nothing, as is the case with the former Bechtel project or the ever-controversial Ploiești-Brașov connection. Another part of the blame lays with the lack of a masterplan adopted by large political consensus, so that priorities don't change with each succeeding prime-minister. Even now, as a master-plan is finally in place, it was done with the unilateral support of the current majority party. Moreover, priorities are left vague and multiple financing scenarios are not explored. Yet another major part of the blame lays with the public-private partnerships, a system that didn't deliver to expectations, as they ended up being more expensive instead of cheaper for the public budget.

We recommend the government to set a more robust list of priorities and seek wide consensus on it, while focusing on EU co-financing as the main source of funding. PPPs where the government is required to give anything more than the required land and logistical support should be out of the questions. All efforts should be done however for the Ploiești-Brașov-Sibiu segment to be included in the EU financing list, as it would provide the most feasible and the least expensive connection opportunity (from both Bucharest and Western Europe) with the region of Moldova, via Bacău and Iași.

7

Opening the energy market for small producers

Romania achieved fast growth in renewable energies, with wind turbines going from 0 to more than 10% of total power output in just five years. Solar power is also a growing business, with the potential to equal wind in the next few years. However, the potential of these two sources is together less than half of that obtained from biomass, which could theoretically add another half to Romania's total output and another percent to each year's GDP growth.

However, biomass is currently discouraged by the current legal framework, as it implies smaller units, more logistics and human resources and much higher administrative overhead. On the other hand, all these things would also translate into higher added value for the local economy, with 50 up to 100 thousand potential jobs created in the most unemployment-prone places – rural and small urban.

The current system of green certificates has proven its success for encouraging large-scale investment, but the other possible approach the so-called "feed-in-tariff" is only a recent and ignored law draft. The law would allow small producers to sell power back into the grid, at a fixed rate and without the chore of searching for customers, thus greatly lowering the barrier to entry, to the point that even homeowners could participate.

Therefore, we recommend the urgent passing of the said law.

8

Stopping the medical brain-drain

Romania provides its residents with probably the worst healthcare in all the European Union, ranking lowest in most indexes. The public spending is also comparatively low, while doctors and nurses are paid amongst the lowest even when compared to the already modest average wage. This led to a massive exodus of medical personnel to better-paying countries, leaving the under equipped hospitals understaffed as well.

Better use of current funds could easily solve the problem, but there are also legal mechanism in place that, if used, could bring more money into the system in the short term within the public resources already available.

We recommend that hospitals use their legal right to charge for a suite of "premium services", such as nominally picking the doctor, granting the second opinion on diagnosis or skipping the waiting lists. An additional source of income would be the delivery of auxiliary medical services, such as accommodation, transport or home care.

9

Using banks to encourage agricultural investments via EU funds

Romania ranks low on absorption for most chapters of EU funds, but there is one good exception – the Common Agricultural Policy money is almost fully drawn every year. However, in terms of spending opportunity, few results are seen. With among the and smallest average farms and lowest land productivity, there is little room for investment as the money is spent on current inputs: seed, fuel or fertilizers. It's almost impossible for farmers to start investing in order to have better productivity and capitalization in the future, hence no chances for spending efficiency to grow.

The missing link in this chain is the banking system, as the banks treat agriculture as too risky to lend to, unless they can mortgage the land. However, the steady stream of CAP funds could be a further guarantee that the credits would be paid back, if only there was a legal framework for this. What the government can do is step in and establish mechanisms that allow the use of future cash-flow as further collateral.

In the medium and long term, this alone could substantially increase agricultural output (20-30%) and greatly increase added value (up to 100% or even more), with a gradual 0,5% to 1% added to the GDP each year.

10

Flexible oil taxation that finds the mid-ground between investments and tax revenues

Romania has some of the lowest royalties for public natural resources and missed the chance to increase them at the start of this year, when a 10-year clause in the privatization contract of the oil company Petrom expired. The balance lost is estimated at about half a billion euros, enough money to either double all doctor's wages or double all child's allowances or lower the tax-burden on labor with a further 4%. The government's explanation for the 1 year postponement was that "time was too short to make a decision", the issue is still under consideration.

Romania has long passed it's own peak oil and only has about 15-20 years left of proven reserves. Energy security dictates that it should preserve them as much as possible, importing when it's cheap to and only extracting when the international barrel price is high. To this end, the higher the royalty, the better. On the other hand, exploring for new wells could substantially add to the proven reserves, but high royalties would be a huge disincentive.

We suggest a two-tier system, that addresses each issue in turn. For mature wells, we recommend a fixed cost and a negotiated operational profit being left to the operator, while all "windfall profits" become public revenue. For new operations, we recommend a settled amortization period, counted in years, during which no royalties are charged, so that the investors are sure to recoup their capital.

11

Secure farmers against theft

One of the most ignored problems of Romanian agriculture is systemic theft, to the point that losses due to fear, that leads to missed opportunity, are much greater then actual produce stolen. Law enforcement largely turns a blind eye to this, leaving the farmers with two suboptimal options: either spend a good part of their budgets for guarding the fields, often more than 10-20%, or choosing the least productive crops, that are too uninteresting even for thieves.

This leads to a general low level of value added and to inefficient use of the agricultural workforce – a good part of which already had to migrate to the Western Europe in order to find the secured farms that allow them to do their jobs.

Small farms, of which Romania has the most in the EU (almost a third of all EU farms, on just 7% of the EU agricultural surface), are especially victims, as they cannot efficiently produce bulk crops, nor can they secure higher-yielding ones, not even fruits or vegetables.

We suggest a policy of zero tolerance towards agricultural criminality, with special human and technical resources dedicated for this purpose and clear hierarchical responsibilities. Moreover, the government should reimburse insurers for thefts in areas where criminality stays significantly above average, as this is an indicator that they didn't do their tax-financed job.

12

Moving tax collection policy from penalty to stimulus

Only two thirds of due taxes end up in the public treasury, partly because high tax evasion and partly because levels are set too high for some companies to even survive. This is especially true for VAT, where collection is at a mere 40% and where total income as percent of GDP is now (at a 24% taxation level) the same as 4 years ago (at a 19% taxation level) after a short-lived spike. It's now too late to even lower back the VAT, as revenues would dive for at least another couple of years before reaching the same levels again, if ever.

One of the culprits is the tax authority itself, after the companies that showed the greatest level of voluntary conformity were the ones taxed most – as this was the easiest path whenever they had orders to “fight tax evasion” hence “increase revenue”. Companies were driven or kept out of the formal accounting and reporting system, thus generating competitive pressure on those who tried to comply until running out of business. It’s almost impossible to reverse this trend now, but good taxpayers should be given carrots, not more sticks.

We suggest a system that encourages electronic payments and the integration of bank and accounting balances, to the point that the bank becomes responsible for issuing invoices and submitting tax returns. Taxpayers who voluntarily pick such a system should be rewarded with lower taxation levels and bonuses for paying on time. On the long term, taxes should be cut incrementally to the point where revenue collection meets tax levels, with minimal exceptions that become manageable by law enforcement.