

## What Lies beyond the Romania's Economic Development

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### Abstract

This paper analyzes the dynamic of economic development in Romania, underlying the steps already made by Romania on the way of economic development, as well as the causes of the slowness of this long term process. Four dimensions of the economic development are particularly analyzed here, i.e. the GDP, health, education and income inequality, with a great emphasis on the per capita GDP dynamic. The paper also looks at two contemporary challenges of Romania with a considerable impact on economic development – the progress made in the process of EU funds absorption and the income polarization, which is at present a matter of concern for the whole EU. The components of Romania's economic development are presented in comparison with those of the New Member States.

**Keywords:** economic development, economic growth, Gini.

### 1. Introduction

The economic development is a broad and multidimensional concept which reflects the improvement in the standard of living, as a consequence of economic growth. The economic development is often confounded with economic growth, but despite their association, the economic growth denotes just a dimension of economic development. The economic growth does not imply economic development, but the economic development requires economic growth, at least in a first stage of this process. In comparison with economic growth, economic development is a normative concept, open to subjectivity and interpretation.

The implications of economic development in the national economy are broad and they mainly regard the changes in the socio-economic structure of a country, e.g. increase in the share of industries, banking, construction and services in GNP, changes in the production management, innovations, a different pattern of income distribution etc.

The most significant indicator of economic development is the GDP per capita, because the economic growth is the engine and also the root of economic development. But the GDP does not illustrate the extent to what the economic growth contributes to the social welfare. A particular situation is when a high economic growth can feed only the upper tiers of income distribution and therefore it might hide a high social inequality or poverty. To avoid this misunderstanding, beside the GDP per capita, other economic and social indicators should be added to complete the picture of economic development. They should reflect other aspects of development, beside the economic ones, such as health and education.

The analysis of economic development has a particular importance for the developing countries because the economic growth does not always lead to well being for all inhabitants. This paper examines the economic development in Romania – a former communist country, at present member of the EU, which had an impressive economic growth after 2000, but still a modest economic development.

The paper is structured as follows: section 1 is the introduction, section 2 represents a theoretical approach to economic development, section 3 is an empirical analysis of economic growth in Romania, section 4 describes the dynamic of the standard of living in Romania, section 5 addresses the difficulties met by Romania on the road of economic development and section 6 concludes on the main findings of this paper.

## **2. Dimensions and spaces of economic development**

In the literature, the explanation of the “economic development” concept starts with the concept of economic growth and ends into the space of socio-economic indicators of well-being, such as: education, health, nourishment, capabilities etc. In other words, “economic growth is one aspect of the process of economic development” (Sen, 1983). In this light, the economic development represents a broad and complex dynamic process, comprising both economic growth and standard of living.

The relationship between economic growth and economic development is a bilateral one. As suggested above, the economic growth stimulates the increase of consumption and therefore leads to economic development (Ranis, 2000). But this happens only when the economic growth is directed toward all tiers of income distribution, especially the bottom ones. On the other part, the economic development involves the increase of standard of living for a large proportion of population, which is a source of aggregate consumption. The increase of aggregate consumption leads further to economic growth.

Fundamental structural changes are needed to accompany the economic growth in order to stimulate the economic development. Because it involves a complex process over time, which allows new institutions, values, markets and products to arise, the economic development is also described as a “high quality growth”, according to the IMF terminology.

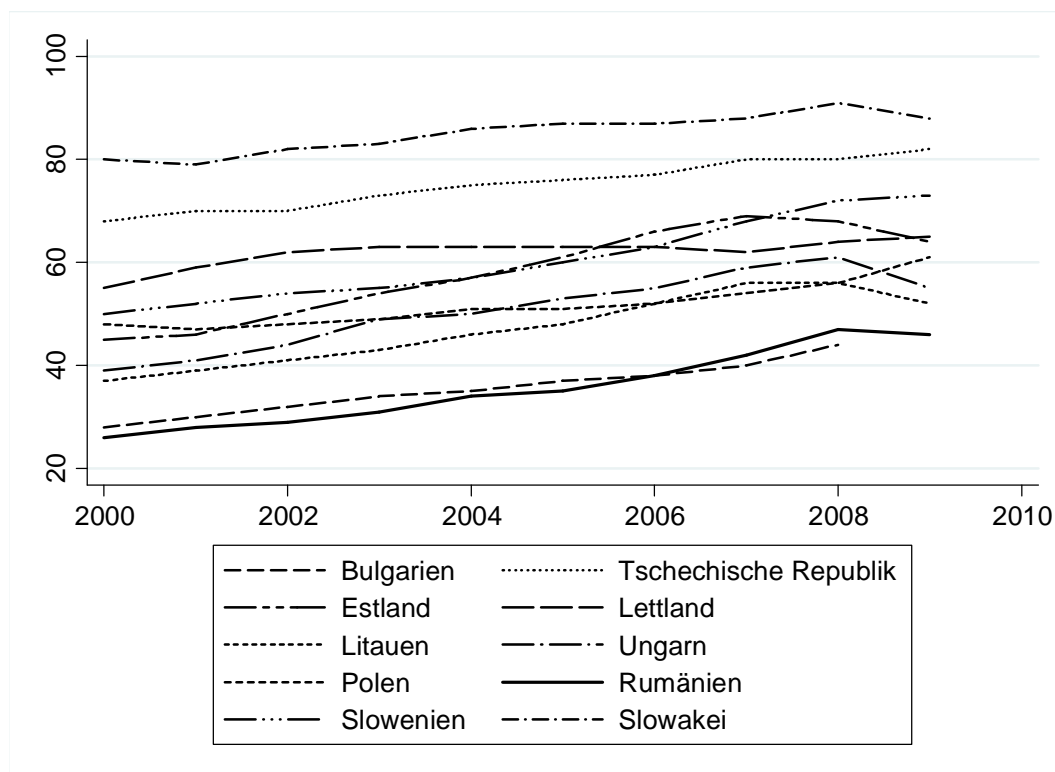
But the economic growth is just a dimension of economic development and not a sufficient condition for the increase of standard of living. The GDP growth doesn't improve the standard of living in any situation. This relationship between economic growth and standard of living depends on the effects of economic growth on income distribution and social inequality. If the level of inequality is high, then only a small proportion of population will benefit from the GDP increase. Economic growth is therefore a factor but not a sufficient condition for economic development.

The interactions between economic growth and income inequality have always raised debates in the literature, but all empirical works have a common point: the seminal work of Kuznets (1955), who states that the relationship between economic growth and social inequality takes the form of an inverted –U, which suggests that in the early stages of development inequality increases, it reaches then a maximum point at a medium level of income, and declines when the average level of per capita income is relatively high.

While GDP is a widely recognized indicator of economic growth, the economic development has not an official measure due to its multidimensional nature, and especially to the “standard of living” component, which denotes a subjective socio-economic status. The Human Development Index (HDI) calculated by the United Nations Development Programme is the most common measure of economic development. This composite indicator ranks countries upon their level of “human development” and classifies them into four categories: “very high human development”, “high human development” (which includes Romania), “medium human development” and “low human development”. Both monetary and non-monetary factors are included in the HDI structure: the GDP per capita (PPP), life expectancy at birth and literacy rate. In other words, the HDI reflects three essential aspect of life: monetary welfare, education and health.

## **3. The Romania's economic growth**

The engine of economic development is the GDP per capita. Although it reflects just the monetary aspects of the economic development, the GDP per capita is the most important indicator of well being, being measurable and allowing for international comparisons without any controversial. From 2000 to 2008 the GDP per capita has gradually increased in Romania, indicating a long period of economic expansion. Starting with 2008, the global economic crisis has first induced a drop in the level of GDP in Romania (2008-2009), as well as in most of CEECs, and then a stagnation from 2009-2010 (figure 1). After 2011 the international economic organizations predict a very slow comeback on the path of economic growth.



Source. World Bank Indicators

Figure 1. GDP per capita, New Member States, 2000-2010

First as a candidate, and then as a member of the EU, Romania was always interested in fulfilling the nominal convergence criteria and also in following the real convergence process in order to be able to join the European Monetary Union and to get real benefits from this membership. Empirical studies show that in the years preceding the global economic crisis, all New Member States (NMS) were successfully participating at the real convergence process (Figuet and Nenovsky, 2006, Borys, Polgar and Zlate, 2008; Ouardighi and Kapetanovic, 2009), most of them being very close to fulfill the nominal convergence criteria. Despite of the progress made by the process of real convergence in the period 2000-2008, some authors consider that the EU is not an optimum currency area (OCA), and therefore the EMU should not rush to extend its borders until the OCA conditions are not completely fulfilled (Rinaldi-Larribe, 2008, Kocenda et al., 2005). In their view, Romania should delay the moment of entering the EMU. Anyway, the global crisis has moved away the EU countries from the path of real convergence, rising questions about the Euro future.

In comparison with 2008 when Romania was meeting three out of five nominal convergence criteria (i.e. regarding the public deficit, exchange rate fluctuations and public debt), in 2011 Romania is far away from meeting any of them. The public debt hit the highest level after 2000 (45.3% of GDP), while the inflation rate (7.96%) and the budgetary deficit (6.58%) were among the highest levels after 2000. In this light, the dream of entering the EMU in 2014 has vanished. As underlined above, the predictions for the Euro zone future are pessimist.

#### 4. The dynamics and dimensions of standard of living in Romania

In the New Member States, as well as in the entire EU, the empirical evidence of the last decade has shown that a high level of income inequality determines the shrinking of middle class, being therefore obstructive for economic growth (Kornai, 2000). Behind this evidence there is a

theoretical reasoning. In early stages of development inequality stimulates economic growth because the wealth accumulated by a small number of people allows investments and production, but in another perspective this might be detrimental for economic growth, because the access to such economic activities is limited. If this hypothesis also applies in the case of Romania, then one could state that the economic growth couldn't help the alleviation of poverty and reduction of social inequality.

As shown in figures 2 and 3, from 2000 to 2007 in Romania both the economic growth and income inequality have increased, the economic growth almost linear and income inequality having a sharp increase from 2006 to 2007. This pattern suggests that the beneficiaries of economic growth have been those from the upper part of income distribution. This evidence reflects the inefficient social and economic policies conducted by the Romanian authorities in this period of time.

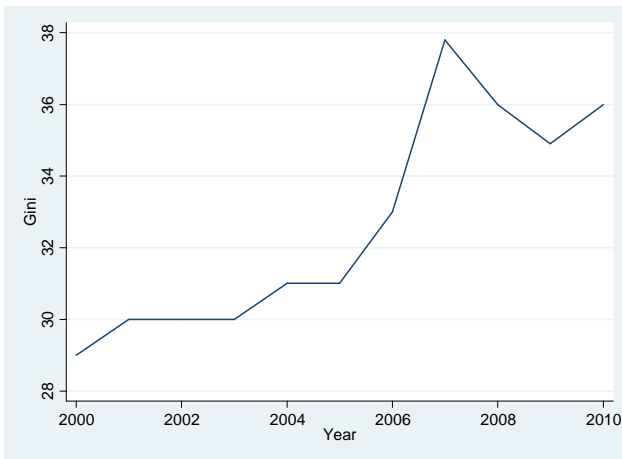


Figure 2. The Gini coefficient  
Romania 2000-2010

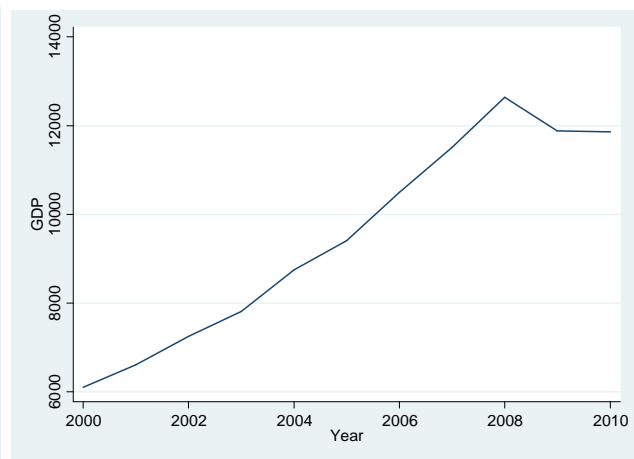
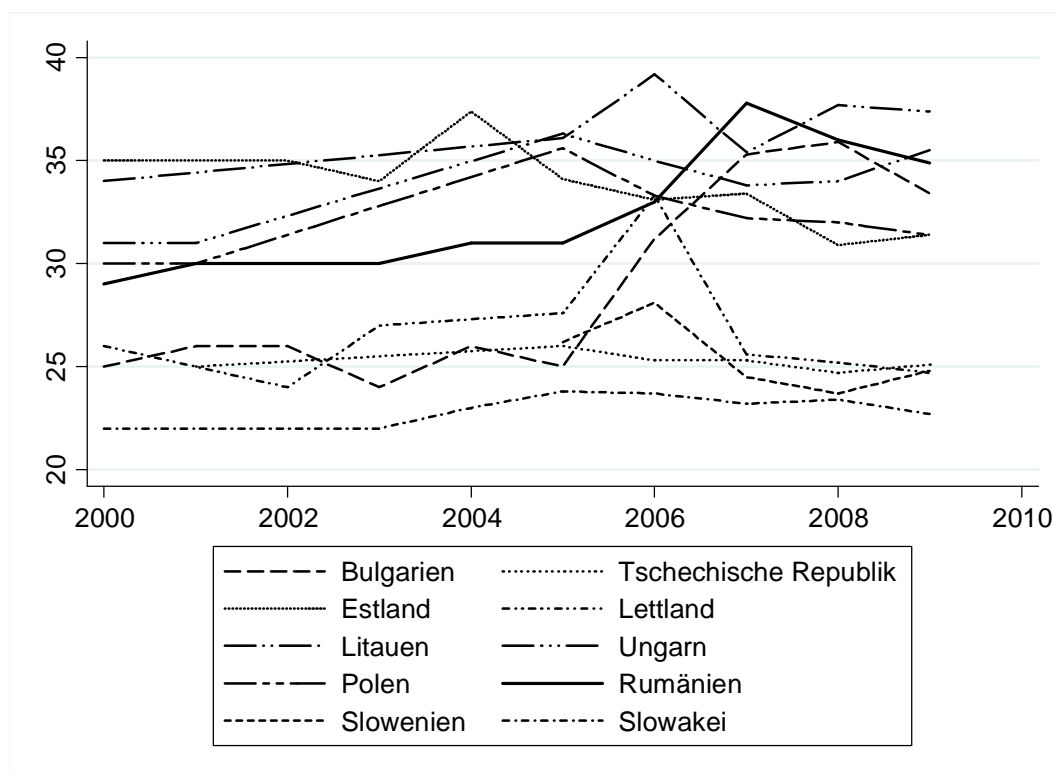


Figure 3. The GDP per capita  
Romania, 2000-2010

At the moment of Romania's entering the EU, the Gini coefficient indicated a value equal to the average of the EU members (0.31). Apart from other countries, in Romania, during the entire transition period, this value has continued to rise. From 0.28 in 1998, the Gini coefficient has increased at 0.29 in 1999, 0.30 in 2001, 0.31 in 2004 and 0.32 in 2008. But the crisis has deepened even harder the income inequality. In 2010, the Gini coefficient indicates that, after Latvia, the income inequality is the highest in Romania, reaching the value of 0.36 (figure 4).



Source. Eurostat data

Figure 4. Gini indicator, CEECs, 2000-2010

The causes of income polarization in Romania are complex. First, as in the whole EU, in Romania as well, the shrinking of middle class has determined the polarization of society, which is a step behind/ away from the social European model. The shrinking of middle class in Romania is mainly due to the economic changes specific to the transition period. For instance, the bankruptcy or restructuring of former state companies, the restrictive economic policies conducted by governments in difficult moment of transition and in particular the cutting of public expenditures aimed at reducing the budgetary deficit pushed into poverty a large part of population. They either accepted lower wages at the same working place, or were not able to find better jobs according to their professional track, and changed several jobs with low remuneration. The purchasing power of employees in the public sector has decreased and instead of participating at the middle class, they belong now to the poor class.

A second cause of income polarization in Romania is derived from the inequality between the Romanian regions. With the exception of Bucuresti-Ilfov region (the region also comprising Bucharest), the economic growth follows the axe West-East, the Western frontier being the source of economic growth transmission toward the other Romanian regions. Due to this transmission channel, the Nord-East and the South are the poorest regions in Romania. In these regions, the underdevelopment is associated with unemployment, rural activities, dependency on agriculture and inability to attract foreign investments. The Nord, Nord-West and Central regions have attracted more FDI and foreign capital, being preferred by investors especially for the good business environment they provide, good infrastructure (e.g. existence of airports) and qualified labor.

According to Eurostat, in 2003 the Nord-East region was the poorest region of EU. Since 1995 it has confronted with a high migration and an increasing inequality between the rural and urban areas. The situation of this region has improved over time, but it still remains the poorest region of Romania.

Another basic dimension of the standard of living is the health status. The governmental health policy is conducted by authorities according to the national priorities and the public financial resources. The economic growth allows but not guarantees the increase of public health expenditures. In turn, the investment in health is a precondition of a decent standard of living.

In present, the health system confers to Romania the worst position in the EU. In order to improve it, the public expenditures and programmes in health should take into consideration two major facts: the population aging process and the importance of health-specific prevention activities. The natural aging process requests specific health services for the aging population, which are absent now in Romania. This process will also involve the increase of the total health public expenditures and the increase of the share of health expenditures for elderly into the total health expenditures. As the public health budget is always constrained by the Romania' restrictive economic and social governmental policies, the special attention should be particularly given to elderly. But this seems to become a reality only in the far future. As shown in the figure 5, the health care expenditures in Romania are among the lowest in the New Member States.

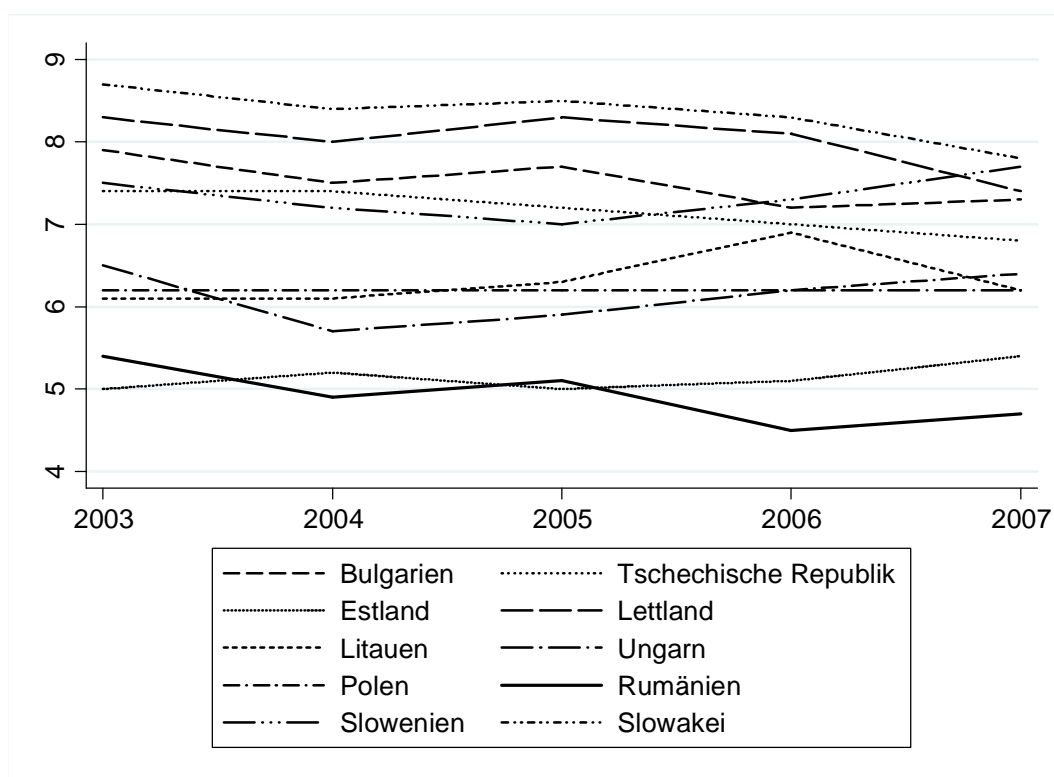


Figure 5. Health (health care expenditures as % in GDP)

As regards the education system, which is the third component of the standard of living, after GDP and health, Romania is placed in the top of Eastern European countries with good educational achievements. One suggestive indicator is the secondary school enrolment, as shown below (figure 6).

Given the coexistence of the persistent economic growth and increasing income inequality between 2000 and 2008, a good scenario for Romania would be the income redistribution from rich to poor through a new social contract. But this solution is controversial, because it does not stimulate work and disadvantages the endeavor activities.

Considering all above, despite of the progress after 2000 on the path of human development, Romania is still far away from a decent standard of living. Although the global crisis has worsened the economic situation and has imposed adoption of restrictive policies, as also recommended by

the Romania's main creditor IMF, the health and education should become priorities in order to ensure the Romania's durable economic development.

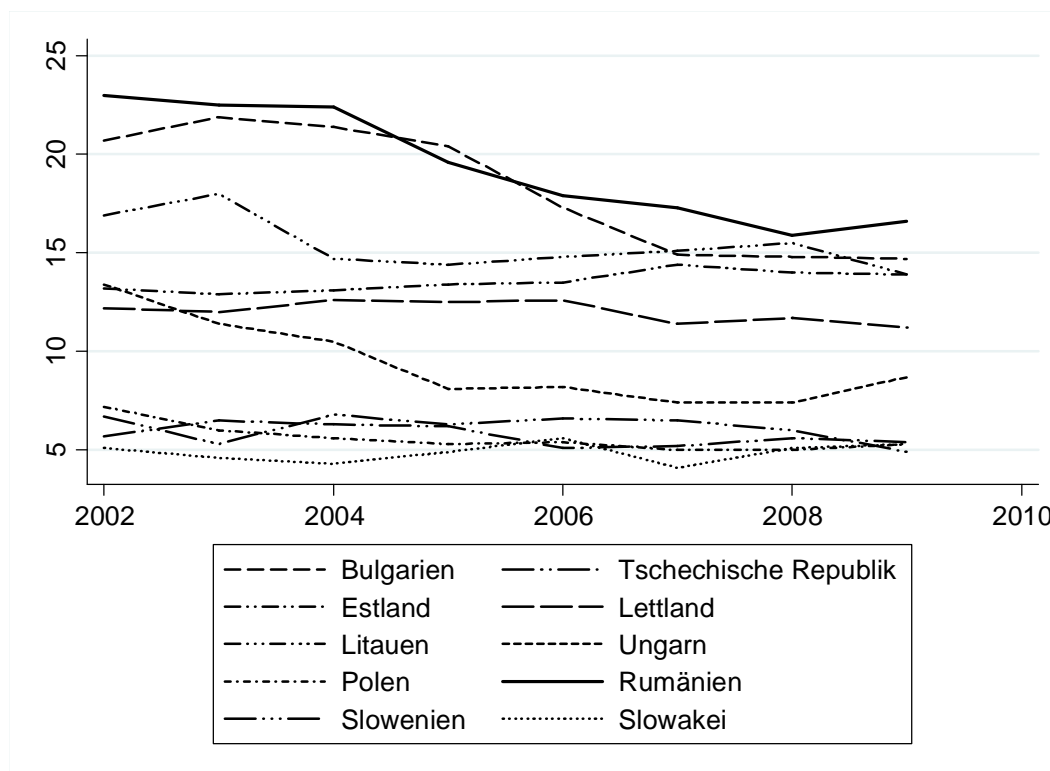


Figure 6. Secondary school enrolment, New Member States, 2002-2010

### 5. Difficulties met by Romania in the process of economic development

Before to go into the analysis of the breaks and progress made by Romania on the way of economic development, a short examination of the relative position that Romania takes in the world, upon the level of economic development, is required.

Upon the Human Development Index (HDI), in 2007 Romania was taking the 63<sup>rd</sup> position in the world, with a value of 0.754. This reflects a modest level of human development at the moment of entering the EU (the lowest in the EU that time), which places Romania near countries like Trinidad-Tobago (0.837) and Montenegro (0.834). In the dynamic of HDI in Romania during the transition period, a substantial increase is visible since 2000 onwards, which corresponds to the period of economic boom (2000-2007). In the structure of HDI, life expectancy places Romania on the 80<sup>th</sup> position in the world in 2007, and the literacy rate ensures the 54<sup>th</sup> position. This indicates that Romania should invest more in economic development, especially in the public health services, in order to increase the standard of living.

In 2010 Romania jumped on the 50<sup>th</sup> position out of 169, being very close to move from the “high human development” category into the “very high human development” one. This time, as shown in table 1, Romania (0.767) is ranked before Bulgaria (0.743) and right after Latvia (0.769) and Lithuania (0.783). Still the health sector and particularly the life expectancy at birth, remain the main challenge for the Romanian governments, because although it has slightly improved from 2007 to 2010, it continues to be the lowest in the EU.

Table 1. The Human Development Index, New Member States, 2005-2010

	<b>Human Development Index value</b>					
	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>
Bulgaria	0.724	0.729	0.736	0.741	0.741	0.743
Czech Republic	0.838	0.841	0.843	0.844	0.841	0.841
Estonia	0.805	0.811	0.816	0.816	0.809	0.812
Hungary	0.798	0.802	0.803	0.804	0.803	0.805
Latvia	0.763	0.771	0.777	0.777	0.769	0.769
Lithuania	0.775	0.780	0.785	0.789	0.782	0.783
Poland	0.775	0.779	0.784	0.788	0.791	0.795
Romania	0.733	0.743	0.754	0.765	0.764	0.767
Slovakia	0.796	0.803	0.811	0.816	0.815	0.818
Slovenia	0.813	0.819	0.825	0.828	0.826	0.828

*Source: UNDP*

One of the most important resources of economic development for Romania in the transition period are the European Funds, i.e. the pre-accession funds before the Romania's entering the EU and the structural funds after 1997. Unfortunately, this resource has not been completely exploited by Romania by now.

Although for the period of time 2007 - 2013 Romania can access European Structural Funds amounted 19.2 billion Euros, only 11.06% of this maximum level allocated to Romania has been contracted at the half of 2011. The absorption of all disposable funds until the end of 2015 requires annual inflows 7 times higher than the amount used in 2010. In a comparative approach, at the end of 2010, Romania had the lowest absorption rate (only 8.6%) in comparison with other CEECs, e.g. Bulgaria (10,2%), Czech Republic (12,4%), Poland (20,4%), Estonia (26%) and Latvia (29%).

Apparently these inflows from the European Union are "free money", but in fact Romania has to pay an annual contribution of 1% of GDP to the EU budget. A low absorption rate pushes therefore Romania into the category of "net contributors" to the EU, as it was the case of the period 2007-2009.

The structural funds could carry a positive effect on Romania's economic growth. Given that the GDP amounts 120 billion Euros, the annual absorption of 3-4 billion Euros through structural funds can generate an annual increase of economic growth by 1.5-2.5 pp.

The European structural funds can be seen as a driver of the economic development for all CEECs, but especially for Romania, which has a delay of economic development in comparison with the other NMS. Why the structural funds are so important in the process of economic development? This is because the EU structural funds are designed to reduce the regional disparities and social inequalities within the EU, to promote the social cohesion and sustainable economic development in the EU.

But the question that arises is why Romania was not able these years to direct the European funds toward economic development and especially toward the alleviation of poverty and decrease of inequality? And why Romania is not able to attract a higher amount of money from the EU? The Romanian experience has shown that most Romanian successful projects are only short-term oriented. The mission to produce long-term positive effects, such as durable development, is absent.



Due to the co-financing requirement, the access to European funds is limited and the real transfer toward the real beneficiaries is often obstructed by corruption and the short-term interests.

Another problem occurring in the process of economic development in Romania is corruption, because when corruption is persistent on long term, the income and wealth distribution are negatively affected.

Despite of the warnings sent to Romania by the international organizations during the transition period, Romania's governments which succeeded over time were not very incisive in fighting corruption. According to the corruption perception index (CPI), Romania had a low index during the entire transition, being therefore placed in top three EU countries with the highest corruption. In 2009 Romania had the highest CPI (3.8) in the EU, and in 2010 the situation has slightly improved, Romania being the third country with the highest corruption (3.7), after Bulgaria (3.6) and Greece (3.5). In the Romanian society the corruption is met at the individual level as well as at the government level, especially in justice, and it has a traditional component (e.g. in the health sector). The difficulty of having real results in the fight with corruption arises from the complexity of its structure because, as suggested above, corruption is widespread at all levels in society. Beside its traditional root, it is also fed by the governments' incapacity to make progress in reducing poverty, inequalities and to ensure a long term economic growth. Due to the slow progress done in combating corruption the European Union still monitors in 2011 problems like justice and corruption in Romania, although the status of EU member from 2007 wouldn't request this surveillance.

## 6. Conclusions

Although Romania is among the EU countries with the highest economic growth rates since 2000 onwards, the social inequality has continued to rise and the standard of living has slightly deteriorated. This evidence is indicative for the weak economic and social policies that the Romanian governments adopted in this period and proves that only the upper tiers of income distribution have benefited from this growth.

When defining economic development upon the HDI, the health sector seems to be particularly responsible for the low progress in the achievement of economic development. This recommends supplementary funds in health, because the access to health services is a fundamental dimension of the standard of living.

The European structural funds represent the most important factor stimulating the economic development in Romania, especially the regional development, but the corruption and bureaucracy have obstructed in the last years the efficient absorption of EU funds. The only European program which has an efficient absorption in Romania is the regional operational programme. This success could help Romania in fighting the regional disparities and inequality.

In Romania, as well as in other New Member States the governments which succeeded in the transition period were focused on adopting pro-growth measures, but the experience of the last decade has shown that beside the positive effects in economy, the economic growth has also raised the inequality. The economic development must be therefore based on a sustainable and durable economic growth and should ensure the equilibrium between the fast economic growth and the social welfare.

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