

**Report Concerning an Investment in Romania**  
10 May 2005

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## Synopsis

This report summarizes our findings concerning the potential difficulties and obstacles to the operational implementation of an industrial investment in Romania. A team of three experts conducted this study and contacted 18 sources. Among those, over half were business executives from major investors in Romania (**Renault, Valeo, Faurecia, Alcatel, Lafarge, Trinity Industries, Honeywell Garrett**) and some of their advisers (an American business lawyer, a French tax expert, a high-level representative of the **American Chamber of Commerce** in Romania), and the rest were institutional sources (from international organizations like the **OECD** and the **EC**, from the Romanian government, and from the French administration).

## Background

Romania is the largest recipient of Foreign Direct Investment in South-East Europe with an accumulated stock estimated at USD15 billion at the end of 2004.<sup>1</sup> There are indications that these investments have been fairly evenly distributed between ‘greenfield’ investments and acquisitions. According to IMF projections, Romania will attract an annual FDI flow of USD2.4 billion until 2008, which will contribute significantly to the financing of its large current account deficit.

Romania concluded, from a technical point of view, the last two chapters of the *acquis communautaire* (Competition; Justice and Home Affairs) on 8 December 2004. The Accession Treaty for Romania was signed on 25 April 2005 and full membership will take place as of the beginning of 2007 provided that the Romanian government complies with the commitments made during the negotiations. Therefore, the accession process is not finished: clauses within the Accession Treaty allow the EU to postpone by one year the accession date until January 2008 if Romania fails to meet some requirements, which include fighting corruption, strengthening public administration systems and introducing competition policy measures. Our source at the **MINEFI/DGTPE**,<sup>2</sup> indicated that the implementation of the *acquis communautaire* is closely monitored. It should be noted that Romania’s accession to the European Union is not conditional on the ratification of the draft European Constitution.

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<sup>1</sup> Romanian FDI data do not include reinvested earnings.

<sup>2</sup> Direction générale du Trésor et de la politique économique.

With an educated, low-cost labour force, dynamic small and medium enterprises and good energy resources, Romania's comparative advantage is in manufacturing. This comparative advantage is revealed by the fact that according to the **National Office of Trade Register**, 64% of FDI is absorbed by the manufacturing sector. In turn, the share of foreign affiliates in total manufacturing output was more than 50% in 2002. These companies employed one third of the manufacturing workforce. Such high shares of FDI penetration in manufacturing with relatively low levels of FDI stocks when compared with the Czech Republic, Hungary and Poland can be explained by the fact that firms and other productive assets have been and still are relatively cheap in Romania. Moreover, minority foreign ownership is more widespread in Romania than in these countries and, as a result, foreign owners produce with less capital invested. Whether a relatively low FDI/output ratio experienced in Romania translates into high returns on investment over the longer term depends on the characteristics of the business environment for FDI in manufacturing.

From a second comparative perspective, it can be argued that since it will probably join the European Monetary Union later than some if not all new EU Members (2015?), Romania will be over time in a better position to protect the competitiveness of enterprises through currency depreciation if real labour costs increase faster than elsewhere.

FDI is concentrated in steel, chemical industries, clothing and leather although, more recently, the range has been expanded to electrical machinery and car parts.<sup>3</sup> Among the top 10 foreign investors, two are in the automotive sector (Renault and **Daewoo**). Many other foreign companies have an established presence in the automobile and automotive components sector in Romania.<sup>4</sup> More recently, **Yazaki** of Japan opened two car parts manufacturing plants in Ploesti (USD16 million) and **Draxlmaier** of Germany opened a plant in Hunedoara (EUR15 million). Car electronics supplier **Ruwel** of Germany announced in June 2004 that it will proceed with an investment in Cluj (EUR80 million). Finally, in the fall of 2004, **Montupet** of France decided to invest some EUR120 million in the production of aluminium auto parts.

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<sup>3</sup> Romania is the only country in South-East Europe with an important export-oriented manufacturing sector. Foreign manufacturing affiliates sell on average 50% of their production abroad. For example, 70% of the steel output is exported.

<sup>4</sup> **Alcoa, Continental, Daimler Benz, Delphi, Faurecia, Honeywell Garrett, Johnson Controls, Michelin, Siemens, and Valeo.**

## Framework conditions for investment

The government of **Prime Minister Calin Tariceanu**, which took power in December, understands the need for favourable investment framework conditions based on best international practices. The Enterprise Policy Performance Assessment of Romania (an independent and comprehensive annual assessment of public policies carried out by the EC General Directorate for Enterprise and Industry, the **EBRD** and the OECD) shows a considerable improvement in several policy areas and last year Romania became the first country of South-East Europe to be accepted as an adherent to the OECD investment instruments. The general view is however that despite significant progress, Romania still faces challenges in completing its institutional and policy reform. The heritage of forty years of very rigid central planning together with a poorly designed and weakly coordinated first decade of transition have been responsible for slower economic restructuring than in countries of Central Europe. In particular, laws, emergency ordinances, regulations and methodological norms have been issued with a high frequency by the Parliament, the government, various ministries and regulatory bodies without much co-ordination and, until recently, without consultations with the stakeholders. In some cases, new legislation conflicts with older, still valid legislation or with international agreements. This has brought a degree of legal instability in the past and has created some regulatory and administrative opacity.

The main obstacles to foreign direct investment mentioned by our sources appear to be this legislative, regulatory and governmental instability and the changing nature of contractual obligations. An executive with Renault summed up the latter issue: “*Un contrat n’est pas la fin en soi, mais seulement une étape... car on recommencera à négocier le lendemain.*”<sup>5</sup> Our source with Alcatel, one of the most successful foreign firms in Romania, pointed to the interpretation of national laws at the local level as a constant, and costly, problem: “*des écarts de 15 à 20% souvent, notamment pour la concession de terrains, la négociation à l’embauche, le niveau des rémunérations.*”

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<sup>5</sup> Another source, a former ambassador of France to Romania talked about the « *esprit de négociation permanente.* »

Consequently, there is a potential for inflation of the estimated cost of doing business in Romania. An executive with Faurecia advised: “*il faut être très prudent dans l’appréhension des coûts sociaux.*”<sup>6</sup>

An executive with Valeo remarked: “*Comme les syndicats sont importants et l’un des freins principaux, comme la population a faim, que le pays ne décolle que depuis quelques années, il y a clairement pression sur les salaires, et d’une année sur l’autre on peut lâcher 20%. Même s’il reste de la marge, il faut tout de même être conscient du phénomène.*”

Labour costs are, nonetheless, the primary factor for foreign industrial investment. The Valeo source was clear: “*bien évidemment, on a cherché ici la compétitivité par les coûts. Salaire horaire chargé: Allemagne €26, France €18, Espagne €15, Roumanie €2... On n’a pas besoin de faire un dessin.*”

The following components of the business environment are addressed below: the legal and regulatory framework for business; taxes, incentives and tax administration; labour markets; the judiciary system and corruption; banking and other financial services; and infrastructure.

#### ***a) The legal and regulatory framework for business***

##### ***(i) The FDI regime***

Romania has an open regime towards FDI. There are no specific laws on FDI except for the law governing the creation and functioning of the **Romanian Investment Promotion Agency (ARIS)** which informs and assists foreign investors. National treatment prevails *de facto* in all areas. There is no screening and there are no equity or performance requirements. There are guarantees against nationalisation and expropriation. Foreign investors are generally allowed to invest in any field (except for minor restrictions in maritime transport, fisheries and legal services) and in any legal form and they can convert and transfer abroad profits derived from their investment and proceeds obtained through the liquidation of their investment. They can participate in the privatisation of state-owned enterprises and benefit from all available tax

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<sup>6</sup> At the same time, Faurecia appears to be taking well to Romania, as its executive indicated that the 250 employees or so will augment to 500 to 600 by 2007. Valeo has been in Romania for less than a year and already employs 500.

and customs incentives. Since some incentives are available only for investments above USD1 million, it can be argued that foreign investors have an advantage over domestic investors whose projects often involve amounts below this floor. To sum up, **the overall business environment faced by foreign investors is similar to those encountered by domestic investors.**

(ii) Establishing a business: registration

A new registration system has been adopted. Importantly, a law on tacit silent approval procedure allows companies to undertake activities if the government authority concerned has not responded within 30 days to their request to establish business. While a high-level Romanian official responsible for “business environment” indicated that few investors take advantage of this procedure, according to an interview with a business organisation representative, the problem resides more with public officials who do not understand fully how to apply the law and are reluctant to decide and expose themselves.

The **World Bank** indicates that investors can expect to go through 5 steps to launch a business over a period of 28 days on average. In addition to company registration, these figures include tax and labour-related registration procedures as well as health, safety and environment-related procedures. According to the Romanian official, this is no longer true: investors can now register and start a business in three days on the basis of a statement of personal liability and proceed subsequently with the health, tax, labour and other registrations delivered by the ministries concerned. Satisfaction with the new procedure was confirmed by other interviews. There is no minimum deposit requirement to obtain a business registration number.

In the event of a ‘brownfield’ investment, any acquisition of existing facilities from the state through privatization can imply all sorts of investment and upgrade obligations, environmental commitments and labour guarantees. In addition, fiscal liabilities and penalties may appear which were never disclosed through the normal due diligence and negotiation process. If, on the other hand, a facility is acquired from a private operator, these issues may not be as prevalent, but what often exists are problems with corporate governance, as well as financial irregularities which the investor will need to cleanse in order to protect itself against the loss of investment capital and potential legal liabilities. The situation is often mitigated if

the private facility already has outside equity investors (such as a private equity fund) or debt investors (such as a major commercial bank), since these institutions will typically have undertaken in-depth due diligence and required the company to clean up its operations.

(iii) Land and real estate ownership

By establishing a company in Romania, and thus acquiring the status of a Romanian legal person, foreign investors can acquire ownership of real estate, including land. According to EU accession terms, non-resident EU enterprises will be able to buy land as from accession, while physical persons will acquire this right seven years after accession.

However, the costs of administrative barriers to secure rights to property are significant. The number of procedures necessary to transfer a property title from the seller to the buyer is 8 compared to a regional average of 6 and an OECD average of 4. It takes 170 days to register property, compared with the regional average of 133 and OECD average of 34. A similar situation prevails for building permits. In both cases, a lack of policy coherence between the government and regional authorities aggravates the situation. A high-level Romanian official responsible for “business environment” confirmed that this is indeed an issue: regional/local authorities have a tendency to apply subjectively the law and regulations. In choosing a location, potential investors should engage not only the national government but also regional and local authorities before making a decision.

The ownership of land and real estate remains a key issue for foreign investors because the restitution of property to former owners is still in progress. We strongly recommend that research into the title to the land that might be acquired be extremely thorough and go back to the period in the 1940s – 1950s when the property might have been expropriated and nationalized. Heirs to the property owners might bring legal action against the Romanian government with respect to the property, which might affect your rights to or use of the property.

This is an important point, since the Romanian government has recently confirmed that it wants to solve the question of restitution of nationalized property according to the principle of “restitutio in integrum.”<sup>7</sup>

The land issue is key, especially when contemplating a greenfield investment. As an American legal counsel with one of the most extensive experiences in Romania explained: *“In the event of a greenfield transaction, the biggest issues tend to involve the land acquisition – i.e. ensuring that the title is clean, that the purported owners in fact own the land, that there are no encumbrances, that the land is properly zoned for commercial/industrial use (i.e. intravilan, non-agricultural), that all taxes and other financial obligations have been paid. Once the land status has been verified, the next difficult steps involve obtaining all building and construction permits and authorizations – these can be a bureaucratic headache, since depending where the land is located multiple jurisdictions (municipal, ‘judet’/county, etc.) may be involved. Moreover, construction should not be commencing until all permits and authorizations are properly obtained.”* A related aspect mentioned by this legal expert was cost escalation (a concern generally echoed by most of our sources): *“Assuming you have all permits, and commence construction, you need to protect against cost escalations in the construction process. This will involve negotiation of clear and binding contracts with deliverable milestones, timing obligations and penalties for late delivery or quality defects. Hence, we typically recommend to clients that they use more reputable (although typically more costly) construction companies that have the financial wherewithal and requisite experience to back up any construction guarantees and warranties.”*

#### (iv) Government procurement

Romania is not party to the WTO Plurilateral Agreement on Government Procurement. The Law on Public Procurement no. 212/2002 is based on principles of competition, transparency and national treatment for established foreign investors. While the situation has progressively improved (including with the help of on-line tenders in some cases), concerns were expressed by an OECD official about a lack of transparency and derogations granted at political level by the previous government. This could also be the situation in the future.

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<sup>7</sup> See *Le Monde*, 23 avril 2005, « La Roumanie va restituer les maisons confisquées par le régime communiste. » Our source at MINEFI/DGTPE also indicated that *“On ne connaît pas de contentieux grave, sauf peut être à l’amont, pour l’achat de terrains...”*

(v) Protection of the intellectual property rights

Romania is a member of the WTO, the Berne Convention, the World Intellectual Property Organisation, the Paris Intellectual Property Convention, the Patents Cooperation Treaty, the Madrid Convention, and the Hague Convention on Industrial Design, Drawings and Models. In particular, Romania has passed domestic legislation and begun to implement enforcement measures to comply with obligations under the WTO Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS). The WIPO Copyright Treaty has been ratified. When questioned, a high-level Romanian official recognised that here, like in several other areas, enforcement is a problem. For example, prosecutors are not always sufficiently trained to address complex IPR problems. Romania is on an IPR watch list in the USA. Romania can be considered as a medium-risk jurisdiction for companies transferring processes involving high-value technology or sensitive information.

The transfer of technology in and out of Romania is not always straightforward. Honeywell Garrett, the automotive division (turbochargers) of the industrial technology group, ran into problems with the **Romanian Agency for Export Controls (ANCEX)**, when it tried to re-export high-precision machines they had brought into Romania during the first phase of investment. When Honeywell Garrett decided to significantly upgrade its production of turbochargers at its Bucharest plant and bring in new production units, it attempted to re-export some of its machines to a plant owned by a subcontractor, located in former Yugoslavia. Because Honeywell Garrett's machines were deemed to be "dual use", and that it did a poor job when it approached ANCEX, its strategic plans were affected for several months.

***(b) Taxes, incentives and tax administration***

(i) The Fiscal and Fiscal Procedure Code

The new Fiscal Code which was introduced on 1 January 2004 brings together all the existing tax laws and regulations. One year later, in an effort to reduce tax evasion, corruption and informal, non-registered business activity ("grey economy"), the new government introduced a flat 16% rate, replacing personal income tax brackets that ranged from 18% to 40% and a corporate income tax of 25%. These two measures have considerably improved Romania's

business environment. The general view is that the net gains from the lower corporate rate were higher for large firms than for SMEs because a simultaneous increase in a number of fees absorbed most of the gross gains of the SMEs. The value added tax presently at 19% might be raised to 21% as a result of IMF pressure.

The **Foreign Investors Council** is encouraging the government to follow OECD guidelines and align its transfer pricing regulations with that of other countries. While norms published in 2004 constitute a positive development, interviews with Romanian officials have indicated that work on further reform of the transfer pricing regulations is at its early stages. In particular, the tax authorities still have to recognise how important international cost-sharing arrangements are for foreign investors that are part of an international group. More generally, the tax administration needs to deepen its understanding of transfer pricing issues.

A French accounting and taxation expert who recently assisted a large company to invest in Romania indicated that *“en fonction du principe de ‘méfiance’ courant dans les anciens pays communistes, les charges et les produits ne sont comptabilisés que si le ‘document’ est là. Les écritures d’inventaire sont donc très réduites par rapport à ce qu’on peut faire en France. En Roumanie on ne comptabilise que les factures physiquement reçues ou émises avant la fin de l’exercice.”*

Romania has entered a large number of agreements on the avoidance of double taxation, largely based on the OECD model.

(ii) Incentives rooted in the law no.332/2001 on “the promotion of direct investments with a significant impact on the economy”

In addition to the incentives found in the Fiscal Code, an investor can benefit from the following incentives provided that some conditions are met:

- Exemption from the payment of custom duties for the technological machinery, installations, equipment, measuring and control apparatus, automation equipment and software products purchased from Romania or abroad, necessary for achieving the investment, provided that the goods are new, were produced one year at most prior to entry into Romania and have never been used. Custom duties have been abolished on

industrial goods imported from the EU (Law no. 20/1993). Trade policy will become EU prerogative after accession.

- Deduction from profits of 20% of the value of new investments, calculated for the tax purposes in the month the investment is completed. Tax losses generated by these deductions can be carried over against taxable profits during 5 years.
- The use of accelerated depreciation with no obligation for prior approval from the local tax authorities, exempting building investment.
- Exemption from or reduction on the payment of the land tax for up to three years.

According to officials contacted at the **Competition Council of Romania**, the organisation which is in charge of examining the compatibility of various incentives and subsidies with the Romanian State Aid Law (a law which in turn is compatible with the EU provisions in this area), the first two incentives will be abolished upon accession and only the last two items will remain operational. It is to be noted however that although the European Commission did not explicitly demand a re-examination of the law as part of remaining accession requirements, apparently the Competition Council will soon discuss law no. 332/2001.

(iii) Incentives in favour of disadvantaged areas will be abolished upon EU accession. These incentives involve:

- an exemption from payment of customs duties for raw materials and components imported for investing in the area
- an exemption of taxes for withdrawing from agricultural use the land which is the object of the investment.<sup>8</sup>

(iv) Incentives in free trade zones will be abolished upon EU accession. Like several other transition economies, Romania has established free trade zones with special incentives to attract FDI:

- Aid of 50% of the eligible costs of investment made by large companies and 65% by SMEs.

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<sup>8</sup> Government Emergency Ordinance no. 24/1998 on Disadvantaged Zones, as amended by Government Emergency Ordinance no. 75/2000. The disadvantaged zones are strictly limited geographical areas and must meet one of the following conditions: local unemployment level is at least three times higher than the national level for the last 3 months, the region is isolated, lacking communication means and appropriate infrastructure.

- A special customs regime (Law no. 141/1997 of the Romanian Customs Code and subsequent amendments).
- Exemption from VAT under some conditions.

(v) The burden of reporting obligations to the tax administration

Interviews indicate that the fulfilment of reporting obligations to the tax administration constitute a heavy cost for investors, especially for SMEs. The number of monthly tax and tax-related declarations is excessive. The declarations must be submitted either to the Tax Administration or to the agencies administering the respective state fund or both in some cases (e.g. the Unemployment Fund and the Social Contribution Fund).

If there is ambiguity in the tax legislation or in the methodological norm (i.e. application rule), the investor can ask for clarification (i.e. an advanced fiscal ruling) in written form and the Ministry of Finance has an obligation to respond. However, interviews revealed that the deadline for the reply is rarely respected and, also, the information received does not have regulatory power and therefore does not protect the investor against a potentially different view in case of an audit.

***(c) Labour market***

Large segments of the labour force are in low-productivity activities: subsistence farming and loss-making state-owned enterprises. Changes in the labour market are principally driven by job losses in large, state-owned enterprises and job creation by private firms, which are mostly small and medium sized.

Although labour costs are a major consideration for foreign investors, the level of education and the workers' capacity and motivation to learn also matter.

During a recent Franco-Romanian intergovernmental workshop, one participant cautioned that the productivity of the Romanian workforce is not as good as that of Central European nations. Nevertheless, he added that *“on va avoir besoin d'ingénieurs et de techniciens roumains, dans le cadre de délocalisations, car les usines de l'ouest qui délocalisent en Roumanie partiront un jour plus à l'Est vers l'Ukraine ou la Moldavie.”*

The Renault source offered a specific point of view: *“Plutôt employer des femmes que des hommes. Elles sont, en Roumanie, beaucoup plus responsables, éclairées, carrées. Elles réussissent très bien, sont créatives, animatrices, les hommes ne les craignent pas (comme en Occident).”*

The generational issue was mentioned by this source and several other sources: those over 40 have ingrained attitudes sourced in the communist regime, which penalized initiative and creativity. *“Les anciens, il ne faut surtout pas recruter car ils ne sont pas formatés pour un monde de gestion, d’informatique, de performance,”* said the Faurecia source. *“Par contre, la génération montante assure une relève assez superbe mais à laquelle il manque toujours le côté pratique,”* said the Renault source.

At Faurecia, a number of key positions are staffed by expatriates: *“directeur d’établissement, responsable qualité, contrôleur de gestion, logisticien: ils formeront (les roumains) sur le tas, le temps qu’il faut, éventuellement toujours.”*

Geographical (i.e. from one ‘judet’/county to another) mobility is low. In addition to other considerations, this characteristic of the labour market should be kept in mind when an investor chooses a location. While interviews do not suggest that employers encounter particular difficulties in recruiting workers at this time, unemployment is low in several counties and the recruiting situation might change if investment growth accelerates. Our Valeo source confirmed the tightness of the labour market in some areas: *“Si le chômage est à 6% à l’échelle nationale, il n’est que de 2% dans la région de Pitesti. La densité industrielle, la proximité de Bucarest, la compétition entre les entreprises pour s’approprier les meilleurs de la main d’oeuvre qualifiée font qu’une concurrence forte s’arrache les candidats, ce qui entraîne un fort turnover.”*

#### (i) Labour Code

The general view is that labour markets are not particularly flexible and it is difficult to dismiss personnel. According to the World Bank, the cost of firing (the number of weeks of wages in severance, notification and penalties that must be paid to dismiss a worker) is 98 compared to a regional average of 38 and OECD average of 40.

The Labour Code adopted on 1 March 2003 contains a number of restrictive provisions:

- The requirement to contribute, beyond unemployment insurance, to a “wage guarantee fund” to compensate employees in case of bankruptcy is costly (that compensation is twice the amount of the annual wage bill).
- The cap of 8 hours of overtime per week leading to a 48 hours limit on the working week is too rigid for some sectors.
- There is considerable paper work involved with keeping personnel records and with hiring and dismissing personnel.
- The requirement to pay a premium to employees who agree to a “non-competition clause” (i.e. agree not to work concurrently for a competing company during the employment period) is absurd.
- The requirement for employers to establish “work quotas” (which guarantee minimum days/hours of work for both “blue collar” and “white collar” employees) in negotiation with trade unions is unusual.
- The requirement to provide training for all employees on an annual basis rather than according to actual needs is too rigid.

However, top management can be engaged pursuant to individual management contracts. Furthermore, as our source with Trinity Industries, the American transportation equipment manufacturer indicated, *“although the country has a national labour agreement, you can negotiate with the union to change big portions of it... but we had tough times negotiating with labour. It was harder to deal with than we expected. But like all unions anywhere in the world, it is mostly function of their leader. In our case, the union leader was tough. Also, it is sometimes hard to communicate Western concepts.”*<sup>9</sup>

There is a strong likelihood that the new government will review the Labour Code in 2005, to meet concerns of the business community. In fact, the government has agreed within the framework of the Stand-by-Agreement with the **IMF** to submit to Parliament a number of amendments to the Labour Code and it is presently engaged in active consultations with social partners. Moreover, a “twinning” project with Spain started in April 2005 aims to harmonise the Labour Code with EU norms.

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<sup>9</sup> Our source continued : *« Particularly, they do not understand how to do more with less – they thought they needed more people in order to increase production and did not believe we could quadruple production with half the employees. »*

(ii) Labour costs

Wage-setting is essentially done at the enterprise level but there are also industry-wide negotiations. Collective labour contracts and powerful trade unions have limited the capacity of the government to enforce a restrictive wage policy in the state-owned enterprises. As a result, wages in these enterprises have tended to be above productivity levels. In June 2002, the trade unions have also pressured the government into an unexpected increase of 43% in the economy-wide minimum wage. Although higher public-sector wages tend to spread to the economy as a whole, the perception is that collective bargaining has tended to produce responsible outcomes in private enterprises.

Depending on the size of the facility, workers have the right to try to unionize, if they want. In the experience of a long time expatriate legal counsel, this has not been as much of a problem with privately run facilities. Workers recall from socialist times that the unions did not always protect their best interests and if the management is transparent and provides appropriate incentives to the work force, the workers can usually be dissuaded from unionizing or otherwise engaging in labour unrest activities. This was echoed by our Renault source: *“Comme les entreprises étrangères paient tous les mois, ça calme.”*

Various sources indicate that average and median gross earnings in Romania are much lower than in all recent EU members. There are important earning differential across counties with Bucharest and Timisoara at the upper end and Moldova at the lower end. A high-level international official mentioned that some investments originally located in Hungary and Poland have lately been moving to Romania to take advantage of the difference in labour costs.<sup>10</sup>

(iii) Work permits for foreign nationals

Work permits are issued by the **Office of Labour Immigration**. A permit gives foreign citizens the right to be employed under an individual contract with legal and natural Romanian persons or with authorised branch offices in Romania of legal persons based abroad. This process is not always entirely smooth.

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<sup>10</sup> See *New York Times*, 2 September 2003, « Just East of the West, Unity Has Its Costs. »

***(d) The judiciary system and corruption***

**(i) The judicial system**

Opinion surveys indicate that while the trust of Romanians in their political elite is roughly similar with the perception prevailing in other transition countries, their trust of in judicial system is far below average. Despite the reform of the judicial system, reports by the European Commission indicate that the rule of law (i.e. ensuring legal rights through the proper enforcement of laws and regulations) is still the key institutional weakness of the business environment.<sup>11</sup>

Even if the EU *acquis communautaire* is adopted in the sense of “law in the books”, when it comes to “law in action” the court system is struggling to keep pace and ensure that the judicial system is giving full support to a well-functioning market economy and the enforcement of investors’ property and contractual rights. An important step was the passing of a new law establishing specialised commercial courts. Second, the independent Superior Council of Magistrates was established with responsibility for the recruitment and career of judges and prosecutors.

Recognising the remaining deficiencies, the government is actively working on the reform of the judiciary and aims to comply with the obligations undertaken under the EU accession procedure. To this end, the new government released in April 2005 a strategy for the reform of the judicial system (2005-2007) together with a detailed action plan for implementation with deadlines, clear institutional responsibilities, budgets and performance assessment indicators. The objectives include guaranteeing the effective independence of the judiciary; increasing the efficiency and accountability of the judiciary; strengthening the business environment and preventing and combating corruption within the judiciary. While this was not spelled out as a policy, people interviewed have suggested that the government is planning *de facto* a generational change in the judiciary where many judges have been appointed during

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<sup>11</sup> In fact, the safeguard that postpones accession by one year can be decided with qualified majority among member states (instead of the unanimity normally required) if it is based on shortcomings in Romania’s fulfilment of commitments in the area of Justice and Home Affairs (see the European Commission’s Report on the Results of the Negotiations on the Accession of Bulgaria and Romania to the European Union, DGEI 5859/05, February 2005).

the communist regime. According to the same interviews, recent appointments are encouraging.

A number of measures will be specifically targeted to the strengthening of the business environment: specialising magistrates in commercial matters; unifying the jurisprudence in commercial matters; reducing the duration of procedures; and establishing more efficient insolvency procedures. Until now, bankruptcy proceedings were difficult and expensive and rarely introduced. Because of weak effective enforcement of the bankruptcy legislation, some companies have faded away without legal procedures and creditors were left without protection.

#### (ii) Enforcement of contracts

The ease or difficulty of enforcing commercial contracts can be measured by the number of procedures counted from the moment the plaintiff files a lawsuit until actual payment, the associated time, and the cost (in court and attorney fees), expressed as a percentage of debt value. According to the World Bank, the cost of enforcing contracts as a percentage of the debt involved is in Romania 12.4, compared with the regional average of 17.7 and OECD average of 10.8.

#### (iii) Arbitration of investment disputes

Investor risks are commonly addressed by including appropriate dispute settlement provisions in a contract. This raises the issue of enforceability of these contractual provisions in the event of a dispute. Interviews indicate that the international arbitration is the safest option in this regard and it is widely used. Romania has entered a large number of bilateral agreements on the promotion and reciprocal protection of investment. The right of establishment in these agreements follows EC rules. Post-establishment clauses are largely based on the OECD model.

According to a high-level official, only one arbitration case is ongoing where the Romanian state has been involved: **Noble Venture**, an American investment group, purchased **Resita Steel**, the country's third-largest steel plant, for USD4.5 million, assumed outstanding debt on its books and promised to invest USD85 million. While Noble argued that Romania promised

to reschedule this debt, Romania's position was that it only promised to try to restructure it. Romania retook control of the factory in 2001 and Noble filed an arbitration case against the country at the World Bank's International Centre for Settlement of Investment Disputes within the framework of Romania's bilateral agreement with the United States on the promotion and protection of investment.

The main point of the Resita Steel dispute is the point made by at least two sources from the private sector: governmental instability. This was the first and main point emphasized by Trinity Industries, the transportation equipment manufacturer that purchased four state-owned enterprises in Romania: *"My main problem was government change... Attitudes can change so suddenly. It was quite disconcerting."*

Another source, an executive from Renault said *"Il faut être en permanence à l'affût des changements qui interviennent en ce domaine et où les roumains excellent, car rien n'est jamais figé. D'où la nécessité d'une 'tête chercheuse' roumaine pour rectifier le tir en permanence, régler les problèmes entre roumains, ce qu'un étranger ne saura jamais faire."*

Indeed, what happened in the Resita Steel case is that the Nastase government, when it came to office in 2000, reneged on the terms agreed to by the previous government and refused to reschedule the USD35 million in unpaid tax and utility debt. There might also be a deeper political side to this case and two similar cases: the fact that Romania has sold a number of its steel and other metals works (aluminium) to Russian investors. Resita Steel was taken away from Noble and sold to **TMK**, a Russian steelmaker. **Otelu Rosu** was also taken away from an initial investor (**Gavazzi Steel** of Italy) and sold to **Ductile Steel** of Russia.

#### (iv) Corruption

Romania has ratified the Criminal Law Convention of the Council of Europe and has a well-developed anti-corruption legislation. Surveys indicate however that corruption is perceived as a widespread problem by foreign investors as well as by Romanians who have recently elected a president who campaigned on an anti-corruption platform.

According to **Transparency International's** Corruption Perception Index, Romania was consistently the worst performer among EU accession countries since 1997. A recent

independent audit carried out by the American think-tank **Freedom House** claimed that because of a lack of political and professional independence, public prosecutors “*considered many public persons who should have been prosecuted invulnerable.*”

The new government released a national anti-corruption strategy (2005-2007) in April 2005. Given the complexity of the problem and the fact that anti-corruption institution building and training require time, several Romanian and international officials believe that only slow progress can be expected in the fight against corruption.

Measures targeted to areas vulnerable to corruption in the business environment include the recent revision of the fiscal evasion and bankruptcy provisions. The government also plans to introduce more transparency in the criteria governing rescheduling of and exemptions from the payment of arrears to the state budget.

Notwithstanding the above, dealing with corruption offences will remain a regular burden for foreign investors for some time to come. However, its negative impact on the business environment is partly compensated by its predictability. Interviews indicate that foreign investors tend to see corruption as a lesser problem than in other countries because it is common knowledge how much to pay to whom and, importantly, results are generally obtained following payment.

In other words, while micro-corruption clearly increases business transaction costs, it seems to be seen more like “grease” than “sand” in the wheels of these transactions. Yet, according to a senior representative of a business organisation, demands for illicit payments should be resisted vigorously because a single payment will trigger many other requests from various sources. Who pays bribes is also common knowledge.

This was corroborated by private sector sources and legal counsel: “*I would recommend against paying any bribes or “spaga”, as this practice is coming under increasing scrutiny, especially with the upcoming accession and increased anti-corruption drives – recently ABB has been in hot water for bribes allegedly paid to a former Bucharest mayor.*”

## Recommendations

We recommend engaging in a well-planned lobbying campaign on an on-going basis. This entails getting to know the local power players, building detailed personal profiles of all key stakeholders, identifying the best networks of local professional or informal lobbyists, and informing them of the benefits of the project for the community, emphasizing that the project will bring jobs and higher wages to their local constituencies.

With most difficulties encountered in the areas of regulatory and administrative opacity, and the fluid nature of contractual obligations – particularly with the state – our sources emphasized the necessity of a continuous dialogue with relevant authorities, as the best way to stay one step ahead of any changes in your immediate business environment.

Because so much importance is given to the labour factor – the first competitive advantage of an operation based in Romania, but also an area with which all foreign investors appear to have struggled at times, we paraphrase one of our sources: « *Têtes bien pleines plus que bien faites.* » The competitive advantage is a potential that can be unlocked by careful management of the Romanian work force.

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