COUNTRY BRIEFING ROMANIA

Vienna Institute for International Economic Studies

Industrial Policy for a New Growth Model

Country Briefing Romania

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This publication is edited by the FES programme on Economic Development in Central Eastern and South Eastern Europe »European Economies of the East«. The program is headed by Ernst Hillebrand.

Please find all the publications of the programme under its webpage:
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Special thanks to Maciej Grodzicki (Jagiellonian University), Michael Landesmann (wiiw), Julie Pellegrin (CSIL), Slavo Radosevic (UCL) and Roman Stöllinger (wiiw, WU) for their valuable inputs and guidance in the writing of the report.

CENTRAL AND EASTERN EUROPE NEEDS INDUSTRIAL POLICY TO ESCAPE THE MIDDLE INCOME TRAP

Since the early 2000s, the EU member states of Central and Eastern Europe (EU-CEE) have achieved an impressive economic catch-up process. However, the previously successful model of taking over labour-intensive production steps as an 'extended workbench' of Western corporations has reached its limits. Combined with major global challeges such as decarbonisation and digitalisation, this makes it essential for EU-CEE to develop a new, innovation-based economic model. Only then will these states be able to complete the catch up with Western Europe in terms of productivity and living standards. The situation is exacerbated by the economic consequences of the war in Ukraine, such as permanently higher energy prices and higher inflation, which pose grave challenges for the region's external competitiveness.

The problem is that the central technological competences and those parts of production with the highest added value are located in the 'headquarter economies' of Western Europe. Meanwhile, the EU-CEE countries – Poland, Czechia, Slovakia, Hungary, Slovenia, Croatia, Romania, Bulgaria and the three Baltic states – are still extremely specialised in labour-intensive production. They depend heavily on lower labour costs, and this restricts their prospects of catching up economically with Western Europe. A good example of this is the car industry, which is so important for the region as indicated by its high share of value added, jobs and exports, especially in the Visegrád states, Romania and Slovenia.

The study shows that the EU-CEE countries have so far lacked a constructive approach to industrial policy in their development trajectories. They have had a very broad ranging FDI promotion policy, weak investment environments for start-ups, and the activities of state-owned enterprises have not been aligned with the greater development goals. In general, there is a lack of state entrepreneurship in these countries that could nurture promising industries. This is particularly challenging for regions that are lagging behind within countries, as they lack the technical capacities for industrial policy. Due to these factors, the study argues that the EU-CEE countries are struggling to get out of their middle income trap.

Their EU membership offers unique opportunities for industrial policy, but also challenges. On the plus side are access to funds, participation in research networks and the opportunity to shape industrial policy on the EU level. Importantly, industrial policy in the EU has taken a much more prominent role in recent years as shown by initiatives such as the European Chips Act or the Important Projects of Common European Interest (IPCEI). This provides some momentum for the development of industrial policy in the EU-CEE countries. Strict state aid rules and an EU competition policy that gives preference to free market principles, on the other hand, are challenges for an effective industrial policy.

As discussed above, the growth model of the EU-CEE countries must be made fit for the future. Decarbonisation, digitalisation and a shrinking labour force require massive efforts to be made. For countries like Poland, the green transition is a major challenge. This transition can only be managed through huge public investments in green technologies and digitalisation, combined with the right conditions for private enterprise to thrive, to create a fully joined-up approach combining the best of the public and private sectors and academia. This means more money for education, research and development, as well as active labour market policies to manage the transition.

Above all, however, the countries of the region need a strategically oriented industrial policy to support the emergence of more globally competitive companies and to emphasise their own economic strengths. While a true "entrepreneurial state" may be too ambitious for many EU-CEE countries in the coming years, steps in this direction are the way to go. We propose eight steps, that should be taken:

1. Create a national innovation system in each country, bringing together the private sector, universities, key ministries, and business agencies. Within this biotope, new ideas can be developed, tested, and financed. Each country should define which sectors and specialisations are promoted, rather than relying solely on external market forces.

2. Make full use of EU funds and maximise participation in EU research initiatives to advance industrial policy goals. Governments should also get more involved in industrial policy debates at the EU level. Greater participation in the EU's Horizon Europe research funding programme or in the EU's Important Project of Common European Interest (IPCEI) initiative would also be particularly important for the region's technologically less advanced countries.

3. Learn from each other's successes stories to emerge as frontrunners in the digital economy. Estonia is generally well prepared in this area and often raised as an example. However, there are also other positive cases in the region. Romania and Croatia have a particularly high proportion of graduates in ICT, relevant for digitalisation. Czechia shines with its digital start-ups, the Baltic states with the quality of their digital public services. The Visegrád countries and Slovenia have highly digitalised and automated industries.

4. Harmonise investment schemes to attract foreign companies with national industrial policy. Instead of providing blanket support for all investments by foreign companies, national governments should strategically consider which sectors and parts of the value chain they want to attract, and create incentives that maximise the potential for spillovers from foreign giants to domestic firms.

5. Identify and exploit promising niches. Given the lack of technological experience, the establishment of the semiconductor industry in the EU-CEE countries, for example, would not be very promising. However, each country has traditional strengths that should be built upon.

6. Institutional reforms. In some states of the region, the quality of public institutions has declined significantly in recent years. This is worrying. Countries in East Asia have a lot of experience in building adequate institutions for an active industrial policy, even if the framework conditions there partly do not meet Northwest European standards. This experience should be used.

7. Structural change must be cushioned socially in order not to lose the support of the population. EU-CEE countries should aim for a flexible labour market to ease the transition from old to new jobs, but underpin this with extensive retraining programmes and a social safety net that means that workers themselves do not bear the costs of the transition.

8. Each country needs a tailor-made industrial strategy adapted to its specific needs. While the Baltics, for example, are well positioned for the digital transformation, they are struggling above all with distribution problems and a shrinking population. Czechia, Poland or Slovenia are industrially the most advanced, but must make the transition from ‘extended workbench’ to innovative economy. For the less developed parts of EU-CEE such as Bulgaria and Romania, the priority should be on maximising the transfer and knowledge and innovation from big foreign investors.

COUNTRY BRIEFING ROMANIA

COUNTRY OVERVIEW

Romania is the second poorest country in the EU, only ahead of Bulgaria, in terms of GDP per capita, but strong purchasing power puts it in a row with Slovakia and Hungary. Following a decade of fast economic growth, Romania was classified as a high-income country in 2020 by the World Bank and entered negotiations to join OECD in 2022.

The country has medium-high level of industrialisation with higher-than-average structural sophistication. The share of manufacturing has fallen below 16 per cent of GDP in recent years on account of a fast expansion in wholesale and retail trade. Romania has joined the central European car industry hub by attracting FDI. Dacia, a subsidiary of Renault largely relies on domestic components and has been successful internationally among the low-cost brands. Several international car component producers are present with a wide range of products. The most important are the Mercedes-Benz subsidiaries Star Assembly and Star Transmission in Sebes, where the construction of a factory for electric engines is about to start. Romania has retained a number of traditional labour-intensive industries such as the production of apparel and furniture. The country has good potential for expanding food production and a tradition in the chemical industry. Labour productivity (gross value added per persons employed) in manufacturing is second lowest in the EU; there is no single manufacturing activity with a significantly better position.

Romania's main economic success story is the ICT sector. Despite the country's poor DESI index, high readiness for digital transition and increasing skills make Romania a growing digital outsourcing destination. A handful of start-ups have achieved international reputation with own products. The robotic process automation company UiPath is the first Romanian unicorn listed on the New York Stock Exchange after reaching a valuation of USD 1 bn.

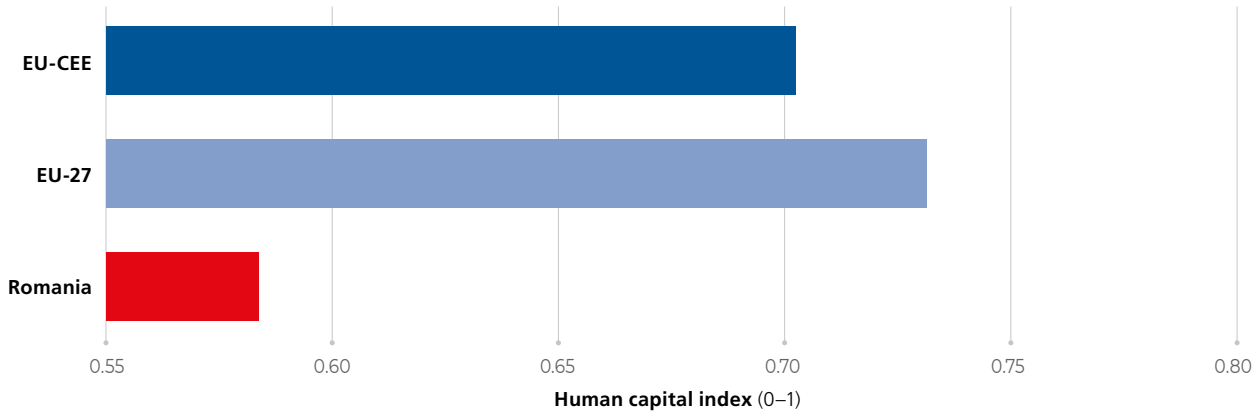
Large income and educational polarisation hinder industrial development. Romania has the lowest share of income held by the poorest quintile and one of the lowest employment rates and HCI index in the EU. An educated and digitally skilled urban middle class coexists with a traditional rural population not fit for matching modern industry's labour demand. The country is lagging most EU-CEE peers in terms of competitiveness, transition performance, especially as regards economic and social transition. But it is 10th best in the EU in terms of environmental transition following the shutdown of many of the polluting heavy industry plants built under communist rule. The governance indicator rank is close to average only because public finances are in relatively good shape. But the country has one of the highest corruption perception rates and is second worst in terms of voice and accountability in the EU.

Industrial development – I

	Competitive industrial performance index	Manufacturing value added (MVA) (% of GDP)	Medium- and high-tech MVA (% of total MVA)
Romania	0.09	18	44
EU-27	0.14	15	41
EU-CEE	0.10	17	38

Note: 2020 values. The CIP index assesses the strength and complexity of an economy's industry, with Germany claiming the maximum score in 2020 at 0.42.
Source: UNIDO

Human capital quality



Note: A Human Capital Index of 0.75 means a child born today will be expected to be 75 percent as productive at the age of 18 as they would against a scenario of having enjoyed complete education and full health.
Source: World Bank

INDUSTRIAL COMPETITIVENESS – SWOT

Strengths

- The diversified industrial base allows for producing a wide variety of products limiting dependence on volatile international supply chains.
- Energy security is provided by domestic oil and gas resources as well as abundant though irregular supply of hydro-energy which provides 36 per cent of the generated electricity. Government grants based on EU funds have attracted large private investments in green transition including photovoltaic parks.
- There are numerous SMEs in the software industry, many of them internationally based. Low taxes attract specialists and reduce brain drain in the ICT sector.

Weaknesses

- Backward transport infrastructure is a bottleneck for just-on-time deliveries. The construction of the motorway network is behind schedule.
- Labour intensive and energy intensive industries have relatively high share in the manufacturing production. A large part of the labour force is tied in low value-added industries, has limited skills and gets inadequate training. The country has a relatively small share of digitally educated population.
- Romania has the lowest R&D expenditures in % of GDP in the EU. It has also the worst innovation index and DESI. Many of the past government development programmes were either ill-prepared or only partly implemented failing to bring improvement.

Opportunities

- Access to large EU funds in the amount of 5–7 per cent of GDP annually helps to improve infrastructure and provides solid funding to digital and green transition. The country participates in related EU programmes which can spread knowledge and give financial support.
- Large number of internationally successful software firms can have spill-over effects to manufacturing companies. The ICT industry could grow faster if qualified labour would be more abundant.
- Climatic conditions are favourable for the further development of photovoltaic and wind parks.
- State ownership in a large part of the industry could enhance structural change and generate islands of modernization.

Threats

- Shrinking population mainly on account of emigration combined with low participation rate limit the access to new labour force.
- Large social inequality and the backwardness of rural areas hinder the spread of digital and industrial skills and the education of a wider labour force.
- Administrative and institutional bottlenecks can hinder the access to EU funds. The tendering process is slow and cumbersome.

INDUSTRIAL POLICIES AND STRUCTURAL REFORM DEVELOPMENTS

FDI promotion and value chain upgrading

- A liberal economic environment, low taxes and educated urban workforce have attracted export oriented FDI in manufacturing and services. The government sees its main reform task in enhancing competition and managing the access to EU funds.
- FDI and general investment policy priorities support technological change and R&D by tax allowances. Two state aid schemes are in place to support FDI with a total budget of EUR 1.5bn for the 2014–2023 period which is a rather small amount in comparison to the expected investment volumes. Aid is available to all investments in all sectors above a certain size of investment. Industrial parks offer ready-made infrastructure and locate most of the modern manufacturing projects.
- The Romanian state has one of the smallest budgets in percent of GDP in the EU, thus it has limited own resources to finance industrial policy programmes. The role of the state is large in industry as the main energy

sector companies and mines are state-owned. State ownership may enhance modernisation programmes but the government is mainly engaged in inefficient cross-subsidisation.

New technologies, digitalization, innovation

- Romania is a policy taker of EU priorities to attract the available funding. Institutional capacities are overstrained by external requirements; no room remains for autonomous setting of goals. Nevertheless, EU programmes are adequate in size and content to raise competitiveness and improve living conditions. The country benefitted from EUR 35bn development financing under the 2014–2020 financial framework in which environmental protection and low carbon economy projects were supported with EUR 6bn. It will receive EUR 31.5bn from the Cohesion Fund in 2021–2027. The country can also benefit EUR 29bn in grants and loans from the RRF over three years, of which 41 per cent will support green transition and 20 per cent the digital transition.
- The RRF Digital Transformation pillar provides about EUR 2bn for the development and improvement of e-government, governmental cloud and electronic ID cards. The National Strategy on Digital Agenda targets the development of ICT skills for citizens, labour force and digital experts. These programmes are expected to increase the efficiency of public administration.
- Multinational companies, especially in the automotive cluster are well integrated in national and international value chains. Development programmes can rely to a great extent on local suppliers and international suppliers from the neighbourhood.
- A recent industrial policy priority is military industry. New production facilities involve FDI or other forms of international cooperation to increase the capacity and modernize the production of weapons.

Green transformation of industry

- The greenhouse gas emission per capita is second lowest in the EU; it is in the mid-field in relation to GDP. EUR 6.75bn EU funds will be available for green transition under the 2021–2027 financial framework, for developing green energy, reduction of carbon emissions, environmental infrastructure, biodiversity conservation, green spaces, risk management and sustainable urban mobility measures. Companies will be invited to tenders to improve their processes and to supply inputs to public investment projects.
- Investments from the same funds is planned to improve the energy performance of residential and public buildings and to develop renewable energy sources and smart energy systems. Projects will reduce energy consumption, support the decarbonisation of the energy sector and generate demand for a wide range of products which domestic suppliers could deliver.
- The government's recent short-term initiatives go partly against mid-term priorities. In response to the current energy crisis, they have declared to reactivate coal-fired power plants, earmarked substantial funds for gas infrastructure and gas-fired power plants and a law was passed to promote the production of fossil gas and crude oil.

COUNTRY-SPECIFIC RECOMMENDATIONS

In the main part of the study, we identify Romania as one of the least developed parts of EU-CEE, falling most notably behind the technological frontier. Therefore, policymakers should make it a priority to import knowledge and capabilities in a strategic and targeted way, and to identify promising areas for leapfrogging opportunities. Specifically, we propose the following policy priorities:

- **Increase institutional capacity and build government-industry-research-university linkages to coordinate industrial policy.** Cooperation and synergy effects could increase funding, improve targeting and coordination of R&D activities and the use of available knowledge (see policy recommendation 5.1 of the main report). Horizontal and vertical cooperation could increase the efficiency of public institutions, enable state entrepreneurship, and generate strategic programmes for economic modernisation.

- **Increase fiscal space to be able to finance a pro-active industrial policy, R&D activities and improve the efficiency of public spending.** Although low taxation is a competitive edge attracting FDI, investors need better infrastructure, higher qualified workforce and digital public services to bring more sophisticated technology into the country which can only be attained by public investments. This echoes the point we raised in the main report, that FDI policy ought to be a part of an overall industrial policy mix, and aligned with a national Innovation strategy (see policy recommendation 5.4).

- **Efficiency of spending should also be enhanced by increasing administrative capacity, improving decision-making processes and streamlining public administration.** Faster tendering and implementation of required reforms should accelerate the access EU funds. As the second poorest country of the EU-CEE, making use of all the available EU financial instruments is particularly vital (see policy recommendation 5.2 in the main report). Corporate governance of state-owned enterprises should improve to increase efficiency and meet long-term modernization goals.

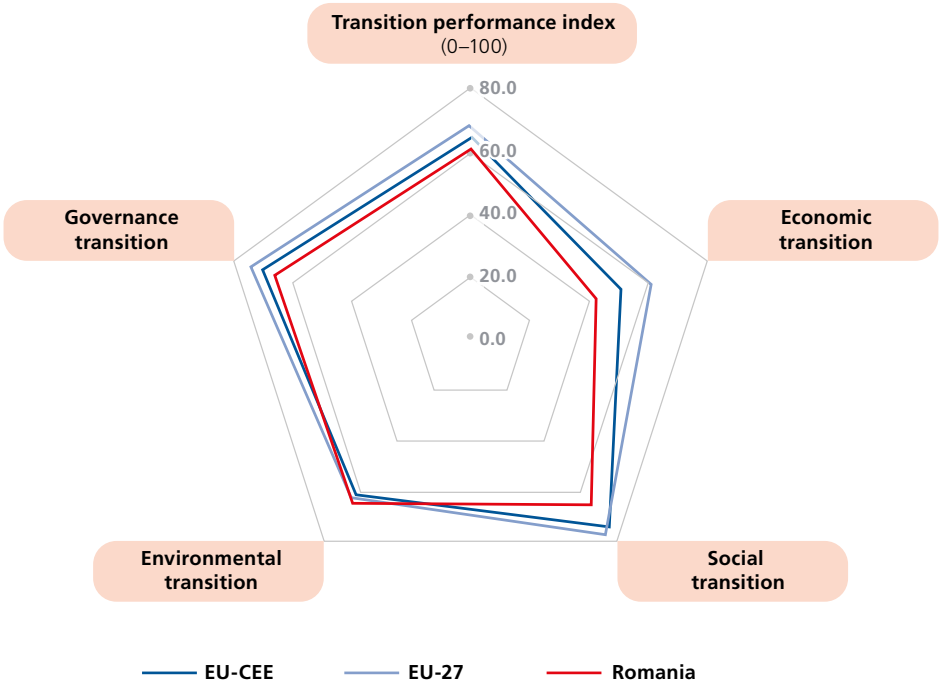
- **Improve education and skills on all levels of the education system to improve labour qualification and participation.** As emphasised in the main report, successful industrial policymaking considers distributional implications and balances growth with equality. In this sense, social equity should increase the mobility of rural labour force to mitigate urban labour shortages. Increasing labour market participation should be supported which, in turn, would mitigate poverty.

Industrial development – II

Sector	Percent of manufacturing employment
Motor vehicles, trailers and semi-trailers	15.7
Food products	13.3
Wearing apparel	10.4
Fabricated metal products, exc. machinery and equipment	7.4
Rubber and plastic products	5.5
Furniture	5.1

Note: 2018 values.
Source: Eurostat Structural Business Statistics.

Transition performance scorecard



Note: 2020 values. The TPI scores countries based on 4 pillars of a transition to a more sustainable, inclusive and resilient economy.
Source: European Commission

Romania

COUNTRY OVERVIEW

Romania is the second poorest country in the EU with a medium-high level of industrialisation. Labour productivity in manufacturing is second lowest in the EU

Relatively strong ICT sector, making Romania a growing digital outsourcing destination.

Income and educational polarisation are high and the rural population not fit for matching modern industry's labour demand.

INDUSTRIAL DEVELOPMENT

	Competitive industrial performance index	Manufacturing value added (MVA) (% of GDP)
ROMANIA	0.09	18%
EU-27	0.14	15%
EU-CEE	0.10	17%

Note: 2020 values.
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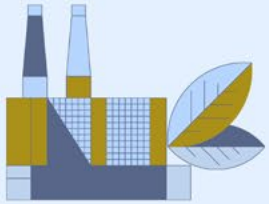

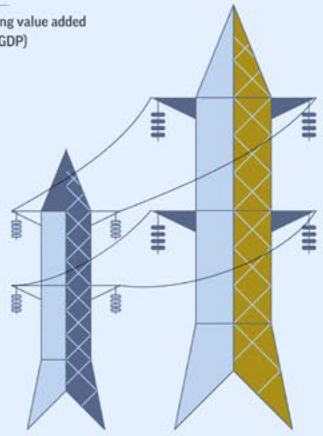

INDUSTRIAL COMPETITIVENESS – SWOT

STRENGTHS

- Diversified industrial base allowing the production of a wide variety of products.
- High energy security due to domestic oil and gas resources and abundant though irregular supply of hydro-energy.
- Large private investments in green transition including photovoltaic parks.
- Numerous SMEs in the software industry. Low taxes attract specialists and reduce ITC-brain drain.

WEAKNESSES

- Backward transport infrastructure is a bottleneck for just-on-time deliveries.
- High share of labour- and energy intensive industries in manufacturing.
- Large part of the labour force in low value-added industries, with limited skills and inadequate training. Relatively small share of digitally educated population.
- Romania has the lowest R&D expenditures in % of GDP in the EU.

OPPORTUNITIES

- EU funds help to improve infrastructure and provide solid funding to digital and green transition.
- Large number of internationally successful software firms can have spill-over effects to manufacturing companies.
- Climatic conditions are favourable for the further development of photovoltaic and wind parks.
- State ownership in a large part of the industry could enhance structural change and generate islands of modernization.

THREATS

- Shrinking (working) population.
- Large social inequality and the backwardness of rural areas hinder the spread of digital and industrial skills and the education of a wider labour force.
- Administrative and institutional bottlenecks can hinder the access to EU funds.

WHAT SHOULD BE DONE?

COUNTRY-SPECIFIC RECOMMENDATIONS

- Policymakers should make it a priority to import knowledge and capabilities in a strategic and targeted way via FDI, and to identify promising areas for leapfrogging opportunities.
- **Increase institutional capacity and build government-industry-research-university linkages to coordinate industrial policy.**
- **Increase fiscal space to be able to finance a pro-active industrial policy, R&D activities and improve the efficiency of public spending:** investors need better infrastructure, higher qualified workforce and digital public services
- **Efficiency of spending should also be enhanced by increasing administrative capacity, improving decision-making processes and streamlining public administration.**
- **Improve education and skills on all levels of the education system to improve labour qualification and participation.**

IMPRINT

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ISBN 978-615-6289-49-0

Design/Typesetting: pertext, Berlin
Cover photo: Nataliya Hora / Shutterstock.com

Industrial Policy for a New Growth Model: A Toolbox for EU-CEE Countries

This country briefing is a short summary of a much broader study that deals with the perspectives of industrial policies in Central Eastern and Southern Eastern Europe and the question how these countries can avoid to get stuck in a middle-income trap. The study has been authored by a team of experts from the Vienna Institute for International Economic Studies on behalf of Friedrich-Ebert-Stiftung.

The study argues that the EU-CEE countries have so far lacked a systematic approach to industrial policy in their development trajectories. They have had a very broad ranging FDI promotion policy and weak investment environments for start-ups, while the activities of state-owned enterprises have not been aligned with the greater development goals.

Hence, the growth model of the EU-CEE countries must be made fit for the future. Decarbonisation, digitalisation and a shrinking labour force require massive efforts to be made. This transition can only be managed through public investments in green technologies and digitalisation, education and infrastructure, combined with the right conditions for private enterprise to thrive.

The study includes eleven country profiles that analyse the economic and industrial structures for their strengths and weaknesses and identify possible courses of action for an active industrial policy.

The full study can be found here:
http://library.fes.de/pdf-files/bueros/budapest/20260.pdf

Industrial Policy for a New Growth Model: A Toolbox for EU-CEE Countries
Vienna Institute for International Economic Studies, Friedrich-Ebert-Stiftung Budapest, 2023, 103 Seiten, ISBN 978-615-6289-36-0

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