Payment arrears have been an endemic phenomenon throughout Romania's economic transition and have been widely used as financing for both state-owned and private companies. Political economy considerations and a vertically-integrated industrial structure lay behind the persistence of arrears. Only in recent years the accumulation of new arrears to general government has been significantly reduced, thereby improving fiscal transparency and reducing the hidden subsidies provided to households and companies via the tolerance of unpaid tax and social security obligations. Efforts to step up the restructuring of state-owned enterprises and stricter enforcement of overdue claims lay behind these results. The repeated use of debt cancellation has given rise to adverse incentives and seems to have failed in improving financial discipline. Weak creditor protection and protracted bankruptcy proceedings remain main obstacles to effectively hardening the budget constraint.

Weak financial discipline is a persistent problem

In Romania, continued accumulation of payment arrears has been a long-lasting problem. Although decreasing over recent years, the stock of arrears in the economy remains stubbornly high at 20% of GDP. Most creditors continue to be faced with non-paying clients and large uncollected receivables (Chart 1).

Chart 1: Total arrears by creditor

Source: Ministry of Public Finances of Romania

* Directorate for International economic and financial affairs.

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The accumulation of new arrears to general government, notably in the form of unpaid tax and social security obligations, constitutes a substantial hidden subsidy to the private sector, both because debts have systematically been cancelled or rescheduled on favourable terms and because the interest and penalties imposed on overdue payments are often low compared to market financing conditions. In this way, the tolerance of arrears has been used to support loss-making state-owned companies, which increases the deficit of the public sector in a broader sense. The accumulation of arrears is also closely linked to the use of off-budget state guaranteed loans to energy sector companies, which have provided energy below cost recovery level and have been lenient with non-paying clients. These features have hampered fiscal transparency. Attempts to clear net arrears through injections of base money have also delayed the disinflation process. As a soft budget constraint makes companies less prone to change behaviour in response to market changes, the tolerance of arrears have as shown by Djankov and Murrell (2000) also had a negative impact on the allocation of resources.

Contrary to many other transition economies, the accumulation of arrears in Romania has not been temporary and is not confined to the relationship between state and public enterprises. The persistence of the problem at a broadly unchanged level and the widespread use of arrears as financing for both public and private companies make Romania’s situation particular. Arrears between enterprises account for about 10% of GDP (Chart 1). A large part of these arrears is unpaid utility bills. Arrears to banks stand at about 1% of GDP after having topped in the late 1990’s. Overdue payments of tax and unpaid social security contributions have declined only slowly to around 6% of GDP in mid-2005. Other arrears, predominantly unpaid wages, account for around 4% of GDP.

The stock of arrears provides only a proxy for the problem of financial indiscipline. In Romania, frequent debt write-offs have lowered the stock without any improvement in discipline, while better accounting practices and incurred interest and penalties have increased the stock without worsening financial discipline. The existence of chains of arrears, for example between end-user, supplier and producer of energy, also implies some double-counting. Finally, from an economic point of view, the flow of new arrears rather than the stock would best reflect the evolution of financial discipline. Due to limitations in the official data, it is not possible to fully factor in these issues, but the change in the stock of arrears is a proxy for the accumulation of new arrears (Chart 2). Banks effectively hardened the budget constraint for their clients after the banking crisis in the late 1990’s. Progress in reducing new arrears to general government and between companies was slow until 2003. Since 2003, restructuring of state-owned enterprises and stricter enforcement of overdue claims have begun to yield results, even if Romania estimates new arrears to general government, called state guarantees and the losses of state-owned enterprises to still amount to 2.6% of GDP in 2004 (Romania, 2005).

Political and economic considerations lay behind the accumulation of arrears

Two main strands of theory seek to explain the existence of soft-budget constraints in transition economies, and both may help understanding the occurrence and
The persistence of payment arrears in Romania. In political economy models, the government aims typically at preserving employment, for example in order to alleviate the social impact of transition. A simple bargaining model in which company managers call for subsidies against the promise of maintaining employment, while politicians provide budgetary aid, may explain why a loss-making company is kept running (Shleifer and Vishny, 1994; Staehr, 1993).

The experience of Romania as well as other transition countries (Schaffer, 1995 and 1998) confirms that political economy considerations often explain why unprofitable enterprises are kept operational by providing financial aid. In Romania, regional dependency on certain enterprises, the heritage of an industrial structure with strong vertical linkages and close links between politicians, managers and trade unions, may help understand why soft budget constraints have been widespread and persistent. The private sector represents today two thirds of all arrears in Romania. While this reflects the privatisation process, it also shows that change of ownership may not in all cases improve financial discipline. If tolerated by creditors or if low creditor protection prevails, as in Romania, also private enterprises will be inclined to not meet their obligations. State-owned enterprises do, however, represent a relatively large share of arrears to the state and Hildebrandt (2002) has shown that in Romania state ownership is a strong determinant for higher arrears. On the basis of the financial reporting of 49.000 Romanian companies, Fennema and Schaffer (2003) show that financial difficulties increases the likelihood of tax arrears. Weak financial performance is again related to the degree of state-ownership (Chart 3). Continued public ownership of many companies combined with low profitability is therefore a main explanation for the arrears phenomenon in Romania.


![Chart 3](image)

Source: Own calculations based on Ministry of Public Finances of Romania

Imperfect information models see the continued extension of credit to loss-making companies as a rational economic choice by a creditor. Due to information imperfections, which are pronounced in a transition environment, some economically unworthy projects will initially receive financing. When subsequently faced with a non-performing project, the wait-and-see option of refinancing rather than bankruptcy proceedings may be the optimal choice for the creditor (Maskin, 1999; Perotti, 1993). These models may in particular help explain inter-enterprise arrears (Condon and Ramachandran, 1995). In order to keep production going while redirecting sales, it may be rational to extend a trade credit to another company even if it is financially shaky. However, when the debtor does not pay, the creditor may be faced with a liquidity squeeze. In a vertically-integrated industrial structure, as in Romania, even profitable enterprises may therefore resort to overdue trade credits. This may lead to the spreading of arrears. Hildebrandt (2002) shows that in Romania, a company’s overdue claims on clients are a strong determinant of the company’s overdue liabilities, which implies that chains of arrears are important. Also for the state, it may in principle be optimal to grant financial aid while restructuring a company in order to increase its selling price and thereby recover unpaid taxes. Romania’s experience shows, however, the difficulty of applying in practice such “market economy creditor principle”. When faced with political economy considerations, the government may use privatisation prospects as a pretext for keeping afloat non-viable companies.
**Tackling the problem: what works?**

The existence of chains of arrears speaks in favour of consequent action vis-à-vis perennial non-payers, thereby limiting the proliferation of financial indiscipline. Romania has since 2001 under its IMF arrangements monitored the financial performance of a group of large state-owned companies, which had accumulated around one fourth of all arrears in the economy. Management incentives to reduce payment arrears were provided. Companies were acquitted of monitoring only when privatised or when no longer having arrears. Other companies were introduced into the monitoring system. The monitored companies make up the hard core of non-paying state-owned enterprises, which in late-2005 consisted of about 50 companies with total arrears of 3-4% of GDP. Energy, mining and railway companies are most problematic.

**Chart 4: Arrears of monitored companies**

![Bar chart showing arrears of monitored companies from end-2001 to end-2004.](chart)

*Source: Own calculations based on Ministry of Public Finances of Romania*

The experience of monitoring state-owned companies has been moderately encouraging. Until end-2003, there was overall little improvement as the stock of net arrears to general government, calculated by subtracting incurred interest and penalties and correcting for the effect of rescheduling, declined only slowly to 2% of GDP by end-2003 (Chart 4). In 2004, the government’s efforts to enhance the collection of overdue claims were stepped up, utilities providers took a more active stance against non-payers and energy prices were raised to a level close to cost recovery. These steps had a positive impact, and arrears to both general government and other creditors fell. Importantly, the decline in arrears also holds when excluding the impact of debt cancellation (Chart 4, marked with *). This demonstrates an improvement in financial discipline.

In the energy sector, insufficient enforcement only partly explains the endemic problem, which is structural in character and relates notably to slow progress in privatisation of utilities suppliers until 2003, low efficiency of production facilities, and the deliberate use of energy subsidisation (Cossé, 2003). Lately, more consequent action has been taken in the energy sector to address the root causes of arrears. Prices were increased towards cost-recovery level. Privatisation of gas and electricity distributors moved forward decisively. Restructuring of the heating sector envisages more efficient production, network modernisation and improved metering.

Stricter tax enforcement, in particular seizure of bank accounts and assets, has also shown its worth in improving financial discipline. Tax authorities survey the tax record of enterprises more systematically, which has led to more bankruptcy cases being launched. These efforts contrast with the continued use in Romania of cancellation of tax arrears, which has made financing by arrears more attractive and has caused adverse incentives. The latest large write-off took place in 2004. There is little evidence that the scheme permanently improved financial discipline (Chart 5). Until 2003, a positive flow of new arrears to general government continued. In mid-2004, the debt cancellation halved the amount of arrears and for the following six months arrears continued to contract. The positive effect vanished, however, and no further reduction in arrears occurred in 2005. It seems therefore that the debt cancellation had little permanent positive impact on enterprise behaviour. Romania’s decision to make a stop to debt cancellations is therefore an important step forward, which if adhered to will improve financial discipline.
A main obstacle to dealing with the arrears problem is the weak creditor protection and weaknesses in Romania’s bankruptcy framework. Non-profitable companies do often not face a cut-off in financing followed by bankruptcy proceedings and liquidation. In some cases, this reflects a continued preference by the state to seek reorganisation of companies over bankruptcy. In many cases, however, non-exit is due to insolvency proceedings not being an effective remedy. The time required to resolve bankruptcy cases is unfavourable and the share of claims recovered from insolvent firms, stood in 2005 at 17.5%, well below its peers (Chart 6).

**Conclusion**

A hard budget constraint in the interface between the state and enterprise sector and among companies is a crucial element in a market economy. In Romania, the continued accumulation of payment arrears at all levels of the economy has been an endemic phenomenon, which still today hampers enterprise restructuring and have substantial fiscal effects. Romania has over recent years intensified its efforts to address the root causes of non-payment, and considerable progress has been made in limiting the accumulation of new arrears, not least due to industrial restructuring and the monitoring of a hard core of perennial non-payers. This progress should be sustained by continued restructuring and privatisation, debt cancellation should be carefully restricted and shortcomings in the bankruptcy system should be addressed to ensure that effective mechanisms for market exit are put in place. EU accession, inter alia by contributing to a level playing field in the enterprise sector, promoting fiscal transparency and providing a clear state aid framework, will support Romania in its efforts to fully restore financial discipline.
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