FOREIGN DIRECT INVESTMENT IN ROMANIA - RECENT TRENDS

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Abstract: Though some substantial gains in recent years, direct investment flows have remained relatively low compared to the potential of a market with great natural resources, skilled labor and flexible legislative environment. Romania has lowered personal income and corporate tax rates and strengthened tax administration in order to attract the investor's interest but the legislative unpredictability continues and determines the investor's lack of confidence.

Key words: foreign direct investment, taxes , integration, investors

Introduction

Romania joined the EU on 1st of January 2007, a historical date, being an enormous chance for future generations and for the economy development. This accession, together with Bulgaria's, means that EU now has 27 members and half a billion people, and stretches as far east as the Black Sea.

Romania gets rid off communism in 1989, applied for EU membership in 1995 and began accession discussions in 2000. In September 2006 the European Commission settled the date of 1st of January 2007 as accession date for Romania, together with Bulgaria.

Romania benefits from the EU accession that offers a harmonization of capital market regulations and taxation accounting rules. The exporting procedures to the EU members are now simplified in business administration, the exchange risks and conversion charges are diminished and a new extended market is open.

Though, the road to full integration into the European structures has not yet ended, more efforts being required in order to fulfill the European standards and norms.

Legal framework with impact on direct investment

In order to improve the business climate and to offer incentives for large investment projects, the Romanian legislation regulating the foreign direct investment is still subject to frequent revisions.

The foreign investors in Romania are stimulated and attracted by free access to domestic markets, the possibility of taking part in privatizations, no imposed limits on foreign participation in commercial enterprises. Also, foreign investors despite usually prefer Joint Ventures, are also free to establish foreign-owned enterprises in Romania, and more, to repatriate 100% of their profit after taxes.

Foreign investors may use as main ways for engaging in business activities in Romania:

• setting up a new commercial company, a subsidiary or a branch (wholly owned or in a partnership with a Romanian part);

• acquiring shares, or by increasing the capital of an existing company;

• acquiring concessions or leases.

The Parliament has issued in 2001 the Law No. 332 regarding the promotion of direct investment with significant impact on the economy. Investment that qualify has a value higher than USD 1 million (or equivalent), is made in the forms and ways provided by the law and contributes to the development and modernization of the Romanian economic infrastructure, determining a positive spin-off effect in economy and creating new jobs. Direct investment with significant impact on economy regulated by Law No. 332 are allowed in all economic sectors with the exception of financial, banking, insurance and re-insurance, as well as the sectors regulated by special laws.

A significant step forward taken for improving the relationship with the investors is the establishment of a governmental agency in charge with attracting and maintaining the contact with foreign investors in Romania. This is the Romanian Agency for Foreign Investment (ARIS), which has as main objectives to increase significantly the investment volume in Romania, to actively promote investment opportunities and to offer professional services for foreign investors, all along the investment cycle.

The Fiscal Code, enforced starting 2004, maintained and reinforced the investment incentives introduced by this law, such as:

• exemption from payment of custom duties for the machinery, installations, equipment, measuring and control devices, automation equipment and software products purchased from abroad (outside the EU), necessary for achieving the investment;

• carrying forward the fiscal loss during the following 5 years from the taxable profit;

• other incentives that may be granted by the local authorities (such as exoneration or reduction of local taxes, etc).

Besides the law regarding the direct investments with significant impact on the economy, the other most significant legal incentive offered to direct investment in Romania is the new single tax reform, introduced by the Government at the beginning of 2005. Thus, following a successful model already introduced by other countries in the region, the corporate and individual incomes are levied with a single tax rate of 16%. This fiscal reform was coupled with a softening of the taxation principles on which all fiscal procedures will be based: transparency, simplicity, partnership with taxpayers, and prudence.

This modification brought Romania among the most competitive investment destinations in the region. Presently, the Romanian single tax rate is competitive compared to the other countries levels of taxation (figure 1).

According to the experience of other countries, the accession to the European Union will increase Romania's competitive advantage in attracting higher FDI, especially in export oriented, labor intensive and high value added industries.

In spite of the advantages of the new single tax system, its downside appeared already after six months. In order to counter the lower taxes collected on corporate and individual income, the Government was forced to raise quotas for other taxes, such as: tax on dividends (from 5 to 10% for individuals, and subsequently to 16%), tax on capital gains (from 1 to 10%, and then 16%). The new fiscal strategy of the Government puts emphasis on indirect taxes, as compared to direct taxes (which are aligned at 16%, the same quota applicable for tax or income). Plus, Romania has revised its taxation system in order to bring it closer to the EU system and line it with the recommendations of the World Bank.

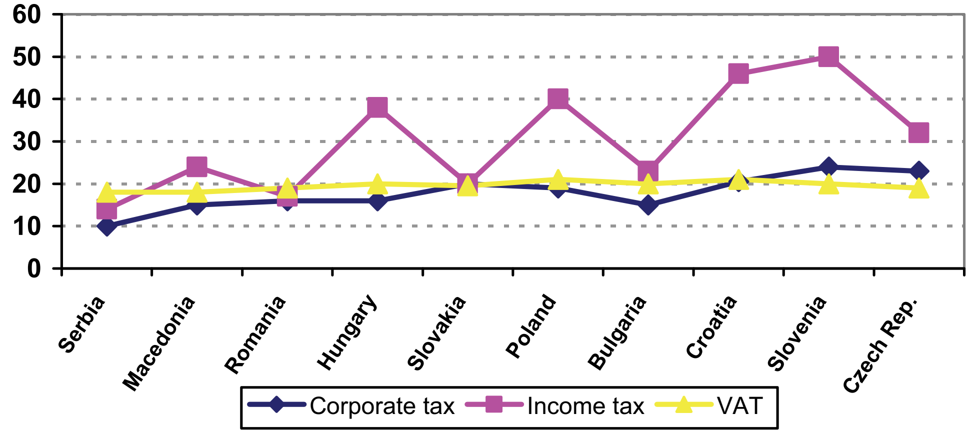


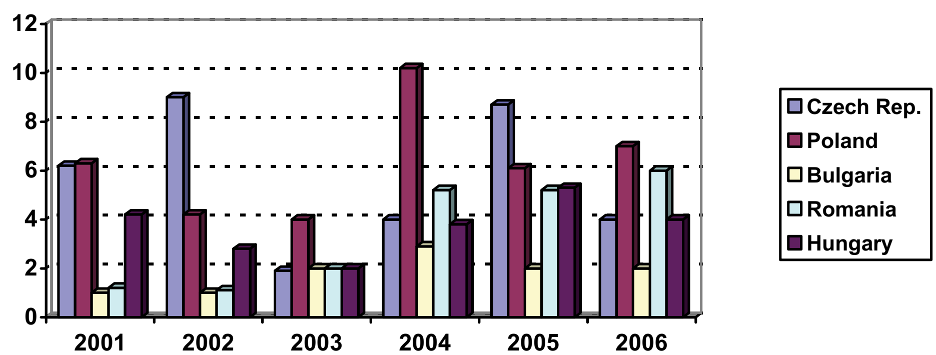
Figure 1. Taxation level applicable in the South and Easter European Countries (2006)

Some other changes in the Fiscal Code may take place in accordance with the specific timetables agreed with the EU. Prospective investors should investigate the current status of the fiscal incentives and also consider some future changes that may occur as a result of the EU accession when drafting investment plans.

Recent evolutions of FDI in Romania

Once part of the European Union, Romania has created a legal framework consistent with a market economy and investment promotion, and still continues to harmonize its legislation to the EU, by adding the so called "acquis communautaire".

Romania has a leading role in attracting FDI in Southeast European region. In 2005, out of the total EUR 10.4 billion in FDI attracted by countries in the region, Romania received half of these inflows. The positive trend continued in 2006, when, during the first four months of the year, FDI increased by 30% compared to the similar period of the previous year (figure 2).

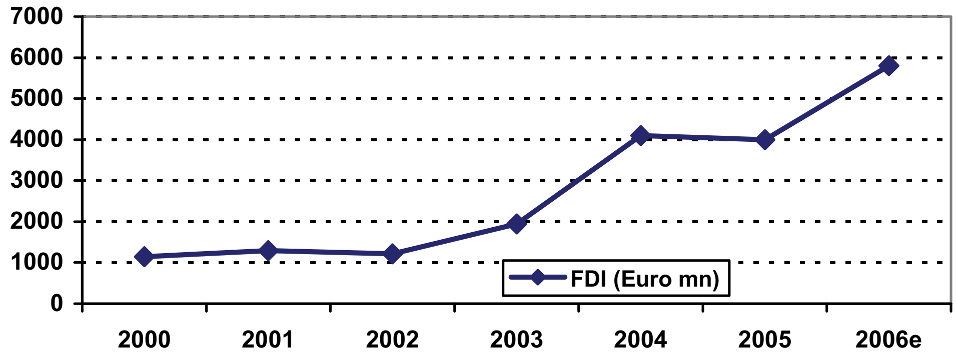


Source: Central banks

Figure 2. Evolution of FDI in Center and Eastern European Countries (Eur bn)

In Romania, the record level of investment inflows in the last years, compared to the other South-East European countries, was partly a result of the successful privatizations. Inflows were also important in green-field and expansion projects, particularly in the automotive industry and in services. The accelerated growth pace in the last three years has placed Romania among the leading FDI destinations in Center and Eastern European region.

In 2006, the investor's interest for Romania increased, and in 2006, Romania registered - accordingly with the Romanian Agency for Foreign Investments (ARIS) - 6.2 billion Euro in FDI in comparison with the 5.2 billion Euro in 2005. The improvements in the business environment, the flat tax of 16% and a positive attitude from foreign partners helped improving FDI inflows dramatically. A direct impact on the FDI level has also the process accession to the EU that changes the investor's attitude towards the country that now has the status of a member state.



Source: ARIS INVEST - The Romanian Agency for Foreign Investment

Figure 3. The evolution of FDI in Romania (2000-2006)

Though some substantial gains in recent years, direct investment flows have remained relatively low compared to the potential of a market with 21.2 million inhabitants, great natural resources, skilled labor and flexible (but still under changes) legislative environment. Still, Romania has lowered personal income and corporate tax rates and strengthened tax administration in order to attract the investor's interest. Though, the legislative unpredictability continues and determines the investor's lack of confidence.

Having in view that FDI in a country is facilitated, inter alia, by the development of the infrastructure, the efficiency of administration, and by an adequate legislative system, the international financial institutions are actively supporting Romania in its efforts to meet these criteria, and surpass the difficulties of the transition.

Main actors for FDI in Romania

The European Bank for Reconstruction and Development (EBRD) is the largest individual investor in Romania, country which is the third-largest recipient of EBRD funding. As of December 2005, EBRD signed a number of 106 investment projects in Romania, totaling EUR 3.2 billion. A total of 67% of investments are concluded in the private sector, with its portfolio rapidly expanding in areas such as private sector investment, financial sector development, critical infrastructure such as power, transport and municipal infrastructure and large-scale privatization with strategic investors. Whenever possible, EBRD is encouraging the private financing of infrastructure through concessions and build, operate, transfer (BOT) schemes. The Bank is also actively supporting the development of the non-banking financial sector by promoting investment in leasing and insurance companies and in equity, mortgage and pension funds.

The World Bank is Romania's largest institutional creditor and its assistance covers all areas of the economy. The World Bank has financed over 40 operations in the country for a total original commitment of almost USD 5 billion.

In addition, rural development and poverty alleviation programs aim at improving rural infrastructure, including irrigation systems, social services and the rural finance system, through a participatory process. Bank's assistance focus is progressively changing from financing the "hard" sectors, such as industry and infrastructure, towards the "softer" sectors, such as human development and social protection, health, education and environment. In the coming future the World Bank is set to increase its involvement in developing rural infrastructure, providing finance to rural areas, social sector development, agriculture and forestry.

In support of the country integration into the EU community, the EU Commission actively assisted Romania technically and financially. It is estimated that the non-reimbursable funds that were made available for Romania in the last couple of years were up to EUR 650 million annually. The funds were allocated for projects supporting convergence with the EU and focused on updating the legislation, aid to institutionalized children, supporting solutions to minorities' issues, etc. The Government main tasks in the integration process were: to create the conditions for a functional market economy, to increase the financial discipline, to reduce inflation, and to stop injecting money into the big state-owned companies, and privatize them, in order to reduce losses.

As part of the EU, Romania will benefit of structural, post accession funds, as part of 7-year allocation plans, in amount of EUR 16.4 billion. The main recipients of these funds will be local and state administration, mainly for infrastructure projects.

The amount of FDI in a country is dependent also upon the privatization strategy adopted by the government. Until the end of 2005, the Romanian government has privatized most of the sectors of the economy. The largest privatization deals concluded are: Banca Comerciala Româna (sold to Erste Bank at the end of 2005), Petrom (the national oil company, sold to OMV in 2004), Agricultural Bank (sold to Raiffeisen Bank in 2001), Sidex - the giant steel mill (sold to LNM Ispat in 2000), Romanian Development Bank (sold to Société Générale in 1998), and Dacia car manufacturer (sold to French Renault in 1997).

Romania is actively integrated into the European economical environment, as reflected by the distribution of FDI per countries of origin. The top ten countries' classification according to foreign capital registered as at 30th of April 2006 is presented in table 1.

With over 20% of total foreign investment in Romania, The Netherlands occupies the first place in the top of foreign investors. More than 2,600 companies activating on the Romanian market have Dutch capital, high investment being made by Unilever, ING (ING Bank, ING Nederlanden, and ING Securities), ABN AMRO Bank, Frans Maas, Remco, Philips, Damen Shipyards Group, KPMG, Heineken, etc.

Since 1990, Austria has constantly been among Romania's most important trade partners. Currently, Austria ranks second within the classification of foreign investors in Romania, the subscribed equity capital amounting to EUR 1.9 billion, with over

4,100 companies having Austrian capital, and over one hundred thousand employees in joint ventures. The leading Austrian investors in Romania are, apart from the new entrant Erste Bank: OMV, Raiffeisen, Schweighofer (wood processing), Strabag (construction), Brau Union, Bramac Baumit and Wienerberger (building materials), Porsche Romania, Volksbank.

Table no. 1. Distribution of FDI per countries of origin - for companies with foreign ownership

Country	Registered capital brought in foreign currency (Euro mn)	% in total capital
The Netherlands	3,112	20.82
Austria	1,983	13.37
France	1,593	10.59
Germany	1,516	10.14
Italy	845	5.66
USA	705	4.71
United Kingdom	681	4.55
Dutch Antilles	567	3.79
Greece	543	3.63
Cyprus	538	3.60

Source: Statistical bulletin of the National Trade Registry Office, Nov. 2006

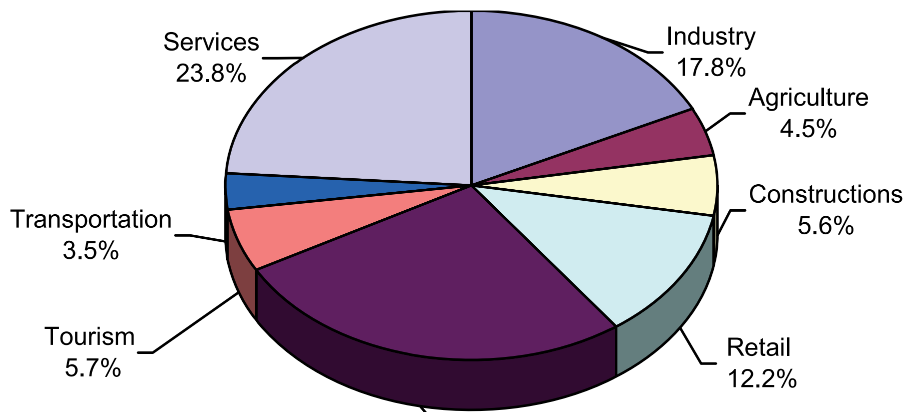
Over 4,600 French capital companies are registered with the Romanian Trade Registry, France occupying currently the third position in the top of foreign investors in Romania. The major French investors are France Telecom, Société Générale, Lafarge Romcim, Renault-Dacia, Vivendi Environment, Carrefour and Alcatel. French investors were mainly interested in companies being privatized, greenfield investments being less preferred. One exception is Alcatel that invested in Romania starting with 1991 and later France Telecom, which invested in Orange Romania.

Germany is one of the most important commercial partners of Romania, occupying in November 2006 the fourth position after The Netherlands, Austria, and France, with a total value of registered capital brought in foreign currency of EUR 1.5 billion and over 14,000 companies registered and operating in Romania. The majority of German investments are in small businesses. More than 90% of these investments amount to less than EUR 40,000, still the Germany's contribution to the strength of the Romanian economy is substantial. The main investment sectors for the German companies are: automotive industry, metallurgy, wholesale trade, plastics industry, textile industry, retail trade and main players are: Metro, Praktiker, Selgros, Billa, Tengelmann (Plus), Steilmann, Linde, Heidelberger Zement (CarpatCement), Siemens, Dr. Oetker, etc.

Italy is presently one of the most important commercial partners of Romania ranking fifth in the top of foreign investors in Romania, with more than 21,000 Italian capital companies registered with the Romanian Trade Registry. Mainly Italian investment is focused on the so-called "labor intensive" projects, developing the lohn system with raw materials brought from Italy. The traditional sectors in which Italians have been investing so far are textiles, construction, trade, services and agriculture. The main Italian investors are Italstrade Spa, Unicredito Italiano Spa, Radicifibres, Butangas, Pirelli Telecom, Tenaris Dalmine, Radici, Natuzzi, and Zoppas.

American investor became key players within a series of strategic Romanian industries such as telecommunication, infrastructure, construction of large machines, finance, and agriculture. There are more than 4,800 companies with US participation registered at the end of 2006. In total, the American investment in Romania exceeds EUR 700 million, the main investors being General Electric, Citigroup, AIG, IBM, Procter & Gamble, Coca Cola, Philip Morris, Solectron, Timken, McDonald's System of Romania Inc., Trinity Industries Inc., Kraft Foods International Inc., American Life Insurance Company.

After seventeen years of transition, however, the results of the gradual reform and restructuring are beginning to show results. The services and the distribution, overlooked in the communist regime, have grown steadily, outshining the industry. The distribution of foreign investments stock per economic sectors reflects the development and the attractiveness of the industries for foreign investors, dependent also on the privatization strategy of the government. For the period 1991-April 2006 The foreign direct investments were registered in the following main fields: industry wholesale, services, retail (figure 4).



Source: National Trade Registry Office

Figure 4. Distributions per industries of share capital stock subscribed in foreign companies(2006)

The foreign investment funds are among the most active players acting on the Romanian market. The investment fund is defined as a venture capital association set-up as a closed investment fund or investment company, which manages the funds of private or corporate persons. Their presence on the market was simultaneous with the consolidation of the private sector. The targeted companies were mainly those with an important growth potential, a steady market and a competitive management.

Regional funds are becoming more active compared with country funds, particularly with respect to large deals. 2006 was considered by players the year of exists, considering the number of important exits concluded successfully by the major funds. Competition, not very intense until recently, is becoming stronger among the funds. Offering, besides financing option, know how, the funds are now of interest for investors, especially in lack of any serious competition coming from the banks. The banks, are not a threat for venture capital funds in the real economy, as they are not yet prepared to provide long-term development financing. This leads to relatively low entry valuations and may ensure significant returns. As the capital market is still not enough developed, the most probable exit route to be used by the funds active in Romania is via sales towards strategic investors.

Conclusions

For 2007, the estimations are also optimistic for FDI, at approximately 10 billion Euros, mainly due to the EU accession. The FDI increase will be determined by major players that were not until now present on the Romanian market, but decided to enter the ten countries that joined in 2004, immediately after the accession. The same strategy will most probably be applied in Romania.

Among the factors that are deemed to support higher FDI in the future the following are the most important:

• Romania is a politically and socially stable country, part of the European Union since 1st of January 2007;

• Romania has gained full membership of NATO;

• Romania represents the second largest market in the CEE region;

• the crucial geographical positioning of the country, a gateway between East and West of Europe;

• the commitment of investment funds present in the country to develop their business and the association of the government with international financial institutions, such as IMF, EBRD, World Bank, and the EU Commission;

• the high qualification of labor force and its low costs, below the levels of other countries in the CEE region;

• existence of important natural resources and proximity to energy suppliers;

• as the market is growing, there are increasing business opportunities, while the entry barriers remain low.

Romania is ready to accommodate a higher inflow of FDI in sectors such as agriculture, construction materials, automotive industry, constructions and real estate, oil and gas, petrochemical, energy, metallurgy, telecommunications, transportation, air transport, railways, shipping and shipbuilding, food industry, retail, tourism, IT, financial sector, and distribution. Among these, the most appealing for foreign investors are automotive, financial services, software, constructions and real estate, electronics, telecom, pharmaceutical, and chemical industries.

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