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Operation Name	Second Fiscal Effectiveness and Growth Development Policy Loan
Region	EUROPE AND CENTRAL ASIA
Country	Romania
Sector	Central government administration (70%); Capital markets (15%); Public administration- Industry and trade (15%)
Operation ID	P149776
Lending Instrument	Development Policy Lending
Borrower(s)	MINISTRY OF PUBLIC FINANCE
	Ministry of Public Finance Romania
Implementing Agency	Ministry of Public Finance Romania
Date PID Prepared	April 23, 2015
Estimated Date of Appraisal	September 1, 2015
Estimated Date of Board Approval	November 24, 2015
Corporate Review Decision	TBC
Other Decision	N/A

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I. Key development issues and rationale for Bank involvement

Sound macroeconomic policies helped Romania restore growth and narrow its output gap after a deep and prolonged slump in the wake of the 2008 global crisis. As the output gap closes, medium-term growth prospects will hinge on Romania's ability to improve the effectiveness of the state in key areas such as fiscal management and governance of SOEs and facilitate private sector investment through the deregulation of key markets. Improvements in these area are likely to reduce poverty and improve the welfare of all Romanians.

II. Proposed Objective(s)

The proposed Second Fiscal Effectiveness and Growth DPL series aims at: (i) strengthening fiscal management and SOE performance; and (ii) improving the functioning of property, energy, and capital markets.

Preliminary Description

The proposed Fiscal Effectiveness and Growth Development Policy Loan (FEG-DPL2) of US$ 1,000 million equivalent is the second of a programmatic series of two Development Policy Loans (DPLs) to Romania. This series supports reforms to strengthen fiscal management and performance of state-owned enterprises (SOEs), and improve the functioning of property, energy, and capital markets. Sound macroeconomic policies helped Romania restore growth and narrow its output gap after a deep and prolonged slump in the wake of the 2008 global crisis. As the output gap closes, medium-term growth prospects will hinge on Romania's ability to improve the effectiveness of the state in key areas such as fiscal management and governance of SOEs and facilitate private sector investment through the deregulation of key markets. This series, which builds upon previous policy lending operations to Romania, supports key pillars of the Country Partnership Strategy (CPS) for 2014-18.

Strengthening fiscal management and SOE performance will be important to reap the benefits of fiscal consolidation and support Romania's sustainable growth. To sustain growth and lower fiscal deficits, the Government will need to strengthen its medium-term fiscal policy framework and management, particularly in the areas of social spending and public investment. The targeting of social spending has been weak so far. In 2014, means-tested programs accounted for only 17 percent of the total social assistance budget, though Romania had one of the highest incidences of poverty in the European Union (EU). Improving the targeting of social assistance programs will not only be important for improving social outcomes but also for stimulating private demand and growth. The quality of Romania's infrastructure ranks among the lowest in the EU, in particularly in transportation and energy. This is to some extent attributable to a large and inefficiently managed SOE sector, which not only poses fiscal risks but also leads to systemic underinvestment in such key sectors as energy and transportation. Expanding the role of the private sector in these areas while improving SOE corporate governance will be important to improve financial performance of SOEs and infrastructure service delivery. Romania's capacity to manage its debt effectively is limited by a shallow domestic government securities market and constraints too engage in buy-backs raises Romania's vulnerability to external shocks and rollover risk.

Though Romania's private sector has developed substantially in recent years, key markets supporting it are not yet functioning efficiently. A relatively weak business environment constrains private investment, in particular, the creation of new firms. The entry rate of new firms was significantly below the average of Romania's neighboring countries during the last five years though empirical evidence shows that new firms have been a key driver of productivity growth in Romania. Firms report that access to land, finance and good infrastructure are among their main constraints for doing business in Romania. Only 15 percent of total estimated properties are registered in the electronic Romanian cadastral records. Unclear ownership right and incomplete records, particularly in rural areas, promote litigation and limit investment. An efficient financial sector that pools domestic savings and mobilizes capital also fosters productive investments. At €18.4 billion in 2014 (12.4 percent of GDP), Romania's stock market capitalization is below that of other EU peers, such as Hungary (14.3 percent of GDP) and the Czech Republic (14.0 percent of GDP). Its daily turnover, at € 8.4 million in 2014, is substantially below regional peers. The incomplete liberalization of electricity and gas markets constrains energy efficiency, investments, and exports. In response, the government re-launched

reforms in 2011 to ensure compliance with the EU third energy package for electricity and gas, and fully liberalized non-residential electricity markets in 2014 and non-residential gas markets in 2015.

III. Poverty and Social Impacts (PSI) and Environmental Aspects

Poverty and social impacts of the Second Fiscal Effectiveness and Growth DPL are expected to neutral or positive. The measures supported aim to make public spending more effective, including by improving the targeting of the social assistance program and improve the functioning of energy, property and capital markets, which should improve the ability of individuals and businesses to mobilize human and physical capital, thus creating the basis for sustained poverty reduction and improvements in shared prosperity. The poverty and social impact of debt management reforms is expected to be neutral. They could potentially benefit the population at the bottom 40 percent of the income distribution by reducing roll-over risk interest spending. The implementation of centralized procurement in the Ministry of Health could provide significant savings in the health sector which could be used to scale up primary care health services, benefitting the poor. Improvements in project prioritization could also have positive effects on the poor by reducing travel costs. The new law on the Minimum Social Insertion Program will consolidate three existing means-tested programs and is expected to improve the coverage, targeting and generosity of benefits. The work with counterparts on the development of eligibility criteria is still ongoing under a RAS program, and the PSIA will take advantage of the work undertaken under this program to evaluate the poverty and social impact of the introduction of the MSIP. It is expected that i) the MSIP will cover a larger share of households, including in-work poor; ii) will improve the take-up of the current means-tested programs; and iii) cover the in-work poor which are currently excluded from some of the programs. This will be particularly beneficial to poor households. Overall, the proposed reforms are expected to lead to improvements in service delivery for all, including the bottom forty percent and those socially excluded.

SOE restructuring reforms will result in some loss of employment, but the overall social impact will be limited because of compensating severance payments. In addition, the share of SOE workers among the bottom 40 of the population is relatively low at 19 percent in 2013. Since severance payments tend to cover lost income in the first 12-14 months, the long-term impact of SOE restructuring depends on whether those who are in the bottom 40 percent find employment once severance payments are exhausted. If none of them finds a job and cannot receive social benefits, the poverty rate (at US$5 PPP) can be expected to increase by between 0.2 and 0.3 percentage points. This scenario is unlikely however, given the envisaged expansion of safety nets supported by the operation.

Policies supported by the proposed DPF series are not expected to have significant effects on Romania's environment, water resources, habitat or other natural resources. Scenarios for significant direct or indirect negative impacts appear very unlikely. In the cases of the Hunedoara and Oltenia complexes, however, the subsequent implementation of the restructuring plans may result in the closure or downsizing of obsolete energy production units and mines. This would lead to reductions in fossil fuel consumption and of emissions of CO_2 and other pollutants, but may also require environmental rehabilitation of the respective areas. Romania

has adequate environmental controls, and its legislation and regulations are closely aligned with EU directives. Romania has adopted the EU guidelines for integrating environmental assessments into project planning and programming and the EU Environmental Liabilities Directive setting out liability for damage to properties and natural resources.

IV. Tentative financing

Source:	($m.)
Borrower	0
International Bank for Reconstruction and Development	1000
Borrower/Recipient	
IBRD	
Others (specifiy)	
Total	

V. Contact point

World Bank
Contact: Doerte Doemeland
Title: Lead Economist
Tel: (202) 458-1238
Fax:
Email: ddoemeland@worldbank.org

Borrower
Contact: Boni Cucu
Title: General Director, International Financial Relations General Directorate
Tel: +40 21 319 9854
Email: Boni.cucu@mfinante.ro

VI. For more information contact:

The InfoShop
The World Bank
1818 H Street, NW
Washington, D.C. 20433
Telephone: (202) 458-4500
Fax: (202) 522-1500
Web: http://www.worldbank.org/infoshop