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Letter of Development Policy

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Romania: Second Fiscal Effectiveness and Growth Development Policy Loan

Dear Dr. Kim,

The Government of Romania appreciates the long-standing partnership and cooperation with the World Bank (Bank) on a range of important economic and social reforms; in particular, we remain cognizant of the significant policy financing and implementation support that the Bank has provided to Romania's reform program and transition over the last two decades. Many of these reforms will accelerate the convergence in living standards with the European Union, reduce poverty and strengthen the confidence of the investors in our economy. By promoting a disciplined macroeconomic management and vigorously pursuing structural reforms, we expect to achieve significant productivity gains and enhance the medium term growth potential of our country.

Romania has achieved remarkable progress in the last decade, supported by programs from the European Union, the IMF and the World Bank. This Fiscal Effectiveness and Growth Development Policy Operation (FEG-DPO) is another important milestone. It is the second in a programmatic series of two loans aimed at strengthening fiscal management and the performance of state-owned enterprises (SOEs) and improving the functioning of energy, property, and capital markets. The structural reforms promoted with the support of the FEG-DPO are of critical importance. This letter outlines the main directions of economic policy and structural reforms underpinning this operation.

From crisis to a solid recovery

The Romanian economy has achieved solid growth thanks to a disciplined macroeconomic management and continued structural reforms. In spite of strong external headwinds from the global crisis, market turbulences and regional tensions, Romania grew at an average rate of over 3.4 percent per year from 2013 to 2015. Growth accelerated to 3.8 percent in 2015, the second highest economic expansion in the European Union (EU). Growth was underpinned by a steep increase in household real disposable income as a result of increases in wages, lower taxes and low consumer prices. Investments also experienced strong growth. We expect growth to further accelerate to around 4.8 percent in 2016 and remain at an average of 4.4 percent in the medium term, in spite of the still anemic economic conditions in the Eurozone and the volatility of the financial markets. Our optimism regarding the economic growth of 2016 has been confirmed by a solid performance in the first semester, when the economy advanced by 5.2 percent, the highest in the EU, driven by the domestic demand.

In parallel, the government focused significant effort on restoring fiscal balances in recent years. We have succeeded in reducing the consolidated government cash fiscal deficit from an unsustainable 7.2 percent of GDP in 2009 to 1.5 percent of GDP in 2015, with emphasis placed primarily on curtailing inefficient expenditures, while preserving public investments. This has helped reduce the level of public spending in GDP from 39.5 percent in 2010 to an estimated 34.3 percent in 2016. Our public debt [1] is the fifth lowest in the EU, at 37.9 percent of GDP, at the end of December 2015.

[1] Calculated according to EU methodology

Following the rapid and significant fiscal adjustment since 2009, we have also recently taken a number of fiscal relaxation measures in response to expectations from citizens, who bore most of the fiscal adjustment costs. We reduced the level of social contributions in 2014 by 5 percentage points, from one of the highest levels in the EU, cut VAT for food products from 24 percent to 9 percent in June 2015, which benefitted primarily the poor and vulnerable, and reduced overall VAT from 24 percent to 20 percent since January 2016. Public sector wage increase and reforms to move towards a unitary pay law have also contributed to a widening of the fiscal deficit.

Looking forward, we remain determined to implementing a medium term fiscal framework consistent with macroeconomic stability and sustainable and inclusive growth, in line with our commitments under the EU Fiscal Compact, while increasing targeted spending for the social programs. As we have emphasized on each occasion, a solid macroeconomic framework is a precondition for Romania to achieve sustainable economic growth and convergence with the EU in living standards. Thus, we are determined to keep the budget deficit below 3 percent of GDP over the short and medium term and avoid the EU Excessive Deficit Procedure. As presented in our Convergence Program, submitted to the European Commission in May 2016, we plan to gradually reduce our budget deficit from an estimated 2.9 percent of GDP in 2016 to around 1.6 percent of GDP in 2019. As explained below, we are strongly committed to further strengthening tax administration and revenue collection, enhancing the transparency of spending by public entities and improving the efficiency of public spending. We are also committed to continue to put important resources into public investment, including from the EU funds, in order to close the infrastructure gap with the EU. We are currently focusing significant institutional efforts on simplifying the access to and improving the transparency of the EU funds. At the same time, we are working on addressing the distributional aspects of growth. Thus, have launched a major anti-poverty program and will comprehensively reform the social assistance system, concomitantly with putting significantly larger budget resources to ensure that all citizen benefit from economic growth and prosperity.

Solid macroeconomic management has helped us to considerably reduce external imbalances and contain inflation. The current account deficit, at 0.6 percent of GDP in 2015, is one of the lowest in the EU and, since 2013, it has been more than fully covered by FDI inflows. Inflation is currently in negative territory, at around -0.6 percent, aided by the cut in VAT, enabling the central bank to maintain a low interest rates environment and have ample liquidity in the markets. The National Bank of Romania (NBR) expects a gradual return of inflation to positive figures and projects an inflation of -0.4 percent at end-2016 and 2.0 percent at end-2017.

The banking sector is well capitalized. No bank had to be bailed out by the government during or after the global crisis. The capital adequacy ratio, of about 19.1 percent, is comfortable. NPLs have declined steadily from a peak of around 22 percent in 2013 to around 11.3 percent currently, driven by the restructuring of bank portfolios under the strict supervision of the NBR. More than 90 percent of the NPLs are provisioned. Deleveraging has slowed down substantially, and the loans-to-deposits ratio is now around 84 percent, down from a peak of over 122 percent in 2008. The adoption of the debt discharge law by Parliament in April is likely to adversely affect credit growth and conditions and will impact banks' balance-sheets. However, we believe that there are no systemic risks associated with the application of the law, and a number of severely distressed borrowers will benefit, especially those with low incomes.

The authorities have taken firm measures improve the functioning of the non-banking financial markets. Supervision and regulation of the capital, insurance and pensions markets was consolidated into a single Financial Supervisory Authority (ASF). A new capital markets law was adopted and the ASF has passed a number of subsequent regulations to simplify market access for investors. Firm steps have been taken by ASF to address weaknesses in the insurance market. A review of the market was conducted and the largest company has been put into insolvency.

Government's Reform Program

In January 2016, we launched an ambitious reform program focused on boosting sustainable and inclusive economic growth, reforming public administration and enhancing the accountability of the public sector towards civil society and citizens. We revived the structural reforms agenda, stalled in 2015, in a number of areas and have accelerated reforms. In implementing the reforms, we pay considerable attention to maintaining macroeconomic stability; improving transparency and promoting good governance; and ensuring the sustainability of the reforms.

A key reform area for our government is to strengthen public finances. Cognizant of the need to boost budget revenues by improving tax compliance, we have launched a comprehensive reform of the Tax Administration (ANAF). Working with the World Bank and benefiting from IMF support and that of a number of EU peer members, we have strengthened the large taxpayer unit and have prepared plans to overhaul the business processes of ANAF; strengthen risk management procedures; consolidate human resources; upgrade services offered to taxpayers; and modernize IT systems. We are currently in the process for an international tender of a modern IT system for ANAF. Our reforms are already yielding results: in 2015, we collected 32.8 percent of GDP in government revenues, 0.7 percent of GDP higher than in 2014. The Ministry of Finance has also made significant progress in strengthening public debt management including by enabling the use of buy-backs and exchanges and implementing the electronic trading platform for the secondary market.

In parallel with reforming the revenue side of the budget, we are putting significant effort into enhancing the efficiency and efficacy of public spending using a number of measures. In order to improve the prioritization of public investments, we have established a Unit for the Evaluation of Public Investment Projects (UEIP) in the Ministry of Public Finance (MoPF). The UEIP, working alongside the relevant line ministries, has prepared a list of prioritized investment projects which has been published on the MoPF's website. We will continue to improve the alignment of the budget allocation with the prioritized list and the list itself by adding more information about project implementation. We also recently established a spending reviews directorate in MoPF that will work closely with the line ministries to review the efficiency of public spending with the view to identifying savings and reorienting public expenditure to higher return activities. This will benefit from technical assistance from the IMF and the World Bank. To improve the transparency of the budget, we have made monthly budget execution public for all government spending agencies at central and local level at the following site: www.transparenta-bugetara.gov.ro

The government is paying important attention to strengthening the linkages between policy-making and planning and budgeting in order to enhance the quality of public spending. The aim is to gradually introduce performance based budgeting, with the goal of moving towards program-based budgeting in the medium term. In this context, we have been working on strengthening the center of the government to improve policy-making oversight and ensure improved policy coordination and harmonization. In this respect, we plan to establish a Strategy Unit within the Chancellery of the Prime Minister and we are working on putting a process for policy-making in place with clearly defined roles, responsibilities and deliverables. In MoPF we are working on conceptualizing the introduction of performance-based budgeting.

A key priority on our agenda is to reform the health sector. With support of this DPL program we are expanding centralization of procurement for medicines and medical devices carried out by the Ministry of Health, through its specific structure. Since 2013, when the Ministry of Health has been assigned, as Centralized Procurement Unit, we have achieved important savings (of around 25 percent per year for each completed tendering procedure) which we would like to expand to other categories of medical and non-medical products used by the health care units. We have expanded centralized procurement in health. This will generate savings, as additional resources for the health sector and consequently ensure an unit price at the national level for centrally procured products. In parallel, we are strengthening the Centralized Procurement Unit in the Ministry of Health by recruiting additional staff. We also plan to build a number of modern regional hospitals with funding from the EU, the national budget and from

IFIs if needed and work on introducing new criteria for selecting managers in the health sector. We are, however, aware that the health sector requires comprehensive reforms, which need strong commitment over a sustained period of time. We have developed pillars for the medium to long term strategy for this reform agenda and plan to work on defining concrete measures for implementation.

Strengthening the corporate governance framework of SOEs and restructuring them is a key pillar of our reform program. The SOE sector remains large in Romania and continues to generate arrears and distort the functioning of the markets. To address these challenges, we have decided to promote legislation enabling SOEs to recruit competent professional boards and management through open, transparent, and competitive procedures, in line with good international practice. In this endeavor we have benefited from support from the EC, the IMF and the World Bank. The new legal framework for corporate governance of SOEs was adopted in May 2016, supported by this DPL program, and the norms of the new law were approved in September 2016. In parallel with the new legal framework, we have accelerated the selection of professional management for a number of key SOEs. We have already launched the selection of professional boards and executive management for 11 SOEs and, in line with, the secondary legislation on corporate governance, more companies will start this process in the next months. MoPF has established and consolidated a unit which monitors SOE performance, and which has also been tasked to oversee the implementation of the new corporate governance framework, and these reforms are already yielding results. Those companies where professional managers and boards have been recruited already show improved profitability. MoPF has begun publishing an annual report on the performance of SOEs, and will prepare unitary criteria and procedures for management selection and SOE reporting. Restructuring SOEs is key reform priority for our government. In recent years, we conducted several IPOs and SPOs, mostly in the energy sector out of which the largest was the IPO of Electrica, supported by the DPL. While privatization stalled in 2015, we aim to re-launch it in 2017, when we expect to conduct IPOs for at least two large SOEs.

We recognize the importance of the energy sector as a driver of growth and we have achieved significant reforms in this sector. To facilitate the functioning of the energy markets and the allocation of resources, we have fully liberalized electricity and natural gas prices for companies, and we are on track for doing the same for households, keeping in mind the need to protect the vulnerable consumers. We have connected the Romanian electricity market with those of Hungary, Czech Republic and Slovakia, and this has facilitated a price convergence and has boosted Romania's exports of electricity to over 10 percent of output in 2015. We have consolidated the gas and electricity exchange on centralized markets OPCOM, the largest and most modern in the region and on the Romanian Commodities Exchange and have adopted legislation requiring all traders to trade electricity exclusively through the market. This has led to a decline in the wholesale prices of electricity and improved the transparency of contracts. Moreover, we have passed legislation requiring gas producers and suppliers to trade a minimum amount of their produced/supplied natural gas on these platforms. In order to address endemic problems with arrears and transparency of contracts, we have taken important steps in terms of restructuring for CE Hunedoara, an important coal-fired generator. CE Hunedoara was placed into insolvency, as evidenced by the Hunedoara Tribunal's certificate dated June 23, 2016. We are also putting in place measures to mitigate the social and environmental consequences of the process, including by allocating complementary payments from the budget during 2016 – 2018. In 2012, we also placed Hidroelectrica, the largest electricity generator, into insolvency in order to facilitate restructuring of its bilateral contracts and in insolvency, Hidroelectrica has undergone a major restructuring program; has had unprofitable contracts removed; and has become one of the most profitable companies in Romania, achieving a profit of around Euro 240 million in 2015. Hidroelectrica has recently exit insolvency and in order to ensure the sustainability of the restructuring, we plan to launch an IPO for Hidroelectrica in the first half of 2017.

In October 2016, we have adopted the National Climate Change and Low Carbon Green Growth Strategy 2016-2020. As a member state of the EU, we are committed to meeting our obligations in terms of reducing greenhouse gas (GHG) emissions from economic activities in alignment with the EU targets and adapting to the effects of climate variability and change, both current and future. By implementing the National Climate Change (NCC) Strategy, Romania aims to transition to a society in which social, economic, and environmental policies and actions are interlinked and designed to ensure sustainable development and shared prosperity, with high living standards for all, as well as a high environmental quality. Based on the NCC Strategy, a National Action Plan on Climate Change Strategy for 2016-2020 has been developed. The Action Plan proposes concrete measures to be implemented between 2016 and 2020 to combat climate change and help to restructure the economy for greener growth. These measures include results indicators, financing sources, and responsible institutions, which we will closely monitor.

In order to accelerate the registration of property and land titles, into the integrated system for cadaster and land book, we have launched a number of measures to reform the legal and institutional framework of cadaster and land registration. In 2014 we granted partial financial and operational autonomy to the Agency for Cadastre and Land Registration (ANCPI), which currently retains and uses all the revenue which it collects from the services provided within the National Program for Cadastre and Land Book, based on which is carried out no-cost the registration of all real estates in Romania into the integrated system for cadastre and land book. With help from the DPL, we are in the process of reforming the legal cadastre and land registration framework by addressing a number of inconsistencies between the relevant legislation in the field and other piece of legislation and by improving the governance structure of ANCPI. A new legal framework was adopted in 2015 and 2016, introducing systematic registration of properties and removing taxes and fees for the first registration of a property. This will benefit primarily the poor and marginalized communities. Furthermore, we are finalizing a comprehensive cadastre law, which will integrate past legislative changes and simplify legislation. Adoption of this law will be a significant step towards boosting investment in Romanian agriculture and the functioning of the property and land markets; it is also expected to improve economic planning. Once the new law is in place, we are strongly committed to scaling up property registration, in the integrated system for cadastre and land book especially in rural areas, which we recognize to be key for facilitating investments, with significant benefits also for the poorest communities, which currently face significant challenges to property registration.

We are cognizant of the fact that poverty remains wide-spread in Romania and disproportionately affects certain groups of the population, particularly the Roma. Thus, fighting poverty features highly on the government's agenda and our efforts are anchored in the National Strategy on Social Inclusion and Poverty Reduction and also in the comprehensive anti-poverty package which we launched in January 2016. A number of anti-poverty measures have been promoted in recent years, including increases in pensions and the minimum wage; reductions in VAT; and increases in the budgets of the better targeted anti-poverty programs: the guaranteed minimum income; family benefits; and heating subsidies. These, together with higher employment as a result of economic growth, have put absolute poverty on a constant decline in recent years. Nevertheless, poverty in Romania remains high. In response to this challenge, we have prepared a comprehensive National Strategy on Social Inclusion and Poverty Reduction for 2015-2020 with support from the World Bank. The overarching objective of the Strategy is that: all citizens are provided with an equal opportunity to participate in the society; feel valued and appreciated; live in dignity; and have their basic needs met and differences respected. The Strategy proposes a series of key interventions to reduce poverty and facilitate social inclusion, with a focus on employment, social transfers, social services, education, health, housing and social participation. We have recently adopted 48 new initiatives aimed at better targeting the poor. These measures include a program to enrol children into kindergarten; subsidies to poor children for school supplies, clothes and food; grants for schools in disadvantaged areas; revival of vocational education; a program to facilitate the employment of graduates with special needs; support for rural and social entrepreneurship, etc. With support from this DPL, we approved the Minimum Inclusion Income Program (MIIP) in April 2016, which was adopted by the Parliament in October. The MIIP consolidates the guaranteed minimum income, family benefits and heating subsidies into one program. MIIP implementation is intended to reduce errors of excluding the poor; increase the generosity of benefits for households in most need; reduce the private costs of the beneficiaries and make them more likely to apply for it; and improve targeting for those with lower incomes. All these elements of the program are expected to have a direct impact on shifting the poverty rate towards EU convergence. The MIIP law has been adopted by Parliament in October 2016. We are confident that the associated IT system and process will be develop in time and that we can launch the program as planned in April 2018. We are also gradually doubling the budget of the MIIP. To facilitate the financing of anti-poverty measures, we have dedicated to this objective a specific Priority Axis under the Human Capital Operational Program with a total budget of Euro 1.110 billion. The interventions under this are focused on the active inclusion at the level of disadvantaged communities, as well as on the accessibility and quality of the medical services, social assistance services and social services of general interest, including here the support of deinstitutionalization process. A special attention we pay to the marginalized communities and communities with Roma people, under dedicated specific objectives, through a multi-sectorial approach – by interventions in education, employment, housing, medical and social assistance services, fighting against segregation measures. The people at risk of poverty or social exclusion will benefit also from the implementation of the Local Development Strategies which will be financed through the Community Lead Local Development instrument. With support from the World Bank Social Assistance System Modernization Project we are working towards improving the performance of our social assistance system by strengthening performance management, improving equity and administrative efficiency and reducing error and fraud.

As mentioned above, our government has an ambitious agenda of public transparency and openness, with the purpose of transforming the manner in which public institutions share and communicate information of public interest. In this respect we have promoted a set of initiatives. The Parliament recently approved a key legislative package on public procurement which transpose the EU Procurement Directives to ensure a reliable, coherent and predictable framework: a public procurement law that promotes transparency (including e-procurement); a law on procurement in the utilities' sector; a law on the award of concessions contracts of works and services; and a law on remedies. A Transparency Registry to record interactions between the public sector and private sector is about to be established. The Ministry of Public Consultation and Civic Dialogue has introduced tools to facilitate and encourage citizens to offer comments and suggestions for legislation in public consultation and to raise awareness on the decisions taken in the weekly government sessions.

Improving the absorption of EU funds is a priority for our government in order to accelerate the convergence with the EU and boost their efficient use for shared prosperity. In spite of improvements, the absorption rate for EU funds for 2007-13 remained below expectations. Gaps in the legal framework, and excessive bureaucracy partially explain these absorption rates; a weak project pipeline, as a result of capacity constraints with strategic planning and project preparation and execution levels, are also contributing factors. We are taking steps to address these issues; we are also improving the legal framework for procurement, concessions and public contracts. With support from the World Bank, EIB and other IFIs, we have prepared sectorial strategies which should help us improve the absorption of the EU funds for 2014-20. We have approved the transport master plan, which provides the roadmap for future investments in infrastructure. We are aware that more effort is required to further simplify procedures and strengthen capacity for project prioritization, preparation and implementation.

We strongly believe that the World Bank will continue to be a major supporter of our reform program. The Bank's knowledge and global expertise provides a key impetus towards the fulfilment of our reform objectives.

Yours sincerely,

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Prime Minister	Minister of Public Finance
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