Report No. 51191-RO

Romania
Public Expenditure and Institutional Review

(In Two Volumes) Volume I: Main Report

February 17, 2010

Poverty Reduction and Economic Management Unit
Europe and Central Asia Region

Document of the World Bank

CURRENCY EQUIVALENTS
(February 1, 2010)

Currency Unit = New Romanian Leu (RON)
US$ = 2.9509 RON

FISCAL YEAR
January 1 – December 31

ABBREVIATION AND ACRONYMS

CAP	Common Agricultural Policy
CFR	Romanian Railways Company
CNDP	Complementary National Direct Payments
CPI	Consumer Price Index
DPL	Development Policy Loan
EAFRD	European Agricultural Fund for Rural Development
EC	European Commission
EU	European Union
EUROSTAT	Statistical Office of the European Communities
FRL	Fiscal Responsibility Law
GDP	Gross Domestic Product
GP	General Practitioner
GSG	General Secretariat of the Government
HFADB	European Health for All Database
ILO	International Labor Organization
IMF	International Monetary Fund
IRR	Internal Rate of Return
ITC	Information Technology and Communication
MERYS	Ministry of Education, Research, Youth and Sports
MOH	Ministry of Health
MoPF	Ministry of Public Finance
MOT	Ministry of Transport
MTEF	Medium-Term Expenditure Framework
NHIF	National Health Insurance Fund
OECD	Organization for Economic Co-operation and Development-
PBB	Performance-Based Budget Process
PFL	Public Finance Law
PFM	Public Financial Management
PIRLS	Progress in International Reading Literacy Study
PISA	Program for International Student Assessment
PMMR	Performance-Based Maintenance and Management of Road Contracts
PSC	Passenger Service Contract
RNCMNR	Romanian National Company of Motorways and National Roads
RON	New Romanian Lei
SDR	Standardized Death Rate
SOE	State-Owned Enterprise
SPC	Strategic Planning Committee
TIMSS	Trends in International Mathematics and Science Study
VAT	Value-Added Tax
WHO	World Health Organization

Vice President	:	Philippe H. Le Houerou, ECAVP
Country Director	:	Peter Harrold, ECCU5
Sector Director	:	Luca Barbone, ECSPE
Sector Manager	:	Bernard Funck, ECSP2
Team Leader	:	Catalin Pauna, ECSP2

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ACKNOWLEDGEMENTS

This report is based on background papers and contributions prepared by a World Bank team led by Cătălin Păuna and composed of Bernard Myers, Lars Sondergaard, Mariana Moarcă , Mohammed Dalil Essakali, Gerald Paul Ollivier, Agnes Couffinhal, Richard Florescu, Ufuk Guven, Holger Kray, Nadia Badea, Eugen Scânteie (consultant), Ana Otilia Nu u (consultant), Lucian Luca (consultant).

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EXECUTIVE SUMMARY

1. **The government has embarked upon a comprehensive and difficult medium term program for reforming the public sector aimed at rebalancing the relation between revenue and spending and enhancing the efficiency and efficacy of service delivery.** Reforms include the gradual introduction of a unitary public pay system aligned with European practices to upgrade the capacity to attract and retain appropriate skills in public administration; the adoption of a multi-annual fiscal framework to optimize resource mobilization by better aligning strategic planning, policy and expenditure; reform of the pension system to place it on an equitable and financially sustainable path; sectoral reforms in education, health and social assistance to improve allocative efficiency and strengthen the safety net.

2. **The reform agenda is however severely constrained by the fiscal framework, which deteriorated substantially in recent years.** Public spending expanded from around 31 percent of GDP in 2001 to 37 percent of GDP in 2008, without being matched by an increase in government revenue, which has remained flat at around 31-32 percent of GDP. Most of the increase in spending went into the public sector wage bill and public pensions. The wage bill almost doubled in nominal terms between 2005 and 2008, while the public pension fund moved into deficit from an initial surplus. As a result of the excessive spending, Romania entered the global crisis with the largest structural deficit in the EU[1].

3. **Under these conditions, there is little room for fiscal stimulation.** The highly pro-cyclical fiscal policy promoted in recent years does not give the government room to adopt an expansionary fiscal stance in support of the dwindling aggregate demand as a result of the crisis.

4. **Instead, the government should focus on reconciling the tight fiscal resources with spending priorities to invest in reigniting a robust and equitable growth and creating sustainable jobs.** In the short run, the focus should be on reducing the budget deficit and reallocating spending towards productive ends and social assistance. To reinstate macro-stability and fiscal discipline, it is key for the government to meet its deficit targets. The government should eliminate low priority spending in order to generate savings that can be directed to priority high return investments to boost productivity and competitiveness.

5. **The government has already taken a series of measures to restore fiscal discipline and improve the quality of spending.** Such measures include a freeze on public sector employment and cuts in personnel costs, work in progress to upgrade the legal framework for pay and fiscal policy conduct, and steps aimed at establishing an MTEF. This is however a long term process, whose success hinges on the determination and the strategic approach of the government and the ability to mobilize popular support and the appropriate engagement of the public institutions.

[1] 7.9 percent of GDP in 2008, according to the 2009 EC Spring Forecast.

6. **The surge in spending was not accompanied by measures to enhance its quality.** The report shows that outcomes in education, health and transport remain poor, pointing to chronic structural problems besetting the public sector: an oversized and inefficient public administration; endemic governance challenges; and an unrestructured public enterprise sector, draining considerable resources.

7. **Addressing the root causes leading to an inadequate quality of service delivery and fiscal indiscipline requires a long term reform agenda which should aim at radically transforming the public policy framework.** Reforms should focus on: establishing an MTEF; enhancing planning and policy-making capacity in the government; developing a multi-annual investment program; putting in place reliable periodic financial reporting along with efficient and effective commitments and expenditures controls; restructuring tax administration; and modernizing the human resources framework. These reforms nevertheless need to be initiated now to reduce fiscal vulnerabilities, which prompted the fiscal crisis, and take advantage of the crisis context and the available technical and financial support.

8. **The focus of this report is twofold.** First, it offers an overview of the main challenges faced in key sectors -- education, health, transport, agriculture, public pay and pensions – seen from a resource allocation perspective. To address these, the report proposes a series of short and long term measures, consisting of legal, institutional and policy reforms aimed at enhancing efficiency and efficacy in public sector service delivery.

9. **Second, the report proposes a series of measures to bridge the considerable short term gap between the government's budget revenues and expenditures.** This can only be achieved by undertaking policy corrections on both sides of the government's balance-sheet. These corrections need to be large and, in some cases, of a permanent nature. In particular, in the current crisis environment and consistent with experience worldwide, significant emphasis should be placed on permanently reducing current spending.

10. **In the public pay area, the challenge is to move away from the current non-transparent and highly fragmented pay practices**. These practices emphasize seniority, and rely excessively on a large number of bonuses and allowances. As a result, similarly qualified people are paid substantially differently, some several times more than others. To address this situation, a pay reform strategy is needed, with focus on aligning pay levels with job responsibility and performance. In the short run, there is a need to reduce the public sector wage bill through a combination of (substantial) employment and wage cuts in order to bring about medium-term sustainability.

11. **The public pension system is financially unsustainable**, running a fast-increasing deficit. At the same time, it is beset by structural problems: generous retirement age and indexation rules, special conditions granted to privileged groups of retirees, a low contributor-to-beneficiary ratio, and high levels of social contributions, penalizing competitiveness. The reform agenda should focus on indexing pensions to inflation, equalizing retirement age for women and men, reviewing the level of contributions and eliminating the privileged pensions. In the short run, the report suggests applying the same treatment to the "special" pensions as to the public ones. Concomitantly, employees of the special sectors (defense, public order, etc.) should pay social insurance contributions at the same levels with the rest of the labor force.

12. **In education, the key challenges are its quality, relevance for the labor market and access,** especially in rural areas. A main constraint impeding the sector from delivering better results is related to how, as opposed to how much, the education sector spends. Reforms require the introduction of per capita financing, greater local autonomy to create better incentives for performance, and coherent policies for teachers remuneration and their accomplishments. The capacity for policy formulation, programming, monitoring and evaluation should be upgraded. In the short run, there is scope to increase class sizes and considerably reduce the number of teaching positions, and revise investment plans in line with a prioritized resource envelope.

13. **In health, the financing base remains excessively narrow, undermining the sharing of risks, while the distribution of spending is biased towards hospitals, at the expense of preventive and primary care.** Disparities in access to medical services persist between rural and urban areas and among income groups. The report recommends shifting the emphasis towards outpatient care, the introduction of quality assurance mechanisms, the revision of the benefits package and advancing hospitals reforms, including rationalization. In the short run, savings can be achieved reviewing the hospital expansion strategy and broadening the tax base for healthcare.

14. **The transport sector faces systemic financing, institutional and governance constraints, and a disconnect between the policy agenda and the capacity to formulate and implement expenditure plans.** These result in cost overruns, uneconomic uses and misallocations. The report suggests the articulation of a sector-wide, medium-term action plan for the development of the sector, matched by appropriate levels of resources, including from the European funds, a clear definition of responsibilities of the actors in the sector, and the restructuring of the roads and railways agencies. In the short run, important savings can be achieved by reviewing the payments calendar for the Brasov-Bors highway, the introduction of cost benchmarking for contracts and projects, and the reduction in the volume of services to match the reduced subsidies in rail companies.

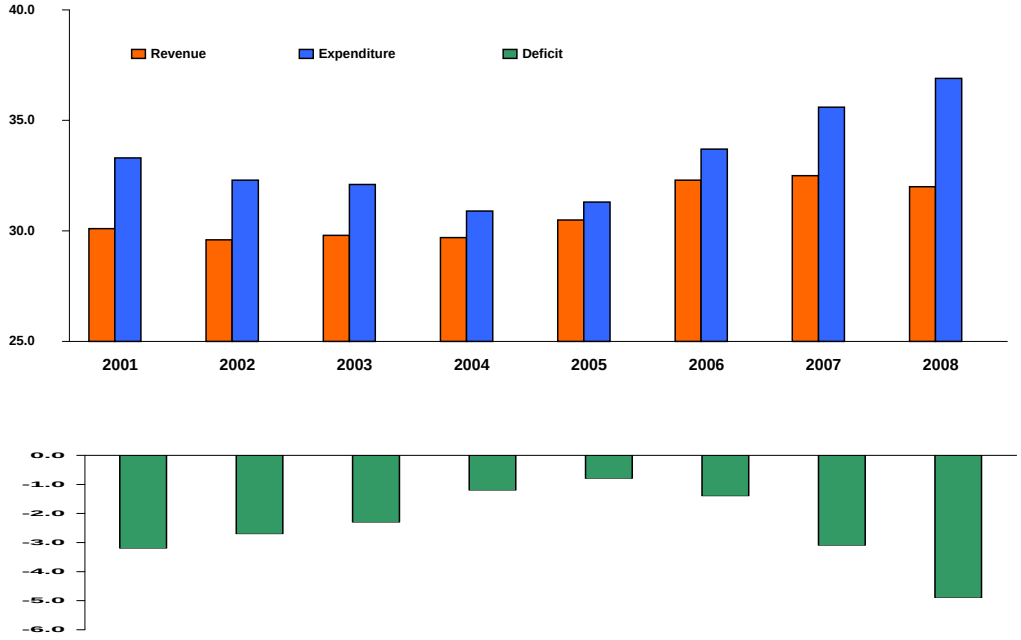
15. **Agriculture suffers from a dual farm structure, a large and aged labor force and severe capacity constraints in planning and financial programming**. These should be addressed by making a better use of the available EU Common Agricultural Policy funds for both agriculture and rural development. Funds should be channeled to competitiveness-boosting priority activities, in particular to support medium-sized farmers and rural infrastructure. Reforms should focus on aligning institutions and capacities with policy objectives to improve the quality of services provided to farmers. In the short term, significant savings can be achieved by phasing out several national programs which are not needed to improve farmers' welfare, nor the competitiveness of agriculture.

16. **The report proposes a series of further revenue enhancement measures and expenditure cuts.** These include the temporary introduction of a "solidarity" tax, the sale of surplus of CO2 emissions rights, the revision of the level of royalties, and the introduction of electronic procurement for all public sector entities. Should the gap between government revenue and expenditure remain large, an increase in VAT and/or income taxes may be contemplated.

I. INTRODUCTION

17. **The Romanian economy has been hit hard by the global economic downturn.** Latest estimates suggest that real GD may have contracted by around 7 percent in 2009, before modestly recovering in 2010. The severe decline in output has had a significant adverse effect on consolidated budget revenues, which fell substantially below the initial target in 2009. To prevent a further deterioration of the already large fiscal deficit, the shortfall in revenue has led to adjustments in spending. Consolidation of expenditure needs however continue in order to put public finances on a sustainable trajectory over the medium term.

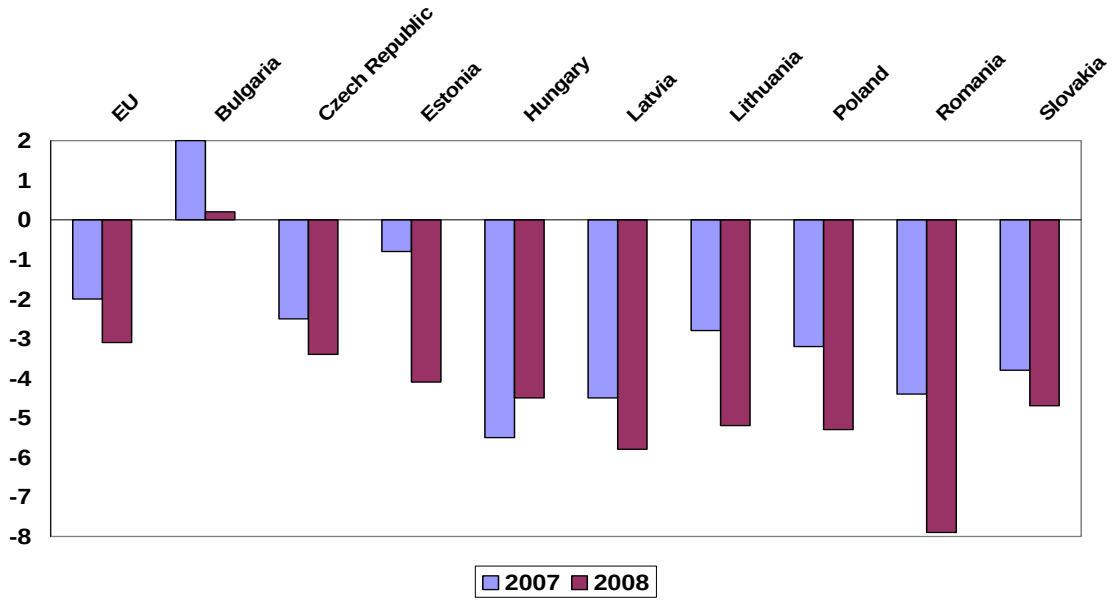
Figure 1. Government Revenue vs. Expenditure, 2001-2008 (% of GDP)



Source: Ministry of Public Finance

18. **The global crisis has exposed the vulnerabilities of the economy and, in particular, of the fiscal framework.** A highly pro-cyclical fiscal policy adopted in recent years, in the context of poor quality public service delivery, led to government spending increasing from 31 percent of GDP in 2004 to 37 percent of GDP in 2008, while revenues stagnated to around 31-32 percent of GDP. Most of the increase was in current spending. The public sector wage bill almost doubled, as percentage of GDP, during this period. Thus, public sector wages have become, on average, the second highest in the country after those in the financial sector. Concomitantly, a significant hike occurred in public employment, which expanded by 15 percent between 2005 and 2008. Two consecutive increases in public pensions brought the pension fund from surplus into deficit, undermining its long term financial sustainability. The situation was exacerbated by further expenditure hikes in the run up to the elections in the final months of 2008.

Figure 2. Structural Budget Balance (% of GDP)



Source: EC Spring Forecast 2009

19. **To confront the challenges, the government has embarked upon a comprehensive and difficult medium term program for reforming the public sector aimed at rebalancing the relation between revenue and spending and enhancing the efficiency and efficacy of service delivery.** Reforms include the gradual introduction of a unitary public pay system aligned with European practices to upgrade the capacity to attract and retain appropriate skills in public administration; the adoption of a multi-annual fiscal framework to optimize resource mobilization by better aligning strategic planning, policy and expenditure; reform of the pension system to place it on an equitable and financially sustainable path; sectoral reforms in education, health and social assistance to improve allocative efficiency and strengthen the safety net.

20. **Policy options are however limited by the severity of the downturn and the fragility of the fiscal conditions.** As the country has entered a severe recession, an easing of fiscal policy to cushion the downturn is not possible, with spending already too high for medium term sustainability and the government's ability to finance a large deficit limited. Rather, the authorities need to implement a restrictive budget in 2010 and beyond to gradually bring the fiscal imbalances under control.

21. **At the same time, the crisis offers the context to undertake some of the more difficult structural reforms which have prevented the Romanian economy from realizing its full potential.** Decisive action from the government is necessary to restore and broaden the reform agenda, largely stalled in recent years. In turn, this is needed to stimulate confidence in the economy, improve competitiveness, enhance employment and contain the slowdown in aggregate demand, as well as to protect the poor and vulnerable from the effects of the crisis. The government's resolve and capacity to act will decide the evolution of the economy after the crisis.

22. **A key challenge of the government is therefore to reconcile the tight fiscal resources available with spending priorities to invest in reigniting a robust and equitable growth and creating sustainable jobs.** In the short run, the focus of the policy agenda is on reducing the budget deficit and reallocating spending towards productive ends and social assistance. To reinstate macro-stability and fiscal discipline, it is key for the government to meet its deficit targets. The government aims to eliminate low priority spending in order to generate savings that can be directed to priority high return investments to boost productivity and competitiveness. To mitigate the effects of the crisis, additional resources are dedicated to protecting the poor and vulnerable groups, traditionally disproportionately affected by crises.

23. The focus of the report is, in this context, twofold:

- First, **it proposes a menu of options which can help bridging the considerable short term gap between the government's budget revenues and expenditure.** The fast and dramatic deterioration in the level of economic activity and the consequent decline in the in government revenue relative to the initial forecast are putting severe pressure on the budget deficit. In these conditions, the government needs to make hard fiscal policy choices in order to strike the appropriate balance between the medium term adjustment objectives and the short term need to allow automatic stabilizers to work. Preliminary 2009 budget execution figures suggest that the disparity between current spending and revenue has continued to widen. Much of this is the carry over effect of policies pursued in the second half of 2008, when public wages and pensions expanded fast. Nevertheless, the current trend is unsustainable and both incisive and large fiscal adjustments are needed in order to place the budget deficit on a downward path over the medium term consistent with the macroeconomic consolidation framework agreed with the IMF[2].

- Second, **it suggests a series of short and long term measures, consisting of legal, institutional and policy reforms aimed at enhancing efficiency and efficacy in public sector service delivery.** The focus of the report is on the key public spending areas[3] – education (4.5% of GDP in 2008), health (3.8%), transport (4.0%), agriculture (1.4%), public pay (8.2%) and pensions (6.7%) – which benefited from substantial and increasing budgetary allocations in recent years. Yet, in most of the cases, the increase in spending was not reflected in better performance. The report looks at the key challenges of these sectors, seen from a resource allocations perspective, and offers a menu of policy reform suggestions.

24. The report is structured in two volumes. The first volume synthesizes the menu of options suggested to reduce the short term gap between budget expenditure and revenues. It also highlights the key challenges and recommendations for improving efficiency and efficacy of spending in the sectors investigated. Volume two consists of the background analyses, with individual chapters dedicated to the fiscal framework; public pay; pensions; education; health; and agriculture.

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[2] The fiscal adjustment effort is around 2.2 percent of GDP in 2009 and 2.5 percent of GDP in 2010 in structural terms.

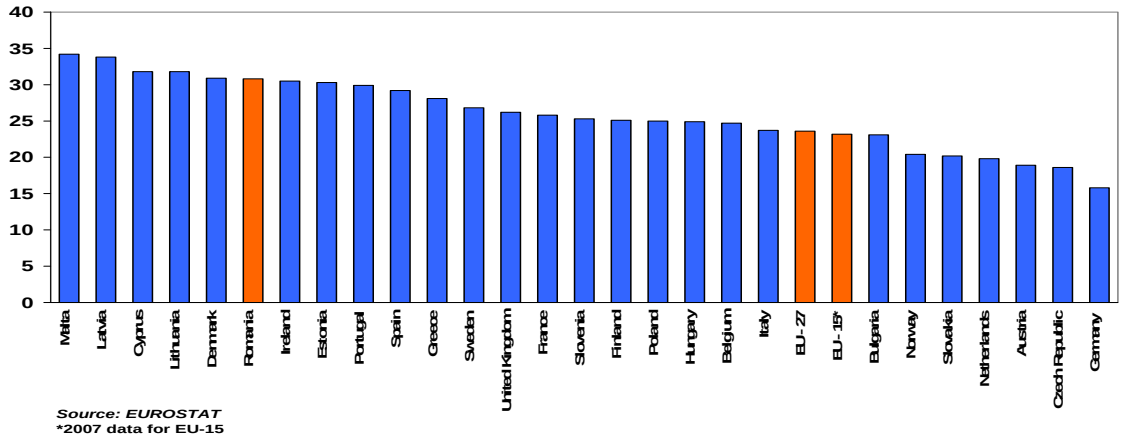
[3] These key sectors constitute a significant share of public spending. Other large spenders include defense and public order and safety.

II. ACHIEVING SHORT TERM FISCAL SAVINGS AND IMPROVING RESOURCE ALLOCATION IN THE PUBLIC SECTOR

25. **Bridging the gap between current spending and revenue can be achieved by undertaking policy corrections on both sides of the government's balance-sheet.** We propose below a series of options for raising additional revenue and pursuing expenditure cuts. The report does not suggest the concomitant introduction of all these measures, but it offers a menu of options. What it suggests, however, based on the evidence provided in the core chapters, is that a combination of significant expenditure cuts and revenue enhancing measures is needed in the short run to avoid a widening and endemic budget deficit, difficult to correct subsequently, and a sharp escalation of public indebtedness.

26. **The report makes the case that, in the current crisis environment and consistent with experience worldwide, the gap between expenditure and revenue should be done primarily by reducing the level of current spending.** Further raising revenue by 5-7 percent of GDP to match the current level of spending is unlikely and not advisable in the short or medium run. Such a move would require substantial hikes in the level of statutory taxes, some of which, such as the taxes on labor, are already high compared with those in other European countries. In addition, tax hikes would need to be coupled with major improvements in tax compliance, tax collection, broadening the tax base, and addressing tax arrears which, in turn, require considerable institutional and administrative reforms of the tax system. At the same time, the present levels of current spending are unsustainable relative to the revenues raised by the budget. Spending on personnel, for example, is among the highest in Europe, relative to government revenue (Figure 3).

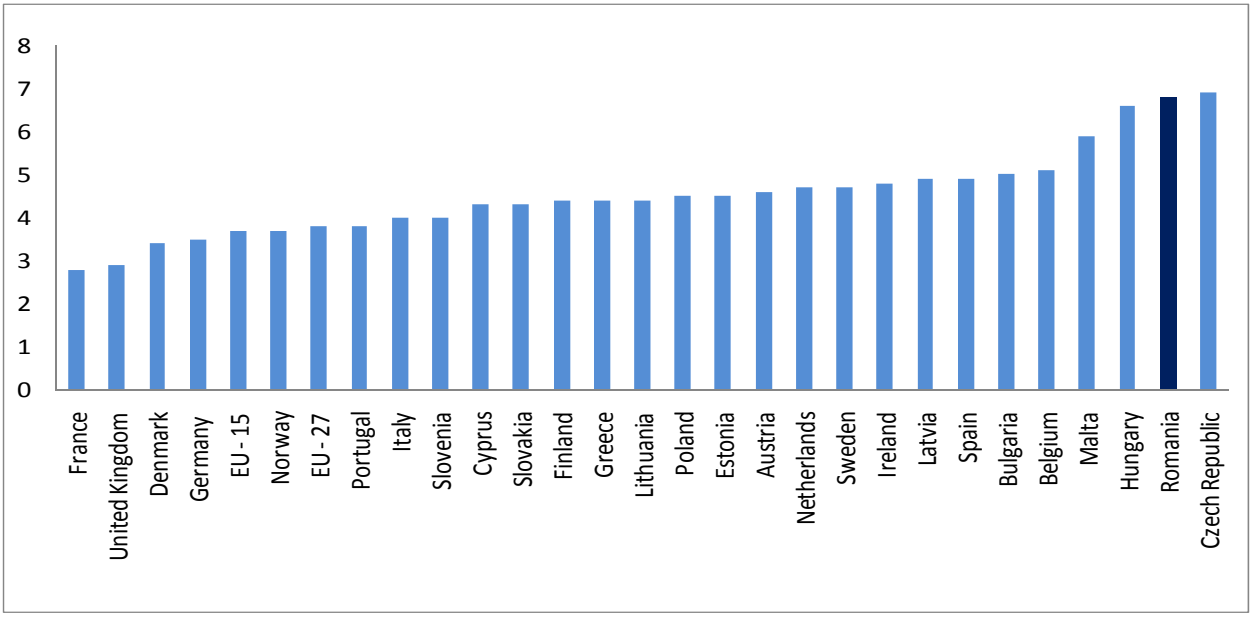
Figure 3. Personnel Expenditure, as Share of Government Revenue (2008, %)



27. **Substantial resource savings can come from addressing the endemic input orientation of the budget.** The current system of budget appropriations does not stimulate restructuring and performance by offering credit holders the appropriate incentives to effectively use resources. Instead, the objective remains to finance a certain level of inputs, some determined on a historical basis. A comparison of government spending with the rest of Europe

shows that Romania continues to allocate outsized public resources to economic affairs (energy, industry, agriculture, transport). This level, measured as percentage of GDP, is the second highest in Europe, after the Czech Republic, and almost double than the EU average. These resources come in various forms- subsidies, transfers, arrears and direct allocations- largely unrelated to the performance of the sectors. Thus, there are no incentives to save resources or reallocate them towards better ends. Such a system also discourages the consolidation of the management capacity of the credit holders, which often have a mere accounting role. Moving towards performance budgeting, by strengthening the linkage between the resources allocated and results, could bring substantial fiscal benefits. This is however a medium term process which requires a comprehensive overhauling of the public administration.

Figure 4. Government Expenditure on Economic Affairs, 2007 (% of GDP)

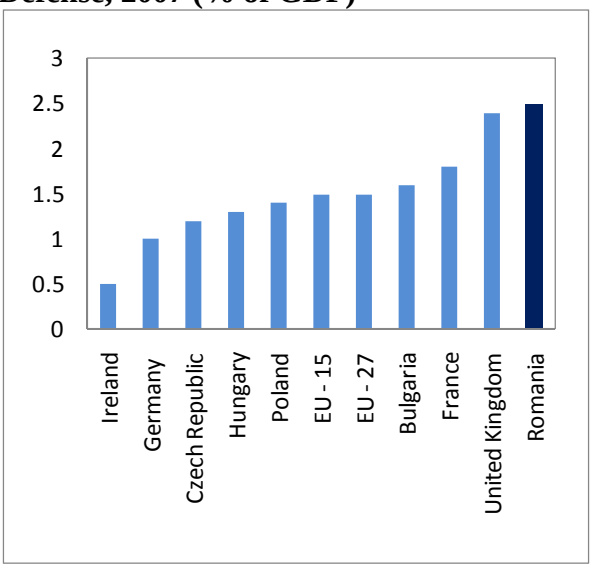


Source: EUROSTAT

28. **Reviewing the relation between the budgetary allocations and results of the special sectors can also generate important savings and help improve efficiency.** The figures below suggest that Romania allocates substantial resources to defense and public order. Eurostat figures reveal that the allocation to defense was the highest in the EU in 2007, while that to public order was among the top, measured as percentages of GDP. While it has not been the intention of this report to assess the quality of spending in these areas[4], the numbers recommend a thorough performance analysis in the respective sectors.

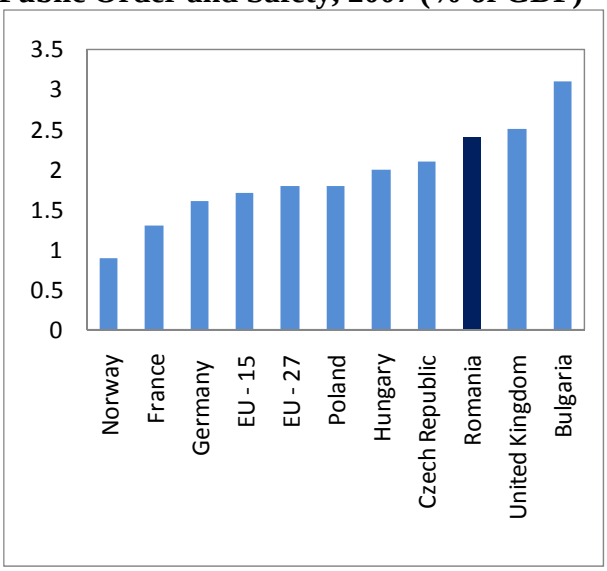
[4] Public information on the resources allocated to defense and public order and safety is scarce.

Figure 5. Government Expenditure for Defense, 2007 (% of GDP)



Source: EUROSTAT

Figure 6. Government Expenditure for Public Order and Safety, 2007 (% of GDP)



Source: EUROSTAT

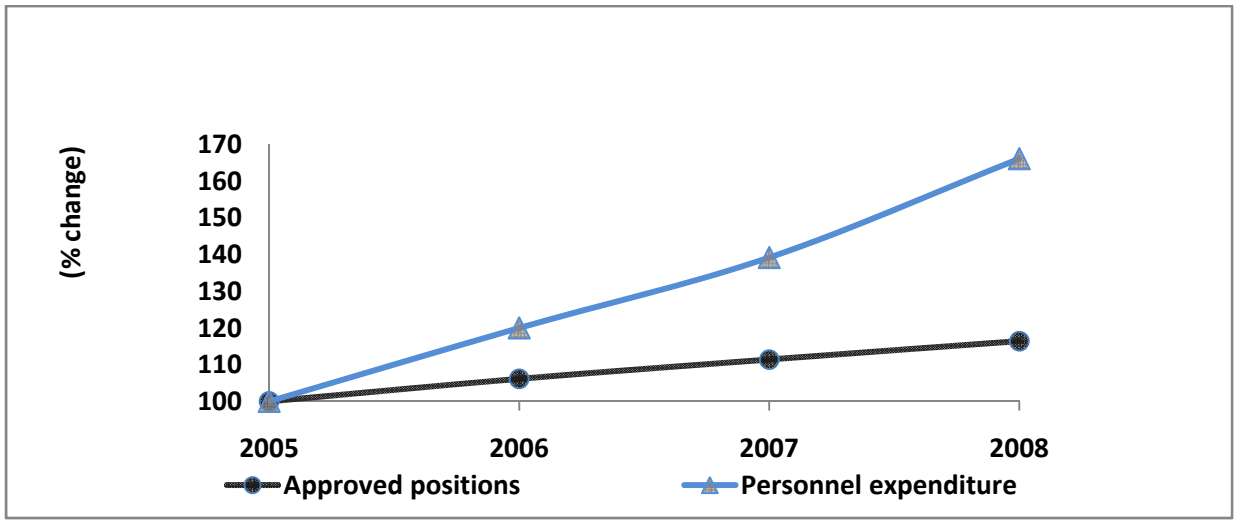
II.1 PUBLIC PAY AND ADMINISTRATIVE REFORMS

Key Challenges

29. **The public sector wage bill and employment expanded substantially in recent years, severely straining the scarce budgetary resources in the current crisis conditions.** As the figure below suggest, personnel costs expanded by around 66 percent in real terms[5] between 2005 and 2008, while public sector employment increased by some 16 percent. The increase in employment[6] occurred at all levels of government, including at central level (up 20%), local governments (up 17%) and public institutions financed from own sources and subsidies (up 35%). As a result of the substantial salary hikes, the public wage bill was, in 2008, one of the largest in the EU, measured as a share of government revenues (see the Fiscal Framework chapter in Vol. 2). The carry-over effects of the previous pay policies have led to a higher than initially planned increases in the wage bill in 2009, in spite of measures to contain wage expansion through bonuses reductions, a freeze on existing vacancies and the replacement of one in seven positions made vacant. Important slippages occurred primarily at sub-national level and in the self-financed public entities.

[5] CPI deflated.
[6] Approved positions.

Figure 7. Public Sector Personnel Expenditure Dynamics, 2005 - 2008



Source: Ministry of Public Finance

30. **The structure of the public sector pay system remains a significant impediment to improving the quality of public services in Romania.** Although the government focused in the past four years on increasing average salaries, the overall system of remuneration is unchanged and varies significantly from those found in other EU countries:

- **Non-wage compensation represents a disproportionate share of total compensation**, well above EU practice, varying anywhere from 68 percent for teachers to 42 percent for military and 45 percent for public safety employees (this excludes the amounts that are paid by the employer for social contributions). In most European countries base salary is at least 80 percent of total pay.

- **Allowances undermine transparency** and lead to discretionary practices. Diverse allowances are described in employment statutes, with some given to almost all employees to top-up base salaries and others reserved for certain categories (e.g., police officers who use codes). Yet other elements of remuneration are in the form of in-kind benefits, and not explicitly authorized in the law.

- **The basic principle of 'equal pay for equal work' is not respected.** Some people are paid several times more than others who perform a similar function. Genuine differences in performance and responsibilities can explain some variance in pay, but not of the magnitude found in the Romanian data.

- **Incentives for performance are undermined by the compressed salary scale.** The differences in base pay that result from promotions to positions of higher responsibility are relatively small. Therefore, performance incentives that come through the prospect of career advancement are weak.
- **Seniority is rewarded at the expense of performance.** Seniority is rewarded in other countries through movement within a salary range for a specific position – as a partial recognition of performance in that particular job. But in Romania it is an

automatic payment irrespective of actual performance or responsibility. Moreover, because of its size – up to 25 percent of base salary – it can overshadow the rewards that come from career advancement. For younger staff entering the public service, the opportunities for salary enhancement are quite limited in the short to medium term, and this may explain in part the high turnover rates.

- **Compensation decisions are not based on reliable information on private sector comparators.** In most EU countries public sector salary levels may be below those in the private sector. This reflects non-monetary benefits such as enhanced job security and other factors. Specialized salary survey data is used periodically to assure that salaries for various types of positions remain within a desired range.

Recommendations

31. **Institutional authority for coordinating reform of public administration should be built up at the center of government.** The current ad hoc negotiation of pay levels with individual unions reflects weak central policy coordination capacity for personnel management. With respect to personnel policy:

- The institutional responsibility for human resource management needs to be clearly defined.

- Basic indicators to be used for effective management need to be collected systematically. Indicators would measure the impact of new policies on recruitment, retention rates, training, and overall employee satisfaction.

32. **A medium term pay reform strategy should be implemented to increase transparency of the pay system and to align pay levels more closely with actual job responsibility/performance**:

- The strategy should include an overall goal/target for the size and cost of the public administration over the medium term.

- Non-wage compensation should be substantially reduced over time so that the pay system is more transparent and less subject to abuse.

- A comprehensive grading framework, including a serious effort to validate the relative "job weight" of common public sector occupations would also help to improve simultaneously the internal equity and external competitiveness of positions. One aim should also be to improve the attractiveness of the public sector to university graduates and to reduce artificial constraints on advancement.

- Formal labor market surveys should also be implemented with which to assess compensation for different categories of positions with their most relevant private sector comparators.

33. **The government has recently taken an important step in the reform of the public pay system through the passage of a unitary pay framework law.** The law introduces annual targets for the overall public sector wage bill over the medium term, measured as percentage of GDP, and defines the principles that will lay at the foundation of a new pay and grading system. These principles include: (i) a reformed grade structure using a modern job evaluation methodology based on occupation and job responsibilities, so as to promote equal pay for equal work; (ii) within a grade, the assignment of all positions to a job family based on the content of the actual work responsibilities; (iii) a single unified payscale for all public institutions, defining the available base rates for all jobs in all grades; (iv) for any grade and job family higher reward will be given to greater responsibility, and incentives will be created for suitably qualified and experienced staff to take on greater responsibilities; (v) competitiveness in relation to the labor market, within the affordable budget envelope, in order to attract and maintain qualified personnel; (vi) unified control of public service by Cabinet. The government has committed to working over the following months to draft the secondary legislation for the framework law, with the intention to begin the implementation starting with January 2011.

34. **The incentives for public institutions to focus on performance, including their efficiency and effectiveness of public resource use, should be improved:**

- Performance measurement for senior managers and directors of departments will be much easier when the institutions themselves have well-established objectives and measurable indicators of performance.

- The government should conduct functional reviews of major ministries and the overall structure of the public administration to identify options for streamlining important functions.

- Reducing the number of authorized positions would be one way for the government to release more resources for improving the public pay system.

Achieving short term savings

35. **Reducing the public sector wage bill through a combination of employment and wage cuts is key to bringing government spending on a sustainable downward path.** The public sector wage bill has almost doubled in nominal terms since 2005 and is not sustainable at the current level of around 9 percent of GDP and over 35 percent of total government revenue. The increase in the wage envelope has come from both an increase in public employment, of about 16 percent, and a rise in the average wage in the public administration, which is currently significantly above the average wage in the private sector. Evidence suggests that the wage bill of the sub-national governments and self-financed public entities has continued to expand. Part of this comes from the large wage increases granted in the last quarter of 2008 under the bargaining of the collective contracts and reflect the unbalance between the relative power of the trade unions and of the state employers. Nevertheless, following the contraction of revenue collection well below the levels projected at the time of the wage negotiations, the granted wage increases are hardly or not at all financeable and require tough adjustments to prevent large increases in arrears, which are already on a upwards trend.

36. **So far, the measures adopted by the government in 2009 to reduce the public sector wage bill have had a modest effect.** These measures have been: a freeze imposed on the existing vacancies; the replacement of one in seven positions made vacant; and the adoption of a government ordinance stipulating the elimination of some bonuses and allowances and the reduction of others, in April 2009. Attempts of the government to cut earnings have often been challenged in courts, leading to the reinstatement of various bonuses[7] and to penalties for the government.

37. **In these conditions, given the substantial worsening of the fiscal framework, we view large public sector employment cuts as imminent at all governmental levels: central, sub-national, SOEs and agencies**. Simulations suggest that net savings of around 0.5 percent of GDP for a full fiscal year can be achieved by reducing around 80,000 average staff in the public sector. This would represent around 5.5 percent of total public sector employment.

38. **While the reduction in employment has to be targeted, done according to clear criteria and in the appropriate areas, our analyses suggest that a reasonable number of positions can be eliminated in the short run without affecting the performance of a particular sector**[8]. In education, for example, the reduction in teaching loads can make redundant up to 20,000 positions. The increase in class sizes can also eliminate further numerous positions (see the Education chapter in Vol. 2). At the local level, the intention of the government to introduce personnel norms function of the size of the community can bring important savings, although, on the other hand, can induce more rigidity in the allocation of resources.

39. **In parallel with these savings-oriented measures, a thorough assessment of the functions, organizational structures and available skills in public agencies should be initiated and a multi-annual plan prepared for a comprehensive overhaul of the public sector, which would also place personnel costs on a sustainable long-term trajectory**.

II. 2 PENSIONS

Key challenges

40. **Romania's public pension system is under considerable stress and its prospects are bleak unless far-reaching reforms are initiated soon:**

- The first pillar system is financially unsustainable and requires sizeable and increasing state budget support; it is affected by important inequities; and it taxes employers excessively, curtailing competitiveness and fuelling the informal economy. Many of the standard indicators used to determine the health of the pension system place Romania at the bottom of the EU.

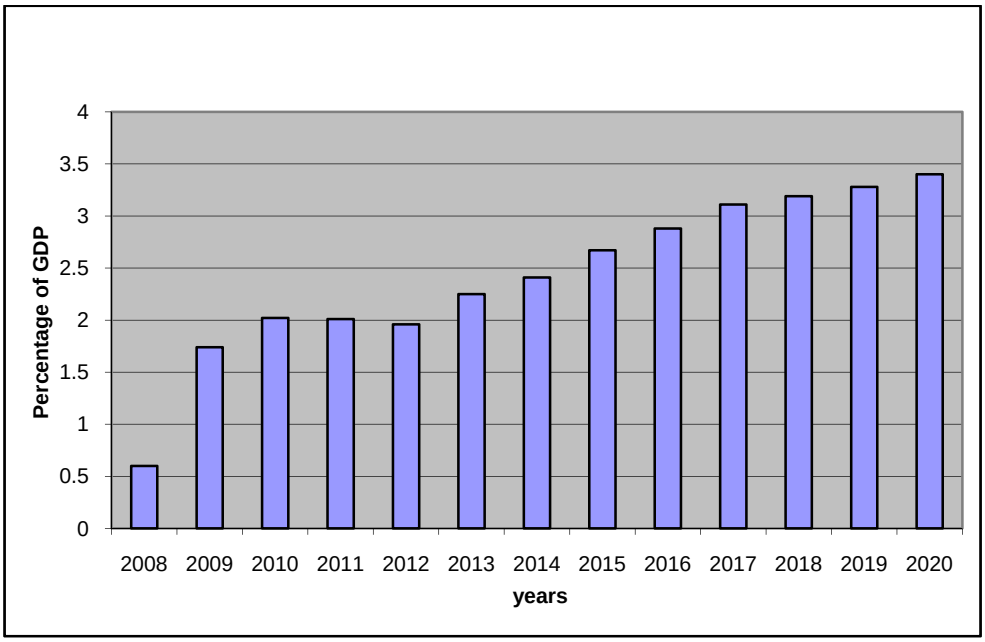
[7] Judges and prosecutors, for example, obtained in courts the reinstatement of the bonuses for neuropsychological stress, risk and anti-corruption.

[8] In fact, in many areas, the increase in employment and personnel costs was accompanied by a decline in performance. Education is an example.

- The economic crisis has painfully exposed these problems, as the government is being forced to extend massive financial support at a time when it can hardly afford it.

- Without reform, the pension system will continue the present downward spiral which will require ever-increasing diversion of state budget resources from their normal uses, undermining economic convergence, and affecting the very livelihood of future generations of retirees.

Figure 8. Projected Public Pension Fund Deficit, 2008-2020



Source: World Bank projections 2009.

41. **The pension system is beset by serious structural problems:** Some - primarily ageing of the population – are shared by most EU members, but most are due to ill-considered decisions driven by short-term political considerations:

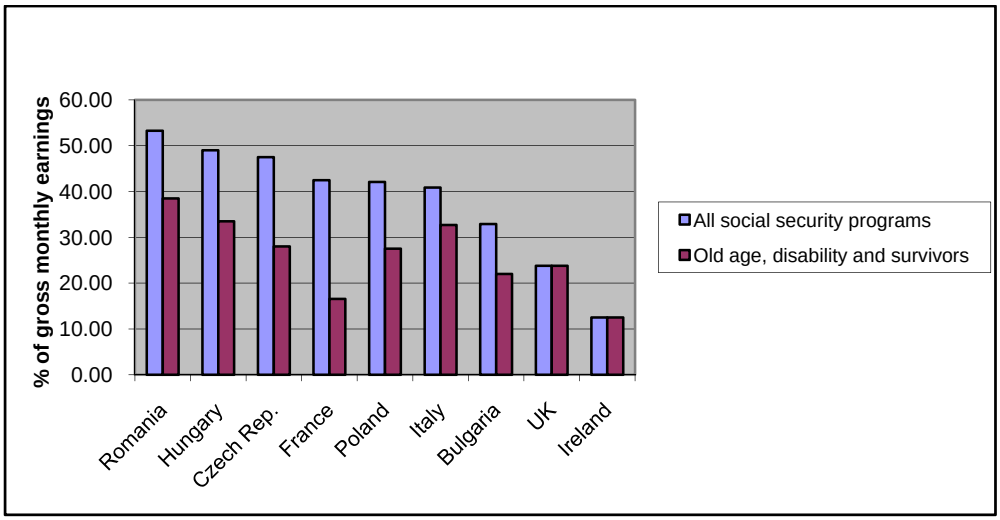
- Generous retirement age and pension indexation rules;

- Special conditions granted to some privileged groups of retirees;

- The drain of young workers attracted by employment opportunities abroad;

- The attempt to meet the increasing financial gap of the system by raising social security taxes can penalize economic competitiveness and drive an increasing proportion of labor to the informal economy, fostering a vicious circle of a declining contributors-to-beneficiaries ratio and increasing taxes. Romania has the highest taxation of social security and one of the lowest ratios of contributors to beneficiaries in the EU.

Figure 9. Social Security Contributions in Selected Countries, 2008



Source: United States Social Security Administration, *Social Security Programs Throughout the World: Europe, 2008*

Recommendations

42. **In the short term, the reform should focus on achieving savings and improving the financial sustainability of the pension fund.** Financial stability requires:

- de-linking retirement benefits from gross average wages;
- replacing the current indexation system with inflation-based indexation;
- equalizing the retirement age for women with that for men;

43. **Reviewing the status of the "special" pensions.** Retirees from the defense sector, public order, the judiciary, parliamentarians, civil aviation and other categories receive pension benefits from both the public sector and special funds from the state budget. These privileges are mostly granted under special legislation. Integrating this legislation into the pension law can yield some fiscal savings, even in the short run.

44. **Other short term measures** should include:

- restoring the schedule for gradually increasing the financing of the second pillar by 0.5 percent a year until reaching the 6 percent target; and
- designing and implementing a zero pillar system addressing social protection of non-contributing elderly poor.

45. **In the medium-term,** attention needs to be devoted to:

- reviewing labor taxes and contributions for employers with a view to gradually bringing them down;

- implementing a capacity building program aimed at strengthening pension administration and monitoring, including the integration of ITC systems in the National House of Pensions, the National Agency for Employment, the National Agency for Social Assistance Benefits Payment, and the Ministry of Labor, Family and Social Protection;

- replacing the compliance-based supervision of the pension fund market with risk-based supervision; and

- implementing an information-education-communication (IEC) program to improve the financial awareness of contributors, and help them understand the impact of their decisions on future benefits.

II. 3 EDUCATION

46. **The need for education reform is widely accepted** across the political spectrum, as proven by the adoption in March 2008 of the National Pact on Education endorsed by all political parties as well as by other stakeholders, including all major trade unions active in the sector. The next major steps contemplated by the Authorities are decentralization of education financing, administration and management of human resources, and the related introduction of per capita financing.

Key challenges

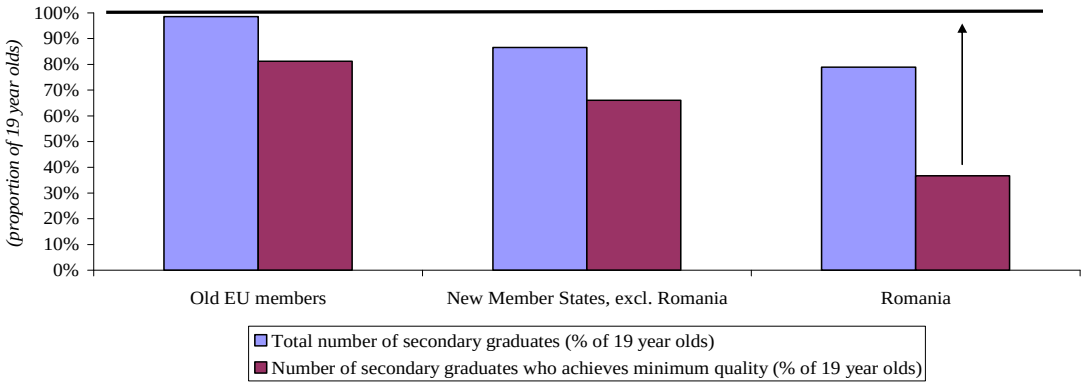
47. **Romania's main challenge in education is related to weaknesses in quality.** Romania's youth – for the most part – attend school and graduate, but international assessment data suggest that many of them may be graduating from school without acquiring the necessary skills to succeed in life and in the labor market. In particular, OECD's Programme for International Student Assessment (PISA) reveal that a large proportion of Romanian students – 53.5 percent of the 15-year olds – scored at a level ("below level 2") indicating "serious deficiencies in students' ability to use reading literacy as a tool for the acquisition of knowledge and skills in other areas."[9]

48. **The international test results not only reveal problems with the overall quality of education, they also show a high polarization of students' results.** In particular, students in rural areas score significantly lower. For example, results from the international PIRLS 4th grade reading assessments show that scores were 5 and 11 percent higher in urban areas in 2001 and 2006, respectively, compared to rural areas. PISA 2006 findings were similar, with students from large cities scoring 10 percent higher in mathematics, 13 percent higher in science, and 22

[9] Similar findings apply for scoring in science and mathematics, and they are confirmed by similar surveys: MSS 2003 for 8th graders, PIRLS 2001 and 2006 for 4th graders. Also TIMSS 4th and 8th graders 2007 (TIMSS & PIRLS International Study Center, Boston College, 2008).

percent higher for reading.[10] The results of students' national testing after the 4th grade and national exams after the 8th grade confirm these findings.[11]

Figure 10. Number of graduates and number of graduates achieving minimum level of quality, as a share of 19 year olds[12]



Source: Eurostat, OECD (PISA results 2006) and World Bank staff calculations

49. The report suggests that:

- Significant challenges remain in primary and secondary education, primarily related to the quality and the relevance of the education provided.

- The main constraint impeding the sector for delivering better results is related to *how* the education spends its resources as opposed to *how much* the education sector spends. For instance, low class sizes in large urban schools divert resources from the rural schools where they are most needed.

- Using resources more effectively will involve creating better incentives at the local and school level to create larger classes – within maximum class size norms – and more strategic, medium-term planning at the Ministry of Education, Research, Youth and Sports (MERYS).

Recommendations

- Introduce per capita finance and greater local autonomy to create better incentives (and more flexibility) to increase class sizes (which, at their current level of 20, could likely be increased without hurting the quality of education).

[10] MERI Annual Report 2008, pp. 62-64.
[11] Ibid. pp. 96-102.
[12] "Minimum quality" is defined as scoring above level 1 on PISA 2006 exam. To draw this graph a key assumption is needed, namely, that the distribution across different quality levels of 15-students (as measured by PISA) is indicative of the distribution across different quality levels of upper secondary graduates.

- Implement measures to strengthen accountability for results in exchange for more flexible financing. For instance, increasingly the financing of education needs to be linked to results, and school and local authorities need to be held accountable for delivering higher quality education (e.g. as measured by standardized tests).

- In addition to creating better incentives at the school and local level, MERYS can improve the management of fiscal resources in other ways:

    - First, it can help change the culture of budgeting by implementing an MTEF.
    - Second, given that the most important input in terms of learning is teachers, special attention is needed to steer policies regarding their salaries and their performance. In the future, discussions of salary increases needs to involve discussions of cutting the number of teachers, and linking further increases in wages to teacher performance.

Achieving short term fiscal savings

50. **The report suggests that substantial savings can be generated in the education sector, even in the short-run, in a way that neither the access to nor the quality of education would be impaired.** Savings can come primarily from the following sources:

51. **Reducing teaching positions by increasing class sizes in large schools.** Average class sizes are low in Romania, at around 20 students per class. At this ratio, there is substantial room to increase class sizes, primarily in the large schools (with more than 600 students). Ministry of Education figures indicate that there are 1400 large schools in Romania, and the average class size of these is 23 students. Simulations show that, by raising the average size of the class in the large schools to around 27.6 students, an increase which may not affect the quality of teaching, would lead to a decline of 18,000 full time (8% of total full time positions in the country) and 2,000 part time (9% of total part time teachers) teaching positions. Such a measure would result in savings of around 0.23 percent of GDP for a full school year. Naturally, MERYS should put in place a rigorous impact evaluation to measure the impact of such policy change on the quality of learning. However, given the savings which could be generated by such move – and diverted to rural schools where they are more needed – it seems worth pursuing.

52. **Increasing average class sizes in municipalities.** The government should consider also increasing class sizes beyond the large schools. This can be done by reorganizing, merging and closing schools. The report suggests two possible approaches for achieving this. Estimating potential savings from such a decision is however a function of the way by which consolidation is pursued.

53. **Postponing part of the planned capital expenditure.** Short term savings can be achieved by deferring part of the 2010 investment plans for the sector. For example, in 2008, a large program of school rehabilitations was launched, involving some 4,000 schools. These schools are at different stages of completion. The government should probably focus on completing works in those schools which are at most advanced stages, and defer the completion

of the rest, to the extent that this does not impair the quality of education and the contractual relations with the contractors allow it.

54. **Savings can be achieved by targeting scholarships to poorer students and introducing a student loan scheme**.

II. 4 HEALTH

Key challenges

55. **The reforms undertaken in the past two decades have been substantial and are still on-going, but the agenda remains unfinished.** A reform package introduced in 2006 consolidated and built upon a number of existing laws focusing mainly on decentralization, prevention and the development of primary health care, private sector involvement in health financing, and the clarification of the relationships between the health and social care systems. Decentralization is still on-going and a strategy on this issue was approved in May 2009.

Table 1. Selected Health Indicators, 1989-2006

Indicators	1970	1980	1990	1995	2000	2005	2006
Female life expectancy at birth	70	72	73	74	75	76	76
Male life expectancy at birth	66	67	67	66	68	69	69
SDR ischemic heart disease 0-64 per 100,000 males	26	42	55	72	63	86	85
SDR all causes and ages,	1,236	1,284	1,169	1,224	1,098	1,064	1,026
Infant mortality rate (per 1,000 live births)	49	29	27	21	19	15	14
Maternal mortality (per 100,000 live births)	116	132	83	48	33	17	15

Source: WHO HFADB and MoH Statistical Annual Book

56. The unfinished reform agenda needs to address a series of key challenges:

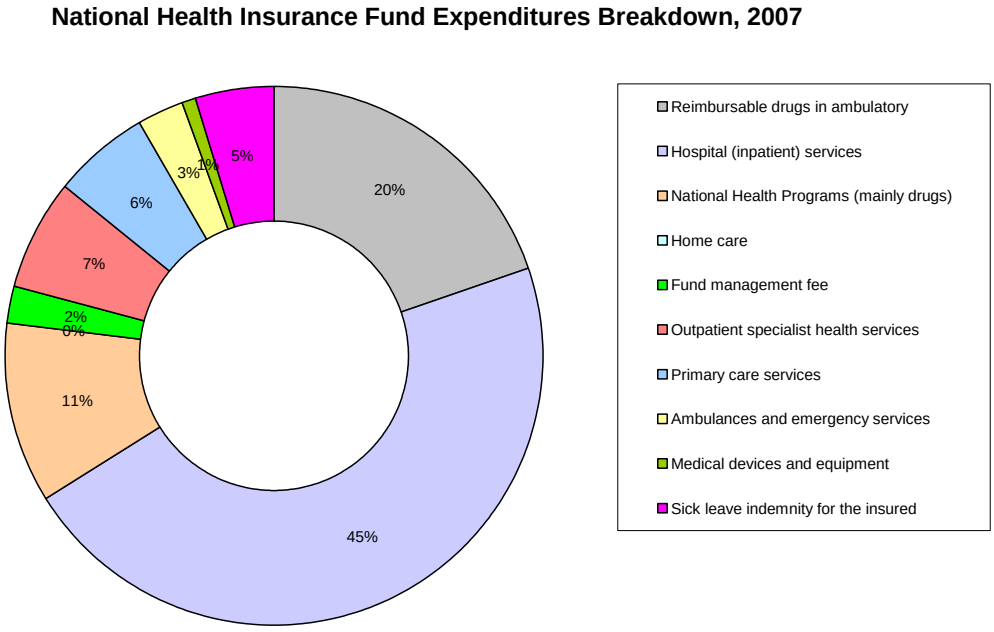
- The financing base of the sector remains excessively narrow. Although the reliance on contributions has decreased over time, following the introduction of sin taxes, the number of people who contribute to the funding of the quasi-universal system is low, which undermines the sharing of risk. Currently, there are 5.8 million insured, out of a population of 21 million, and most of non-wage-earners do not contribute.

- The distribution and efficiency of spending. There is ample room to improve technical and allocative efficiency of current spending, which remains biased towards hospital care. Preventive and primary care are reportedly under-funded and family doctors do not have the means or the incentives to upgrade their skills and equipment. As a result, hospitals remain main providers even for basic treatments and diagnostics.

- Despite a stated commitment to reduce inequities, disparities in access to medical services persist between rural and urban areas and among income groups. They reflect both supply-side constraints (investments in services and infrastructure are biased

towards richer and urban areas) as well as demand side barriers, including informal payments.

Figure 11. National Health Insurance Fund Expenditures Breakdown, 2007



Source: National Health Insurance House

Recommendations

57. **The reforms proposed by the Ministry of Health, revision of the benefits package and measures against informal payments and hospital rationalization are most welcome, but will probably meet some resistance.** Key stakeholders in the sector (medical staff, management) have strong incentives to maintain the status-quo: health staff because they supplement their income with informal payments, management because the current mechanisms limit the possibilities for effective performance monitoring (e.g., the mix of DRG and national programs to cover treatments). Part of this resistance could be overcome by setting clear prioritized results which the reforms will need to achieve, by generating public debate to build consensus around the choice of policies to achieve them, but also by measuring and documenting whether the intended result are indeed produced for the benefit of patients and citizens.

58. **Shifting the system towards providing more and better access to outpatient care requires**:

- Reduce hospital overcapacity, but also increase the autonomy of the hospital system to respond to incentives, monitor and reward performance. Future hospital investments should be guided by a master plan and selected according to equity criteria with the objective to reduce inequalities in access to care;

- As part of quality assurance, health technology assessment needs to be introduced and used as a basic tool for equipment investment and establishing the pharmaceutical reimbursement list (cost-benefit, cost-effectiveness assessments);

- Develop and strengthen preventive, primary, and outpatient care particularly in rural areas and improve referral systems.

59. **These reforms should be supported by:**

- Revisions in the provider payment system to encourage the expansion of outpatient care, limit fragmentation in funding so as to increase accountability for resources, harmonize funding across all facilities of the same type and reward performance;

- Quality assurance mechanisms. The recent development of guidelines for ten frequently treated conditions is a step in the right direction, but they need to be institutionalized and their implementation monitored. One option would be to create a Quality Assurance Agency in charge with coordination of clinical guidelines development, accreditation of health care providers, investigation of medical incidents/accidents, and elaboration of quality of care policies, education and training for quality assurance in health care. The performance of all health care services providers should be systematically assessed and monitored. As part of quality assurance but also in relation to the revision of the benefits package, health technology assessment needs to be introduced and used as a basic tool for equipment investment and establishing the pharmaceutical reimbursement list (cost-benefit, cost-effectiveness assessments);

- A clear strategy on medical and social care. The relationships between MOH, NHIF, Ministry of Labor, Family and Social Protection need to be clarified to improve chronic, long term and home care and set up a strategy for integrated medical and social care.

60. **In the longer run**, to ensure that the system received increased and adequate funding, it will also be important to:

- Establish a functional National Health Accounts system to support policy making, monitor the impact of the crisis on health expenditures and of reforms.

- Strengthen the capacity of the sector to generate, analyze and use economic information and data for decision-making (including the preparation of the MTEF).

Achieving short term savings

61. **The report make the case that savings can be identified in the health sector even in a situation of economic crisis and even in an area where the resources allocated are, as a share in GDP, below the EU average**. These savings can come from:

62. **Reviewing the hospital expansion strategy**. Romania has too many hospitals and beds and it is still planning on building eight new ones, while it has no overall framework for the hospital sector. As a consequence, hospitals are in the border land between independence and line item control of many decisions by the Ministry of Health (MoH). As an immediate step, the report argues that investments stop until an acceptable master plan is developed. In addition to shelving these investments, MoH could use the budget crisis as a context to close down, rationalize or sell entire buildings within the next period to reduce the drain of these institutions on the public budget. The two items are not contradictory because simple criteria could be developed for closings that would allow a sensible reduction. The goal would be a target for total beds in 2010 and 2011 budgets with quantitative savings. People would not necessarily need to be made redundant but could be redeployed, particularly if the closing down is in areas with obvious oversupply, such as Bucharest.

63. **Developing outpatient and general practitioner (GP) services as an alternative to hospital care**. The gatekeeper function of GPs would need substantial reinforcement to change how patients use the system, and it would result in lower costs. Additional short term investments would be needed in this area to build it up as a low cost and more effective alternative to hospitals and to improve use of the system by patients.

64. **Broadening the payroll tax for healthcare**. On the revenue side, the payroll tax base for the health insurance system is narrow today. One policy option to explore is whether to continue keeping such a narrow and labor market-distorting base or to move health to some percent of the VAT or an income tax set-aside. In that manner, revenues for health might also be increased over time as a quid pro quo for a substantial and immediate set of reforms that would create a much better integrated and efficient system with a lid on costs and a much better service for patients. This would be a longer term reform that might be set in motion now as part of the reform agenda.

65. **Introducing co-payments for health services might also contribute to short-term cost savings.** The main purpose of this measure from a health standpoint is to improve the use of the system by patients. Co-payments can induce savings under certain circumstances: for instance, if the demand for services is reduced and the public funding received by health facilities adjusts to the drop in volume rapidly (this would be the case where providers are paid by the health insurance fund on a fee-for-service or reimbursed on a per case basis). Another option to reduce government outlays is to organize the co-payment system so as to operate a substitution between private and public funding. Roughly speaking, the total price received by the facility for a given service remains the same, but the public payment decreases by the amount of the copayment. This may not be easy to organize and administer, or even desirable for all services. Indeed, low prices are one reason why informal payments take place (to pay for input or supplement salaries). If the revenues collected are retained and managed by the facilities, they can help ease some of these constraints and contribute to reducing copayments. The report suggests the introduction of co-payments to inpatient stays, laboratory tests, and specialist care. It also argues for charges for non-emergency use of emergency care (about 25% of cases are non-emergency today). As co-payments are put in place, a special provision in the safety net would have to be created to make sure that access is not affected for the poor.

66. **Fine tuning the benefits package and establishing competitive procedures for price setting mechanisms for generic medicines should also reduce spending.**

II. 5 TRANSPORT

Key challenges

67. **Both roads and railways face systemic financing, institutional and governance constraints stemming from unfinished reform and capacity limitations**. The reform process that started more than a decade ago has lost momentum in recent years, and there is a high risk that continuing a "business as usual" approach would not only squander future economic prospects through continued asset deterioration and increasingly higher transport costs, but also lay waste to the past investments and reforms. The consequences of the unfinished reforms are already visible today: the Romanian railways system—which was until recently a model of railway reforms in the entire region—has seen many past achievements reverted, such as financial stability or simply being a viable transport option for businesses and passengers; and the restructuring and development of the road network is severely behind schedule, while construction cost overruns are alarmingly high. Resolving the issues facing roads and railways in Romania should recognize the following specific challenges:

- Investment and maintenance of roads and railways necessary to meet the mobility requirements of a modern Romanian economy are significant—relative to the size of the economy—reflecting years of under-investments and in many instances misallocation of scarce financial resources.

- Funding of investment and maintenance of roads and railways assets in Romania will be constrained in the near and medium term because of the fiscal constraints of the general budget, and the limited ability to pay of road and railway users. This is currently exacerbated by the global financial crisis. Investment decisions under these constraints intensify the onus on the government to use available funds wisely and to protect that investment with the strongest management model possible for the efficient utilization of resources, timely project implementation, and efficient operation of transport services.

- Severe institutional and governance shortcomings plague the transport sector in Romania and they need to be addressed urgently. Investments in transport infrastructure are long term actions with significant economic, social, and fiscal consequences over a long period of time. Operational and management decisions are better when kept at arm's length from policy making. However, strategies and priorities change frequently in Romania. Many programs and the use of public funds are carried out on an ad hoc basis. Sector institutions and entities lack management autonomy and are treated as departments of the Ministry of Transport. The existing decision-making practices for investments overestimate the availability of resources and the implementation capacity in the sector.

Table 2. Total Spending on Roads, 2004-2008 (% of GDP)

	2004	2005	2006	2007	2008	Average 04-08
Roads expenditure total	1.45	1.39	1.12	0.92	1.12	1.20
Maintenance	0.38	0.70	0.32	0.29	0.29	0.40
Capital expenditure: rehabilitation, new construction	1.03	0.43	0.66	0.48	0.66	0.65

Source: World Bank estimates, RNCMNR

68. **Moving forward, the following sector's structural issues need to be addressed for the road sector plans and programs, their budgets and financing sources to have their intended impact**.

- The roles of the Ministry of Transport, Roads Company (RNCMNR) and railway company (CFR) have to be clearly defined.
- The road and railways sector targets and performance indicators must be agreed upon (both in the medium term and annually).
- An MTEF should be adopted, covering at least the election cycle.

Recommendations

69. **Addressing the key challenges requires complex measures, articulated in a coherent plan comprising both short term and medium term actions.** The major institutional capacity challenges concern the stability of management and organization; the governance structure and the operational autonomy of the roads and railways companies; the financial sustainability of these companies; and the internal capacity to program and plan investments and maintenance in the medium term.

70. **In the short run, the focus of the reforms should be on ensuring the best use of limited resources, rationalizing costs and improving organizational efficiency.**

71. **In the roads sector, the Brasov–Bors highway contract should be examined**, particularly in the light of prevailing cost overruns. While the motorway itself is justified from a strategic point of view, the experience so far has highlighted the governance and limited implementation capacity in the roads sector. Project preparation, the financial structure, the procurement, and later the actual implementation have all had important shortcomings. In 2009, half of the budget of the Roads Company RNCMNR was earmarked for payments for this contract. The payments schedule of the contract and the implementation timetable should be reexamined.

72. **The maintenance and management of the national roads should be improved.** There are significant efficiency gains in moving away from executing maintenance by in-house force account and in using modern road asset management tools to prioritize and plan maintenance activities. Additionally, RNCMNR should pilot the performance-based maintenance and management of roads contracts (PMMR), for which a study has already been completed and the pilot region was identified. Experience elsewhere in Europe shows that these three actions combined can lead to significant savings on road maintenance costs that can reach 15 to 40 percent. Finally, RNCMNR should abandon the practice of using short term expensive commercial loans to finance maintenance activities, and move gradually to use the revenues from the vignette as the main source of funding for maintenance.

73. **Adjust the level of public passenger railway services to be commensurate with budget constraints.** In recent years compensation from the state budget for Public Passenger Service Contracts (PSC) and subsidized tickets has grown significantly—reaching about Ron 1.2 bn in 2007. Even with this compensation, CFR Calatori is not able to cover the total cost of its passenger service operations as set in the PSC, and it was unable to fully pay track access charges to CFR Infrastructure starting a vicious spiral of arrears in the railways system. The size of state budget compensation for PSCs is several folds the level of state aid for infrastructure investments—which was Ron 171 mn in 2007. This is clearly a serious misallocation of scarce public funds between subsidies to over-supplied, underutilized passenger services on one hand and productive infrastructure investments on the other hand. The government should elaborate a detailed service plan under budget constraints based on the comprehensive study "Survey of Market Demand for Railway Passenger Services" undertaken by CFR Calatori in 2008. The service plan should rationalize compensation for PSCs and free public funds for the much needed investments in the railway infrastructure. Local governments are an important stakeholder in this process; they should be consulted on their needs and they should consider financial contributions for passenger services they deem necessary.

74. **Invest strategically in railways infrastructure and increase CFR Infrastructure productivity**. Investment in the railway infrastructure has been lagging in recent years despite the significant role railways play in Romania and the European Union's promotion of railways as a viable and sustainable mode of transport. The low level of investment in railways in Romania is caused by the large commitments for specific road investments and by the misallocation of public funds for railways to passenger services operations at the expense of railway infrastructure. This situation needs to be rectified. In addition, CFR Infrastructure must increase its productivity and reduce its costs. By European standards, the railway traffic intensity is relatively low, and the average number of staff per kilometer of track is high. Railway networks respond to large economies of scale—the higher the traffic levels, the lower the unit operating costs. Railway infrastructure operating cost affects the efficiency of railway transport services in general. Therefore, it is strongly recommended that Romania implement existing plans to right-size the railway network, modernize the core network, achieve inter-operability with European railways, and maintain sufficient connections with neighboring countries' railway networks. Rightsizing will involve some combination of options for about 3,000 km of the railway network, such as closing uneconomical lines, and reclassifying remaining railway lines into categories based on strategic importance and traffic levels. Policies for modernization and operation should be developed for each category, including rules for allocating infrastructure cost, involving local authorities in covering infrastructure costs of secondary lines deemed

necessary to their area of the country and lobbied for by local interests; granting exclusive rights to selected private operators for some secondary lines by leasing of infrastructure and rolling stock, etc. Finally, CFR Infrastructure should invest in efficiency-increasing measures for railway infrastructure operation (maintenance, repair, traffic control) by two interlinked actions. First, mechanize and automate infrastructure operations, and second, implement condition-based maintenance for railway infrastructure. These actions have been assessed and developed under a recent study "Business Processes Redesign for Railways" and they must be now effectively pursued and implemented.

75. **Establish clear relationships between MoT, RNCMNR, CFR, CFR Passengers, CFR Freight.** All companies are commercial entities, but they are managed like departments within the Ministry of Transport, from where they receive day-to-day instructions. The relationships should be defined in clear, performance-based contracts, assigning proper responsibilities for program funding to MoT and project prioritization and implementation to companies. In the case of railways Multi-annual Passenger Service Contracts (Calatori) and Long-term Infrastructure Maintenance Contracts should be strengthened to increase the railways' accountability. Similar performance agreements should be developed for roads. Public funds should be transferred only when contractual obligations are fulfilled, including specific targets for delivery, punctuality, maintenance standards, and productivity. For the successful implementation a transparent relationship with roads and railways, the Ministry of Transport should strengthen its capacity to develop, negotiate, and monitor multi-annual contracts.

76. **Ensure management and organizational stability.** The management of the companies must be appointed based on a transparent and merit-based selection process. Key performance indicators to measure performance, profitability, or customer satisfaction should be established and linked to an incentive system for managers who reach them. The government should also limit political interference in the operations of the roads and railways companies. Key qualified staff must be maintained to speed up the project cycle to absorb the EU funds and to bring data and management systems for project prioritization and monitoring into day-to-day management.

77. **Introduce cost benchmarking for contracts and projects**. The Roads Company RNCMNR has an expensive contract for the construction of the Braşov-Borş motorway, and costs escalate, but no new assessment of the project efficiency (IRRs, etc) has been made. Other contracts have also had upward cost revisions for various reasons (initial faulty designs, delays in construction caused by land expropriation issues etc.). The escalation of these costs must be carefully monitored, particularly during the crisis, as they drain important resources from other programs (e.g., maintenance). A comparison with international costs for similar works would be a good measure of whether projects continue to be justified in terms of priority. Similar benchmarking methods should be introduced also for maintenance, to check whether costs for maintenance done in-house or externalized are in line with the international ones**.**

78. **The possible establishment of an electricity distribution company for the railways– as announced recently—must be carefully examined to avoid cross-subsidization from the energy sector.** The transformation of CFR Electrificare (subsidiary of CFR) into an electricity distributor with the purpose of bringing significant reduction in the electricity bill should be done without obtaining preferential prices from other state-owned companies. This would be contrary to governance reforms pursued in the past 15 years in both railways and electricity.

In the medium term, the reform agenda should be centered on:

79. **Continuing the restructuring the government owned transport companies**. A longer term reform is needed to fully transform the roads and railways companies into viable institutions with clear roles. This includes the need to design an effective system of road user charges to ensure sustainable financing. For the railways, the experience with the newly introduced methodology for track access charges should be reviewed in order to realign the balance between state aid to railway infrastructure and revenues from railway infrastructure users with European practices. The reorganization of road administrations is a continuous process in many European countries. Specific features due to the size and administrative culture of the various countries notwithstanding, four general principles–which are also applicable to railways - have emerged from this process: (i) the respective roles of the parent ministry and the road administration must be well defined and governed by performance agreements limiting political interference; (ii) the entire public transportation network and its financing mechanisms must be taken into account, and road administration and management must be assigned to one or more organizations; (iii) organizational change must be planned carefully, and the road administration professional personnel must participate in defining change and its process; and (iv) design, construction, and maintenance services must be essentially carried out by private suppliers on the basis of a competitive and transparent framework.

II. 6 AGRICULTURE

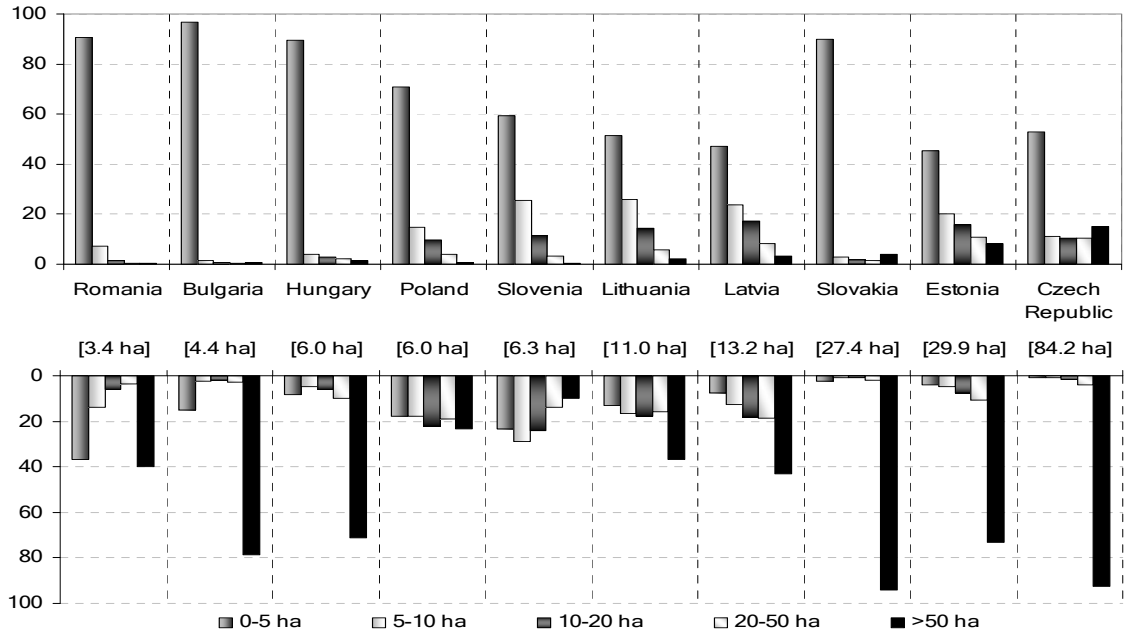
Key challenges

80. **Romania has a dual farm structure unparalleled in the EU and an aging agricultural labor force.** About half of the land is tied up in subsistence holdings, accounting for around 90 percent of the 4 million farms. Most of these farms are not eligible for EU direct payments. At the same time, around 2000 large farms operate close to 20 percent of the agricultural land. Around 43 percent of farmers are above the retirement age, and another 22 percent are older than 55.

81. **Intermediate farms suffer from a significant competitiveness gap.** This is attributable to multiple obstacles, ranging from access to markets, access to credit, lack of machinery, etc., as a disproportionate share of the financial support goes towards the large farms.

82. **Weaknesses in planning and programming capacity of the Ministry of Agriculture and the Paying Agencies.** The targeting of the national programs is limited, while information on the impact of the resources allocated is scarce, impeding taking informed policy decisions. As a result, the programming of support measures tends to focus on improving farm liquidity rather than farm profitability.

Figure 12. Farm population (upper panel) and farm land (lower panel): distribution by physical size (%, 2005)



Note: Figures in Square Brackets Indicate Average Farm Size.

Recommendations

83. **Optimize the mix of Common Agricultural Policy and national funds to maximize impact on competitiveness.** Funds should be channeled to priority activities, some of which are currently under-funded. Measures can assist small and medium-sized farmers to overcome access to inputs, machinery, land, credit, or meet safety and quality standards.

84. **Align institutions and capacities with policy objectives to improve the quality of services provided to farmers.** The functions and structures of the Ministry of Agriculture should be reviewed and its capacity for strategic planning and programming should be strengthened. Services offered by the agricultural and paying agencies should be tailored to the needs of different client groups (smallholders, family farmers, large competitive farms).

85. **Allocate more resources to the LEADER program** to absorb more of the EU Pillar II funds and with a larger impact on competitiveness and growth of agriculture.

Achieving short term savings

86. Policy and programming in agriculture is largely subject to a seven-year programming cycle, 2007-2013, during which some potential for budgetary adjustments exists. Two major national spending categories remain -State Aid and Complementary National Direct Payments- but are subject to a scheduled phasing out. While State Aid will have to be discontinued at the

end of 2009 ("sunset clause"), CNDP will have to be fully discontinued at the latest by 2016. This report recommends to adopt a faster pace.

87. The assessment of spending has highlighted the following short-term budget rationalization areas:

88. **Review and reduce the Complementary National Direct Payments (CNDP).** CNDP are mainly[13] financed by the national budget and are granted in addition to the EU-funded direct income support under CAP Pillar1. Though CNDPs are subject to a phasing out by 2016, this is not scheduled to impact the 2010 budget, as phasing out starts in 2014. Based on the current and prior assessments, it is considered that, from a sector income perspective, CNDPs at current level would have been more justified during the initial years of EU membership that they would be nowadays. The assessment identifies two immediate savings potentials. First, Romania should resist any attempts to further increase CNDPs, though this would be permissible after such option was granted by the European Council. **Increasing CNDPs up to the now threshold of 50 percent of EU-15 average would increase national budget requirements by about euro 500 mn annually.** The increase is not needed to safeguard farm incomes, nor to enhance competitiveness. Second, alongside with the scheduled phasing-in of EC-funded direct income support and to continue support for farm incomes in an environment of declining fiscal space, the gradual phasing-out of CNDPs could be initiated starting in 2010. The report proposes a gradual phasing out equivalent to euro 85 mn (0.07% of GDP) annually. Higher levels would be possible from a farm income perspective, but might be met by resistance.

89. **Selectively discontinue State Aid**. Within the existing support envelope for State Aid to Agriculture, about Euro 540 mn constitute 'Existing State Aid', i.e. measures in place before accession and approved by the EC to be extended until the end of 2009 ("sunset clause"). The government needs to soon take a policy decision on how to replace the existing State Aid. The available options are: a) the elimination of Existing State Aid starting in 2010, thus substantially reducing agricultural spending; and/or b) the transfer of part of the budget from these measures to new measures that are compliant with EC regulations (required e.g. for continuation of calamity compensation schemes, irrigation, genetic resource protection, agricultural retirement, etc.). The selective discontinuation of the State Aid could bring savings of Euro 250-400 mn (0.21-0.34 % of GDP) in 2010.

90. **Rationalize other National Programs**. Potential savings arising from the rationalization of other National Programs and Administrative/Institutional Structures have not been assessed in this report. However, the forthcoming Functional Review of the Agricultural and Rural Development Administration, to be undertaken under the Memorandum of Understanding with the EU, would focus on identifying such savings.

[13] The reverse modulation of rural development funds (EAFRD) to CNDP has to be discontinued starting 2010 and thus induces an additional national budget requirement of up to Euro 70 mn.

III. OTHER PROPOSED SHORT TERM MEASURES TO ENHANCE BUDGET REVENUE AND CUT EXPENDITURE

91. Matching the present level of current spending would require to permanently and significantly raise budget revenues. Such a move would however not be recommended as some of the taxes are already high relative to EU averages, such as taxes on labor, while tax compliance remains reduced. Nevertheless, collecting more revenue in order to narrow the gap with spending is possible. We present below a series of revenue-enhancing policy options available to the government.

92. **Introducing a temporary "solidarity" tax on high incomes.** While it is our belief that reducing the gap between current expenditure and revenue should be done primarily by adjusting the level of current spending, curtailing the public sector wage bill through large employment cuts might prove difficult in the short run. To bridge the immediate fiscal gap, the government can consider the introduction of a solidarity tax, on a temporary basis. We present in Table 4 in the annex the potential revenue impact of introducing a solidarity tax of 2 percent for a 12 months period for incomes exceeding Ron 2000 per month. The table suggests that imposing such a tax would bring additional revenue to the budget of up to 0.14 percent of GDP. The bulk of this money would come from the contributions of the employees and self-employed. If such a tax would be applied to incomes of above Ron 1500 per month, for example, revenue collected could raise noticeably, as the tax base would broaden significantly, by up to 650,000 employees and self employed and around 130,000 pensioners. As the adjustment of current spending occurs, the solidarity tax can be phased out.

93. **Broadening the income tax base and hiking the contributions of the employees in the "special" sectors.** Pension House records indicate that a number of around 5,950,000 people paid social insurance contributions as of November 2008. At the same time, the Labor Force Survey puts the occupied population at around 6,700,000[14] people. The difference between the two figures suggests that around 700,000 individuals do not pay social contributions, although they appear in employment as per the ILO definition. Part of these people is employed in the "special" public sector (defense, public order, etc.), paying a social contribution between 0 and 11 percent of their gross wage. As we suggest above to include the pensioners of the special sectors into mainstream, this would automatically imply the alignment of the social contributions payments for those employed in these sectors with those of the public pension system. Currently, public pension contributors pay around 11 percent of their gross wages for pensions. While it is difficult to estimate the impact of such a measure in the absence of detailed information from the special sectors, the budget revenue effect will certainly be non-negligible. Concomitantly introducing social contributions for the employers in the special sectors, which are actually state entities, will have a zero net effect on the budget. Those working in the informal sector should largely represent the other part of non-contributors in employment. Bringing them into the formal sector will prove difficult, especially under crisis conditions. Nevertheless, a better integration of the actions of the Pension House, Fiscal Administration and Labor Inspection could yield some positive results.

[14] We do not include in this figure the self-employed in agriculture, which are around 2,700,000, most of them subsistence workers.

94. **Raising VAT and/or re-introducing a progressive profit and income tax** system (equivalent to eliminating the flat tax). Currently, the government collects around 8 percent of GDP from VAT. Assuming no changes in collection compliance[15], an extra percentage point increase in the VAT rate, from 19 percent currently, could bring up to 0.4 percent of GDP in additional revenue. In parallel, however, efforts need to be made to improve revenue collection, as tax compliance appears low relative to other countries in the region. Bulgaria, for example, collects significantly more from VAT, around 11 percent of GDP, at a statutory rate of 20 percent, marginally higher than in Romania.

95. The introduction of the flat profit and income tax of 16 percent in 2005 appears to have led to improved revenue collection from wages, although it is difficult to distinguish it from the influence of the strong economic growth. However, evidence[16] appears to indicate that the high income earners benefited most from the flat tax, as low wage earners were not better off. A progressive income tax system could bring in more revenue from the high earners, although there is a possibility that they could wrap their incomes under other vehicles such as dividends or profits, both taxed at 16 percent. By contrast, the relaxation generated by the flat tax has not led to increased revenue collection from profits, in spite of companies enjoying a period of strong economic growth. From this angle, the policy intention of the government not to tax reinvested profits, which will result in further revenue loses, bears little justification.

96. **Other revenue enhancing measures to be considered**

- Selective tax increases (e.g. accelerating the increase in excise taxes to converge to EU levels). Tobacco and alcohol taxes are prime candidates.

- Cuts in the large number of fiscal instruments for which administrative costs prove to be higher than the revenues they bring in. This should reduce transactions costs for companies and lead to additional revenue to the budget. The government has already taken steps in this direction.

- Simplification of procedures for obtaining licensees and permits, which severely affect the business environment. Some rules can be easily simplified, at no fiscal costs, with impact on the operation of businesses and benefits for the budget.

- Sale of part of the surplus of CO2 emission rights under the Kyoto Protocol. This could bring revenues estimated at over 0.7 percent of GDP, in the pessimistic case. It is surprising that Romania has not yet sold any of its surplus, when its emissions will clearly be well below the Kyoto targets. The proceeds of this sale could be invested in energy conservation programs, such as the thermal rehabilitation of buildings, currently financed from the budget, and which can be substantially expanded, with major benefits for the economy.

[15] This can however be a strong assumption, especially in crisis conditions. Faced with increased taxation (social contributions have already been raised by 3.3 percent in the first quarter of 2009) companies may choose to migrate into the informal sector in a lax control environment.
[16] A study conducted by the Group of Applied Economics in 2008.

- Resumption of privatization, including of utilities, and the sale of the minority stakes which the state still holds in companies.

- Revision of the levels of royalties.

- Stricter oversight of tax collection efforts.

- Elimination or reduction of fiscal facilities, such as the deduction of VAT and of maintenance of company cars.

97. **Other expenditure rationalization measures to be considered**

- The revision of the investment plans of line ministries proposed in the 2010 budget on the basis of economic return, readiness for implementation and availability of financing. Contracts in transport, environment and municipal development are prime candidates. In view of the uneven annual capital spending distribution, which concentrates in November and December, significant cuts can be made in non-essential investment such as on cars, furniture and durables. With the appropriate level of tightness, savings of up to 0.10-0.15 percent of GDP annually can be contemplated.

- The revision of the subsidies for public companies and private operators. Further cuts in subsidies to non-performing companies in mining and energy and a better collection of arrears should bring sizeable savings.

- Making the use of electronic public procurement mandatory for all public entities.

Table 3 below summarizes the main revenue enhancing/expenditure reduction measures proposed above and their potential budgetary impact.

Table 3. A summary of proposed short term measures with impact on the budget

Proposed measure	**Potential budgetary impact (% of GDP)**
Temporary solidarity tax on high incomes of 2 percent	+0.13
Introduction of social contributions for employees of the special sectors at the standard level	Tbd
Increase in VAT	+0.4 per each extra VAT point
Reintroduction of progressive profit and income tax	function of level and tax base
Cut in public sector employment	+0.5 for a 5.5 percent decline in employment
Increase in class sizes in large schools	+0.23
Reduction in subsidies for CFR	Tbd
Revision of works and payments schedule for Brasov – Bors highway	Tbd
Gradual phasing out of Complementary National Direct Payments for agriculture	+0.07
Selective discontinuation of State Aid for agriculture	+0.21 - +.34
Increase in royalties	function of level
Sale of CO2 surplus emissions	+0.7
Introduction of electronic public procurement for all public entities	Tbd

Source: Staff computations.

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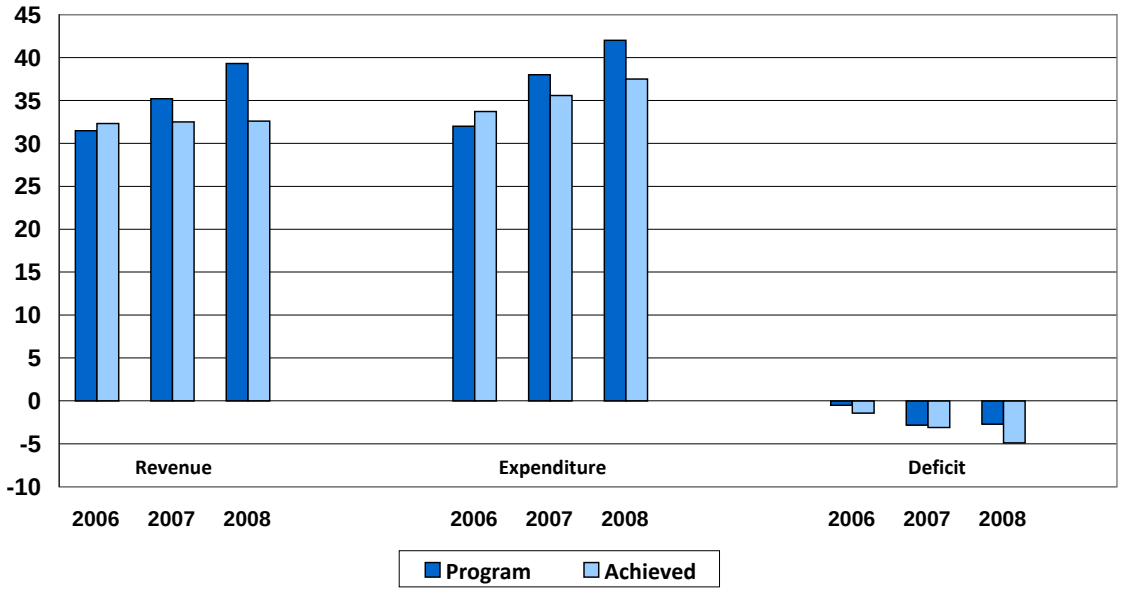
IV. PILLARS OF THE LONG TERM PUBLIC FINANCE MANAGEMENT REFORM AGENDA

98. **The root-causes of the current vulnerable fiscal situation lie in the chronic structural problems besetting the Romanian public sector**:

- **An oversized public administration, which consumes more and more budget resources every year.** The size of the public administration has constantly expanded. Human resources are large, but with little incentives to perform and capacity to deliver or be responsive to the citizen. Human resource policy is not centered on merit-based career development and on the relationship between compensation and performance. Obsolete structures and activities throughout the public sector impose high transactions costs and impede productivity and the effective use of scarce resources. In general, there is no clear distribution of functions and responsibilities

across the government and within line ministries. There is no visible institutional authority to coordinate the reform of public administration.

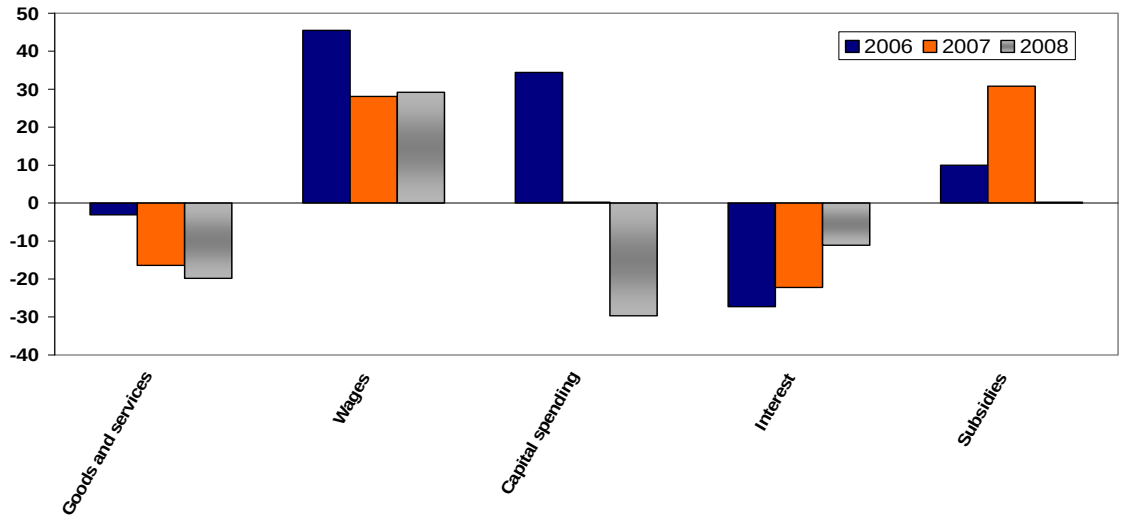
Figure 13. Budget Program vs. Actual Execution (% of GDP)



Source: Ministry of Public Finance

- **Serious endemic governance challenges, affecting the transparency and accountability of resource allocation.** In the absence of strategic planning capacity, independent oversight of the budget execution and accountability mechanisms in place, budgetary allocations lack a policy and results orientation. As a result, appropriations are largely done based on historical grounds and political bargaining and influence, undermining the credibility of the budget as reflected by the significant budget rectifications and variances between planned and actual expenditures (Figure 14). The absence of effective performance monitoring and evaluation systems in place does not allow to judge to what extent resources allocated to various activities and credit holders achieve their intended outcomes and with what level of efficiency. The provision of public services or goods is consequently done at unit costs which often exceed market values or those observed for similar levels of services elsewhere in Europe, sometimes by a large margin.

Figure 14. Actual versus Planned Expenditure by Economic Classification (% change)



Source: Ministry of Public Finance

- **The allocation of public resources preserves the status quo, at the expense of economic restructuring and productivity growth**. Romania is trailing behind other EU members in terms of restructuring its economy. Part of this is attributable to the historical and substantial bias of the budgetary allocations towards un-restructured parts of the economy and to feeding the large public administration. Even today, unprofitable enterprises in energy, mining, transport, etc., benefit from considerable direct and indirect subsidies without linkages to performance or the need to restructure. Thus, the budget resources allocated to economic affairs are the second highest in Europe[17]. The politically-motivated, untargeted large increases in public pensions in recent years have made the pension fund financially unsustainable, draining large subsidies from the state budget, leading to a widening of income disparities between pensioners. Personnel costs have almost doubled between 2004 and 2008.

99. This explains why **the public finance management system suffers from persistent institutional, process and policy weaknesses, which considerably and constantly undermine fiscal policy conduct and hamper the effective use of resources:**

- **Limited planning and policy formulation and implementation capacity.** This is the case for both the centre of government and the line ministries. There is no strategic, multi-annual planning and, with rare exceptions, policies are not guided by an explicit framework defining government goals and objectives clearly. Policy proposals submitted by line ministries are seldom subject to thorough economic and financial analyses or reviews.

[17] Eurostat, 2007. The figure is 6.8 percent of GDP for Romania, while the EU average is 3.7 percent of GDP.

- **Weak linkages between planning, policy and resources.** The absence of a Medium Term Expenditure Framework (MTEF) undermines aggregate fiscal discipline and the alignment of resources with the strategic priorities of the country. As a result, there are significant departures in budget execution from the indicative multi-annual plans and from the approved budget (see the Fiscal Framework section), preventing credit holders from pursuing coherent multi-year, outcome-oriented programs. Communication within the line ministries and with the MoPF is limited, both in budget formulation and execution.

- **An input-based orientation of the budget.** The current system of budget appropriations does not stimulate restructuring and performance by offering credit holders the appropriate incentives to effectively use resources. Instead, the objective is to finance a certain level of inputs, some determined on a historical basis. In education, for example, the allocation of resources to decentralized administrations is done on the basis of a payroll and school inventory determined centrally. Thus, there are no incentives to save resources or reallocate them towards better ends. Such a system also discourages the consolidation of the management capacity of the credit holders, which often have a mere accounting role.

- **An ad-hoc management of the budget**. Budget formulation lacks a policy orientation. The disconnect between policy and resources frequently leads to unpredictable amputations of credit appropriations due to unforeseen claims on budget resources, done through frequent rectifications. Actual allocations across credit holders or economic categories could differ substantially from initial plans. The wage bill has been, for example, systematically underestimated in the formulation of the budget, sometimes by 30-40 percent. Budget execution suffers from the lack of proper mechanisms to control commitments, have periodic and reliable financial reports to monitor and ensure the budget is executed as planned in a timely manner. This in part can be related to the still significant reliance on manual accounting and bookkeeping processes.

- **Low revenue collection**. In spite of measures to enhance collection, revenues of the consolidated budget have not increased in the last three years, if measured as percentage of GDP. The overall level of revenue is among the lowest in Europe, for tax rates comparable to those of Romania. Bulgaria, for example, collects significantly more (see Table 7, annex 1, Volume 2), as percentage of GDP, though most of statutory tax rates are below those in Romania, with the exception of VAT. Bulgaria also has a much lower number of tax administration offices and staff, translating into lower transactions costs of collection. This points towards a limited tax compliance and the need for further reforms of tax administration.

Recommendations

100. **Unlocking the growth potential of the country requires an urgent and radical transformation of the public policy framework with the objective to establish a performance-based budget process (PBB).** The priority of the reforms should be to strengthen

the linkages between performance and outcomes and the available public resources. Being of a longer term nature, requiring phased measures to be implemented over several years, these reforms nevertheless **need to be initiated now** to reduce fiscal vulnerabilities, which prompted the fiscal crisis, and take advantage of the crisis context and the available technical and financial support:

- **Establish an MTEF**. This is needed to sustainably restore aggregate budget discipline, improve the efficiency and efficacy of public expenditure and enhance transparency and accountability. The MTEF will integrate planning, policy and budgeting in a multi-annual, programmatic framework, and ensure that the amounts budgeted reflect the spending priorities of the country and are actually implemented. The MTEF should be introduced gradually and should cover all levels of government.

- **Strengthen the capacity of the Cabinet and the line ministries to prioritize, and design, implement and evaluate programs and policy proposals.** The reform of public spending requires a major overhauling of the public finance management processes and institutions and is a long term process. The government should launch this process by carrying out, in a systematized manner, institutional assessments of the functions, institutional structures and skills of the public sector agencies with the view of eliminating duplications, simplifying organization and work flows and enhancing the professionalism of the personnel. These would bring important savings to the budget, which could be redeployed for productive investments. Key components of the public financial management reform should be the modernization of the accounting system and the introduction of an integrated financial management information system at all levels of government to strengthen the quality and reliability of financial information and monitoring of the budget.

- **Design and implement a multi-annual public investment program.** This should be part of the MTEF and is aimed to provide a framework for reorienting the budget resources from sustaining the high levels of current spending and economic inefficiencies towards growth and productivity-enhancing investment programs. To ensure that the resources go where they are needed and their impact is maximized in terms of economic returns, strong monitoring and evaluation arrangement are necessary in the line ministries and MoPF.

- **Reform tax administration.** To enhance tax compliance and increase revenue collection, there is a need to overhaul the tax administration. The government should prepare a multi-year action plan aimed at redesigning business processes, enhancing professionalism of staff and rationalizing the institutional structure of ANAF. Improving the dialogue with tax-payers should be part of the agenda. Experience elsewhere in the region shows that better tax collection can be achieved with lower administrative costs.

- **Reform public administration with the aim to enhance capacity and establish the appropriate incentives.** To consolidate the fiscal framework and avoid being locked into a low economic growth trajectory following the crisis, the government needs to revigorate the large unfinished structural reforms agenda. Many of the fiscal slippages of the recent years have deeply-rooted structural causes which, if not addressed, will

certainly resurface with the next opportunity. A meritocratic, professional and depoliticized civil service should be established, funded with a sustainable public sector wage bill and transparent salary setting mechanisms. Administrative accountability should be strengthened, particularly in the areas of policy formulation, public access to information, and anticorruption. Effective decentralization should advance, though at a pace which would warrant a transparent and effective use of the public resources at sub-national level.

101. Giving the complexity of the agenda proposed above**, considerable attention should be devoted to prioritizing and sequencing the reforms** and ensuring that the strategic and technical capacities to pursue the changes are in place**.** To guarantee the appropriate tractability and coordination, reforms should be driven by the center of government. These aspects are particularly critical, as the government has already embarked upon a package of substantial institutional and policy changes (see below).

Steps to improve the framework for Public Finance Management

102. The government has already taken or planning to take a series of legal, institutional and process steps to improve public finance management (PFM). These include:

103. **The adoption of a Fiscal Responsibility Law.** The Parliament is in the process of drafting a Fiscal Responsibility Law (FRL), applicable to all public entities receiving or managing public resources. The FRL should contain a series of fiscal principles and rules on revenue, expenditure, deficit, public debt and risk management with the aim to enhance fiscal discipline and improve the efficiency of PFM. The FRL should be approved by mid-2010.

104. **The amendment of the Public Finance Law** (PFL). The PFL should be amended to be harmonized with the FRL. Amendments can focus on strengthening and clarifying the sanctions applying to the breach of PFL, on strengthening the position of MoPF in the budget formulation process, including the ability to reject non-conforming budget bids, and, eventually, prohibit the move of funds from capital to current spending. The timing of the PFL amendment should align with the approval of the FRL.

105. The adoption of the FRL and the amendment of the PFL would however require conducting a thorough analysis on how functions, roles and responsibilities of various actors in the public administration, including at sub-national level, will be affected.

106. **The adoption of a medium term Fiscal Strategy.** The Strategy would be a key policy document covering three years ahead aimed at providing guidance to policy making for the preparation of the annual budget and in the medium term. The Strategy should be prepared well ahead of the annual budget and should include medium term information on the macroeconomic forecasts; revenue, debt and expenditure forecasts; spending priorities and ceilings; fiscal rules and risk assessments. The annual budget process has to use the Strategy as a framework, including reflecting key requirements in the budget instructions and conducting the discussions with the line ministries in line with the constraints of the Strategy. The Strategic Sectoral Plans of the line ministries, drafting and annul updating of which is required by the current legislation,

should also align with the Fiscal Strategy and should be integrated into the annual budget formulation process.

107. **The establishment of an independent Fiscal Council.** The Council would have the role to support ensuring that policies are aligned to delivering on the commitments of the government. The Council would provide opinions on the macroeconomic and fiscal forecasts; on the Fiscal Strategy; on the alignment of the annual budget with the Strategy; on the quality of policy proposals with major spending impact; and on the ex-post evaluation of the budget execution. The Council should be established by mid- 2010.

108. Other recommended measures to improve the budget process and PFM systems that can be initiated fast would be:

109. **The revival of the Strategic Planning Committee (SPC).** The SPC should articulate the national priorities of the country and set the budget priorities in the medium term framework established through the Fiscal Strategy.

110. **Strengthening the role of MoPF in reviewing policy proposals of the line ministries.** MoPF should have the mandate to regulate policy flows with fiscal dimensions to the Cabinet, including the authority to return proposals which do not meet standards of fiscal impact analysis or do not fall within fiscal plans, and authorization to resolve and reconcile eventual tensions. This would apply also to capital project proposals, where MoPF should have the power to suspend and stop investment projects which are not justified by economic returns and efficiency, or which are not allocated the appropriate levels of financing. To perform this function, the capacity of the MoPF to review programs and projects should however be substantially enhanced.

111. **Modernizing the public accounting system and introducing an integrated financial management system accompanied by strengthened commitments and expenditures controls.** The downward expenditure adjustments require having in place proper mechanisms to control commitments, have periodic and reliable financial reports to monitor and ensure the budget is executed as planned in a timely manner. There are still several weaknesses in the areas of internal control and internal audit. The accounting and bookkeeping is still largely manual affecting the ability to have reliable and consolidated information on the budget to monitor its implementation on a timely basis. Likewise, the lack of a fully integrated financial management information system reduces the ability to control commitments.

112. **Establishing government-wide monitoring and evaluation systems as a matter of urgency.** At this stage, the central government does not have the capacity to assess the opportunity of a program proposed for financing, such as the expected economic return of an investment, nor to track progress on program implementation. Developing such capacity should receive priority from government, and the systems should also cover the activities of the sub-national governments. As a first step, establishing a database of investment projects, including progress details, should increase the transparency of public spending and could lead to substantial savings of public resources in the medium term.

Improving the Annual Budget Process

113. MPF could play a more assertive in providing strategic policy guidance, screening sector policies and programs, and enforcing coherence between policies, plans, budgets and outcomes. This could be done through the Strategic Planning Committee (SPC) and the other inter-ministerial committees in which MPF participates, in close coordination with the Prime Minister's office and the General Secretariat of the Government (GSG);

114. There is scope for revisiting the stages of the annual budget cycle, and strengthen linkages between planning, performance and the allocation of funds early in the budget process. This requires an effective engagement between MPF and the budget and planning departments in the line ministries early in the formulation of the budget. A ceilings setting process should be part of the dialogue. This could help eliminate excessive initial budget submissions and the need for large cuts, limit the scope for budget rectifications reallocating important resources within the year, and avoid delays in the effective start of the budget cycle. A methodologically stable framework for monthly budgetary reporting should be established in order to improve comparability and transparency.

115. **Ceilings would be explicitly linked to policy objectives.** Ceilings, once developed, would be shared with line ministries, with a deadline for providing arguments for increased allocations and clear guidelines on programs/objectives that would not be funded. MPF would have the final say on the ceilings, while providing an opportunity for consultations on spending priorities. Budget circulars would contain the policy directives and ceilings, and would be made public to ensure transparency and the oversight of beneficiaries. MPF need not commit all funds in the ceilings, and could provision some resources to address unforeseen needs and allow - ministries to compete for additional resources during an appeal process.

116. **Improve intra-Governmental communication channels.** Throughout the budget formulation and execution cycle there is a need to establish a continuous communication channel between MPF and line ministries, with traceable elements of accountability, and, within line ministries, between planning departments, budget departments and project implementation units.

117. **Ad-hoc budget adjustments must be curtailed.** The integrity of the programmatic nature of the budget requires that MPF conditions applications for budget adjustments on a policy or program rationale, and that all budget adjustments must be recorded in a public register that is issued regularly, including details of policy and program implications.

V. CONCLUSIONS

118. **The current fiscal framework is unsustainable, primarily as a result of the pro-cyclical fiscal policy adopted in recent years**. This led to a considerable increase in current spending, without being matched by a proportional expansion in revenues, widening substantially the budget deficit. In the absence of sizeable corrective measures, the consolidated

budget deficit risks expanding further, raising significant financing challenges and threatening economic recovery.

119. **The government has taken a series of measures to contain spending and boost revenue.** They include an increase in social contributions, a freeze on vacancies in administration and attempts to eliminate some of the generous bonuses in the public sector. So far, these measures have not led to a considerable improvement in the budget deficit. More adjustment efforts need to be made.

120. **In parallel, an ambitious but necessary medium term program to reform the public sector has been launched.** The program is aimed at rebalancing the relation between revenue and spending and enhancing the efficiency and efficacy of service delivery. Reforms include the gradual introduction of a unitary public pay system aligned with European practices to upgrade the capacity to attract and retain appropriate skills in public administration; the adoption of a multi-annual fiscal framework to optimize resource mobilization by better aligning strategic planning, policy and expenditure; reform of the pension system to place it on an equitable and financially sustainable path; sectoral reforms in education, health and social assistance to improve allocative efficiency and strengthen the safety net.

121. **The report suggests that, in the short run, the focus should be on reducing the budget deficit and reallocating spending towards productive ends to help reigniting growth and creating jobs.** The deficit can be reduced through a combination of revenue enhancing measures and expenditure cuts. The study recommends that emphasis should be placed primarily on adjusting current spending and offers a series of proposals on how this can be done. Proposals include:

- a permanent and significant cut in the public sector wage bill, thorough a combination of employment and earnings reductions;
- public pensions should be indexed to inflation, rather than wages;
- in education, a large number of teaching positions can be eliminated by increasing class sizes;
- in health, savings can be expected from improved planning and management in the hospital sector, including a rationalization of the existing infrastructure and prioritization of the planned investments, underpinned by increased autonomy and capacity to respond to incentives;
- in railways, the level of services should be downsized to match the reduction in subsidies;
- in roads, the costs and payments schedules of the ongoing contracts should be reviewed and costs benchmarking should be introduced.
- in agriculture, national top-ups should be phased out and programs should be rationalized.

122. At the same time, **the study offers a number of suggestions to enhance revenues to the budget**. These include:

- the introduction of a temporary solidarity tax on high incomes;
- the introduction of social insurance contributions for the employees of the special sectors (public order, defense, etc.) at the standard level;
- the sale of CO2 emissions surplus;
- the government-wide introduction of electronic procurement.

123. Should these measures prove insufficient to bring the budget deficit on a sustainable downwards trajectory, **raising VAT and/or re-introducing a progressive profit and income tax system should be considered**.

124. The report emphasizes that, in parallel with the savings-oriented measures proposed above, **the government should initiate a thorough assessment of the functions, structures and skills available in public agencies and prepare an action plan for the comprehensive overhauling of the public sector**.

125. **The report also investigates the efficiency and efficacy of resources allocation in the main spending areas** – education, health, transport, and agriculture – and proposes a series of measures to address existing key challenges. These comprise:

- the introduction of per capita financing, enhanced policy formulation and implementation capacity and greater local autonomy to create better incentives for performance in education;
- shifting emphasis towards outpatient care, introduction of quality assurance systems, introduction of health technology assessments and copayments in the benefits package and alignment of provider payment systems to support the objectives of transparency efficiency and accountability;
- the articulation of a sector-wide, medium-term action plan for the development of transport, and the restructuring of the roads and railway agencies;
- shifting focus on competitiveness-boosting funding of agriculture, by supporting medium-sized farms and investments in rural development, concomitant with measures to strengthen planning and programming capacity.

126. **The government should embark on a long term reform agenda to improve the quality of public services delivery.** This requires a radical transformation of the public policy framework, with focus on: establishing an MTEF and gradually introducing performance-based budgeting; enhancing planning and policy-making capacity; developing a multi-annual investment plan; continuing implementing a modern accounting system and strengthening internal control and internal audit at all levels of government and in line ministries; introducing an integrated financial management information system; reforming tax administration and human resource management practices. These reforms need to be initiated now to take advantage of the crisis context and the available support.

ANNEX

Table 4. Estimated potential revenue from a 2% solidarity tax

	Contributors	Tax revenue (% of GDP)
Employees and self-employed	1,340,000	0.128
Special pensions	163,600	0.013
Public pensions	43,197	0.001
Total	**1,546,797**	**0.142**

Source: Staff computations.