1. Key development issues and rationale for Bank involvement

Meeting the Challenges of Accession. Romania will become a member of the European Union (EU) on January 1, 2007. EU accession aspirations have enhanced the country’s macroeconomic stability and spurred commitment to reforms in recent years. The economy grew robustly at 4-5% per year during 2000 - 2006 (est.). Inflation declined from above 40% in 2000 to 8.6% in 2005 and expected to fall further to 5% by the end of 2006, the lowest level since the beginning of transition. Structural and institutional reforms accelerated during the same period -- the private sector share of GDP has moved closer to other EU New Member States (NMS-8) levels, more than 90% of banking assets are now held by the private sector, energy reform has resulted in a substantial reduction of quasi-fiscal deficits, and independence of the judiciary has been strengthened.

Nonetheless, Romania still has to complete an ongoing reform agenda to underpin growth and improve living standards. Fiscal risks to macroeconomic stability will have to be addressed and monitored closely by the Government. Reforming the social security and health systems are priorities to reduce fiscal vulnerability. A skills mismatch with market needs acts as a lag on further growth, hinders competitiveness, and will require a reorientation of the educational system. Further urgent improvements in the business environment to meet economic demands include increasing labor market flexibility and reducing labor taxation. Although there has been significant progress in poverty reduction, the benefits of renewed growth have yet to fully filter through to all segments of the population. The gap between urban and rural living standards and regional disparities are still great, and will have to be narrowed. The restructuring of the agriculture sector, which is likely to result in excess labor, will have to be accompanied by measures to mitigate the adverse social impact.

The Need for Reform of the Social Sectors. The Government aims at correcting weaknesses in the health, education and social protection systems -- areas not targeted by the EU accession process. In the education sector, increasing investment in human capital and addressing the skills mismatch with market needs are necessary for successful accession and integration with the EU. The fundamental changes that have occurred in the economy and labor market have led to a shift in the demand for skills resulting in the need to reorient education programs, both at the pre-university and university levels. Despite earlier reforms, average education outcomes continue to be relatively low. In international evaluations, Romania has mean scores lower than OECD averages, lower scores than Bulgaria and the EU-8 new member states (NMS). Enrollment in secondary education (especially in upper secondary education) is
too low to foster a competitive work force. Without interventions, this low enrollment rate, combined
with past demographic changes, could lead to a substantial excess-capacity of teachers. Finally,
outdated human resources policies which fail to link compensation to performance and accountability
have made the sector unattractive to talented young graduates which are hampering the quality of
entrants into the teaching profession. The low quality of teachers in turn lowers the overall quality of
education services and by extension of education outcomes.

Health indicators of the Romanian population have been improving over the last decade. However, key
challenges remain. Principal among these is a bias in health spending towards an inefficient hospital
network which rises overall spending and hinders health outcomes. This bias is aggravated by
weaknesses in and inadequate financing of ambulatory, primary and preventative care. A
disproportionately high level of spending on pharmaceuticals is also creating upward pressures on
overall spending. Increasing the efficiency, equity and transparency of financing — including the
containment of pharmaceutical costs and better definition of the benefit package covered by national
health insurance — would help to rationalize services and control costs. Further, quality assurance
mechanisms in service delivery, especially in hospitals, are inadequate. Additionally, access to health
services in rural areas is low especially among households in lower socioeconomic groups. Finally, out
of pocket payments — especially unregulated payments — impose a heavy burden on households.

The social protection, the single-pillar public security system - that covers losses from old age,
disability, and death of income earners - is a source of long-term fiscal risk. The high statutory levels of
social contributions (at 47.5 percent of the gross salary) discourage participation and push workers into
informal employment. Despite the introduction of the flat income and profit tax, and several reductions
of the social assistance contributions in recent years, the number of contributors remains lower than the
number of beneficiaries, leading to an endemic deficit of the public pension fund. Pension system
deficits are likely to grow substantially without parametric and structural reforms. With financing gaps
mainly covered by the state budget, overall government deficits and public indebtedness will tend to
rise. The urgency for reform is increasing, because of the projected slowdown of population growth and
the steady aging of the population, which will increase the demands on the system. Turning to social
assistance, the main challenges in the current program lie in ensuring that benefits are well targeted,
efficiently delivered, monitored, and that their impact is rigorously evaluated.

Rationale for Bank Involvement. The Country Partnership Strategy (CPS) that guides the Bank program
in Romania focuses on facilitating economic integration and social cohesion with the EU. Building on
both the lessons from EU-8 NMS and Government program, the CPS framework has three pillars: (a)
accelerating structural and institutional reforms to support sustainable growth; (b) addressing fiscal
vulnerabilities and modernizing the public sector; (c) targeting poverty reduction and promoting social
inclusion. The proposed program to foster an enabling environment for investment in human capital,
described in this document, is centrally aligned with all three pillars of the CPS.

2. Proposed objective(s)

The Human Capital Investment Climate (HCIC) lending operation is the first of a proposed program of	hree loans designed to support policy reforms that will foster an enabling environment for household
investment in human capital. The program has been designed to support the Government's strategy of
enhancing human capital development to meet the challenges of EU accession and integration, by
addressing structural weaknesses in the education, health and social protection systems. The specific
objectives of the program initiated by this proposed lending operation are to: (i) bring the education,
health, and social protection sectors, as well as labor market policies closer to EU standards; (ii)
introduce reforms to education, health and social protection that promote an increase in productivity,
competitiveness, and greater skills in the labor force; (iii) improve the efficiency of the health, education, and social protection systems to maintain a fiscally sustainable expenditure framework; and (iv) promote social inclusion and grant the poor equitable access to basic social services.

3. Preliminary description

The Human Capital Investment Climate (HCIC) lending operation has been designed to support the Government’s strategy of enhancing human capital development to meet the challenges of EU accession and integration, by addressing these structural weaknesses in the education, health and social protection systems.

The proposed components of the operation, by subsectors, are as follows:

i. Education. The proposed operation would support policies and the implementation of programs to (i) ensure the quality and relevance of the education and training systems to increase the productivity of the labor force; (ii) improve the efficiency and effectiveness of public expenditures; and (iii) ensure access, especially to the rural and otherwise vulnerable populations. Policies and programs supported by the Second HD Program to achieve these goals would include support to the implementation of human resources strategy to increase the quality of education and to the development of a life long learning system to increase the adaptability and skills of the labor force. Improved budgeting, financing and management of the education system will improve the efficiency of public expenditures on education, while allowing for resources to be targeted towards measures to include disadvantaged groups.

ii. Health. The proposed operation would support policies and the implementation of programs to (i) ensure the fiscal sustainability of the national health insurance system; (ii) increase the efficiency and effectiveness of the health delivery system; and (iii) improve access for those with limited access to health care because of geographical location, insurance status, and/or inability to pay the out-of-pocket payments. Policies and programs supported by the Second HD Program to achieve these goals would include both revenue or expenditure actions to increase the sustainability of the National Health Insurance House; improving the efficient deployment and utilization of health human resources; and increasing the quality of health services in order to decrease duplicative services and increase the efficiency of health expenditures.

iii. Social Protection. The proposed operation would support policies and the implementation of programs to (i) increase the flexibility of the labor market and reduce incentives for informal employment; (ii) ensure the fiscal soundness of the public pension system while supporting the population to invest is a well managed private pension system; and (iii) improve the efficiency and effectiveness of well-targeted social assistance programs. Policies and programs supported by the Second HD Program to achieve these goals would include better monitoring and evaluation of social assistance programs; and supporting the implementation proper legislation, regulation, supervision and development of investment opportunities needed for a successful private pension system.

4. Environment Aspects

No environmental issues are currently foreseen in this program.

5. Tentative financing

Source: ($m.)
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