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REPORT FROM THE COMMISSION TO THE COUNCIL

**Commission report to the Council pursuant to Article -11(2) of Regulation (EC) No
1466/97 on the enhanced surveillance mission in Romania, of 10-11 April 2018**

This report on an enhanced surveillance mission to Romania is transmitted to the Council pursuant to Article -11(4) of Regulation (EC) No 1466/97¹. As foreseen by Article -11(5) of Regulation (EC) No 1466/97, the provisional findings of that mission have been previously transmitted to Romanian authorities for comments.

Romania – Significant Deviation Procedure enhanced surveillance mission, 10-11 April 2018

Report

1. Introduction

As a consequence of the significant deviation from its medium-term budgetary objective (MTO) in 2016, a Significant Deviation Procedure (SDP) was launched for Romania in spring 2017. On 22 May 2017, the Commission issued a warning to Romania and proposed to the Council to launch a SDP. In its SDP recommendation, of 16 June 2017, the Council asked Romania to take measures to ensure that the nominal growth rate of net primary government expenditure does not exceed 3.3% in 2017. It corresponds to an annual structural adjustment of 0.5% of GDP, which is the minimum effort required under the preventive arm of the Stability and Growth Pact (SGP).

As a consequence of no effective action taken by Romania, the Council issued a revised SDP recommendation in December 2017. Based on the September 2017 enhanced surveillance mission findings and on the report submitted by the authorities, the Commission concluded that the authorities did not intend to act upon the SDP recommendation, with efforts solely focused on avoiding breaching the 3% of GDP headline deficit reference value. Therefore, on 5 December 2017 the Council concluded that no effective action had been taken by Romania and issued a revised recommendation. The Council asked Romania to take measures to ensure that the nominal growth rate of net primary government expenditure does not exceed 3.3% in 2018, corresponding to an annual structural adjustment of 0.8% of GDP in 2018. It translated into the need to adopt measures of a total structural yield of 1.8% of GDP in 2018, as compared to the baseline from the Commission's autumn 2017 economic forecast. Romania reported to the Council on action taken on 20 April, after the 15 April deadline. The Commission's assessment of the report is being published as part of the European Semester Spring package.

According to the Commission projections, following the usual no-policy change scenario, both the headline and structural deficit are likely to increase in 2018. The expansionary fiscal policy is set to continue in the near future. The 2018 budget aims at a general government deficit of 3% of GDP, which implies a further increase of the structural deficit in

¹ Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies, OJ L 209, 2.8.1997, p. 1

the presence of an increasing output gap. However, the budget was built on an optimistic macroeconomic scenario and likely overestimates tax revenues. The Commission projects a headline deficit of 3.4% of GDP in 2018, under the usual no-policy change scenario. Public wages have been significantly increased by the unified wage law (UWL) enacted in summer 2017. Old-age pensions will continue to be increased beyond the standard pension indexation mechanism. Moreover, the personal income flat tax (PIT) rate was cut from 16% to 10% from January 2018. On the other hand, a shift of social security contributions from the current 22.75% for employers and 16.5% for employees to 2.25% and 35%, respectively, will partially contain the fiscal cost of the 2018 increases of gross wages in the public sector. Additionally, the 2018 budget contains a cut of the share of social contributions transferred to the second pillar of the pensions system, with a positive impact on general government revenues.

The enhanced surveillance mission by the Commission took place 10-11 April 2018, and thus prior to the submission of the above-mentioned report as required. Subsequent reporting in line with legislative requirements is therefore not taken into account in this mission report. The mission was carried out on the basis of Article -11(2) of Regulation (EC) 1466/97. The mission met the Minister of Finance, Mr. Eugen Teodorovici, the governor of the National Bank of Romania, Mr. Mugur Isărescu, as well as members of the Fiscal Council of Romania. The aim of the mission was to learn in detail about the fiscal actions planned by the authorities, to increase the visibility of the fiscal risks and to encourage compliance with the SGP.

2. Findings of the mission

It is the mission's understanding that the Romanian authorities do not intend to act upon the SDP recommendation. On behalf of the Ministry of Finance and the government, Minister Teodorovici confirmed that the target for 2018 remains the headline deficit of just below 3% of GDP. Given a positive and increasing output gap, this indicates a deterioration of the underlying structural deficit, contrary to the Council recommendation. Minister Teodorovici explained that he is bound by the measures contained in the government programme, which are fully reflected in the budget in terms of both revenue and expenditure. He also expressed confidence that the absorption of the EU funds will pick up this year as compared to 2017 (which, however, would increase co-financing obligations). Minister Teodorovici added that to respect the 3% of GDP headline deficit threshold in 2018 will require additional measures, which Romania would specify in the report on action taken. Minister Teodorovici indicated that those measures would concern improving the functioning of the tax and customs administration, in particular by introducing a new IT system. The mission stressed that the report on action taken, due by 15 April, must contain details and quantification on the planned measures. The mission also noted that the cash budget execution data for the first quarter of 2018 shows a deteriorated balance as compared to the same period of the previous year (a deficit of 0.5% of GDP in 2018Q1 compared to a surplus of 0.2% of GDP in 2017Q1). Minister Teodorovici argued that the deficit outcome is in line with

projections, and is largely due to a one-off expenditure in the defence sector. Finally, Minister Teodorovici informed that he will push to change the practice of late adoption of the State budgets (usually in December of the preceding year) and will try to adopt the 2019 budget at an earlier date.

The government is considering a further reversal of the 2008 systemic pension reform, which introduced the second pension pillar. The authorities have already reduced, as part of the 2018 budget, the share of social contributions transferred to the second pension pillar. According to public statements, the government is considering to make the transfers to the second pension pillar optional, and to make a decision by end-June 2018, after consultation with stakeholders. Those transfers amount to around RON 7 billion annually (around EUR 1.5 billion; 0.8% of GDP). Such a measure would decrease the fiscal deficit in the short term, as the second pension pillar is classified outside the general government under ESA. However, that fiscal gain would dissipate in the long term as the social contributions diverted from the second pillar would be accompanied by an obligation to pay old-age pensions in the future. In addition, such a reversal could have negative implications for the viability of the pensions system and for the development of capital markets. Making the second pension pillar optional would deprive Romania from the possibility of invoking the systemic pension reform clause under the SGP.

The National Bank of Romania (NBR) expressed concerns regarding the impact of the expansionary, pro-cyclical fiscal policy on the current policy-mix. Romania is in the middle of a large economic upswing while the fiscal position of Romania has been highly expansionary. As such, Romania's fiscal policy appears imprudent and strongly conditions monetary policy. According to NBR projections, the general government deficit would increase above 3% of GDP in 2018 in a no-policy change scenario. The NBR stressed that the 3% of GDP headline deficit threshold is well understood in Romania, while there is no public awareness of the preventive arm of the SGP. There is space for fiscal measures on the revenue side, given that the departure from the MTO was driven by indirect tax cuts, the tax rates are low and tax avoidance is high.

The Fiscal Council shared the Commission's concerns regarding the fiscal outlook. According to the Fiscal Council, the structural deficit will substantially deteriorate in 2018 and the headline deficit is projected to breach the 3% of GDP threshold in the absence of countervailing fiscal measures. The scope for cuts to public investment in 2018 is limited as public investment was already at a historically low level in 2017 and EU funds absorption has been picking up in 2018, implying higher co-financing obligations.

STATISTICAL ANNEX

(Forecast data based on the European Commission 2018 spring forecast)²

Table 1: Key economic indicators overview 2010-2019

	2010	2011	2012	2013	2014	2015	2016	2017	2018*	2019*
Gross Domestic Product (annual percentage change, unless otherwise indicated)										
Nominal GDP (in bn RON)	530	562	595	637	668	713	762	858	944	1 020
Real GDP	-2.8	2.0	1.2	3.5	3.1	4.0	4.8	6.9	4.5	3.9
Private Consumption	-3.5	1.1	2.1	0.7	4.7	5.9	7.6	10.1	4.9	4.2
Public Consumption	-4.8	0.2	0.3	-4.6	0.8	0.2	3.1	0.7	1.7	1.3
Gross fixed capital formation	0.1	6.2	3.6	-5.4	3.2	7.4	-2.0	4.7	7.4	6.9
Exports	15.1	11.9	1.0	19.7	8.0	4.6	8.7	9.7	7.5	6.8
Imports	12.5	10.1	-1.8	8.8	8.7	8.0	9.8	11.3	8.2	7.4
Contribution to GDP growth										
Domestic demand	-3.0	2.4	2.3	-1.7	3.8	5.5	4.6	7.5	5.0	4.4
Inventories	0.3	-0.3	-2.2	1.6	-0.3	-0.1	0.7	0.2	0.0	0.0
Net exports	-0.1	0.0	1.1	3.6	-0.3	-1.4	-0.5	-0.7	-0.5	-0.5
Prices										
HICP inflation (average)	6.1	5.8	3.4	3.2	1.4	-0.4	-1.1	1.1	4.2	3.4
HICP inflation (year-end, quarterly)	7.8	3.4	4.7	1.3	1.4	-1.0	-0.1	1.9	3.0	3.1
Labour market										
Total employment ('000 persons)	9 156	9 082	8 645	8 569	8 635	8 526	8 449	8 668	8 748	8 753
Unemployment rate (harmonised:15-74)	7.0	7.2	6.8	7.1	6.8	6.8	5.9	4.9	4.5	4.4
General Government Accounts (in percent of GDP)										
Govn deficit, cash definition **	-6.3	-4.2	-2.5	-2.5	-1.7	-1.3	-2.4	-2.9	-3.0	-2.6
General Government deficit, ESA 2010 definition	-6.9	-5.4	-3.7	-2.1	-1.3	-0.8	-3.0	-2.9	-3.4	-3.8
General Government gross debt, ESA 2010 definition	29.7	34.0	36.9	37.5	39.1	37.7	37.4	35.0	35.3	36.4
Balance of payments (in percent of GDP)										
Current account balance ***	-4.6	-4.4	-4.2	-0.6	-0.1	-0.6	-2.1	-3.5	-3.6	-3.9
Trade balance***	-6.2	-5.6	-5.0	-0.8	-0.4	-0.6	-0.9	-2.1	-2.4	-2.6
Capital and financial account balance	-4.2	-3.0	-1.1	3.3	4.7	3.9	3.4	-0.6	n.a.	n.a.
FDI balance	-1.8	-1.3	-1.9	-2.0	-1.8	-1.8	-2.7	-2.4	n.a.	n.a.
Net international investment position	-62.8	-64.5	-67.9	-61.7	-56.8	-53.7	-49.3	-45.7	n.a.	n.a.
Foreign exchange reserves (in bn Euro)	31.6	32.7	31.1	32.5	32.2	32.2	33.0	32.3	n.a.	n.a.
Gross external debt			75.5	68.0	63.0	57.4	54.7	49.8	n.a.	n.a.
Monetary and exchange rate developments										
Broad money M3 (annual % change, end of the period)	6.9	6.6	2.7	8.8	8.4	9.3	9.7	11.6	n.a.	n.a.
NBR policy rate (in %, end of period)	6.25	6.00	5.25	4.00	2.75	1.75	1.75	1.75	2.00	n.a.
Exchange rate (lei/euro, end of period)	4.28	4.32	4.43	4.48	4.48	4.52	4.54	4.66	4.66	n.a.
REER (to IC37, Unit Labour Costs deflator, % change)	0.82	-6.46	-5.17	0.94	3.49	-5.94	3.16	5.98	n.a.	n.a.

Notes:

* Forecasts or latest values

**2018 and 2019 are projections from the Romanian authorities

*** Current account and trade balances are reported based on the latest Commission forecast using National Accounts Data.

² The Commission forecast will be updated in November 2017.

Table 2: General government accounts 2016-2019 (% of GDP)

	ESA code	2016	2017	2018*	2019*
1. Taxes on production and imports	D2	11.3	10.3	10.4	10.5
2. Current taxes on income and wealth	D5	6.5	6.1	4.7	4.8
2a. - of which, paid by households and NPISH		3.6	3.6	2.1	2.1
2b. - of which, paid by corporations		2.9	2.5	2.6	2.7
3. Social contributions	D61	8.8	9.3	10.7	10.6
4. Sales and other current revenue		3.6	3.6	3.7	3.7
5. Total current revenue (1+2+3+4)		30.2	29.3	29.6	29.5
6. Compensation of employees	D1	8.9	9.7	10.4	10.3
7. Intermediate consumption	P2	5.3	4.9	4.9	4.9
8. Social transfers in kind supplied via market producers		0.9	0.8	0.8	0.8
9. Social transfers other than in kind	D62	10.7	10.8	10.8	11.0
10. Interest	D41	1.5	1.3	1.4	1.4
11. Subsidies	D3	0.4	0.4	0.4	0.4
12. Other current expenditure		1.8	2.1	2.2	2.4
13. Total current expenditure (6+7+8+9+10+11+12)		29.5	30.1	30.8	31.3
14. Gross saving (5-13)	B8g	0.7	-0.8	-1.2	-1.7
15. Capital Transfers, received	D9	1.5	1.2	1.3	1.5
16. Gross fixed capital formation	P51	3.6	2.8	2.9	3.1
17. Other capital expenditure		1.5	0.5	0.6	0.5
18. Total government revenue (5+15)	TR	31.6	30.5	30.9	31.1
19. Total government expenditure (13+16+17)	TE	34.6	33.4	34.3	34.9
20. Net lending (+) / net borrowing (-) (18-19)	B9	-3.0	-2.9	-3.4	-3.8

Note:

*European Commission Spring 2018 Forecast

Source: European Commission

Table 3: General government balance cyclical adjustment 2010-2019 (% of GDP)

	2010	2011	2012	2013	2014	2015	2016	2017	2018*	2019*
Government balance (ESA-2010)	-6.9	-5.4	-3.7	-2.1	-1.3	-0.8	-3.0	-2.9	-3.4	-3.8
Primary balance	-5.4	-3.8	-1.9	-0.4	0.3	0.8	-1.5	-1.6	-2.0	-2.4
Cyclically adjusted balance	-5.3	-4.0	-1.9	-0.9	-0.3	0.1	-2.5	-3.3	-3.9	-4.2
Cyclically adjusted primary balance	-3.8	-2.4	-0.2	0.8	1.4	1.7	-1.0	-2.0	-2.4	-2.7
Structural government balance	-5.4	-2.9	-2.5	-0.9	-0.3	-0.2	-2.1	-3.3	-3.8	-4.2
GDP growth	-2.8	2.0	1.2	3.5	3.1	4.0	4.8	6.9	4.5	3.9
Potential growth	1.5	1.5	2.1	2.0	2.5	3.4	3.8	4.1	4.3	4.2
Output gap	-4.8	-4.2	-5.1	-3.6	-3.1	-2.5	-1.5	1.2	1.4	1.1

Note:

*European Commission Spring 2018 Forecast

Source: European Commission