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DIRECTORATE GENERAL
ECONOMIC AND FINANCIAL AFFAIRS

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Assessment of the 2018 Convergence Programme for

Romania

(Note prepared by DG ECFIN staff)

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1. INTRODUCTION

On 14 May 2018, Romania submitted its 2018 Convergence Programme (hereafter called the Programme), covering the period 2018-2021. The government approved the programme on 11 May 2018. The submission was made well past the deadline defined in Article 8 of Council Regulation (EC) No 1466/97, which defines that the convergence programmes shall be submitted preferably by mid April and not later than 30 April.

Romania is currently subject to the preventive arm of the the Stability and Growth Pact (SGP) and should ensure sufficient progress towards its MTO. In spring 2017, a significant deviation procedure (SDP) was opened for Romania due to the observed significant deviation in 2016. On 5 December 2017, the Council found that Romania had not taken effective action in response to the Council recommendation of 16 June 2017 and issued a revised SDP recommendation for a fiscal adjustment in 2018. On 23 May 2018, the Commission recommended a decision to the Council, which finds that Romania had not taken effective action in response to the revised Council recommendation of 5 December 2017. On the same day, the Commission issued a warning to Romania that a significant deviation from the adjustment path toward the medium-term budgetary objective was observed in 2017 and recommended the Council to adopt a new SDP recommendation.

This document complements the Country Report published on 7 March 2018 and updates it with the information included in the Programme. Detailed information concerning the latest steps within the significant deviation procedure can be found in the Comission Staff Working Document accompanying the legal documents adopted on 23 May 2018.

Section 2 presents the macroeconomic outlook underlying the Programme and provides an assessment based on the Commission 2018 spring forecast. The following section presents the recent and planned budgetary developments, according to the Programme. In particular, it includes an overview on the medium term budgetary plans, an assessment of the measures underpinning the Convergence Programme and a risk analysis of the budgetary plans based on Commission forecast. Section 4 assesses compliance with the rules of the SGP, including on the basis of the Commission forecast. Section 5 provides an overview on long term sustainability risks and Section 6 on recent developments and plans regarding the fiscal framework. Section 7 provides a summary.

2. MACROECONOMIC DEVELOPMENTS

The Programme's macroeconomic scenario assumes that Romania's economy will continue to grow at very robust rates. After reaching a post crisis high of 6.9% in 2017, real GDP growth is projected to decelerate gradually to 6.1% in 2018, 5.7% in 2019 and 2020, and 5% in 2021. Private consumption, which expanded by 10.1% in real terms in 2017, is expected to slow down to an average annual real growth rate of 5.8% over the 2018-2021 horizon but is nevertheless forecast to remain the main driver of growth. Investment growth is projected to further accelerate between 2018 and 2020, before slightly moderating in 2021. Imports are forecast to continue outpacing exports over the forecast horizon and net exports are consequently expected to remain a drag on GDP growth.

The real GDP growth forecast for 2018 was revised upwards by 0.6 pps. compared to the previous convergence programme. This is due mainly to a higher expected contribution to growth from domestic demand.

The real GDP growth projected in the Programme for 2018 and 2019 is higher than the Commission forecast mostly due to more optimistic assumptions regarding the growth rates of

private consumption despite a foreseen deceleration of gross disposable income starting in 2018. The Programme's projections of compensation per employee growth and inflation over the coming two years are in line with the Commission's spring 2018 forecast. The Programme's expectations regarding investment are also broadly in line with the Commission's latest forecast. On the external side, the assumptions of the Programme for export and import growth rates are plausible for 2018 and 2019.

The recalculated output gap as estimated by the Commission based on the information in the Programme, following the commonly agreed methodology, is projected to have nearly closed in 2017, to turn positive in 2018 and to grow further in 2019.

Overall, the economic growth assumptions in the Programme are favourable for 2018-2021. The main downward risk to the macroeconomic outlook stems from a stronger than expected slowdown of private consumption as wage growth tempers and inflation increasingly weighs on real disposable income.

Table 1: Comparison of macroeconomic developments and forecasts

	2017		2018		2019		2020	2021
	COM	CP	COM	CP	COM	CP	CP	CP
Real GDP (% change)	6.9	6.9	4.5	6.1	3.9	5.7	5.7	5.0
Private consumption (% change)	10.1	10.1	4.9	6.5	4.2	6.1	5.8	5.5
Gross fixed capital formation (% change)	4.7	4.7	7.4	7.9	6.9	8.4	8.6	7.4
Exports of goods and services (% change)	9.7	9.7	7.5	7.4	6.8	6.9	7.1	6.9
Imports of goods and services (% change)	11.3	11.3	8.2	8.5	7.4	8.0	7.9	7.8
Contributions to real GDP growth:								
- Final domestic demand	7.5	7.5	5.0	6.7	4.4	6.2	6.1	5.5
- Change in inventories	0.2	0.2	0.0	0.0	0.0	0.0	0.0	0.0
- Net exports	-0.7	-0.8	-0.5	-0.6	-0.5	-0.6	-0.5	-0.5
Output gap[1]	1.2	-0.1	1.4	0.8	1.1	1.2	1.6	1.8
Employment (% change)	2.6	2.6	0.9	2.4	0.1	1.8	1.2	1.0
Unemployment rate (%)	4.9	4.9	4.5	4.8	4.4	4.6	4.5	4.4
Labour productivity (% change)	4.2	4.2	3.6	3.6	3.9	3.8	4.4	4.0
HICP inflation (%)	1.1	1.1	4.2	3.8	3.4	2.8	2.6	2.5
GDP deflator (% change)	5.3	5.3	5.2	2.1	4.0	1.9	1.9	2.0
Comp. of employees (per head, % change)	16.0	16.0	8.7	8.1	6.7	7.0	7.5	7.2
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	-1.9	-2.2	-2.1	-1.4	-2.1	-0.9	-0.3	-0.1

Note:

[1] In % of potential GDP, with potential GDP growth recalculated by Commission services on the basis of the programme scenario using the commonly agreed methodology.

Source :

Commission 2018 spring forecast (COM); Convergence Programme (CP).

3. RECENT AND PLANNED BUDGETARY DEVELOPMENTS

3.1. DEFICIT DEVELOPMENTS IN 2017 AND 2018

In 2017, the general government deficit decreased slightly, to 2.9% of GDP, from 3.0% of GDP in 2016, while the economy grew significantly above its potential. This slight decrease of the headline deficit was cyclical in nature and not due to fiscal consolidation measures. Tax cuts, in particular, a 1pp. cut to the standard VAT rate, had a negative effect on tax revenues. On the expenditure side, compensation for employees increased considerably (by 0.8 % of GDP). On the other hand, public investment dropped (by 0.8 % of GDP). Given that the output gap increased significantly and turned positive, the structural deficit increased to 3.3% of GDP in 2017, from 2.1% in 2016. The 2017 general government deficit outcome of 2.9% of GDP fulfils the target in the 2017 Convergence Programme. Both the revenues and the expenditures turned out lower than planned in the 2017 Convergence Programme. On the revenue side, the target for both indirect and direct tax revenues was not achieved. On the expenditure side, public investment was significantly lower than planned.

In 2018, the programme targets a slight increase of the headline deficit to 2.95% of GDP[1]. This target is slightly higher than the 2.9% of GDP planned in the 2017 Convergence Programme. Both revenues and expenditures are higher as a share of GDP than in the last year's programme. On the revenue side, the planned revenues from social contributions are significantly higher (by 2.2 percentage points of GDP) while the planned revenues from direct taxes are significantly lower (by 1.9 percentage points of GDP) than planned in the 2017 Convergence Programme, reflecting a reform to the fiscal code and a decrease of the share of social contributions transferred to the second pension pillar, both adopted in autumn 2017. On the expenditure side, the planned compensation for employees considerably increased (by 2.0 percentage points of GDP), reflecting the Unified Wage Law adopted in summer 2017. On the other hand, planned public investment dropped significantly compared to last year's programme (by 1.1 percentage points of GDP).

The planned 2018 headline deficit is lower than the 3.4% of GDP projected by the Commision in the spring 2018 forecast. The difference is driven by the revenue side. For more information see section 3.5 below.

3.2. MEDIUM-TERM STRATEGY AND TARGETS

The Programme mantains the MTO of a deficit of 1% of GDP in structural terms. This MTO is more stringent than required by the Pact and aims at taking into account the requirements of the Treaty on the Stability, Coordination and Governance in the Economic and Monetary Union. The Programme plans to deviate from the adjustment path towards the MTO in 2018 and to start to adjust toward the MTO from 2019 onwards. The Programme does not envisage reaching the MTO over the programme horizon (2021).

The structural balance - recalculated by the Commission according to the commonly agreed methodology – is projected to increase from 2.9% of GDP in 2017 to 3.3% of GDP in 2018 and to gradually decrease thereafter, to 2.1% of GDP in 2021.

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[1] In their report on action taken in response to Council recommendation of 5 December 2017, submitted on 20 April 2018, the Romanian authorities mention a headline deficit target of 2.95% of GDP in 2018. The slight difference of the target is due to the revised underling macroeconomic projection.

Table 2: Composition of the budgetary adjustment

(% of GDP)	2017	2018		2019		2020	2021	Change: 2017-2021
	COM	COM	CP	COM	CP	CP	CP	CP
Revenue	**30.5**	**30.9**	**31.3**	**31.1**	**31.5**	**31.8**	**32.0**	**1.5**
of which:								
- Taxes on production and imports	10.3	10.4	10.8	10.5	10.3	10.4	10.3	0.0
- Current taxes on income, wealth, etc.	6.1	4.7	4.9	4.8	5.0	5.1	5.2	-0.9
- Social contributions	9.3	10.7	10.9	10.6	11.5	11.8	12.2	2.9
- Other (residual)	4.8	5.0	4.7	5.2	4.7	4.5	4.3	-0.5
Expenditure	**33.4**	**34.3**	**34.3**	**34.9**	**33.9**	**33.6**	**33.4**	**0.0**
of which:								
- Primary expenditure	32.0	32.9	32.9	33.4	32.6	32.2	32.0	-0.1
of which:								
Compensation of employees	9.7	10.4	10.3	10.3	9.9	9.7	9.4	-0.3
Intermediate consumption	4.9	4.9	4.7	4.9	4.5	4.2	4.2	-0.7
Social payments	11.6	11.6	11.4	11.8	11.8	11.6	11.4	-0.2
Subsidies	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.0
Gross fixed capital formation	2.8	2.9	2.9	3.1	3.0	3.5	4.0	1.2
Other (residual)	2.6	2.8	3.1	2.9	2.9	2.8	2.7	0.1
- Interest expenditure	1.3	1.4	1.4	1.4	1.3	1.4	1.4	0.1
General government balance (GGB)	**-2.9**	**-3.4**	**-3.0**	**-3.8**	**-2.4**	**-1.8**	**-1.5**	**1.4**
Primary balance	**-1.6**	**-2.0**	**-1.5**	**-2.4**	**-1.0**	**-0.5**	**-0.1**	**1.5**
One-off and other temporary	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
GGB excl. one-offs	**-2.9**	**-3.3**	**-3.0**	**-3.8**	**-2.4**	**-1.8**	**-1.5**	**1.4**
Output gap[1]	1.2	1.4	0.8	1.1	1.2	1.6	1.8	1.9
Cyclically-adjusted balance[1]	-3.3	-3.9	-3.3	-4.2	-2.8	-2.4	-2.1	0.8
Structural balance[2]	**-3.3**	**-3.8**	**-3.3**	**-4.2**	**-2.8**	**-2.4**	**-2.1**	**0.8**
Structural primary balance[2]	-2.0	-2.3	-1.9	-2.7	-1.5	-1.0	-0.7	0.8

Notes:

[1]Output gap (in % of potential GDP) and cyclically-adjusted balance according to the programme as recalculated by Commission on the basis of the programme scenario using the commonly agreed methodology.

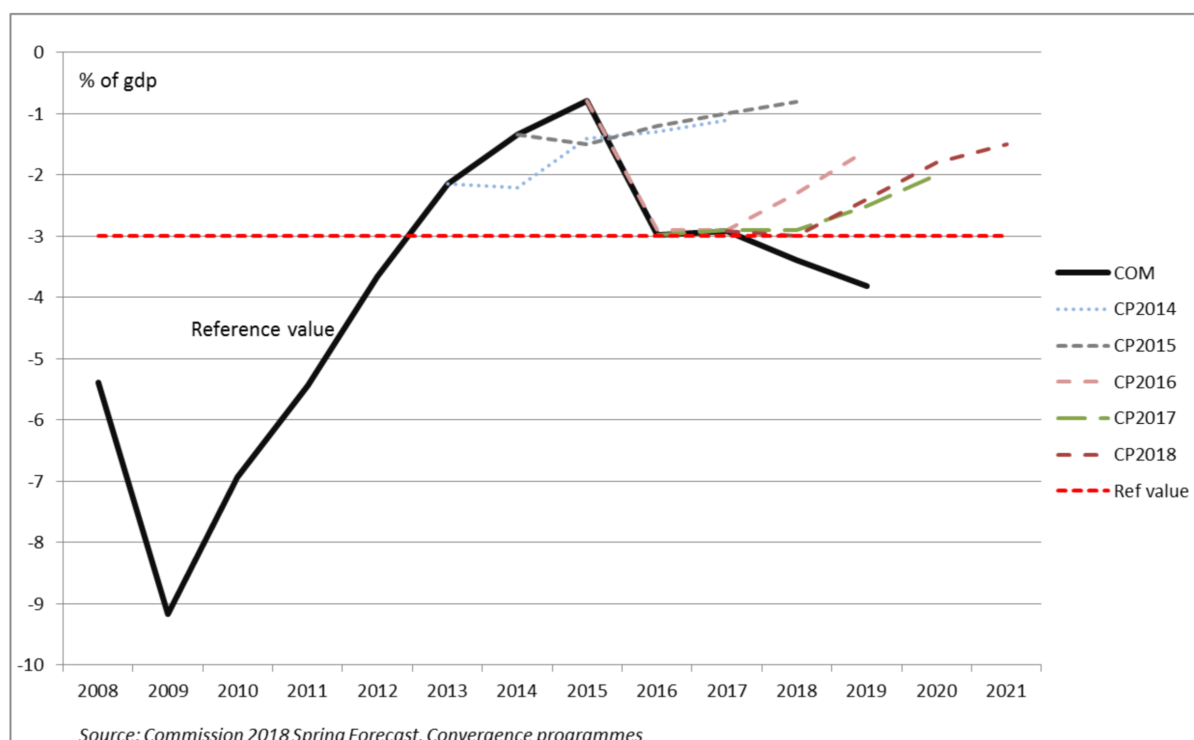
[2]Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

Source :

Convergence Programme (CP); Commission 2018 spring forecasts (COM); Commission calculations.

The Programme plans a gradual improvement of the headline balance over 2019-2021. The planned fiscal consolidaton is based on both the revenue and expenditure side a a share of GDP. On the revenue side, the improvement is due to planned increases of collected direct taxes and social contributions, while on the expenditure side it relies on a moderation of expenditures on public wages, social benefits and spending on goods and services. Public investment relative to GDP is planned to increase. The Programme does not specify the measures which would support the planned 2019-2021 consolidation targets. The deficit targets for 2019-2021 in the current Programme are somewhat lower than the targets from the previous convergence programme (see Figure 1 below).

Figure 1: Government balance projections in successive programmes (% of GDP)



3.3. MEASURES UNDERPINNING THE PROGRAMME

The main measures as reported in the Programme are listed in the table below. In 2018, the unified wage law, enacted in summer 2017, increased gross public wages by 25% in January 2018 and contains additional increases in health and education sectors, leading to a significant increase of spending on compensation of public employees (by 0.6% of GDP according to the programme projections). The fiscal cost of these increases to gross wages is set to be partially compensated by a shift of social security contributions from 22.75% for employers and 16.5% for employees to 2.25% and 35% respectively. Moreover, the government partially reversed the past systemic pension reform by lowering the proportion of the social contributions transferred to the second pension pillar (which is classified outside the general government) from 5.1% to 3.75% of gross wages from 2018. On the other hand, the flat personal income tax (PIT) rate was cut from 16% to 10%. The Programme does not specify measures for 2019 and beyond.

The main new measure as compared to the Commission 2017 autumn forecast is the lowering of the proportion of social contributions transferred to the second pension pillar. The Commission spring 2018 forecast, following a general practice of treating with caution such type of measures, does not take into account the fiscal impact of the VAT split payment and other tax collection and tax compliance measures listed in the report.

Main budgetary measures

<table>
<tr><th>Revenue</th><th>Expenditure</th></tr>
<tr><td colspan="2">2017</td></tr>
<tr><td>

- Cut of standard VAT rate from 20% to 19% (-0.3% of GDP)
- Cut in the excise on energy products and increase in the excise on cigarettes (-0.3% of GDP)
- Elimination of the special construction tax (-0.1% of GDP)
- Exemption of pensions from social and health insurance contributions and exemption of pensions below RON 2,000 from personal income tax (-0.2% of GDP)
- Removal of the cap of 5 gross average salaries for the calculation of the health insurance contribution (0.1% of GDP)
- Cut of the turnover tax on microenterprises and the property transactions tax (-0.1% of GP)
- Increase of dividends from SOEs to 90% of net profit (+0.1% of GDP)
- Dividends from SOEs on profits retained from previous years (+0.3% of GDP; however, under ESA-2010 these are classified as a super-dividend and have no impact on the general government balance)

</td><td>

- Unified Wage Law and other increases of public wages (impact not quantified in the programme)
- Increases to social benefits, including an increase of old-age pensions as from 1 July 2017 beyond the standard indexation mechanism (+0.1% of GDP)

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<tr><td colspan="2">2018</td></tr>
<tr><td>

- Cut of flat Personal Income Tax rate from 16% to 10% (-1.4% of GDP)
- Shift of social security contributions from 22.75% for employers and 16.5% for employees to 2.25% and 35%, respectively (+1.2% of GDP)
- Lowering of the social contributions transferred to the second pension pillar from 5.1% to 3.75% of gross wages (+0.2% of GDP).
- Increase of the excise on energy products

</td><td>

- Unified Wage Law and other increases of public wages (impact not quantified in the programme)
- Increases to social benefits, including an increase of old-age pensions as from 1 July 2017 beyond the standard indexation mechanism (impact not quantified in the programme)

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</table>

from September 2017 and increase of excise on cigarettes (+0.3% of GDP) • Maintaining of dividends from SOEs at 90% of net profit (+0.1% of GDP) • Increase of the taxation base for companies for unemployed persons with disabilities from September 2017 (+0.1% of GDP) • Starting the procedure for selling 5G licences (+0.1% of GDP; however under ESA-2010 the impact of this measure shoud be smoothed out over several years) • Introduction of a split-payment system in VAT, mandatory for companies in insolvency or with VAT arrears, optional to the others (+0.3% of GDP) • Other measures to decrease tax evasion and increase tax collection (+0.2% of GDP)	
Note: The budgetary impact in the table is the impact reported in the programme, i.e. by the national authorities. A positive sign implies that revenue / expenditure increases as a consequence of this measure.	

3.4. DEBT DEVELOPMENTS

General government debt is planned to increase in the programme from 35.0% of GDP in 2017 to 35.8% of GDP in 2019 driven by the negative primary balance due to the enacted fiscal loosening measures. It is projected to start to decrease from 2020 onwards thanks to a planned improvement of the primary balance. The Commission 2018 spring forecast projects a higher debt-to-GDP ratio in 2019 due to the lower projection for the primary balance and real GDP growth. Projections for general government debt in the programme are lower than in the 2017 programme (see Figure 2 below).

Table 3: Debt developments

(% of GDP)	Average 2012-2016	2017	2018		2019		2020	2021
			COM	CP	COM	CP	CP	CP
Gross debt ratio[1]	**37.7**	**35.0**	**35.3**	**35.4**	**36.4**	**35.8**	**35.4**	**34.5**
Change in the ratio	0.7	-2.3	0.2	0.4	1.2	0.4	-0.4	-0.9
Contributions[2] *:*								
1. Primary balance	**0.5**	**1.6**	**2.0**	**1.5**	**2.4**	**1.0**	**0.5**	**0.1**
2. "Snow-ball" effect	**-0.5**	**-2.7**	**-1.7**	**-1.1**	**-1.1**	**-1.1**	**-1.2**	**-0.9**
Of which:								
Interest expenditure	1.7	1.3	1.4	1.5	1.4	1.4	1.3	1.4
Growth effect	-1.2	-2.3	-1.4	-2.0	-1.3	-1.9	-1.9	-1.7
Inflation effect	-1.0	-1.8	-1.6	-0.7	-1.3	-0.6	-0.6	-0.7
3. Stock-flow adjustment	**0.7**	**-1.1**	**0.0**	**0.0**	**0.0**	**0.5**	**0.4**	**-0.1**
Of which:								
Cash/accruals diff.				-0.1		-0.1	-0.1	-0.1
Acc. financial assets				0.0		0.0	0.0	0.0
Privatisation				0.0		0.0	0.0	0.0
Val. effect & residual				-2.4		-1.8	-2.2	-2.3

Notes:

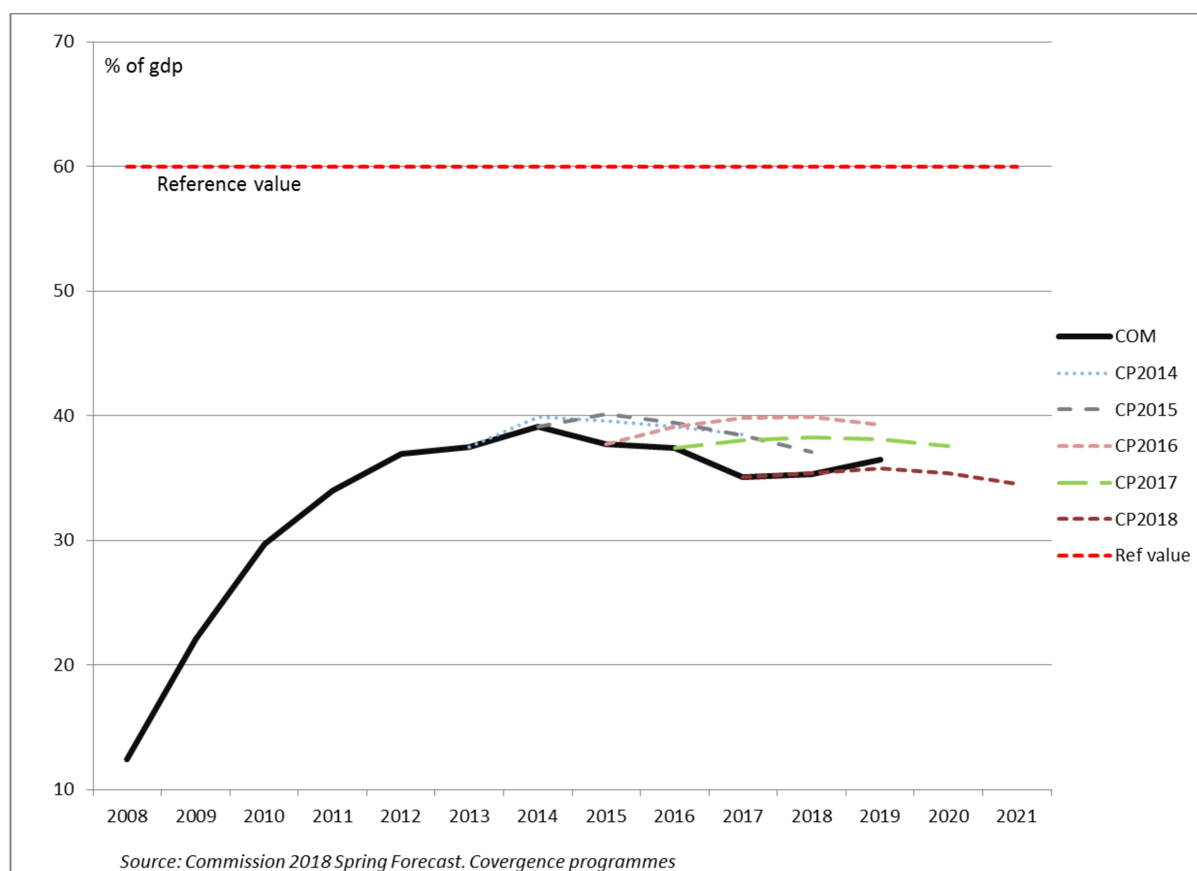
[1] End of period.

[2] The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual effects.

Source :

Commission 2018 spring forecast (COM); Convergence Programme (CP), Commission calculations.

Figure 2: Government debt projections in successive programmes (% of GDP)



3.5. RISK ASSESSMENT

Downward risks to the achievement of the planned budgetary targets stem from the favourable macroeconomic projections underpinning the programme. Moreover, the fiscal consolidation from 2019 onwards is based on fiscal consolidation measures which are not specified in the Programme.

In 2018, the planned headline deficit of 2.95% of GDP is lower than the 3.4% of GDP projected by the Commision in the spring 2018 forecast. The difference is driven by the revenue side. Total revenues as a share of GDP are higher than in the Commission forecast (a difference of 0.4 percentage points), while the expenditure ratio is the same as projected by the Commission. The underlying macroeconomic projection of 6.1% of real GDP growth is more optimistic than the 4.5% forecasted by the Commission, with a positive impact on tax revenues. The projection of revenues from all the main categories of taxes and social contributions is higher than in the Commission forecast (see Table 2). On the expenditure side, current expenditures (in particular social benefits and intermediate consumption) are somewhat lower while capital expenditures are somewhat higher than projected by the Commission.

In 2019, the headline deficit target of 2.38% of GDP in the Programme is markedly lower than the 3.8% of GDP projected by the Commission in the 2018 spring forecast. The difference is partially driven by the 2018 base effect (the difference between 2018 deficit projection of 2.95% of GDP in the Programme compared to 3.4% in the Commission 2018 spring forecast, which carries forward to 2018). The difference is also influenced by the less

favourable macroeconomic projection in the Commission 2018 spring forecast and by the fact that the Commission forecast is based on a no-policy change scenario while the Programme relies on unspecified measures.

4. COMPLIANCE WITH THE PROVISIONS OF THE STABILITY AND GROWTH PACT

Box 1. Council Recommendations addressed to Romania

On 16 June 2017, the Council decided in accordance with Article 121(4) of the Treaty on the Functioning of the European Union that a significant observed deviation from the MTO occurred in Romania in 2016. In view of the established significant deviation, the Council on 16 June 2017 issued a recommendation for Romania to take the necessary measures to ensure that the nominal growth rate of net primary government expenditure[2] does not exceed 3.3% in 2017, corresponding to an annual structural adjustment of 0.5% of GDP[3].

On 5 December 2017 the Council found that Romania had not taken effective action in response to the 16 June recommendation and issued a revised recommendation. In the new recommendation the Council asked Romania to take the necessary 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. It recommended Romania to use any windfall gains for reduction of its deficit, while budgetary consolidation measures should ensure a lasting improvement in the general government structural balance in a growth-friendly manner. The Council established a deadline of 15 April 2018 for Romania to report on the action taken in response to the recommendation.

4.1. Compliance with the deficit criterion

The headline general government deficit amounted to 2.9% of GDP in 2017, just below the deficit reference value of the Treaty. The Programme projects the headline deficit to remain below the 3% of GDP reference value over the programme horizon. However, based on the Commission 2018 spring forecast, Romania's headline deficit is projected to exceed the 3% of GDP in 2018 and in 2019. The differences in the headline deficit projections are driven by a favourable macroeconomic projection and a higher projection of revenues from taxes and social contributions in the Programme. For more details, see section 3.5 above.

4.2. Compliance with the MTO or the required adjustment path towards the MTO

According to the 2017 outturn data, the growth of net primary government expenditure was well above the expenditure benchmark, pointing to a significant deviation from the requirement by a large margin (deviation of 3.3% of GDP). The structural balance deteriorated to -3.3% of GDP from a position of -2.1% of GDP in 2016, also pointing to a

[2] Net primary government expenditure is comprised of total government expenditure excluding interest expenditure, expenditure on Union programmes fully matched by Union funds revenue and non-discretionary changes in unemployment benefit expenditure. Nationally financed gross fixed capital formation is smoothed over a four-year period. Discretionary revenue measures or revenue increases mandated by law are factored in. One-off measures on both the revenue and expenditure sides are netted out.

[3] Council Recommendation of 16 June 2017 with a view to correcting the significant observed deviation from the adjustment path toward the medium-term budgetary objective in Romania (OJ C 216, 6.7.2017, p. 1).

significant deviation from the recommended structural adjustment by a large margin (deviation of 1.7% of GDP). The size of deviation indicated by the structural balance is positively impacted by a higher point estimate for potential GDP growth compared to the medium-term average underlying the expenditure benchmark while the drop in public investment is smoothed out in the expenditure benchmark. Taking into account these factors, the overall assessment confirms a significant deviation from the Council recommendation. This assessment is also in line with the earlier conclusion of 5 December 2017, in which the Council found that Romania had not taken effective action in response to the Council recommendation of 16 June 2017 and issued a revised recommendation. The conclusion of a signficant deviation is confirmed when looking at 2016 and 2017 together.

Based on this, on 23 May 2018, the Commission issued a warning to Romania and recommendation for a Council recommendation in accordance with Article 121(4) TFEU and Article 10(2) of Regulation (EC) No 1466/97, with a view to correcting the significant observed deviation from the adjustment path towards the medium-term budgetary objective[4]. It includes fiscal requirements for 2018 and 2019. The delivery of effective action under the SDP requires compliance with the required adjustment, based on an economic reading of the two pillars. However, there is no notion of broad compliance with recommendations under an SDP.

In 2018, according to the information provided in the Programme, the growth of net primary government expenditure is expected to deviate by 0.7% of GDP from the required adjustment, while the recalculated structural balance is set to worsen by 0.4% of GDP, leading to a deviation by 1.2% from the required adjustment. Based on the Commission spring 2018 forecast, the growth of net primary government expenditure amounts to 10.4%, well above the expenditure benchmark of 3.3%. The structural balance is set to deteriorate by 0.4 % of GDP, reaching a deficit of 3.8% in 2018. This is the opposite of the recommended structural improvement of 0.8% of GDP relative to 2017. Therefore, both pillars point to a deviation from the recommended adjustment by a wide margin. The expenditure benchmark points to a deviation of 2.0% of GDP. The structural balance confirms this reading, but at a relatively smaller margin (deviation of 1.2% of GDP). The structural balance is positively impacted by a higher point estimate for potential GDP growth compared to the medium-term average underlying the expenditure benchmark. Taking this into account, the overall assessment confirms the risk of a deviation from the required adjustment by a wide margin in 2018.

In 2019, according to the information provided in the Programme, the growth of net primary government expenditure is expected to deviate by 0.2% of GDP from the required adjustment. At the same time, according to the programme, the recalculated structural balance is set to improve by 0.5% of GDP, leading to a deviation by 0.3% from the required adjustment. Based on the Commission spring 2018 forecast, both indicators point to a risk of a deviation from the required adjusment of a similar magnitude, of slightly above 1% of GDP. There are no major differences in the reading between both indicators. The overall assessment thus confirms the risk of a deviation from the requirements of the Council recommendation by a wide margin in 2019.

[4] For more information, see the Comission Staff Working Document accompanying the Recommendation for a Council Decision establishing that no effective action has been taken by Romania in response to the Council Recommendation of 5 December 2017 and the Recommendation for a Council Recommendation with a view to correcting the significant observed deviation from the adjustment path toward the medium-term budgetary objective in Romania.

Table 4: Compliance with the requirements under the preventive arm

(% of GDP)	2017	2018		2019	
Initial position[1]					
Medium-term objective (MTO)	-1.0	-1.0		-1.0	
Structural balance[2] (COM)	-3.3	-3.8		-4.2	
Structural balance based on freezing (COM)	-3.3	-3.8		-	
Position vis-a -vis the MTO[3]	Not at MTO	Not at MTO		Not at MTO	
(% of GDP)	**2017**	**2018**		**2019**	
	COM	**CP**	**COM**	**CP**	**COM**
Structural balance pillar					
Required adjustment[4]	0.5	0.8		0.8	
Required adjustment corrected[5]	0.5	0.8		0.8	
Change in structural balance[6]	-1.2	-0.4	-0.4	0.5	-0.4
One-year deviation from the required adjustment[7]	-1.7	-1.2	-1.2	-0.3	-1.2
Two-year average deviation from the required adjustment[7]	-1.7	-1.5	-1.5	-0.8	-1.2
Expenditure benchmark pillar					
Applicable reference rate[8]	1.0	3.3		5.1	
One-year deviation adjusted for one-offs[9]	-3.3	-0.7	-2.0	-0.2	-1.1
Two-year deviation adjusted for one-offs[9]	-2.7	-2.0	-2.7	-0.5	-1.6
PER MEMORIAM: One-year deviation[10]	-3.0	-0.7	-2.1	-0.2	-1.0
PER MEMORIAM: Two-year average deviation[10]	-2.8	-1.9	-2.6	-0.5	-1.6

Notes

[1] The most favourable level of the structural balance, measured as a percentage of GDP reached at the end of year t-1, between spring forecast (t-1) and the latest forecast, determines whether there is a need to adjust towards the MTO or not in year t. A margin of 0.25 percentage points (p.p.) is allowed in order to be evaluated as having reached the MTO.

[2] Structural balance = cyclically-adjusted government balance excluding one-off measures.

[3] Based on the relevant structural balance at year t-1.

[4] Based on the position vis-à-vis the MTO, the cyclical position and the debt level (See European Commission: Vade mecum on the Stability and Growth Pact, page 38.).

[5] Required adjustment corrected for the clauses, the possible margin to the MTO and the allowed deviation in case of overachievers.

[6] Change in the structural balance compared to year t-1. Ex post assessment (for 2017) is carried out on the basis of Commission 2018 spring forecast.

[7] The difference of the change in the structural balance and the corrected required adjustment.

[8] Reference medium-term rate of potential GDP growth. The (standard) reference rate applies from year t+1, if the country has reached its MTO in year t. A corrected rate applies as long as the country is adjusting towards its MTO, including in year t.

[9] Deviation of the growth rate of public expenditure net of discretionary revenue measures, revenue increases mandated by law and one-offs from the applicable reference rate in terms of the effect on the structural balance. The expenditure aggregate used for the expenditure benchmark is obtained following the commonly agreed methodology. A negative sign implies that expenditure growth exceeds the applicable reference rate.

[10] Deviation of the growth rate of public expenditure net of discretionary revenue measures and revenue increases mandated by law from the applicable reference rate in terms of the effect on the structural balance. The expenditure aggregate used for the expenditure benchmark is obtained following the commonly agreed methodology. A negative sign implies that expenditure growth exceeds the applicable reference rate.

Source :

Convergence Programme (CP); Commission 2018 spring forecast (COM); Commission calculations.

To conclude, based on the outturn data and the Commission 2018 spring forecast, the ex-post assessment suggests a significant deviation from the adjustment path towards the MTO in 2017. Following an overall assessment, there is a risk of deviation from the requirements under the SDP in 2018 and 2019. This entails a risk of a significant deviation from the adjustment path towards the MTO in 2018 and in 2019. Overall, Romania is at risk of non-compliance with the requirements of the preventive arm of the Pact.

5. FISCAL SUSTAINABILITY

Romania does not appear to face fiscal sustainability risks in the short run.[5]

Based on Commission 2018 spring forecasts and a no-fiscal policy change scenario beyond the forecast horizon, government debt, at 35.0% of GDP in 2017, is expected to gradually rise to 57.3% in 2028, thus remaining somewhat below the 60% of GDP Treaty threshold. Over this horizon, government debt is projected to peak in 2028. Sensitivity analysis shows higher risks.[6] Overall, debt sustainability analysis highlights medium risks for the country in the medium term. The full implementation of the Programme would nonetheless put debt on a markedly less increasing path by 2028.

The medium-term fiscal sustainability risk indicator S1 (which measures the upfront fiscal adjustment effort required to bring the debt-to-GDP ratio to 60% by 2032) is at 0.9 percentage points of GDP, primarily related to the initial budgetary position. It indicates medium fiscal sustainability risks over the medium term. The full implementation of the Programme would put the sustainability risk indicator S1 at -1.9 percentage points of GDP, leading to low medium-term risk. Overall, risks to fiscal sustainability over the medium-term are, therefore, medium. Fully implementing the fiscal plans in the Programme would decrease those risks.

The long-term fiscal sustainability risk indicator S2 (which shows the adjustment effort needed to ensure that the debt-to-GDP ratio is not on an ever-increasing path) is at 5.5 percentage points of GDP. In the long-term, Romania therefore appears to face medium fiscal sustainability risks, primarily related to the initial budgetary position, and the projected ageing costs. Full implementation of the programme would put the S2 indicator at 3.6 percentage points of GDP, leading to the same category of long-term risk, despite a somewhat lower indicator level. [7]

Implementing reforms to contain the projected age-related increase in spending could improve fiscal sustainability over the long term. A bill equalizing the retirement age for women and men at 65 has been pending before Parliament for several years. Moreover, as described in section 3 above, the authorities partially reversed the past systemic pension reform by lowering the proportion of social contributions transferred to the second pension pillar (which consists of privately managed pension funds classified outside the general government). This cut is set to have a positive short-term effect on government revenues and thus on government

[5] This conclusion is based on the short-term fiscal sustainability risk indicator S0. See the note to Table 5 for a definition of the indicator.

[6] Sensitivity analysis includes several deterministic debt projections, as well as stochastic projections (see Debt Sustainability Monitor 2017 for more details).

[7] The projected costs of ageing used to compute the debt projections and the fiscal sustainability indicators S1 and S2 are based on the updated projections, endorsed by the EPC on 30 January 2018, and to be published in the forthcoming Ageing Report 2018.

balance. However, that fiscal gain is set to dissipate in the long term as the social contributions diverted from the second pillar are accompanied by an obligation to pay old-age pensions in the future. This reversal will result in less diversified retirement income. Furthermore, since mid-2017 the authorities have been increasing the pension point beyond the standard indexation mechanism. The governing programme foresees additional ad-hoc increases until 2020, which, if enacted, would generate higher pension expenditure[8].

[8] Several pension point increases foreseen in the governing programme as social policy targets and not enacted by the cut-off date of the Ageing Report 2018 are not covered by the recent pension projections - see Country Fiche Romania p 5-7, European Commission (DG ECFIN) and Economic Policy Committee (Ageing Working Group) (2018), Country Fiche to the *"The 2018 Ageing Report: economic and budgetary projections for the EU Member States (2016-2070)including Country Fiches"*, forthcoming

Table 6: Sustainability indicators

Time horizon			Commission Scenario		Stability / Convergence Programme Scenario	
Short Term			**LOW risk**			
S0 indicator [1]			0.2			
	Fiscal subindex		0.2	LOW risk		
	Financial & competitiveness subindex		0.2	LOW risk		
Medium Term			**MEDIUM risk**			
DSA [2]			MEDIUM risk			
S1 indicator [3]			0.9	MEDIUM risk	-1.9	LOW risk
of which						
	Initial Budgetary Position		2.8		0.5	
	Debt Requirement		-1.8		-2.3	
	Cost of Ageing		-0.1		-0.1	
	of which					
		Pensions	-0.4		-0.4	
		Health-care	0.3		0.2	
		Long-term care	0.0		0.0	
		Other	0.0		0.0	
Long Term			**MEDIUM risk**		**MEDIUM risk**	
S2 indicator [4]			5.5		3.6	
of which						
	Initial Budgetary Position		3.4		1.4	
	Cost of Ageing		2.1		2.2	
	of which					
		Pensions	0.9		1.0	
		Health-care	0.7		0.7	
		Long-term care	0.2		0.2	
		Other	0.3		0.3	

Source: Commission services; 2018 stability/convergence programme.

Note: the 'Commission' scenario depicts the sustainability gap under the assumption that the structural primary balance position evolves according to the Commissions' spring 2018 forecast covering until 2019 included. The 'stability/convergence programme' scenario depicts the sustainability gap under the assumption that the budgetary plans in the programme are fully implemented over the period covered by the programme. Age-related expenditure as given in the 2018 Ageing Report.

[1] The S0 indicator of short term fiscal challenges informs the early detection of fiscal stress associated to fiscal risks within a one-year horizon. To estimate these risks S0 uses a set of fiscal, financial and competitiveness indicators selected and weighted according to their signalling power. S0 is therefore a composite indicator whose methodology is fundamentally different from the S1 and S2 indicators, which quantify fiscal adjustment efforts. The critical threshold for the overall S0 indicator is 0.46. For the fiscal and the financial-competitiveness sub-indexes, thresholds are respectively at 0.36 and 0.49*.

[2] Debt Sustainability Analysis (DSA) is performed around the no fiscal policy change scenario in a manner that tests the response of this scenario to different shocks presented as sensitivity tests and stochastic projections*.

[3] The S1 indicator is a medium-term sustainability gap; it measures the upfront fiscal adjustment effort required to bring the debt-to-GDP ratio to 60 % by 2032. This adjustment effort corresponds to a cumulated improvement in the structural primary balance over the 5 years following the forecast horizon (i.e. from 2020 for Commission scenario and from last available year for the SCP scenario); it must be then sustained, including financing for any additional expenditure until the target date, arising from an ageing population. The critical thresholds for S1 are 0 and 2.5, between which S1 indicates medium risk. If S1 is below 0 or above 2.5, it indicates low or high risk, respectively*.

[4] The S2 indicator is a long-term sustainability gap; it shows the upfront and permanent fiscal adjustment required to stabilise the debt-to-GDP ratio over the infinite horizon, including the costs of ageing. The critical thresholds for S2 are 2 and 6, between which S2 indicates medium risk. If S2 is below 2 or above 6, it indicates low or high risk, respectively*.

* For more information see Fiscal Sustainability Report 2015 and Debt Sustainability Monitor 2017.

6. FISCAL FRAMEWORK

Based on the information provided in the Programme, the past, planned and forecast fiscal performance in Romania appears to significantly depart from the requirements of the national numerical fiscal rules set in the Fiscal Responsibility Law (FRL) [9]

The main national fiscal rule is the structural deficit rule that requires compliance with or convergence – according to an adjustment path agreed with the institutions of the EU - to the medium-term budgetary objective of a structural deficit not exceeding 1% of GDP. In addition, the national framework contains several auxiliary rules concerning expenditure and revenue items, including a general government expenditure rule that requires compliance with the expenditure benchmark as defined by the SGP. Finally, the debt rule sets a 60% of GDP threshold on public debt.

The national structural deficit rule is acompanied by a correction mechanism, according to which, when identifying a deviation from the MTO or from the timetable of adjustment towards it, the government should prepare a set of measures meant to correct this deviation, unless the deviation occurs in exceptional circumstances as defined in the Stability and Growth Pact and after consultation of the Fiscal Council.

In 2017, the structural balance increased, breaching the structural deficit rule from the national framework. Also, the growth of total expenditure was well above the expenditure benchmark (see chapter 4.2 above). Additionally, the two 2017 budget amendments (adopted in September and in November) broke, among others, rules prohibiting: (i) increases of the headline and primary deficit ceilings during the fiscal year, (ii) increases in personnel expenditure and total government expenditure, excluding EU funds during the fiscal year and (iii) transfers of unspent investment allocations to current expenditures. For 2018, the Programme foresees that the structural balance will deteriorate further, thus continuing to breach the structural deficit rule, and that the expenditure growth will not comply with the recommended expenditure benchmark. On the other hand, the general government debt amounted to 35.0% of GDP in 2017 and is planned in the programme to remain well below the threshold of 60 % of GDP for the entire period.

In spite of the significant deviation from the structural deficit rule, the correction mechanism set in FRL has not been triggered, even thought no exceptional circumstances were identified. This is because both the 2017 and the 2018 budgets contain derogations from the non-respected national fiscal rules, as well as from the correction mechanism itself.

According to the national Fiscal Council, the 2017 budget "deviates deliberately and substantially from the fiscal rules imposed by both national laws and European treaties signed by Romania". Similarly, the 2018 budget "is in flagrant contradiction with the fiscal rules set up by the FRL"[10].

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[9] Fiscal Responsibility Law no. 69/2010, amended by Law 377/2013, as republished in 14 May 2015. It entered into force on 23 April 2010.

[10] Fiscal Council's Opinion on the State Budget Law, the Social Insurance Budget Law for 2017 and the Fiscal Strategy for 2017-2019, and Addendum to Fiscal Council's preliminary opinion on the State Budget Law, Social Insurance Budget Law for 2018 and Fiscal Strategy for 2018-2020, both available at http://www.fiscalcouncil.ro/

7. SUMMARY

In 2017, Romania continued to increasingly deviate from the MTO. The growth of net primary government expenditure was well above the expenditure benchmark, pointing to a significant deviation by a large margin (deviation of 3.3% of GDP). The structural balance deteriorated to -3.3% of GDP, also pointing to a significant deviation from the recommended structural adjustment by a large margin (deviation of 1.7% of GDP). Following an overall assessment, this points to significant deviation from the recommended adjustment path towards the MTO. This assessment is in line with the earlier conclusion of 5 December 2017, in which the Council found that Romania had not taken effective action in response to the Council recommendation of 16 June 2017.

Both in 2018 and in 2019, there is a risk of deviation from the structural adjustment recommended by the Council, both based on the Programme and based on the Commission 2018 spring forecast.

Moreover, although the Programme projects the headline deficit to remain below the 3% of GDP reference value, according to the Commission 2018 spring forecast Romania's headline deficit is projected to exceed the reference value in 2018 and in 2019 based on a no-policy change assumption.

8. ANNEXES

Table I. Macroeconomic indicators

	2000-2004	2005-2009	2010-2014	2015	2016	2017	2018	2019
Core indicators								
GDP growth rate	5.4	4.3	1.4	4.0	4.8	6.9	4.5	3.9
Output gap [1]	-0.2	5.1	-4.2	-2.5	-1.5	1.2	1.4	1.1
HICP (annual % change)	26.0	6.8	4.0	-0.4	-1.1	1.1	4.2	3.4
Domestic demand (annual % change) [2]	7.5	6.6	0.6	5.4	5.3	7.6	4.9	4.3
Unemployment rate (% of labour force) [3]	7.8	6.6	7.0	6.8	5.9	4.9	4.5	4.4
Gross fixed capital formation (% of GDP)	21.3	29.7	25.9	24.7	23.0	22.6	22.9	23.6
Gross national saving (% of GDP)	17.4	18.9	23.6	24.6	21.9	20.9	21.0	21.2
General Government (% of GDP)								
Net lending (+) or net borrowing (-)	**-2.5**	**-4.0**	**-3.9**	**-0.8**	**-3.0**	**-2.9**	**-3.4**	**-3.8**
Gross debt	**22.6**	**14.9**	**35.4**	**37.7**	**37.4**	**35.0**	**35.3**	**36.4**
Net financial assets	**29.8**	**11.2**	**-16.7**	**-20.4**	**-21.4**	**n.a**	**n.a**	**n.a**
Total revenue	32.6	32.5	33.5	35.0	31.6	30.5	30.9	31.1
Total expenditure	35.1	36.6	37.4	35.8	34.6	33.4	34.3	34.9
of which: Interest	2.6	1.0	1.7	1.6	1.5	1.3	1.4	1.4
Corporations (% of GDP)								
Net lending (+) or net borrowing (-)	**-5.3**	**-1.3**	**5.0**	**-5.6**	**-4.2**	**-2.8**	**-1.8**	**-0.5**
Net financial assets; non-financial corporations	**-84.7**	**-97.0**	**-86.6**	**-87.9**	**-83.1**	**n.a**	**n.a**	**n.a**
Net financial assets; financial corporations	**0.3**	**-1.1**	**3.9**	**3.7**	**2.0**	**n.a**	**n.a**	**n.a**
Gross capital formation	17.1	20.1	15.6	14.7	15.3	16.8	17.2	17.7
Gross operating surplus	23.1	26.1	30.3	31.7	32.3	32.7	32.7	33.5
Households and NPISH (% of GDP)								
Net lending (+) or net borrowing (-)	**3.3**	**-3.6**	**-2.7**	**8.2**	**5.4**	**4.2**	**2.9**	**2.2**
Net financial assets	**33.7**	**42.2**	**37.0**	**50.9**	**50.7**	**n.a**	**n.a**	**n.a**
Gross wages and salaries	31.5	31.4	28.1	27.7	29.3	30.4	35.4	35.1
Net property income	3.4	0.7	6.6	18.0	15.6	13.6	12.5	11.6
Current transfers received	15.2	14.7	14.1	13.6	13.7	13.6	13.5	13.7
Gross saving	-2.7	-4.6	0.9	11.3	8.7	7.6	6.2	5.1
Rest of the world (% of GDP)								
Net lending (+) or net borrowing (-)	**-4.5**	**-9.0**	**-1.4**	**1.8**	**-1.1**	**-1.9**	**-2.1**	**-2.1**
Net financial assets	**23.3**	**46.5**	**65.1**	**55.8**	**54.0**	**n.a**	**n.a**	**n.a**
Net exports of goods and services	-7.0	-11.0	-3.6	-0.6	-0.9	-2.1	-2.4	-2.6
Net primary income from the rest of the world	-1.8	-2.3	-1.2	-1.9	-3.0	-2.6	-2.3	-2.3
Net capital transactions	0.4	0.4	1.4	2.4	1.0	1.6	1.6	1.8
Tradable sector	59.1	54.3	50.7	50.3	51.9	52.3	n.a	n.a
Non tradable sector	30.6	34.8	37.5	37.6	37.8	38.3	n.a	n.a
of which: Building and construction sector	5.9	9.3	6.9	5.9	6.1	5.9	n.a	n.a
Real effective exchange rate (index, 2010=100)	72.2	95.9	91.8	85.7	87.6	96.1	98.6	99.4
Terms of trade goods and services (index, 2010=100)	75.6	92.1	101.4	105.9	106.4	104.8	104.9	105.3
Market performance of exports (index, 2010=100)	76.4	90.9	114.8	130.4	136.4	141.7	144.1	146.7

Notes:

[1] The output gap constitutes the gap between the actual and potential gross domestic product at 2005 market prices.

[2] The indicator on domestic demand includes stocks.

[3] Unemployed persons are all persons who were not employed, had actively sought work and were ready to begin working immediately or within two weeks. The labour force is the total number of people employed and unemployed. The unemployment rate covers the age group 15-74.

Source :
AMECO data, Commission 2018 spring forecast