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Assessment of the 2019 Convergence Programme for

Romania

(Note prepared by DG ECFIN staff)

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EXECUTIVE SUMMARY

Romania is subject to the preventive arm of the Stability and Growth Pact.

Romania's economic boom started to cool down in 2018. Real GDP grew by 4.1%, compared to 7% in 2017. In its spring 2019 forecast, the Commission projects the relative slowdown to continue in 2019 and 2020, with real GDP growing at 3.3% and 3.1%, respectively. Private consumption is forecast to remain strong in 2019 and to decelerate somewhat in 2020. Investment growth is expected to return to positive territory, following negative growth in 2018. According to the Commission's spring forecast, Romania's positive output gap started to narrow in 2018 and is set to close progressively on the back of decreasing labour and productivity contributions. The real GDP growth projected in the 2019 Convergence Programme (hereafter called the programme) is significantly higher than the Commission forecast mostly due to more optimistic assumptions regarding the growth rates of private consumption and investment.

The general government deficit increased to 3.0% of GDP in 2018. The programme plans a modest decrease of the deficit to 2.8 % of GDP in 2019 and 2.7 % in 2020. The programme does not envisage reaching the medium-term budgetary objective (MTO) of a structural deficit of 1% of GDP over the programme horizon. The structural balance – recalculated by the Commission according to the commonly agreed methodology – is projected to decrease from 3.0% of GDP in 2018 to 2.7% of GDP in 2019 and increase to 2.9% of GDP in 2020. Downward risks to achieving the planned budgetary targets mostly stem from the favourable macroeconomic projections underpinning the programme, an overly optimistic revenue projection and a possible underestimation of current spending. Moreover, the fiscal consolidation from 2020 onwards is based on measures that are not specified in the programme.

As a consequence of observed significant deviation from the recommended adjustment path towards the MTO in 2018, the Commission recommended to the Council to open a new Significant Deviation Procedure concerning Romania. Both in 2019 and in 2020, there is a risk of deviation from the recommended structural adjustment, both based on the programme and based on the Commission 2019 spring forecast. Moreover, although the programme projects the headline deficit to remain below the 3% of GDP reference value, according to the Commission 2019 spring forecast, based on a no-policy change assumption, Romania's headline deficit is projected to exceed the reference value in 2019 and in 2020.

1. INTRODUCTION

On 8 May 2019, Romania approved and submitted its 2019 Convergence Programme, covering the period 2019-2022[1]. 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. On 22 June 2018, a significant deviation procedure (SDP) was opened for Romania due to the observed significant deviation from the adjustment path towards the MTO in 2017. On 4 December 2018, the Council found

[1] The English version of the programme was submitted on 15 May.

that Romania had not taken effective action in response to the Council recommendation of 22 June 2018 and issued a revised SDP recommendation for a fiscal adjustment in 2019. On 5 June 2019 the Commission recommended a Decision to the Council, concluding that Romania had not taken effective action in response to the revised Council recommendation of 4 December 2018. 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 2018 and recommended the Council to adopt a new SDP recommendation.

This document complements the Country Report published on 27 February 2019 and updates it with the information included in the programme. Detailed information concerning the latest steps within the SDP can be found in the Commission Staff Working Document accompanying the legal documents adopted on 5 June 2019.

Section 2 presents the macroeconomic outlook underlying the programme and provides an assessment based on the Commission 2019 spring forecast. The following section presents the recent and planned budgetary developments, according to the programme. In particular, it includes an overview of the medium term budgetary plans, an assessment of the measures underpinning the 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 the economy will continue to grow at very robust rates. Real GDP grew 4.1% in 2018 and is projected in the Programme to accelerate to 5.5% in 2019 and 5.7% in 2020, before easing to 5% in 2020-2021. Private consumption, which expanded by 5.2% in 2018 in real terms, is expected to increase by 6.4% in 2019 and progressively moderate its growth thereafter, reaching 5.5% in 2022. After falling by 3.2% in 2018, investment is projected to recover strongly and grow by 6.9% and 7.9% in 2019 and 2020 respectively, before slightly moderating thereafter. Import growth is forecast to continue outpacing export growth over the forecast horizon but at a slower pace, thus leading to a still negative but diminishing contribution of net exports to growth over the forecast horizon.

The real GDP growth forecast for 2019 was revised downwards by 0.2 percentage points compared to the 2018 Convergence Programme. This is mainly due to a slightly lower projected contribution to growth of domestic demand.

The real GDP growth projected in the programme for 2019 and 2020 is higher than the Commission forecast mostly due to more optimistic assumptions regarding the growth rates of private consumption and investment. Specifically for the later, the programme’s forecast seems overly optimistic. On the external side, export growth is expected to accelerate while the Commission forecasts a clear deceleration. Imports show a more constant pattern over the forecast horizon, while here too the Commission forecasts a downward trend. This leads to a less negative contribution of net exports to real GDP growth than projected by the Commission. The projections on inflation over the coming two years are in line with the Commission's spring 2019 forecast. Finally, the deceleration in the growth rates of compensation per employee over the forecast horizon is stronger than in the Commission’s forecast.

The recalculated output gap as estimated by the Commission based on the information in the programme, following the commonly agreed methodology, is projected to turn slightly positive in 2019 and to continue increasing thereafter.

Overall, the economic growth assumptions in the programme are favourable for 2019-2022. The main downward risks to the macroeconomic outlook stem from a possible stronger than expected slowdown of private consumption as wage growth tempers, higher inflation than expected (as was the case in the first quarter of 2019) and more muted developments in investment than forecast in the programme, due to the uncertain internal and external environment.

Table 1: Comparison of macroeconomic developments and forecasts

	2018		2019		2020		2021	2022
	COM	CP	COM	CP	COM	CP	CP	CP
Real GDP (% change)	4.1	4.1	3.3	5.5	3.1	5.7	5.0	5.0
Private consumption (% change)	5.2	5.2	5.2	6.4	4.5	6.2	5.6	5.5
Gross fixed capital formation (% change)	-3.2	-3.2	1.4	6.9	2.3	7.9	7.4	7.5
Exports of goods and services (% change)	5.4	5.4	4.4	6.9	3.6	7.1	7.0	7.0
Imports of goods and services (% change)	9.1	9.1	6.9	7.8	4.9	7.9	7.8	7.8
Contributions to real GDP growth:								
- Final domestic demand	2.9	2.9	4.2	6.1	3.8	6.2	5.5	5.5
- Change in inventories	2.9	2.9	0.3	0.0	0.0	0.0	0.0	0.0
- Net exports	-1.7	-1.7	-1.3	-0.6	-0.7	-0.5	-0.5	-0.5
Output gap[1]	0.9	-0.4	0.6	0.1	0.2	0.7	0.7	0.9
Employment (% change)	0.2	0.2	0.3	1.4	0.2	1.2	1.2	1.0
Unemployment rate (%)	4.2	4.2	4.1	4.1	4.0	4.0	3.9	3.8
Labour productivity (% change)	3.9	3.9	2.9	4.1	2.9	4.4	3.7	3.9
HICP inflation (%)	4.1	4.1	3.6	3.5	3.0	2.6	2.5	2.4
GDP deflator (% change)	5.9	5.9	5.2	3.5	3.7	1.9	2.0	2.0
Comp. of employees (per head, % change)	18.4	18.4	13.5	8.1	9.0	6.1	5.5	5.4
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	-3.1	-3.3	-3.4	-1.7	-3.4	-0.8	-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 2019 spring forecast (COM); Convergence Programme (CP).

3. RECENT AND PLANNED BUDGETARY DEVELOPMENTS

3.1. DEFICIT DEVELOPMENTS IN 2018 AND 2019

In 2018, the general government deficit increased to 3.0% of GDP, from 2.7% of GDP in 2017, while the economy grew above its potential. The rise of the deficit was – similarly to previous years – mostly driven by expenditure on compensation for public employees, which increased by 1.1 percentage points of GDP. The unified wage law, enacted in summer 2017, increased gross public wages by 25% as of January 2018 and included additional wage

increases in the health and education sectors. The fiscal cost of these increases in gross wages was partially compensated by a shift in 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 social contributions transferred to the second pension pillar (which is classified outside the general government) from 5.1% to 3.75% of gross wages. At the same time, the flat personal income tax (PIT) rate was cut from 16% to 10%. As a consequence, the revenue from social contributions increased by 2.1 percentage points of GDP while the revenue from direct taxes fell by 1.4 percentage points. Public investment in 2018 remained close to record low level as a share of GDP which had been reached in 2017. Thanks to the one-off effect from reimbursements of a car pollution tax, the structural deficit increased only slightly, from 2.9% of potential GDP in 2017 to 3.0% in 2018.

The 2018 general government deficit outcome of 3.0% of GDP broadly fulfils[2] the target in the 2018 Convergence Programme. Both revenues and expenditures were higher than planned in the 2018 Convergence Programme. On the revenue side, the targets for social contributions and other revenues were overachieved while indirect tax revenue was lower than planned. On the expenditure side, compensation of employees, intermediate consumption and social benefits were all higher than planned, while public investment was lower.

In 2019, the programme targets a headline deficit of 2.8% of GDP. This target has been revised upwards compared to the 2.4% of GDP target in the 2018 Convergence Programme. Both revenues and expenditures are higher as a share of GDP than in the last year's programme. All the items on the revenue side, except direct taxes, are higher than planned in the 2018 Convergence Programme, partially reflecting a base effect from a better than expected 2018 outturn. On the expenditure side, the planned compensation of employees and intermediate consumption considerably increased. Planned public investment is also higher compared to last year's programme (by 0.5 percentage points of GDP).

The 2019 headline deficit target of 2.8% of GDP is lower than the 3.5% of GDP projected by the Commission in the 2019 spring 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 maintains the MTO of a deficit of 1% of GDP in structural terms. This MTO takes into account the requirements of the Treaty on the Stability, Coordination and Governance in the Economic and Monetary Union. It is more stringent than required by the Pact. The programme does not envisage reaching the MTO over the programme horizon (2022). The structural balance – recalculated by the Commission according to the commonly agreed methodology – is projected to decrease from 3.0% of GDP in 2018 to 2.7% of GDP in 2019, increase to 2.9% of GDP in 2020 and to gradually decrease again thereafter, to 2.3% of GDP in 2022.

[2] The 2018 general government deficit outturn amounted to 3.02% of GDP, while the 2018 convergence programme targeted a deficit of 2.95% of GDP.

Table 2: Composition of the budgetary adjustment

(% of GDP)	2018	2019		2020		2021	2022	Change: 2018-2022
	COM	COM	CP	COM	CP	CP	CP	CP
Revenue	**32.0**	**32.5**	**33.8**	**33.3**	**33.8**	**33.5**	**33.9**	**1.9**
of which:								
- Taxes on production and imports	10.4	10.4	10.7	10.4	10.5	10.2	10.1	-0.3
- Current taxes on income, wealth, etc.	4.9	5.1	4.9	5.1	5.0	5.0	5.1	0.2
- Social contributions	11.4	11.9	12.3	12.2	12.5	12.9	13.2	1.8
- Other (residual)	5.2	5.2	5.9	5.5	5.8	5.4	5.5	0.2
Expenditure	**35.0**	**36.1**	**36.6**	**38.0**	**36.4**	**36.0**	**35.9**	**0.9**
of which:								
- Primary expenditure	33.8	34.8	35.4	36.7	35.1	34.8	34.8	1.0
of which:								
Compensation of employees	11.0	11.9	11.7	11.9	11.4	11.0	10.6	-0.4
Intermediate consumption	5.1	5.1	5.0	5.1	4.9	4.8	4.7	-0.4
Social payments	11.7	11.9	11.5	13.0	12.3	12.2	12.8	1.1
Subsidies	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.0
Gross fixed capital formation	2.6	2.9	3.5	3.5	3.3	3.4	3.3	0.7
Other (residual)	3.1	2.7	3.2	2.8	2.8	2.9	2.9	-0.2
- Interest expenditure	1.2	1.2	1.2	1.3	1.3	1.2	1.1	-0.1
General government balance (GGB)	**-3.0**	**-3.5**	**-2.8**	**-4.7**	**-2.7**	**-2.4**	**-2.0**	**1.0**
Primary balance	**-1.8**	**-2.3**	**-1.6**	**-3.4**	**-1.4**	**-1.2**	**-0.9**	**0.9**
One-off and other temporary	-0.3	-0.1	-0.1	0.0	0.0	0.0	0.0	0.3
GGB excl. one-offs	**-2.7**	**-3.4**	**-2.7**	**-4.7**	**-2.7**	**-2.4**	**-2.0**	**0.7**
Output gap[1]	0.9	0.6	0.1	0.2	0.7	0.7	0.9	1.4
Cyclically-adjusted balance[1]	-3.3	-3.7	-2.8	-4.8	-2.9	-2.6	-2.3	0.6
Structural balance[2]	**-3.0**	**-3.6**	**-2.7**	**-4.8**	**-2.9**	**-2.6**	**-2.3**	**0.2**
Structural primary balance[2]	-1.8	-2.4	-1.5	-3.5	-1.6	-1.4	-1.2	0.1

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 2019 spring forecasts (COM); Commission calculations.

The programme plans a gradual improvement of the headline balance over 2019-2022. The planned fiscal consolidation is focused on the revenue side, in particular on increased revenues from social contributions. Expenditures are projected to increase over the programme horizon, driven by increased social spending and public investment. The programme does not specify the measures which would support the planned 2020-2022 consolidation targets. The deficit targets for 2019-2022 in the current programme are higher than the targets from the previous convergence programme (see Figure 1 below).

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

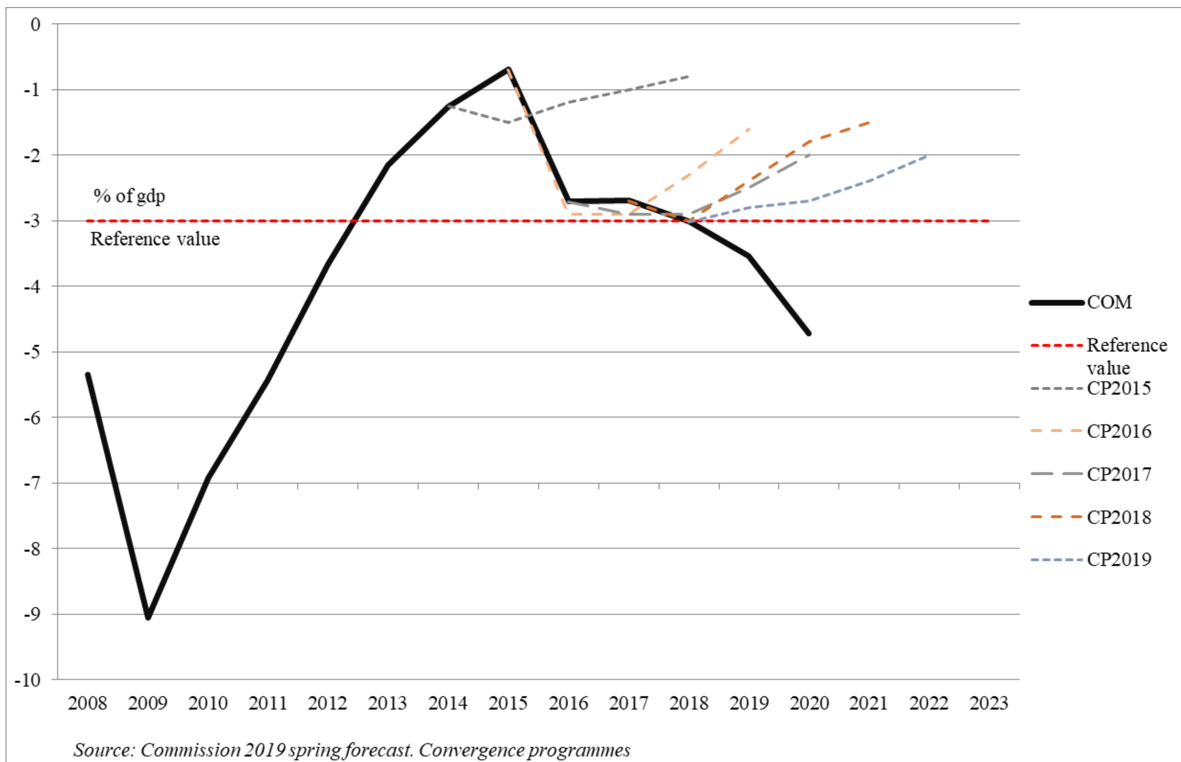
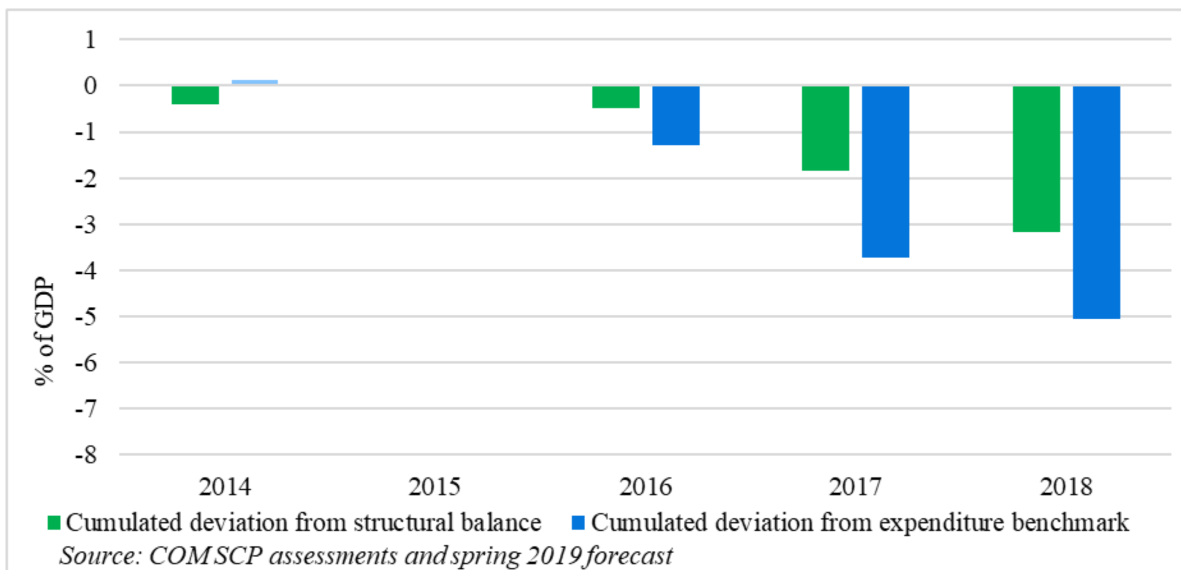


Figure 2: Cumulative deviations of the preceding five years from the upper limit for net growth of government expenditure and from structural effort requirements (in % of GDP)



Romania has been under the preventive arm of the SGP since 2013. Romania was at its MTO in 2014 and in 2015. Since then Romania has deviated from the MTO and from the required adjustment towards it on the basis of the structural balance and the expenditure benchmark every year. The expenditure benchmark has been more stringent than the structural balance for Romania, mostly because of the lower underlying GDP deflators and lower underlying

medium-term potential growth rates. This has led to increasing divergence between the cumulative deviation from the requirements for the two pillars since 2016.

3.3. MEASURES UNDERPINNING THE PROGRAMME

The main measures in 2018 and 2019 as reported in the programme are listed in the table below. The programme does not specify measures for 2020 and beyond.

Compared to the 2018 convergence programme, the main new measures are the significant increases in the pension point indexation in 2019 and 2020 and a set of tax changes (including new sectoral taxes on energy, telecommunication and banking and tax exemptions to the construction sector) contained in an emergency ordinance enacted in December 2018 (GEO 114/2018), slightly amended in March 2019 through a new emergency ordinance. These ordinances are also new as compared to the Commission 2018 autumn forecast.

The programme does not provide an assessment of the quantitative effects of all the listed measures on the general government balance. This is inconsistent with the guidelines laid down in the Code of Conduct.

Main budgetary measures

<table>
<tr><th>Revenue</th><th>Expenditure</th></tr>
<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);
- Other changes to taxation, including an increase of excise on tobacco, changes to taxation of microenterprises, introduction of a split-payment system in VAT and other measures to increase tax collection (impact not specified in the programme).

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- Increases to public wages from Unified Wage Law (the overall spending on compensation of employees increased by 1.1 % of GDP);
- Changes to social benefits in cash, including increase of pension point (main parameter used for pension indexation) by 10% from 1 July 2018; (impact per measure not specified in the programme, the overall spending on social benefits in cash remained stable as a share of GDP).

</td></tr>
<tr><td colspan="2">2019</td></tr>
<tr><td>

- Increase of gambling taxes and of excise duties on tobacco (+0.1% of GDP);
- Sectoral taxes: turnover tax on telecommunication and energy (+0.1% of GDP);
- Construction sector: exemption from PIT and health contributions (-0.2% of GDP);
- Maintaining of dividends from SOEs at 90% of net profit (measure already in force since 2017, therefore no incremental impact);
- Dividends from SoEs: payment as dividends of 35% of unspent investment allocations (+0.1% of GDP according to the programme, however, under ESA, these sums, as superdividends, do not count as government revenue);
- Sale of 5G licences (0.2% of GDP reported in the programme, however, the impact of this measure shoud be smoothed out over

</td><td>

- Changes to public wages, including: (i) application of increases mandated by the Unified Wage Law; (ii) freeze of bonuses and other extra wage elements for various categories; (iii) granting of food allowance to all civil servants; (iv) maintenance of pre-existing measures, e.g. no monetary compensation for overtime work for some categories; (impact per measure not specified in the programme, the overall spending on compensation of employees set to increase by 0.7 % of GDP);
- Changes to social benefits in cash: (i) increase of pension point (main parameter used for pension indexation) by 15% from 1 September 2019; (ii) increase of minimum pension by 10% from 1 Septenber 2019; (iii) increase of child allowance (impact per measure not specified in the programme, the overall spending on social benefits in cash set to decrease by 0.1 % of GDP).

</td></tr>
</table>

several years).	

Note: The table refers to the main measures included in the 2019 Convergence Programme that have an incremental budgetary impact over the programme period. 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

The programme projects the general government debt to increase slightly in 2019, from 35.0% of GDP in 2018 to 35.4% of GDP in 2019 and 2020, driven by the primary deficit. It is projected to start to decrease slightly in 2021 and 2022 thanks to a planned improvement in the primary balance. The Commission 2019 spring forecast projects a higher debt-to-GDP ratio in 2019 and 2020 mainly due to its higher forecast of the primary deficit. Projections for general government debt in the programme are higher than in the 2018 programme (see Figure 2 below).

Table 3: Debt developments

(% of GDP)	Average 2013-2017	2018	2019		2020		2021	2022
			COM	CP	COM	CP	CP	CP
Gross debt ratio[1]	**37.4**	**35.0**	**36.0**	**35.4**	**38.4**	**35.4**	**35.2**	**34.8**
Change in the ratio	-0.4	-0.2	1.0	0.4	2.4	0.0	-0.2	-0.4
Contributions[2] :								
1. Primary balance	**0.3**	**1.8**	**2.3**	**1.6**	**3.4**	**1.4**	**1.2**	**0.9**
2. "Snow-ball" effect	**-1.0**	**-2.0**	**-1.5**	**-1.7**	**-1.0**	**-1.2**	**-1.1**	**-1.2**
Of which:								
Interest expenditure	1.6	1.2	1.2	1.2	1.3	1.3	1.2	1.1
Growth effect	-1.6	-1.3	-1.0	-1.8	-1.0	-1.9	-1.7	-1.6
Inflation effect	-1.0	-1.9	-1.7	-1.1	-1.2	-0.6	-0.6	-0.6
3. Stock-flow adjustment	**0.4**	**0.0**	**0.3**	**0.6**	**0.0**	**-0.2**	**-0.3**	**-0.1**
Of which:								
Cash/accruals diff.				0.1		0.0	0.0	0.0
Acc. financial assets				0.0		0.0	0.0	0.0
Privatisation				0.0		0.0	0.0	0.0
Val. effect & residual				-2.5		-2.7	-2.6	-2.4

Notes:

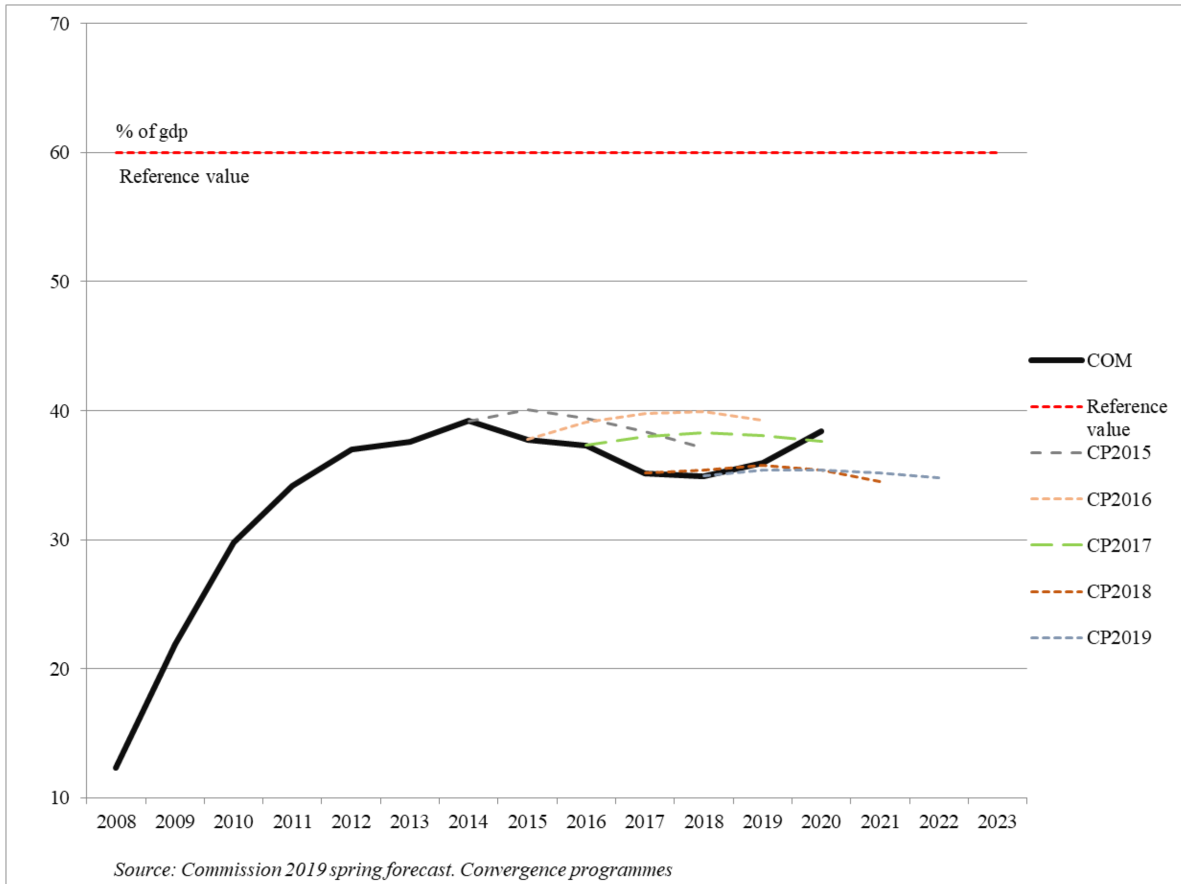
[1] End of period.

[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 2019 spring forecast (COM); Convergence Programme (CP), Commission calculations.

Figure 3: Government debt projections in successive programmes (% of GDP)



Source: Commission 2019 spring forecast. Convergence programmes

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 2020 onwards is based on fiscal consolidation measures which are not specified in the programme.

In 2019, the planned headline deficit of 2.8% of GDP is lower than the 3.5% of GDP projected by the Commission in the spring 2019 forecast. Both total revenues and total expenditures as a share of GDP are higher than in the Commission forecast but the difference is driven by the revenue side. The underlying macroeconomic projection of 5.5% of real GDP growth is more optimistic than 3.3% forecasted by the Commission, with a positive impact on tax revenues. The projection of revenues from indirect taxes and social contributions is higher than in the Commission forecast (see Table 2). On the expenditure side, current expenditures (in particular social benefits) are lower while gross fixed capital formation is higher than projected by the Commission.

In 2020, the headline deficit programme target of 2.7% of GDP is markedly lower than the 4.7% of GDP projected by the Commission in the 2019 spring forecast. The difference is partially driven by the 2019 base effect (the difference between the 2019 deficit projection of 2.8% of GDP in the programme and 3.5% in the Commission forecast, which carries forward to 2020). The difference is also influenced by the less favourable macroeconomic projection in the Commission 2019 spring forecast. Moreover, the Commission forecast is based on a

no-policy change scenario while the programme relies on unspecified measures, in particular on an unexplained drop in expenditure on compensation of employees. Finally, the social benefit expenditures in the programme do not seem to fully reflect the costs of the 40% increase of the pension point from 1 September 2020.

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

Box 1. Council Recommendations addressed to Romania

On 22 June 2018, the Council decided in accordance with Article 121(4) TFEU that a significant observed deviation from the adjustment path toward the MTO occurred in Romania in 2017. In view of the established significant deviation, the Council on 22 June 2018 issued a recommendation for Romania to take the necessary measures to ensure that the nominal growth rate of net primary government expenditure[3] does not exceed 3.3% in 2018 and 5.1% in 2019, corresponding to an annual structural adjustment of 0.8% of GDP in each year[4].

On 4 December 2018, the Council found that Romania had not taken effective action in response to the 22 June 2018 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 4.5% in 2019, corresponding to an annual structural adjustment of 1.0% of GDP[5]. 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 2019 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 3.0% of GDP in 2018, just at 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, the Commission 2019 spring forecast projects Romania's headline deficit to exceed the 3% of GDP in 2019 and continue to increase in 2020. The differences in the headline deficit projections between the programme and the Commission are mostly driven by a favourable macroeconomic projection in the programme, as well as the programme's higher revenue projection and lower projection of current spending, in particular on social benefits. For more details, see section 3.5 above.

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[3] 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.

[4] Council Recommendation of 22 June 2018 with a view to correcting the significant observed deviation from the adjustment path toward the medium-term budgetary objective in Romania (OJ C 223, 27.6.2018, p. 3).

[5] Council Recommendation of 4 December 2018 with a view to correcting the significant observed deviation from the adjustment path toward the medium-term budgetary objective in Romania (OJ C 460, 21.12.2018, p. 1).

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

According to 2018 outturn data, in 2018, the growth of net primary government expenditure was well above the expenditure benchmark, pointing to a significant deviation (deviation of 2.4% of GDP). The structural balance remained broadly stable at around 3.0% of potential GDP, also pointing to a significant deviation from the recommended structural adjustment (deviation of 0.8% of GDP). The size of the deviation indicated by the structural balance is smaller thanks to a revenue windfall, a higher GDP deflator and a higher underlying estimate of potential GDP growth as compared to the medium-term average underlying the expenditure benchmark. On the other hand, the size of the deviation indicated by the structural balance is increased by low public investment expenditures, which are smoothed in the expenditure benchmark. Irrespective of these differences, both indicators confirm a significant deviation from the requirements of the preventive arm of the SGP in 2018. 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 4 December 2018, in which the Council found that Romania had not taken effective action in response to the Council recommendation of 22 June 2018 and issued a revised recommendation. The conclusion of a signficant deviation is confirmed when looking at 2017 and 2018 together.

Based on this assessment, on 5 June 2019, 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[6]. It recommends Romania to take the necessary measures to ensure that the nominal growth rate of net primary government expenditure does not exceed 4.5% in 2019 and 5.1% in 2020, corresponding to an annual structural adjustment of 1.0 % of GDP in 2019 and 0.75% in 2020. 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 2019, according to the information provided in the programme, the growth of net primary government expenditure is expected to deviate by 2.0% of GDP from the required adjustment, while the recalculated structural balance is set to deteriorate by 0.2% of GDP, leading to a deviation by 1.2% from the required adjustment. Based on the Commission 2019 spring forecast, the growth of net primary government expenditure is expected to deviate by 2.1% of GDP from the required adjustment, while the structural balance is set to deteriorate by 0.7 % of GDP, leading to a deviation of 1.7% from the required adjustment. The size of the deviation indicated by the structural balance is smaller thanks to a revenue windfall and a higher GDP deflator. Taking this into account, the overall assessment confirms a deviation from the recommended adjustment in 2019.

In 2020, according to the information provided in the programme, the growth of net primary government expenditure is expected to deviate by 0.8% of GDP from the required adjustment. At the same time, according to the programme, the recalculated structural balance is set to deteriorate by 0.2% of GDP, leading to a deviation by 0.9% from the required adjustment.

[6] For more information, see the Commission 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 4 December 2018 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.

Based on the Commission spring 2019 forecast, both indicators point to a risk of a deviation from the required adjustment of a similar magnitude, of 1.8% in the case of expenditure benchmark and 1.9% of GDP in the case of structural balance. The overall assessment thus confirms the risk of a deviation from the requirements of the Council recommendation in 2020.

Table 4: Compliance with the requirements under the preventive arm

(% of GDP)	2018	2019		2020	
Background budgetary indicators[1]					
Medium-term objective (MTO)	-1.0	-1.0		-1.0	
Structural balance[2] (COM)	-3.0	-3.6		-4.8	
Setting the required adjustment to the MTO					
Structural balance based on freezing (COM)	-3.3	-3.6		-	
Position vis-a -vis the MTO[3]	Not at MTO	Not at MTO		Not at MTO	
Required adjustment[4]	0.8	1.0		0.75	
Required adjustment corrected[5]	0.8	1.0		0.75	
Corresponding expenditure benchmark[6]	3.3	4.5		5.1	
Compliance with the required adjustment to the MTO					
	COM	**CP**	**COM**	**CP**	**COM**
Structural balance pillar					
Change in structural balance[7]	0.0	-0.2	-0.7	-0.2	-1.2
One-year deviation from the required adjustment [8]	-0.8	-1.2	-1.7	-0.9	-1.9
Two-year average deviation from the required adjustment [8]	-1.3	-1.0	-1.2	-1.1	-1.8
Expenditure benchmark pillar					
Net public expenditure annual growth corrected for one-offs[9]	11.5	11.3	11.6	7.8	10.8
One-year deviation adjusted for one-offs[10]	-2.4	-2.0	-2.1	-0.8	-1.8
Two-year deviation adjusted for one-offs[10]	-2.9	-2.2	-2.3	-1.4	-2.0
Finding of the overall assessment	**Significant deviation**	**Deviation**	**Deviation**	**Deviation**	**Deviation**

Legend

'*Compliance*' - the recommended structural adjustment or a higher adjustment is being observed.

'*Some deviation*' - a deviation from the recommended structural adjustment is being observed, but it is below the threshold for a significant deviation.

'*Significant deviation*' - a deviation which has reached or breached the threshold for a significant deviation (i.e. 0.5% of GDP over one year, 0.25% of GDP over two years on average).

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.). In case of a SDP, the requirement corresponds to the Council recommendation when available, otherwise it refers to the Commission recommendation to the Council.

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

[6] 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.

[7] Change in the structural balance compared to year t-1. Ex post assessment (for 2019-1) is carried out on the basis of Commission 2019 spring forecast.

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

[9] Net public expenditure annual growth (in %) corrected for discretionary revenue measures, revenue measures mandated by law and one-offs (nominal)

[10] 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.

Source:

Convergence Programme (CP); Commission 2019 spring forecast (COM); Commission calculations.

To conclude, based on the outturn data and the Commission 2019 spring forecast, the ex-post assessment suggests a significant deviation from the adjustment path towards the MTO in 2018. Following an overall assessment, there is a risk of deviation from the requirements in 2019 and 2020. This entails a risk of a significant deviation from the adjustment path towards the MTO in 2019 and in 2020. 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.[7]

Based on Commission 2019 spring forecasts and a no-fiscal policy change scenario beyond the forecast horizon, government debt, at 35.0% of GDP in 2018, is expected to gradually rise to 66.4% in 2029, thus breaching the 60% of GDP Treaty threshold. Sensitivity analysis, in particular to a positive shock to the interest rates or to a negative shock to primary balance, shows higher risks.[8] Overall, debt sustainability analysis highlights high 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 2029.

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 2033) is at 2.2 percentage points of GDP, primarily related to the high initial budgetary position[9]. It therefore indicates medium sustainability risks over the medium term. The full implementation of the programme would put the sustainability risk indicator S1 at -1.3 percentage points of GDP, leading to low medium-term risk. Overall, risks to fiscal sustainability over the medium-term are, therefore, high. 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 stabilise the debt-to-GDP ratio over the infinite horison) is at 6.3 percentage points of GDP. In the long-term, Romania therefore appears to face high fiscal sustainability risks, related to the initial budgetary position and the projected ageing costs[10]. Full implementation

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[7] 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.

[8] Sensitivity analysis includes several deterministic debt projections, as well as stochastic projections (see Fiscal Sustainability Report 2018 for more details).

[9] The Commission projections, based on a methodology commonly agreed with the Member States, take the forecasted 2020 structural deficit as a starting point for 2021 and beyond (modified by the projected aging costs from the 2018 Aging Report). Therefore, the 40% increase of the pension point from 1 September 2020 is taken into account at 1/3 of its full annual impact in 2021 and beyond.

[10] The projected costs of ageing that are used to compute the debt projections and the fiscal sustainability indicators S1 and S2 are based on the projections of the 2018 Ageing Report. These aging costs projections do not take into account the long-term fiscal impact of legislation adopted after the cut-off date of the Aging Report, such as the pension law passed by the parliament in December 2018. The law changed several parameters used to calculate pension benefits, which will likely lead to substantially higher long-term pension costs. In particular, the pension point value will rise as the indexation factor for existing pensions would no longer converge to prices but will, instead, remain permanently composed of wages and prices. Moreover, the contributory period used in the calculation of one's pension is now shorter, leading to higher pension expenditure for new pensions. On the other hand, the abolishment of the correction index for new pensions (which used to partly link the first pension to wages) will mitigate the overall pension expenditure increase implied by the other parameters.

of the programme would put the S2 indicator at 4.1 percentage points of GDP, leading to medium long-term risk. The debt sustainability analysis discussed above points to high risks so that, overall, long-term fiscal sustainability risks are assessed as high for Romania.

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) and making participation in the second pension pillar optional for those with a contribution history of at least five years. This cut has a positive short-term effect on government revenues and thus on government 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. Moreover, workers in the construction sector were exempted from contributions to the second pension pillar. These changes will result in less diversified retirement income. Furthermore, since mid-2017 the authorities have been increasing the pension point beyond the standard indexation mechanism.

Table 5: Sustainability indicators

Time horizon				Commission Scenario		Convergence Programme Scenario	
Short-term				**LOW risk**			
S0 indicator [1]				0.3			
	Fiscal subindex			0.3	LOW risk		
	Financial & competitiveness subindex			0.3	LOW risk		
Medium-term				**HIGH risk**			
DSA [2]				HIGH risk			
S1 indicator [3]				2.2	MEDIUM risk	-1.3	LOW risk
of which	Initial Budgetary Position			3.9		0.9	
	Debt Requirement			-1.6		-2.3	
	Cost of Ageing			-0.1		0.0	
		of which	Pensions	-0.4		-0.3	
			Health care	0.3		0.2	
			Long-term care	0.0		0.0	
			Other	0.0		0.0	
Long-term				**HIGH risk**			
DSA [2]				HIGH risk			
S2 indicator [4]				6.3	HIGH risk	4.1	MEDIUM risk
of which	Initial Budgetary Position			4.1		1.8	
	Cost of Ageing			2.1		2.3	
		of which	Pensions	1.0		1.1	
			Health care	0.7		0.6	
			Long-term care	0.2		0.2	
			Other	0.3		0.3	

Source: Commission services; 2019 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 2019 forecast until 2020. 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 2033. This adjustment effort corresponds to a cumulated improvement in the structural primary balance over the 5 years following the forecast horizon (i.e. from 2021 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 2018.

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)[11]. In fact, departures from the requirements of the FRL have been systematically observed in every year since 2016.

The main national fiscal rule is the structural balance rule that requires compliance with or convergence to – according to an adjustment path agreed with the institutions of the EU – the medium-term budgetary objective of a government balance not exceeding -1% of GDP in structural terms. 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 national debt rule sets a 60% of GDP threshold on public debt, which is currently non-constraining given the current debt levels. The national structural balance rule is accompanied 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 2018, the structural deficit slightly increased, breaching the structural balance rule from the national framework. Also, the growth of total expenditure was well above the expenditure benchmark (see chapter 4.2 above). Additionally, the 2018 budget amendment from September broke, among others, rules prohibiting: (i) increases to the nominal headline and primary deficit ceilings during the fiscal year; and (ii) increases in personnel expenditure and total government expenditure excluding EU funds during the fiscal year. The second 2018 budget amendment, published in November, also broke several national fiscal rules.

In spite of the significant deviation from the structural balance rule in 2018, the correction mechanism set in the FRL has not been triggered, even though no exceptional circumstances were identified. This was legally possible because, as in previous years, the 2018 budget contained derogations from the national fiscal rules it was not complying with, as well as from the correction mechanism itself. The 2019 budget contains similar derogations.

For 2019 the authorities target an increase of structural deficit, which is contrary to the adjustment mandated by the structural deficit rule. The expenditure growth will not comply with the recommended expenditure benchmark either. Moreover, as in previous years, the authorities did not send an update of the medium-term fiscal strategy to Parliament by the statutory August deadline, thereby undermining its guiding role.

Similarly to previous years, the authorities derogated from the requirement to sign a statement that the 2018 and 2019 budgets and the accompanying fiscal strategies respect the fiscal rules and principles of fiscal responsibility.

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[11] 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.

According to the Romania's Fiscal Council, the 2018 budget "is in flagrant contradiction with the fiscal rules set up by the FRL"[12]. Similarly, in the 2019 budget "the fiscal rules set by the FRL remain inoperable".

7. CONCLUSIONS

In 2018, Romania continued to deviate further away from the MTO. The growth of net primary government expenditure was well above the expenditure benchmark, pointing to a significant deviation (deviation of 2.4% of GDP). The structural balance remained broadly stable at around -3.0% of GDP, also pointing to a significant deviation from the recommended structural adjustment (deviation of 0.8% of GDP). Following an overall assessment, this points to a significant deviation from the recommended adjustment path towards the MTO. This assessment is in line with the earlier conclusion of 4 December 2018, in which the Council found that Romania had not taken effective action in response to the Council recommendation of 22 June 2018.

Both in 2019 and in 2020, there is a risk of deviation from the recommended structural adjustment, both based on the programme and based on the Commission 2019 spring forecast.

Moreover, although the programme projects the headline deficit to remain below the 3% of GDP reference value, according to the Commission 2019 spring forecast, based on a no-policy change assumption, Romania's headline deficit is projected to exceed the reference value in 2019 and in 2020.

[12] Fiscal Council's Addendum to Fiscal Council's preliminary opinion on the State Budget Law, Social Insurance Budget Law for 2018 and Fiscal Strategy for 2018-2020 and Fiscal Council's Opinion on the State Budget Law, Social Insurance Budget Law for 2019 and Fiscal Strategy for 2019-2021, both available at http://www.fiscalcouncil.ro/

8. ANNEXES

Table I. Macroeconomic indicators

	2001-2005	2006-2010	2011-2015	2016	2017	2018	2019	2020
Core indicators								
GDP growth rate	5.7	3.0	3.0	4.8	7.0	4.1	3.3	3.1
Output gap [1]	1.9	3.8	-3.9	-1.9	0.8	0.9	0.6	0.2
HICP (annual % change)	18.6	6.2	2.7	-1.1	1.1	4.1	3.6	3.0
Domestic demand (annual % change) [2]	8.1	4.6	2.3	5.1	7.6	5.7	4.4	3.7
Unemployment rate (% of labour force) [3]	7.7	6.5	6.9	5.9	4.9	4.2	4.1	4.0
Gross fixed capital formation (% of GDP)	22.2	30.3	25.7	22.9	22.4	21.2	21.0	21.1
Gross national saving (% of GDP)	16.8	20.1	23.7	21.3	20.0	19.4	18.8	18.7
General Government (% of GDP)								
Net lending (+) or net borrowing (-)	**-1.7**	**-5.2**	**-2.6**	**-2.7**	**-2.7**	**-3.0**	**-3.5**	**-4.7**
Gross debt	**21.5**	**17.7**	**37.2**	**37.3**	**35.2**	**35.0**	**36.0**	**38.4**
Net financial assets	**23.9**	**6.9**	**-19.2**	**-21.8**	**-21.5**	**n.a**	**n.a**	**n.a**
Total revenue	32.8	32.8	34.1	31.8	30.9	32.0	32.5	33.3
Total expenditure	34.6	38.0	36.7	34.5	33.6	35.0	36.1	38.0
of which: Interest	2.0	1.0	1.7	1.5	1.3	1.2	1.2	1.3
Corporations (% of GDP)								
Net lending (+) or net borrowing (-)	**-5.7**	**4.5**	**11.3**	**12.2**	**11.5**	**8.9**	**7.5**	**7.3**
Net financial assets; non-financial corporations	**-84.1**	**-97.5**	**-87.1**	**-82.4**	**-79.4**	**n.a**	**n.a**	**n.a**
Net financial assets; financial corporations	**-0.4**	**-0.1**	**4.1**	**2.6**	**1.5**	**n.a**	**n.a**	**n.a**
Gross capital formation	18.4	20.2	15.7	15.2	14.5	14.3	13.9	13.2
Gross operating surplus	23.7	31.3	31.3	31.1	31.1	28.6	26.7	25.7
Households and NPISH (% of GDP)								
Net lending (+) or net borrowing (-)	**2.2**	**-7.7**	**-9.2**	**-8.8**	**-10.4**	**-8.8**	**-7.2**	**-5.8**
Net financial assets	**35.2**	**39.2**	**42.0**	**50.6**	**49.0**	**n.a**	**n.a**	**n.a**
Gross wages and salaries	32.1	29.8	27.7	30.2	31.1	38.6	40.9	42.1
Net property income	2.1	0.6	0.4	0.4	0.4	0.1	0.1	0.2
Current transfers received	15.5	14.7	14.0	13.9	13.6	13.4	13.5	14.5
Gross saving	-4.3	-7.0	-5.7	-5.2	-5.0	-3.5	-1.9	-0.2
Rest of the world (% of GDP)								
Net lending (+) or net borrowing (-)	**-5.5**	**-8.4**	**-0.5**	**0.5**	**-1.8**	**-3.1**	**-3.4**	**-3.4**
Net financial assets	**27.7**	**53.4**	**62.7**	**53.2**	**52.3**	**n.a**	**n.a**	**n.a**
Net exports of goods and services	-8.1	-10.4	-2.6	-0.9	-2.1	-3.2	-4.0	-4.4
Net primary income from the rest of the world	-2.3	-1.7	-1.4	-2.4	-2.0	-2.1	-2.0	-1.8
Net capital transactions	0.5	0.7	1.9	2.5	1.5	1.7	1.8	1.9
Tradable sector	59.3	53.9	50.3	50.9	51.7	51.4	n.a	n.a
Non tradable sector	30.4	35.7	37.7	38.8	38.8	39.0	n.a	n.a
of which: Building and construction sector	6.3	9.5	6.6	6.0	5.6	5.4	n.a	n.a
Real effective exchange rate (index, 2000=100)	75.2	98.0	88.2	90.6	96.3	107.1	112.7	116.7
Terms of trade goods and services (index, 2000=100)	72.9	95.7	102.6	105.7	104.0	105.1	105.8	106.2
Market performance of exports (index, 2000=100)	62.0	86.6	121.5	146.7	152.8	156.8	159.2	159.2

Notes:

[1] The output gap constitutes the gap between the actual and potential gross domestic product at 2015 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 2019 spring forecast

Mandatory variables not included in the Convergence Programme

The programme does not include the following mandatory variables: 2018 level of both GDP deflator and HICP. Not included mandatory variables do not impede the Commission's ability to assess the Convergence Programme on the basis of the Programme's assumptions.