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**Assessment of the 2017 convergence programme for  
Romania**

*(Note prepared by DG ECFIN staff)*

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## **1. INTRODUCTION**

On 5 May 2017 Romania submitted its 2017 convergence programme (hereafter called "convergence programme" or "the programme"), covering the period 2017-2020. The programme was adopted by a government memorandum on 5 May 2017.

Romania is currently subject to the preventive arm of the the Stability and Growth Pact (SGP) and should ensure sufficient progress towards its MTO.

This document complements the Country Report published on 22 February 2017 and updates it with the information included in the convergence programme.

Section 2 presents the macroeconomic outlook underlying the convergence programme and provides an assessment based on the Commission 2017 spring forecast. The following section presents the recent and planned budgetary developments, according to the convergence 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 the Commission 2017 spring forecast. Section 4 assesses compliance with the rules of the SGP, including on the basis of the Commission forecast. Section 5 provides an overview of long term sustainability risks and Section 6 of recent developments and plans regarding the fiscal framework. Section 7 provides a summary.

## **2. MACROECONOMIC DEVELOPMENTS**

The convergence programme's macroeconomic scenario assumes a continuous improvement of economic performance. The real GDP growth rate is expected to increase steadily from 4.8% in 2016 to 5.5% in 2018 and to remain sustained at 5.7% in 2019-2020. Domestic demand is set to remain the engine of growth. Private consumption is expected to continue growing fast as labour market growth outlook is improving with increasing employment and sustained wage increases. The growth rate of gross fixed capital formation (GFCF) is forecast to turn around and increase sharply from -3.3% in 2016 to 7.9% in 2018, supported by significantly improving EU funds absorption. Net exports are set to contribute negatively to growth.

The real GDP growth forecast was significantly revised upwards, by almost 1 pp. in 2017 and by 0.8 pp. in 2018 compared to the previous convergence programme. This is due to higher growth of domestic demand, particularly private consumption, and to less negative contributions of net exports.

The (negative) recalculated output gap as estimated by the Commission based on the information in the programme, following the commonly agreed methodology, is projected to have closed in the second half of 2016 and to turn positive in 2017 and 2018.

The real GDP growth in the programme is higher than the Commission projections for 2017 and 2018 mostly due to favourable assumptions for the growth rates of GFCF. The expected growth rates for private consumption are plausible both for 2017 and 2018, taking into account planned wage increases. The GFCF growth rates in the convergence programme for 2017 and 2018 are markedly favourable compared with the Commission projections and assume improvements in absorption of EU funds. On the external side, the assumptions for export and import growth rates are plausible for 2017 and 2018. The projections for the growth rates of compensation of employees per head are markedly cautious for both 2017 and 2018 compared with the Commission 2017 spring forecast, due to differences in the assumptions on public wage increases. The inflation projections of the convergence

programme are in line with Commission estimates for 2017 but favourable (i.e. higher) for 2018 as the Commission projects an earlier closing of the output gap and a higher positive output gap in 2017 and 2018.

Overall, the economic growth assumptions in the convergence programme are favourable for 2017-2020. The main downward risk to the macroeconomic outlook stems from a lower impact of fiscal and structural measures on short- and medium-term growth prospects.

**Table 1: Comparison of macroeconomic developments and forecasts**

	2016		2017		2018		2019	2020
	COM	CP	COM	CP	COM	CP	CP	CP
Real GDP (% change)	4.8	4.8	4.3	5.2	3.7	5.5	5.7	5.7
Private consumption (% change)	7.4	7.4	6.9	7.3	4.7	6.4	6.2	6.0
Gross fixed capital formation (% change)	-3.3	-3.3	1.3	6.9	5.2	7.9	8.4	8.6
Exports of goods and services (% change)	8.3	8.3	6.9	6.8	6.2	6.3	6.9	7.0
Imports of goods and services (% change)	9.8	9.8	8.6	8.5	7.9	7.9	8.1	8.0
<i>Contributions to real GDP growth:</i>								
- Final domestic demand	4.4	4.4	5.1	6.3	4.6	6.2	6.2	6.2
- Change in inventories	1.1	1.1	0.0	-0.3	0.0	0.0	0.0	0.0
- Net exports	-0.7	-0.7	-0.8	-0.8	-0.9	-0.7	-0.6	-0.5
Output gap <sup>1</sup>	-0.1	-0.9	0.7	-0.1	0.8	0.4	1.1	1.7
Employment (% change)	-0.9	-0.9	0.1	0.7	0.4	0.9	1.0	1.0
Unemployment rate (%)	5.9	5.9	5.4	5.7	5.3	5.5	5.4	5.3
Labour productivity (% change)	5.8	5.8	4.2	4.4	3.3	4.5	4.6	4.6
HICP inflation (%)	-1.1	-1.1	1.1	1.2	3.0	2.5	2.3	2.2
GDP deflator (% change)	2.2	2.2	1.5	2.0	2.8	2.1	1.9	1.4
Comp. of employees (per head, % change)	10.3	11.6	9.5	5.8	6.5	5.9	6.0	5.8
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	-1.5	0.2	-1.3	0.4	-0.8	0.8	0.9	0.9
<i>Note:</i>								
<sup>1</sup> In % of potential GDP, with potential GDP growth recalculated by Commission services on the basis of the programme scenario using the commonly agreed methodology.								
<i>Source:</i>								
Commission 2017 spring forecast (COM); Convergence Programme (CP).								

### 3. RECENT AND PLANNED BUDGETARY DEVELOPMENTS

#### 3.1. DEFICIT DEVELOPMENTS IN 2016 AND 2017

In 2016, the general government deficit rose to 3% of GDP, from 0.8% of GDP in 2015, while the economy grew above its potential. Tax cuts, particularly a four percentage point cut in the standard VAT rate, had a negative effect on tax revenues. On the expenditure side, public wages were considerably increased. The 2016 budget outcome was slightly worse than the 2016 convergence programme target of a deficit of 2.9% of GDP. Both the revenues and the expenditures turned out lower than planned in the 2016 convergence programme. On the revenue side, the indirect tax revenues target was not achieved. On the expenditure side,

public investment was significantly lower than planned, mainly due to low EU-funds absorption.

The Commission 2017 spring forecast projects the headline deficit to increase to 3.5% of GDP in 2017. The standard VAT rate was cut by one additional percentage point. Moreover, part of the excise duty on fuel and a special construction tax were abolished. The 2017 budget contains significant increases of public wages and social benefits, including an additional pension increase of 9%, scheduled for July 2017, on top of the standard indexation.

In the programme, the Romanian authorities plan a headline deficit of 2.9% of GDP in 2017. The overall revenues and expenditures ratios are higher than in the Commission 2017 spring forecast. The underlying macroeconomic projection of 5.2% of real GDP growth is more optimistic than the Commission projection, with a positive impact on tax revenues. The projection of revenues from all categories of taxes and social contributions is higher than in the Commission forecast (see Table 2). On the expenditure side, public wages and social contributions are lower than in the Commission forecast, while planned public investment is significantly higher. The lower public investment projection in the Commission forecast takes into account (i) a systematic under-execution in the previous years, (ii) low execution in the first quarter of 2017, and (iii) a more prudent assumption on the military equipment deliveries in 2017.

### **3.2. MEDIUM-TERM STRATEGY AND TARGETS**

The purpose of the programme is to maintain the headline deficit at 2.9% of GDP in 2018 and to achieve a gradual decrease of the headline deficit thereafter, to 2.0% of GDP in 2020. The programme does not change the MTO chosen in the previous programmes of a deficit of 1% of GDP in structural terms. This MTO is more stringent<sup>1</sup> than what the Pact requires and also aims at taking into account the requirements of the Treaty on the Stability, Coordination and Governance in the Economic and Monetary Union.

After significantly deviating from the MTO in 2016, the programme plans to significantly deviate from the adjustment path towards the MTO in 2017- 2018 and to start to adjust toward the MTO only from 2019 onwards. The programme does not envisage reaching the MTO over the programme horizon (until 2020).

The structural balance - recalculated by the Commission according to the commonly agreed methodology – is projected to increase from 2.6% of GDP in 2016 to 2.9% of GDP in 2017 and 3.0 % in 2018, and gradually decrease thereafter, to 2.6% of GDP in 2020. The Commission 2017 spring forecast projects significantly higher structural deficits, of 3.9% of GDP in 2017 and 4.0% of GDP in 2018. The difference is mostly attributable to different headline deficit projections. (see section 3.1 and the paragraph below).

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<sup>1</sup> The MTO selected by the Member State is more ambitious than the minimum MTO by more than 1/2 percentage point. The minimum MTOs are country-specific and calculated based on an agreed methodology.

**Table 2: Composition of the budgetary adjustment**

(% of GDP)	2016	2017		2018		2019	2020	Change: 2016-2020
	COM	COM	CP	COM	CP	CP	CP	CP
<b>Revenue</b>	<b>31.7</b>	<b>30.6</b>	<b>32.2</b>	<b>31.5</b>	<b>32.3</b>	<b>32.8</b>	<b>33.3</b>	<b>1.6</b>
<i>of which:</i>								
- Taxes on production and imports	11.3	10.5	11.0	10.5	11.0	11.0	11.1	-0.2
- Current taxes on income, wealth, etc.	6.5	6.4	6.6	6.6	6.8	7.0	7.1	0.6
- Social contributions	8.1	8.5	8.7	8.4	8.7	9.0	9.4	1.3
- Other (residual)	5.8	5.2	5.9	6.0	5.8	5.8	5.7	-0.1
<b>Expenditure</b>	<b>34.7</b>	<b>34.1</b>	<b>35.1</b>	<b>35.2</b>	<b>35.2</b>	<b>35.4</b>	<b>35.3</b>	<b>0.6</b>
<i>of which:</i>								
- Primary expenditure	33.2	32.6	33.7	33.5	33.7	33.9	33.9	0.7
<i>of which:</i>								
Compensation of employees	8.2	8.7	8.4	8.7	8.3	8.1	8.0	-0.2
Intermediate consumption	5.3	5.2	5.1	5.2	5.0	5.0	5.0	-0.3
Social payments	11.6	12.0	11.7	12.2	12.0	11.7	11.4	-0.2
Subsidies	0.4	0.4	0.4	0.4	0.5	0.5	0.5	0.1
Gross fixed capital formation	3.6	3.5	4.3	3.9	4.0	4.5	5.0	1.4
Other (residual)	4.2	2.9	3.9	3.3	4.1	4.2	4.1	-0.1
- Interest expenditure	1.5	1.6	1.4	1.6	1.5	1.5	1.4	-0.1
<b>General government balance (GGB)</b>	<b>-3.0</b>	<b>-3.5</b>	<b>-2.9</b>	<b>-3.7</b>	<b>-2.9</b>	<b>-2.5</b>	<b>-2.0</b>	<b>1.0</b>
<b>Primary balance</b>	<b>-1.5</b>	<b>-2.0</b>	<b>-1.6</b>	<b>-2.0</b>	<b>-1.4</b>	<b>-1.0</b>	<b>-0.6</b>	<b>0.9</b>
One-off and other temporary	-0.4	0.1	0.0	0.1	0.0	0.0	0.0	0.4
<b>GGB excl. one-offs</b>	<b>-2.7</b>	<b>-3.6</b>	<b>-2.9</b>	<b>-3.8</b>	<b>-2.9</b>	<b>-2.5</b>	<b>-2.0</b>	<b>0.7</b>
Output gap <sup>1</sup>	-0.1	0.7	-0.1	0.8	0.4	1.1	1.7	1.7
Cyclically-adjusted balance <sup>1</sup>	-3.0	-3.8	-2.9	-3.9	-3.0	-2.9	-2.6	0.4
<b>Structural balance<sup>2</sup></b>	<b>-2.6</b>	<b>-3.9</b>	<b>-2.9</b>	<b>-4.0</b>	<b>-3.0</b>	<b>-2.9</b>	<b>-2.6</b>	<b>0.1</b>
Structural primary balance <sup>2</sup>	-1.1	-2.3	-1.5	-2.4	-1.5	-1.4	-1.2	0.0
<b>Notes:</b>								
<sup>1</sup> 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.								
<sup>2</sup> Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.								
<b>Source:</b>								
Convergence Programme (CP); Commission 2017 spring forecasts (COM); Commission calculations.								

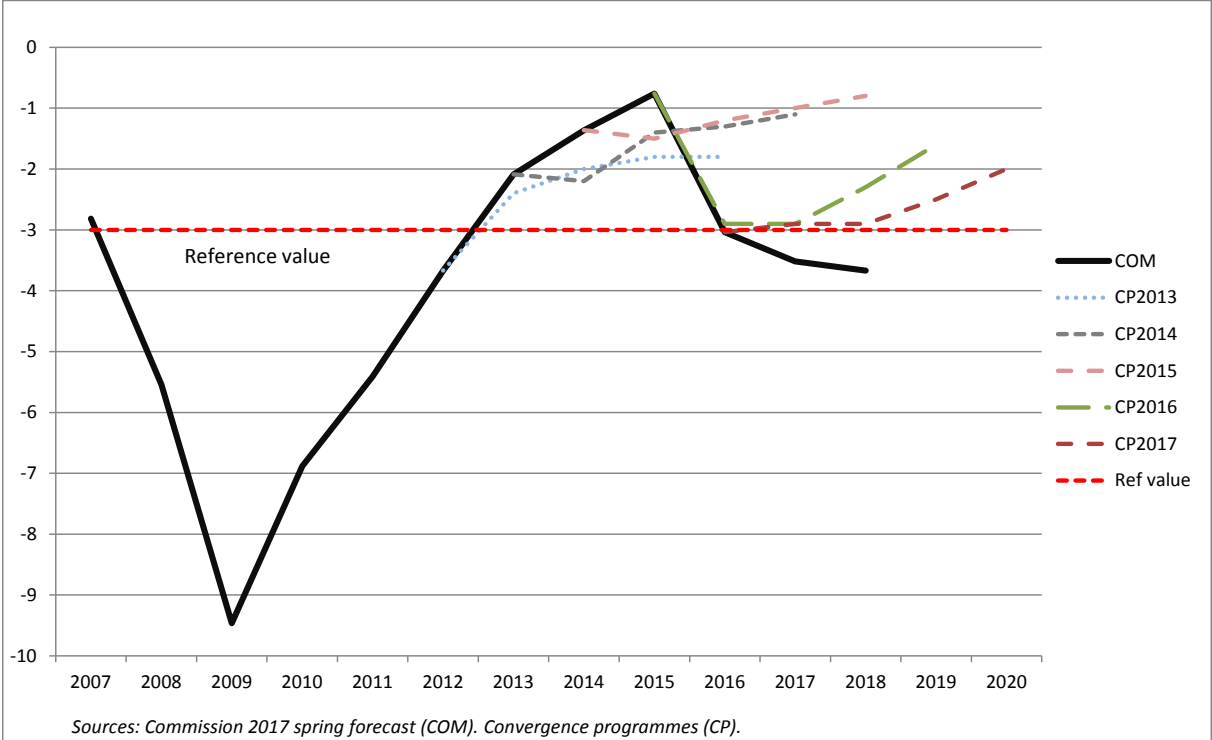
In 2018, the programme projects the headline deficit to remain at 2.9% of GDP, while the Commission 2017 spring forecast projects it to increase to 3.7% of GDP. The difference is mostly driven by the 2017 base effect (the difference between 2017 deficit projection of 2.9% of GDP in the programme compared to 3.5% in the Commission 2017 spring forecast, which carries forward to 2018). The difference is also influenced by less favourable macroeconomic projection in the Commission 2017 spring forecast and by different assumptions regarding the growth of compensation of public employees.

In 2019 and 2020, the improvement of the headline balance planned in the programme relies on an increase of revenues from direct taxes and social contributions relative to GDP and a moderation of expenditures on social spending and public wages. On the other hand, public

investment relative to GDP is planned to increase. The programme does not mention the measures which would support the planned 2019-2020 consolidation targets.

The deficit targets for 2018-2020 in the current programme are higher than the targets from the previous convergence programme, as the start of the fiscal consolidation is delayed by one year, from 2018 in the last convergence programme to 2019 in the current one (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 for 2016-2018 are listed in the table below. The programme does not specify any measures from 2019 onwards. The programme mentions two planned measures: a draft unified wage law (UWL), and a global income tax set to replace the current personal income taxation, but does not include their impact in the convergence programme projections. These two measures pose a significant downward risk to the fiscal projections both in the programme and in the Commission 2017 spring forecast (see section 3.5 below).

**Main budgetary measures**

Revenue	Expenditure
<b>2016</b>	
<ul style="list-style-type: none"> <li>• Cut of standard VAT rate from 24% to 20% (impact not specified in the programme))</li> </ul>	<ul style="list-style-type: none"> <li>• Increases of public wages (impact not specified in the programme)</li> <li>• Pension increase by 5% as of 1 January (impact not specified in the programme)</li> <li>• Doubling of child allowance (from June 2015)</li> </ul>

	<p>(impact not specified in the programme)</p> <ul style="list-style-type: none"> <li>• Reimbursement of foregone salaries to teachers in the public education sector for 2008-2011 (one-off; impact not specified in the programme)</li> <li>• Compensation decisions issued by the National Authority for Restitution of Property (+0.3% of GDP)</li> <li>• Refunding of special motor vehicle tax, pollution tax and the tax on pollutant emissions from motor vehicles following CJEU ruling (+0.1% of GDP)</li> </ul>
<b>2017</b>	
<ul style="list-style-type: none"> <li>• Cut of standard VAT rate from 20% to 19% (-0.3% of GDP)</li> <li>• Cut in the excise on petroleum products and increase in the excise on cigarettes (-0.4% of GDP)</li> <li>• Elimination of the special construction tax (-0.1% of GDP)</li> <li>• Removal of the cap of 5 gross average salaries for the calculation of the health insurance contribution (0.1% of GDP)</li> <li>• Exemption of pensions from social and health insurance contributions and exemption of pensions below RON 2,000 from personal income tax (-0.3% of GDP)</li> <li>• Cut of the turnover tax on microenterprises and Tax cut on property transactions (-0.1% of GP)</li> <li>• Increase of dividends from SOEs to 90% of net profit (one-off; +0.1% of GDP)</li> <li>• Maintaining the contribution rate to the second pension pillar at the 2016 level of 5.1% (impact not specified in the programme)</li> <li>• Employers' contributions for part-time workers to be paid on the gross minimum salary, increase by 1% of excise duty on cigarettes (both from June 2017), VAT for public procurement directly paid into the state budget (from July 2017) (+0.1% of GDP)</li> </ul>	<ul style="list-style-type: none"> <li>• Salary increases for civil servants in the local administration and artists (+0.1% of GDP)</li> <li>• Increase of the pension point to 1,000 RON from July 2017 (+0.3% of GDP)</li> <li>• Increase of the minimum pension to RON 520 (+0.1% of GDP)</li> <li>• Increase of wages in the education and health sector by 15% as of 1 January 2017 (impact not specified in the programme)</li> <li>• Increase of gross minimum salary from RON 1,250 to RON 1,450 (impact not specified in the programme)</li> <li>• Freeze of special pensions and cut of operating costs of public institutions (-0.1% of GDP)</li> </ul>
<b>2018</b>	
<ul style="list-style-type: none"> <li>• Employers' contributions for part-time workers to be paid on the gross minimum salary, increase by 1% of excise duty on cigarettes (both from June 2017), VAT for public procurement directly paid into the state budget (from July 2017) (+0.1% of GDP)</li> </ul>	<ul style="list-style-type: none"> <li>• Reduction of the number of government-subordinated bodies, rationalization of public expenditure, creation of a national employment record for the public administration, improving of corporate governance of SoEs, cut of operating costs of public institutions, 35% price cut for new</li> </ul>



<p>GDP)</p> <ul style="list-style-type: none"> <li>Maintaining of dividends from SOEs at 90% of net profit (one-off, +0.1% of GDP)</li> </ul>	<p>generic drugs, freeze of special pensions, centralization of public procurement, capping of child allowance to RON 5,000-10,000 (-0.2% of GDP)</p>
<p><b>Note:</b> 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 the measure.</p>	

### 3.4. DEBT DEVELOPMENTS

General government debt is expected in the programme to increase from 37.6% of GDP in 2016 to 38.3% of GDP in 2018 driven by the negative primary balance due to the enacted fiscal loosening measures. It is projected to decrease back to 37.6 %of GDP by 2020, thanks to a planned improvement of primary balance. The Commission 2017 spring forecast projects a higher debt-to-GDP ratio in 2017 and 2018 due to lower projections for primary balance and real GDP growth. Projections for general government debt in the programme are lower than in last year's programme (see Figure 2 below).

**Table 3: Debt developments**

(% of GDP)	Average 2011-2015	2016	2017		2018		2019	2020
			COM	CP	COM	CP	CP	CP
<b>Gross debt ratio<sup>1</sup></b>	<b>37.3</b>	<b>37.6</b>	<b>39.3</b>	<b>38.0</b>	<b>40.9</b>	<b>38.3</b>	<b>38.1</b>	<b>37.6</b>
Change in the ratio	1.6	-0.4	1.7	0.4	1.6	0.3	-0.2	-0.5
<i>Contributions<sup>2</sup> :</i>								
<b>1. Primary balance</b>	<b>1.0</b>	<b>1.5</b>	<b>2.0</b>	<b>1.6</b>	<b>2.0</b>	<b>1.4</b>	<b>1.0</b>	<b>0.6</b>
<b>2. "Snow-ball" effect</b>	<b>-0.3</b>	<b>-1.0</b>	<b>-0.5</b>	<b>-1.2</b>	<b>-0.8</b>	<b>-1.2</b>	<b>-1.2</b>	<b>-1.1</b>
<i>Of which:</i>								
Interest expenditure	1.7	1.5	1.6	1.3	1.6	1.5	1.5	1.4
Growth effect	-0.9	-1.7	-1.5	-1.8	-1.4	-1.9	-2.0	-2.0
Inflation effect	-1.1	-0.8	-0.5	-0.7	-1.0	-0.7	-0.6	-0.5
<b>3. Stock-flow adjustment</b>	<b>1.0</b>	<b>-1.0</b>	<b>0.3</b>	<b>0.1</b>	<b>0.4</b>	<b>0.1</b>	<b>0.0</b>	<b>0.0</b>
<i>Of which:</i>								
Cash/accruals diff.				-0.1		-0.1	-0.1	-0.1
Acc. financial assets				-0.4		0.0	0.0	0.0
<i>Privatisation</i>				0.0		0.0	0.0	0.0
Val. effect & residual				-2.1		-2.5	-2.6	-2.4

**Notes:**

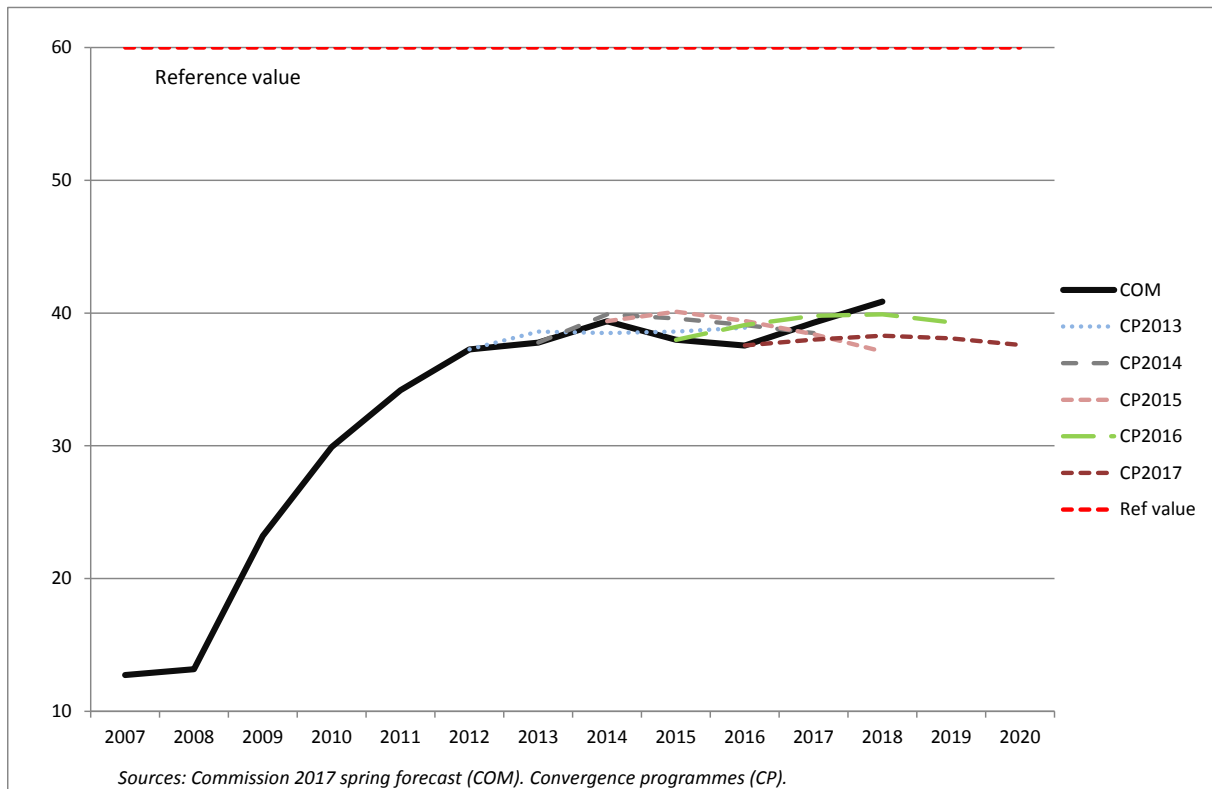
<sup>1</sup> End of period.

<sup>2</sup> 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 2017 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 favourable macroeconomic projections and from reliance on not sufficiently specified fiscal consolidation measures, in particular for 2019-2020. Moreover, the draft unified wage law (UWL), currently debated by the parliament, poses a significant downward risk in 2018 and beyond, with a potential impact on the general government balance of up to -2% of GDP in 2018. The final form and implementation schedule of UWL are not yet known. Therefore, the UWL has not been included in the programme projection nor in the Commission 2017 spring forecast. Additionally, the programme mentions plans for a 10% global income tax, which would replace the existing 16% personal income tax. This planned measure poses a further downward risk to the fiscal projections in the programme and in the Commission 2017 spring forecast.

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

##### **Box 1. Council recommendations addressed to Romania**

On 12 July 2016, the Council addressed recommendations to Romania in the context of the European Semester. In particular, in the area of public finances the Council recommended Romania to limit the deviation from the the medium-term budgetary objective in 2016 and achieve an annual fiscal adjustment of 0.5% of GDP in 2017 unless the the medium-term budgetary objective is respected with a lower effort.<sup>2</sup>

##### **4.1. Compliance with the deficit criterion**

The headline general government deficit increased from 0.8% of GDP in 2015 to 3% of GDP in 2016, exactly at the level of the deficit reference value of the Treaty. The programme projects the headline deficit to remain below 3% of GDP reference value over the programme horizon. However, based on the Commission 2017 spring forecast Romania's headline deficit is projected to exceed the 3% of GDP in 2017 and in 2018. The differences in the headline deficit projections are driven by an optimistic macroeconomic projection and lower projection of current expenditures in the convergence programme. For more details, see sections 3.1 and 3.2 above.

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

According to the outturn data, in 2016, from a position of -0.6% of GDP in 2015, i.e. above the MTO, the structural balance deteriorated to -2.6% of GDP, pointing to a significant deviation from the recommended structural adjustment (a deviation of 1.6% of GDP). The growth of government expenditure, net of discretionary revenue measures and one-offs, was well above the expenditure benchmark, also pointing to a significant deviation (a deviation of -2.0% of GDP). The difference in the indicators is mainly explained by different annual nominal potential GDP growth rates used in their computation. Irrespective of this difference, the overall assessment, in line with the Article 10(3) of Regulation (EC) No 1466/97, confirms a significant deviation from the requirements of the SGP in 2016 based on both indicators.

Based on that, on 22 May 2017, 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.

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<sup>2</sup> On 22 February 2017 Vice-President Valdis Dombrovskis and Commissioner Pierre Moscovici sent a joint letter to the Romanian authorities in which they recalled that Romania was estimated to have significantly deviated from its MTO in 2016, while the Commission forecast pointed to further deterioration of the structural balance in 2017 and 2018. The letter also pointed to a clear risk, based on the Commission forecast for 2017 and 2018, that the deficit criterion for the purposes of the Treaty and of Regulation (EC) No 1467/97 would not be fulfilled. The letter recalled that the Commission would reassess Romania's compliance with its obligations under the Stability and Growth Pact on the basis of the Commission 2017 spring forecast, including the budgetary data for 2016 and Romania's 2017 convergence programme. It recalled the importance that the necessary measures to ensure compliance with the deficit criterion and with the adjustment path towards the MTO were credibly announced by that time. [https://ec.europa.eu/info/sites/info/files/letter\\_to\\_romanian\\_mof.pdf](https://ec.europa.eu/info/sites/info/files/letter_to_romanian_mof.pdf)

In 2017, according to the information provided in the programme, the recalculated structural balance is projected to deteriorate by 0.5% of GDP, pointing to a significant deviation from the adjustment path towards the MTO (gap of -1.0% of GDP from the required adjustment of 0.5% of GDP). The growth rate of government expenditure, net of discretionary revenue measures is forecast to be well above the benchmark rate, also pointing to significant deviation (a gap of -1.1% of GDP). The two indicators provide a fairly similar reading. An overall assessment confirms the risk of a significant deviation. Over two years, this assessment is confirmed. Similarly, based on the Commission 2017 spring forecast, the structural balance is expected to deteriorate by 1.2% of GDP in 2017, pointing to a risk of a significant deviation from the recommended structural adjustment (a deviation of -1.7% of GDP). The growth of government expenditure, net of discretionary revenue measures and one-offs, is forecast to be well above the expenditure benchmark, also pointing to a risk of a significant deviation (a deviation of -1.7% of GDP). That is, both indicators point to a risk of a significant deviation. The overall assessment confirms that there is a risk of a significant deviation from the requirements in 2017 based on the Commission 2017 spring forecast. Over two years, this assessment is confirmed.

In 2018, according to the information provided in the programme, a structural deterioration of 0.2% of GDP is projected, pointing to a significant deviation from the adjustment path towards the MTO (a gap of -0.7% of GDP from the required adjustment of 0.5% of GDP). The growth rate of government expenditure, net of discretionary revenue measures is forecast to be well above the benchmark rate, also pointing to significant deviation (a gap of -0.7% of GDP). Both indicators point to a risk of a significant deviation. An overall assessment thus confirms the risk of a significant deviation. Over two years, this assessment is confirmed. Similarly, based on the Commission 2017 spring forecast, the structural balance is expected to deteriorate by 0.2% of GDP in 2018, pointing to a risk of a significant deviation from the required structural adjustment (a deviation of 0.7% of GDP). The growth of government expenditure, net of discretionary revenue measures and one-offs, is forecast to be well above the expenditure benchmark, also pointing to a risk of a significant deviation (a deviation of -1.1% of GDP). Both indicators provide a fairly similar reading. The overall assessment confirms that there is a risk of a significant deviation from the requirements in 2018 based on the Commission 2017 spring forecast. Over two years, this assessment is confirmed.

To conclude, following an overall assessment, a significant deviation from the adjustment path towards the MTO is expected in years 2017 and 2018, putting at risk the compliance with the requirements of the preventive arm of the Pact.

**Table 4: Compliance with the requirements under the preventive arm**

(% of GDP)	2016	2017		2018	
<b>Initial position<sup>1</sup></b>					
Medium-term objective (MTO)	-1.0	-1.0		-1.0	
Structural balance <sup>2</sup> (COM)	-2.6	-3.9		-4.0	
Structural balance based on freezing (COM)	-2.5	-3.9		-	
<b>Position vis-a -vis the MTO<sup>3</sup></b>	At or above the MTO	Not at MTO		Not at MTO	
(% of GDP)	<b>2016</b>	<b>2017</b>		<b>2018</b>	
	<b>COM</b>	<b>CP</b>	<b>COM</b>	<b>CP</b>	<b>COM</b>
<b>Structural balance pillar</b>					
Required adjustment <sup>4</sup>	0.0	0.5		0.5	
Required adjustment corrected <sup>5</sup>	-0.5	0.5		0.5	
Change in structural balance <sup>6</sup>	-2.1	-0.5	-1.2	-0.2	-0.2
<i>One-year deviation from the required adjustment<sup>7</sup></i>	-1.6	-1.0	-1.7	-0.7	-0.7
<i>Two-year average deviation from the required adjustment<sup>7</sup></i>	-0.6	-1.2	-1.7	-0.8	-1.2
<b>Expenditure benchmark pillar</b>					
Applicable reference rate <sup>8</sup>	3.9	1.0		4.3	
One-year deviation adjusted for one-offs <sup>9</sup>	-2.0	-1.1	-1.7	-0.7	-1.1
Two-year deviation adjusted for one-offs <sup>9</sup>	-1.1	-1.6	-1.9	-0.9	-1.4
<i>PER MEMORIAM: One-year deviation<sup>10</sup></i>	-2.9	-0.7	-1.2	-0.7	-1.1
<i>PER MEMORIAM: Two-year average deviation<sup>10</sup></i>	-1.4	-1.0	-2.1	-0.7	-1.2
<b>Conclusion</b>					
Conclusion over one year	Significant deviation	Significant deviation	Significant deviation	Significant deviation	Significant deviation
Conclusion over two years	Significant deviation	Significant deviation	Significant deviation	Significant deviation	Significant deviation
Notes					
<sup>1</sup> 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.					
<sup>2</sup> Structural balance = cyclically-adjusted government balance excluding one-off measures.					
<sup>3</sup> Based on the relevant structural balance at year t-1.					
<sup>4</sup> 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.).					
<sup>5</sup> Required adjustment corrected for the clauses, the possible margin to the MTO and the allowed deviation in case of overachievers.					
<sup>6</sup> Change in the structural balance compared to year t-1. Ex post assessment (for 2014) is carried out on the basis of Commission 2015 spring forecast.					
<sup>7</sup> The difference of the change in the structural balance and the corrected required adjustment.					
<sup>8</sup> 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.					
<sup>9</sup> 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.					
<sup>10</sup> 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.					
<i>Source:</i>					
<i>Convergence Programme (CP); Commission 2017 spring forecast (COM); Commission calculations.</i>					

## **5. LONG-TERM SUSTAINABILITY**

Romania does not appear to face fiscal sustainability risks in the short run according to the S0 indicator. This indicator captures short-term risks of fiscal stress stemming from the fiscal, as well as the macro-financial and competitiveness sides of the economy.

Based on Commission forecasts and a no-fiscal policy change scenario beyond forecasts, general government debt, at 37.6% of GDP in 2016, is expected to rise to 61.5% in 2027, thus breaching the 60% of GDP Treaty threshold. This highlights medium risks for the country from debt sustainability analysis in the medium term. The full implementation of the convergence programme would put general government debt on a more slowly increasing path, remaining below the 60% of GDP reference value in 2027.

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 2031) is at 1.5 pps. of GDP, primarily related to the initial budgetary position thus indicating medium risks in the medium term. The full implementation of the convergence programme would put the sustainability risk indicator S1 at -0.5 pps. 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 convergence 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 4.6 pps. of GDP. In the long-term, Romania therefore appears to face medium fiscal sustainability risks, primarily related to the initial budgetary position and to the projected ageing costs. Full implementation of the programme would put the S2 indicator at 3.4 pps. of GDP, leading to the same category of long-term risk, despite a somewhat lower indicator level.

Implementing reforms to contain the projected age-related increase in spending could improve fiscal sustainability over the long term. The retirement age is not equal among genders. A bill equalizing the retirement age for women and men at 65 has been pending before Parliament for several years. Moreover, to contain possible pressures on public finances, the government established in 2007 a multi-pillar pension system. However, the implementation of the second pension pillar consisting of privately managed pension savings has been repeatedly delayed. The original plan envisaged that contributions to the second pillar would be raised to 6 percentage points of the employees' contribution to the pension system by 2016. However, the 2016 budget provided for transfers corresponding to only 5.1 pps. of contributions and the 2017 budget maintained this share.

**Table 5: Sustainability indicators**

<i>Time horizon</i>	<b>No-policy Change Scenario</b>		<b>Stability / Convergence Programme Scenario</b>	
<b>Short Term</b>	<b>LOW risk</b>			
<b>S0 indicator</b> <sup>[1]</sup>	0.2			
Fiscal subindex	0.2	LOW risk		
Financial & competitiveness subindex	0.2	LOW risk		
<b>Medium Term</b>	<b>MEDIUM risk</b>			
<b>DSA</b> <sup>[2]</sup>	MEDIUM risk			
<b>S1 indicator</b> <sup>[3]</sup>	1.5	MEDIUM risk	-0.5	LOW risk
<i>of which</i>				
Initial Budgetary Position	2.7		1.2	
Debt Requirement	-1.4		-2.0	
Cost of Ageing	0.3		0.2	
<i>of which</i>				
Pensions	0.0		0.0	
Health-care	0.2		0.1	
Long-term care	0.1		0.1	
Other	0.0		0.1	
<b>Long Term</b>	<b>MEDIUM risk</b>		<b>MEDIUM risk</b>	
<b>S2 indicator</b> <sup>[4]</sup>	4.6		3.4	
<i>of which</i>				
Initial Budgetary Position	3.1		1.9	
Cost of Ageing	1.5		1.5	
<i>of which</i>				
Pensions	0.1		0.0	
Health-care	0.6		0.5	
Long-term care	0.5		0.5	
Other	0.3		0.3	

Source: Commission services; 2017 stability/convergence programme.

Note: the 'no-policy-change' scenario depicts the sustainability gap under the assumption that the structural primary balance position evolves according to the Commissions' spring 2017 forecast covering until 2018 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 2015 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 2031. This adjustment effort corresponds to a cumulated improvement in the structural primary balance over the 5 years following the forecast horizon (i.e. from 2019 for No-policy Change 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 2016.

## 6. FISCAL FRAMEWORK

The national fiscal rules<sup>3</sup> in Romania require that the medium-term budgetary objective cannot be lower than an annual structural general government balance of -1 % of GDP (or -0.5 % if public debt exceeds 60 % of GDP). In case of deviation from the MTO, the structural balance should converge towards this level on a path agreed with the Commission. Moreover, public debt cannot exceed 60 % of GDP.

In 2016, the structural balance significantly departed from the MTO reached in 2014 and 2015, therefore breaching the structural deficit rule from the national law. The convergence programme foresees that the structural balance will deteriorate further in both 2017 and 2018, thus continuing to breach the domestic structural deficit rule. General government debt is planned in the programme to remain well below the threshold of 60 % of GDP for the entire period.

According to the national Fiscal Council<sup>4</sup>, the 2016 budget was "a textbook example for everything that the Fiscal Responsibility Law no. 69/2010 was designed to prevent – simultaneous enactment of tax cuts and increases in the expenditure, both having a permanent budgetary impact, likely to create the premises for lasting and very difficult to correct deviations from a balanced budget". Moreover, "the draft budget for 2017, as well as that one of the previous year, deviates deliberately and substantially from the fiscal rules imposed by both national laws and European treaties signed by Romania"<sup>5</sup>.

In conclusion, based on the information provided in the convergence programme, the past, planned and forecast fiscal performance in 2017-2018 Romania appears to significantly depart from the requirements of the applicable national numerical fiscal rules.

Romania's national Fiscal Council has not been involved in the production nor endorsement of the macroeconomic forecast underpinning the convergence programme. As a non-euro area country, Romania is not required by the Regulation (EU) No 473/2013 to have an independent body to do so. However, when assessing the 2017-2019 Fiscal and Budgetary Strategy, the Fiscal Council referred to "highly optimistic" macroeconomic scenario for 2017 and "extremely favourable" macroeconomic projection over the medium-term, which in conjunction with underestimated budget expenditure for 2017, could lead to higher than projected deficits.

## 7. SUMMARY

In 2016, from a position of -0.6% of GDP in 2015, i.e. above the MTO, the structural balance deteriorated to -2.6% of GDP, pointing to a significant deviation from the MTO. The growth of government expenditure, net of discretionary revenue measures and one-offs, was well above the expenditure benchmark, also pointing to a significant deviation. The overall assessment points to a significant deviation from the requirements of the preventive arm of the Stability and Growth Pact in 2016.

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<sup>3</sup> In particular the fiscal responsibility law no. 69/2010 (amended by law no. 377/2013).

<sup>4</sup> Fiscal Council's opinion on the State Budget Law, the Social Insurance Budget Law for 2016 and the Fiscal Strategy for 2016-2018, available at <http://www.fiscalcouncil.ro/Opinii-eng-2015.pdf>

<sup>5</sup> Fiscal Council's opinion on the State Budget Law, the Social Insurance Budget Law for 2017 and the Fiscal Strategy for 2017-2019, available at <http://www.fiscalcouncil.ro/OpinionStateBudget2017.pdf>



In 2017 and 2018, a significant deviation from the adjustment path towards the MTO is expected both based on the programme and based on the Commission 2017 spring forecast, putting at risk the compliance with the requirements of the preventive arm of the Pact.

Moreover, although the programme projects the headline deficit to amount to 2.9% of GDP in 2017, according to the Commission 2017 spring forecast Romania's deficit is projected to exceed the 3% of GDP reference value in 2017 and in 2018 based on a no-policy change assumption.

## 8. ANNEX

### Table I. Macroeconomic indicators

	1999-2003	2004-2008	2009-2013	2014	2015	2016	2017	2018
<b>Core indicators</b>								
GDP growth rate	3.7	7.2	-0.5	3.1	3.9	4.8	4.3	3.7
Output gap <sup>1</sup>	-2.3	5.7	-3.6	-2.4	-1.3	-0.1	0.7	0.8
HICP (annual % change)	32.7	8.1	4.8	1.4	-0.4	-1.1	1.1	3.0
Domestic demand (annual % change) <sup>2</sup>	4.5	11.3	-2.5	3.4	5.5	5.5	5.0	4.5
Unemployment rate (% of labour force) <sup>3</sup>	7.6	6.9	6.9	6.8	6.8	5.9	5.4	5.3
Gross fixed capital formation (% of GDP)	20.5	29.5	26.2	24.3	24.8	22.7	22.2	22.4
Gross national saving (% of GDP)	15.1	16.2	22.4	24.5	24.4	22.6	21.6	21.6
<b>General Government (% of GDP)</b>								
<b>Net lending (+) or net borrowing (-)</b>	<b>-3.1</b>	<b>-2.5</b>	<b>-5.5</b>	<b>-1.4</b>	<b>-0.8</b>	<b>-3.0</b>	<b>-3.5</b>	<b>-3.7</b>
<b>Gross debt</b>	<b>23.1</b>	<b>14.5</b>	<b>32.5</b>	<b>39.4</b>	<b>38.0</b>	<b>37.6</b>	<b>39.3</b>	<b>40.9</b>
<b>Net financial assets</b>	<b>33.8</b>	<b>14.1</b>	<b>-11.3</b>	<b>-21.1</b>	<b>-20.4</b>	<b>-21.6</b>	<b>n.a</b>	<b>n.a</b>
Total revenue	33.1	33.2	33.0	33.5	35.0	31.7	30.6	31.5
Total expenditure	36.3	35.7	38.5	34.9	35.8	34.7	34.1	35.2
<i>of which: Interest</i>	3.3	1.0	1.6	1.6	1.6	1.5	1.6	1.6
<b>Corporations (% of GDP)</b>								
<b>Net lending (+) or net borrowing (-)</b>	<b>-3.9</b>	<b>-3.2</b>	<b>6.9</b>	<b>-3.8</b>	<b>-5.6</b>	<b>-3.9</b>	<b>-4.0</b>	<b>-3.8</b>
<b>Net financial assets; non-financial corporations</b>	<b>-84.3</b>	<b>-97.3</b>	<b>-87.0</b>	<b>-89.8</b>	<b>-86.2</b>	<b>-82.4</b>	<b>n.a</b>	<b>n.a</b>
<b>Net financial assets; financial corporations</b>	<b>0.3</b>	<b>-1.5</b>	<b>3.1</b>	<b>4.0</b>	<b>3.7</b>	<b>1.9</b>	<b>n.a</b>	<b>n.a</b>
Gross capital formation	15.3	20.9	15.9	15.7	14.7	15.1	14.7	14.6
Gross operating surplus	23.3	26.0	29.5	32.2	31.8	32.5	31.0	30.1
<b>Households and NPISH (% of GDP)</b>								
<b>Net lending (+) or net borrowing (-)</b>	<b>3.3</b>	<b>-4.1</b>	<b>-4.2</b>	<b>7.2</b>	<b>8.2</b>	<b>6.9</b>	<b>6.9</b>	<b>6.7</b>
<b>Net financial assets</b>	<b>34.0</b>	<b>45.0</b>	<b>31.9</b>	<b>49.7</b>	<b>51.0</b>	<b>51.1</b>	<b>n.a</b>	<b>n.a</b>
Gross wages and salaries	31.0	31.3	28.8	27.9	27.8	28.7	29.8	30.2
Net property income	4.9	0.7	3.3	17.6	18.1	16.7	15.7	14.7
Current transfers received	14.9	14.7	14.7	13.4	13.7	13.6	13.9	13.9
Gross saving	-2.1	-5.9	-1.2	10.4	11.4	11.5	11.4	11.1
<b>Rest of the world (% of GDP)</b>								
<b>Net lending (+) or net borrowing (-)</b>	<b>-3.8</b>	<b>-9.9</b>	<b>-2.6</b>	<b>2.5</b>	<b>1.8</b>	<b>-1.5</b>	<b>-1.3</b>	<b>-0.8</b>
<b>Net financial assets</b>	<b>18.9</b>	<b>41.4</b>	<b>65.9</b>	<b>59.4</b>	<b>54.0</b>	<b>53.2</b>	<b>n.a</b>	<b>n.a</b>
Net exports of goods and services	-6.1	-11.7	-4.8	-0.4	-0.6	-0.9	-1.9	-2.3
Net primary income from the rest of the world	-1.2	-3.0	-1.2	-1.0	-1.9	-2.9	-2.5	-2.4
Net capital transactions	0.3	0.5	0.9	2.6	2.4	0.9	1.5	2.0
Tradable sector	59.4	55.0	51.1	49.8	49.8	50.6	n.a	n.a
Non tradable sector	30.3	33.7	37.5	38.7	38.0	39.1	n.a	n.a
<i>of which: Building and construction sector</i>	5.7	8.3	8.3	6.2	5.8	6.0	n.a	n.a
Real effective exchange rate (index, 2000=100)	71.4	93.7	94.1	92.5	86.5	88.4	91.1	92.0
Terms of trade goods and services (index, 2000=100)	73.3	87.5	100.5	103.2	106.4	107.1	106.5	107.4
Market performance of exports (index, 2000=100)	71.4	90.5	107.6	131.5	131.4	137.4	140.8	142.8
<b>Notes:</b>								
<sup>1</sup> The output gap constitutes the gap between the actual and potential gross domestic product at 2005 market prices.								
<sup>2</sup> The indicator on domestic demand includes stocks.								
<sup>3</sup> 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.								
<b>Source:</b>								
AMECO data, Commission 2017 spring forecast								