

Brussels, 26 May 2016

Assessment of the 2016 Convergence Programme for

Romania

(Note prepared by DG ECFIN staff)

CONTENTS

1.	INTRODUCTION	3
2.	MACROECONOMIC DEVELOPMENTS	3
3.	RECENT AND PLANNED BUDGETARY DEVELOPMENTS	5
	3.1. Deficit developments in 2015	5
	3.2. Medium-term strategy and targets	5
	3.3. Measures underpinning the programme	8
	3.4. Debt developments	9
	3.5. Risk assessment	11
4.	COMPLIANCE WITH THE PROVISIONS OF THE STABILITY A	
	4.1. Compliance with the deficit criterion	12
	4.2. Compliance with the MTO	12
5.	FISCAL SUSTAINABILITY	14
6.	FISCAL FRAMEWORK	16
7.	CONCLUSIONS	16
8.	ANNEX	17

1. Introduction

This document assesses Romania's 2016 convergence programme, which was submitted on 28 April and covers the period 2016-2019. It has been approved by the government.

Romania is subject to the preventive arm of the Stability and Growth Pact and should preserve a sound fiscal position which ensures compliance with the medium term objective.

This document complements the Country Report published on 26 February 2015 and updates it with the information included in the Convergence programme.

The following section presents the macroeconomic outlook underlying the convergence programme and provides an assessment based on the Commission 2016 spring forecast. Section 3 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 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 and the quality of public finances. Section 7 provides a summary.

2. MACROECONOMIC DEVELOPMENTS

The convergence programme's macroeconomic scenario assumes a continuous improvement of the economic performance. The growth rate of real GDP is expected to increase steadily to 4.2% in 2016 and 4.3% in 2017. Domestic demand is set to remain the sole engine of growth. Private consumption is expected to continue growing although at a lower pace as of 2017 on the back of economic growth and increasing real household disposable incomes as wages keep growing and the labour market outlook is improving. The growth rate of gross fixed capital formation (GFCF) is forecast to increase steadily from 6.6% in 2016 to 7.5% in 2019, supported also by expected substantial inflows of EU funds.

The real GDP growth forecast was revised upwards from 3.4% for 2016 and 3.7% for 2017 in the previous convergence programme due to better-than-expected growth in 2015, lower oil prices and the impact of the VAT cut for food from 1 June 2015.

Potential output is projected to continue growing from 3.4% in 2016 to 4.2% in 2019¹. The (negative) output gap as recalculated by the Commission based on the information in the programme, following the commonly agreed methodology (in the remainder, the term "recalculated" will be used), is projected to close in 2016 and to turn positive in 2017².

The time horizon used by the Romanian authorities for the calculation of potential growth and the output gap is 2016-2019. According to the Convergence Programme, if the forecast horizon is restricted to 2017, potential growth slows down slightly to 3.2 % in 2016 and 3.7 % in 2017, leading to an output gap of -0.2 % in 2016 and 0.4 % in 2017.

There is a difference between the Commission's estimate for the output gap in 2016 (0.0%) and the (recalculated) output gap in the Convergence Programme (-0.4%). This is also the case for 2017 (output gap of 0.3% according to Commission estimations compared with 0.0% in the Convergence Programme). The differences arise mainly from the longer time horizon of the forecasts in the Convergence Programme.

Table 1: Comparison of macroeconomic developments and forecasts

	20	2015		16	20	17	2018	2019
	COM	СР	COM	СР	COM	CP	CP	CP
Real GDP (% change)	3.8	3.8	4.2	4.2	3.7	4.3	4.5	4.7
Private consumption (% change)	6.1	6.1	6.9	6.3	5.0	5.3	5.1	4.9
Gross fixed capital formation (% change)	8.8	8.8	5.5	6.6	6.1	6.9	7.3	7.5
Exports of goods and services (% change)	5.5	5.5	4.5	4.5	4.8	5.6	6.3	6.6
Imports of goods and services (% change)	9.1	9.1	9.8	8.7	7.6	7.8	7.9	7.8
Contributions to real GDP growth:								
- Final domestic demand	6.1	6.1	6.4	6.0	5.0	5.3	5.3	5.3
- Change in inventories	-0.8	-0.8	0.0	0.0	0.0	0.0	0.0	0.0
- Net exports	-1.5	-1.5	-2.2	-1.8	-1.3	-1.0	-0.8	-0.6
Output gap ¹	-1.1	-1.2	0.0	-0.4	0.3	0.0	0.4	0.9
Employment (% change)	-0.9	-0.9	0.0	0.2	-0.1	0.6	0.9	1.0
Unemployment rate (%)	6.8	6.8	6.8	6.7	6.7	6.6	6.5	6.4
Labour productivity (% change)	4.7	4.7	4.2	4.0	3.8	3.7	3.5	3.6
HICP inflation (%)	-0.4	-0.4	-0.6	-0.5	2.5	2.3	2.5	2.3
GDP deflator (% change)	2.9	2.9	2.0	2.0	2.4	2.1	2.2	2.0
Comp. of employees (per head, % change)	3.2	3.2	6.9	5.6	6.2	5.2	5.1	5.1
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	1.5	1.2	0.1	0.7	-0.7	0.5	0.5	0.5

Note

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

<u>Source</u> .

Commission 2016 spring forecast (COM); Convergence Programme (CP).

The real GDP growth included in the programme is identical with the Commission projection for 2016, but 0.5 pps. higher in 2017 due to favourable assumptions for the growth rates of GFCF and exports. The expected growth rates for private consumption are plausible both for 2016 and 2017. The GFCF growth rates in the convergence programme for 2016 and 2017 are favourable compared with the projections of the Commission. On the external side, the assumptions for export growth rates are plausible for 2016 and favourable for 2017. The growth estimates do not include any impact from structural reforms as the measures presented in the national reform programme are not quantified. The projections for the growth rates of compensation of employees are cautious for both 2016 and 2017 compared with the Commission's forecast, due to differences in the employment growth projections and in the assumptions on public wage increases. The inflation projections of the convergence programme are in line with Commission estimates.

Overall, the economic growth assumptions in the convergence programme are plausible for 2016 and slightly favourable for 2017. Downside risks to the macroeconomic outlook mainly stem from the uncertainty caused by the adoption of a law on debt discharge (see section 3.3 below).

3. RECENT AND PLANNED BUDGETARY DEVELOPMENTS

3.1. Deficit developments in 2015

The 2015 budget deficit amounted to 0.7% of GDP in headline terms and 0.6% of GDP in structural terms. Romania' structural deficit thus remained below its MTO of 1% of GDP.

The 2015 convergence programme targeted a higher budget deficit of 1.3% of GDP for 2015. The better-than-expected outturn is mainly due to better-than-expected tax revenues by 2.2% of GDP, both from indirect and from direct taxes. Strong economic growth and enhanced tax compliance more than offset the adopted tax cuts (in particular, a cut in social security contributions implemented in the end of 2014, a cut in VAT rate for food in force since mid 2015) and the higher expenditure (by 1.7% of GDP). Real GDP growth outturn in 2015 – at 3.8% – was better than the 3.2% assumed in the previous convergence programme, with a positive impact on the general government outturn in 2015.

3.2. Medium-term strategy and targets

The programme plans a significant deterioration of the headline deficit from 0.7% of GDP in 2015 to 2.9% in 2016 and 2017 and a gradual decrease of the deficit thereafter, to 2.3% of GDP in 2018 and 1.6% of GDP in 2019. 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 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. Romania reached the MTO in 2014 and 2015. The programme plans to significantly depart from the MTO in 2016 and to return to an adjustment path toward it from 2018 onwards. The programme does not envisage reaching the MTO over the programme horizon (until 2019).

The deficit targets in the current programme are significantly higher than the ones in the 2015 programme (headline deficit targets of 1% of GDP in 2016 and 0.8% of GDP in 2017). This is mainly due to the significant fiscal loosening measures adopted since the last programme, notably the amendment to the Fiscal Code which introduced significant tax cuts as well as public wage increases. For details on the adopted measures see section 3.3 below.

Table 2: Composition of the budgetary adjustment

(% of GDP)	2015	20	16	2017		2018	2019	Change: 2015-2019
	COM	COM	CP	COM	CP	CP	CP	СР
Revenue	34.8	31.8	32.5	31.5	31.7	31.9	31.8	-3.0
of which:								
- Taxes on production and imports	13.2	11.9	12.0	11.2	11.2	11.2	11.1	-2.1
- Current taxes on income, wealth,								
etc.	6.7	6.4	6.5	6.5	6.6	6.7	6.7	0.0
- Social contributions	8.1	8.2	8.1	8.1	8.1	8.1	8.2	0.1
- Other (residual)	6.7	5.3	5.9	5.8	5.8	5.9	5.8	-0.9
Expenditure	35.5	34.6	35.4	34.9	34.6	34.1	33.4	-2.1
of which:								
- Primary expenditure	33.9	32.9	33.8	33.1	33.0	32.5	32.0	-1.9
of which:								
Compensation of employees	7.6	8.3	8.1	8.4	7.9	7.8	7.7	0.1
Intermediate consumption	5.6	5.6	5.6	5.6	5.5	5.5	5.4	-0.2
Social payments	11.5	11.4	11.4	11.2	11.2	11.0	10.7	-0.8
Subsidies	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.0
Gross fixed capital formation	5.1	3.8	4.6	4.1	4.5	4.5	4.5	-0.6
Other (residual)	3.6	3.4	3.6	3.3	3.4	3.4	3.3	-0.3
- Interest expenditure	1.6	1.7	1.6	1.7	1.6	1.6	1.4	-0.2
General government balance								
(GGB)	-0.7	-2.8	-2.9	-3.4	-2.9	-2.3	-1.6	-0.9
Primary balance	0.9	-1.1	-1.3	-1.6	-1.2	-0.7	-0.2	-1.1
One-off and other temporary	0.3	0.1	0.0	0.0	0.0	0.0	0.0	-0.3
GGB excl. one-offs	-1.0	-2.8	-2.9	-3.4	-2.9	-2.3	-1.6	-0.6
Output gap ¹	-1.1	0.0	-0.4	0.3	0.0	0.4	0.9	2.0
Cyclically-adjusted balance ¹	-0.4	-2.8	-2.7	-3.4	-2.9	-2.4	-1.9	-1.5
Structural balance ²	-0.6	-2.8	-2.7	-3.4	-2.9	-2.4	-1.9	-1.3
Structural primary balance ²	1.0	-1.1	-1.1	-1.7	-1.3	-0.8	-0.5	-1.5

Notes:

<u>Source</u> .

Convergence Programme (CP); Commission 2016 spring forecasts (COM); Commission calculations.

In 2016, the programme envisages a significant deterioration of the headline balance to -2.9% of GDP, while the structural balance (recalculated by the Commission on the basis of the information in the programme according to the commonly agreed methodology) is set to decrease to -2.7% of GDP. The deterioration is driven by the revenue side. Significant tax cuts enacted in 2015 are set to have a negative impact on revenues. The expenditure-to-GDP ratio is projected to be broadly stable, with the significant increases of public wages offset by a fall in gross fixed capital formation. The 2016 deficit projection in the programme is similar to the one from the Commission' spring 2016 forecast.

In 2017, the programme envisages an unchanged headline deficit at 2.9% of GDP, and a (recalculated) structural deficit at the same level. A decrease of the revenue-to-GDP ratio, driven by further, already enacted tax cuts, is planned to be offset by moderation on the

¹Output 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.

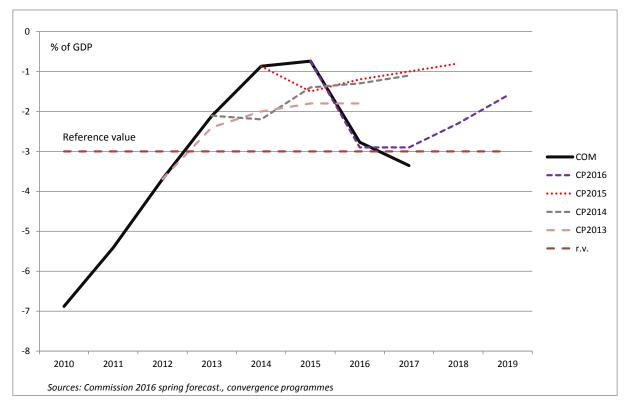
²Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

expenditure side. The 2017 projection in the programme is more optimistic than the Commission's (3.4% of GDP). The difference is due to more optimistic macro scenario in the programme (2017 real GDP growth of 4.3% in the programme compared to 3.7% of GDP in the spring forecast) and to consolidation measures on the expenditure side which are not specified in detail.

The planned improvement of the headline balance in 2018 (-2.3% of GDP) and 2019 (-1.6% of GDP) relies on a steady fall of expenditures as a share of GDP, while the revenues are projected to remain broadly stable. The envisaged consolidation relies on unspecified measures, as the programme does not explain in detail the measures supporting the planned consolidation targets.

The headline balance targets for 2016-2017 are much lower – by around 2 percentage points of GDP – compared to previous convergence programmes (Figure 1) due to the significant fiscal easing measures (in particular the amendment to the Fiscal Code) enacted since the previous convergence programme.

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



3.3. Measures underpinning the programme

The main measures as reported in the programme are listed in the table below. The most significant measures are the significant tax cuts over 2016-2017 included in the amendment of the Fiscal Code adopted in 2015 as well as wage increases for different categories of public sector workers with a major impact in 2016. The programme does not specify additional measures from 2018 onwards (apart from the change of schedule of phasing-in of the second pension pillar and a planned introduction of a minimum insertion income).

The programme provides for a further postponement of the phasing in of the second pillar of the pension system in 2017 (increase of the share of the contribution sent to the second pillar of the pension system by 0.4 percentage points, instead of 0.9 percentage points in the previous schedule). This 2017 postponement was not included in the Commission spring forecast, since it had not been announced by the cut-off date.

Main budgetary measures

Expenditure
015
016
 Increases of public wages and other expenditure categories (+1.5% of GDP) Doubling of child allowance (+0.2% of GDP; implemented in mid-2015)
017
 Planned unified wage law (+0.2% of GDP) Removal of the ceiling on the monthly maternity benefit (+0.1% of GDP)

contributions at 5 national gross average salaries (-0.1% of GDP)

- Introduction of a permanent tax on the petroleum sector (+0.1% of GDP compared to the scenario with no taxation, no significant impact compared to the previous, temporary tax regime which has been prolonged since 2013)
- Increase of the contribution rate to the second pension pillar by 0.4 percentage points (-0.1% of GDP compared to the 2016 contribution rate, +0.1% of GDP compared to the originally planned increase by 0.9 percentage points)

2018

- Increase of the contribution rate to the second pension pillar by 0.5 percentage points (-0.1% of GDP compared to the 2017 contribution rate)
- Introduction of minimum insertion income (effect not specified)

<u>Note</u>: 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

Government debt projections have deteriorated compared to the previous years (Figure 2). General government debt is expected in the programme to gradually increase from 38.4% of GDP in 2015 to 39.9% of GDP in 2018 on the back of a significant decrease of the primary balance from a surplus of 0.9% of GDP in 2015 to a deficit of -1.3% of GDP in 2016 due to the enacted fiscal loosening measures. It is then projected to decrease somewhat in 2019, thanks to the gradual improvement of the primary balance by 1.1 percentage points of GDP between 2017 and 2019. The Commission projects a lower debt-to-GDP ratio by 0.4% of GDP in 2016 due to a similar projected improvement in the primary balance. For 2017 the Commission forecasts a slightly higher debt-to-GDP ratio (by 0.3% of GDP) due to a somewhat higher primary balance projection (by 0.4% of GDP).

Table 3: Debt developments

(0/ -fCDD)	Average	2015	20	2016		2017		2019
(% of GDP)	2010-2014		COM	CP	COM	CP	CP	CP
Gross debt ratio ¹	35.9	38.4	38.7	39.1	40.1	39.8	39.9	39.3
Change in the ratio	3.3	-1.4	0.3	0.7	1.4	0.7	0.1	-0.6
Contributions ² :								
1. Primary balance	2.1	-0.9	1.1	1.3	1.6	1.2	0.7	0.2
2. "Snow-ball" effect	-0.1	-0.8	-0.6	-0.6	-0.5	-0.7	-0.9	-1.1
Of which:								
Interest expenditure	1.7	1.6	1.7	1.6	1.7	1.7	1.6	1.4
Growth effect	-0.5	-1.4	-1.5	-1.5	-1.3	-1.6	-1.7	-1.8
Inflation effect	-1.2	-1.1	-0.7	-0.7	-0.9	-0.8	-0.8	-0.7
3. Stock-flow	1.2	0.4	-0.2	0.0	0.3	0.2	0.3	0.3
adjustment	1.4	0.4	-0.2	0.0	0.3	0.2	0.5	0.5
Of which:								
Cash/accruals diff.				-0.2		-0.1	-0.1	-0.1
Acc. financial assets				-0.3		0.0	0.0	0.0
Privatisation				0.0		0.0	0.0	0.0
Val. effect & residual				-1.7		-2.0	-2.1	-2.1

Notes:

<u>Source</u>:

Commission 2016 spring forecast (COM); Convergence Programme (CP), Comission calculations.

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.

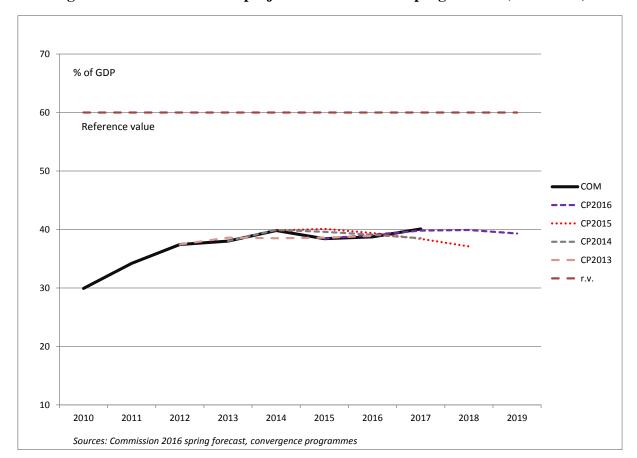


Figure 2: Government debt projections in successive programmes (% of GDP)

3.5. Risk assessment

The main risks to the achievement of the planned budgetary targets stem from the risks to the macroeconomic outlook, the reliance on measures which are not sufficiently specified and implementation risks in view of upcoming elections.

Downside risks to the macroeconomic outlook stem from the uncertainty caused by the adoption of a law on debt discharge ('datio in solutum') by Parliament on 13 April 2016 and its subsequent promulgation by the President. Under the law, debtors with mortgage loans or real-estate backed consumer loans of up to €250 000 will be given the option to hand over the property used as collateral to the bank in exchange for full termination of their contractual obligations. Banks will not be able to make any further claims on debtors after the enforcement of the debt discharge law. This law poses substantial risks for the stability of the financial sector and has multiple implications for the economy as a whole. More specifically, it may potentially undermine the stabilization of the real estate market, slow down the recent rebound in credit to the economy, with negative effect on employment, and eventually discourage investors by undermining their perception of legal certainty in the country. The programme relies on expenditure measures which are not sufficiently specified. It relies on a significant moderation of expenditures (fall by 2% of GDP from 2016 to 2019) in order to compensate for the impact of the tax cuts in 2016 and in order to gradually decrease the general government deficit from 2018 onwards. However, the programme does not specify in sufficient detail the underlying measures which would ensure such expenditure developments.

Moreover, a downward risk to the fiscal outlook stems from potential additional expansionary legislative initiatives in the run-up to the local and parliamentary elections in 2016.

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

Box 1. Council recommendations addressed to Romania

On 14 July 2015, the Council addressed recommendations to Romania in the context of the European Semester. In particular, in the area of public finances the Council recommended to Romania to limit the deviation from the medium-term budgetary objective in 2015 to a maximum of 0,25 % of GDP as specified under the 2013-15 balance-of-payments programme and return to the medium-term budgetary objective in 2016.

4.1. Compliance with the deficit criterion

Romania's deficit is projected to exceed the 3% of GDP reference value in 2017 based on the Commission's spring 2016 forecast. The Commission projects the headline balance to deteriorate from 2.8% in 2016 to 3.4% of GDP in 2017 due to enacted tax cuts, such as the cut in the standard VAT rate from 20% to 19%, the abolition of the extra excise duty on fuel, and of the special construction tax. These tax cuts are not sufficiently compensated by other enacted measures. At the same time, the programme projects the headline deficit to remain at 2.8% of GDP in 2017. This difference is partially due to more optimistic macroeconomic assumptions in the programme as compared to the Commission forecast and partially due to reliance on unspecified measures.

4.2. Compliance with the MTO

Based on outturn data, in 2015 the structural balance amounted to -0.6% of GDP, and thus remained above the MTO which it had reached already in 2014.

In 2016, according both to the information provided in the convergence programme, and to the Commission 2016 spring forecast, a structural deterioration of 2.2% of GDP is projected, pointing to a significant deviation from the MTO (gap of -1.8% of GDP from the required adjustment of -0.4% 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 a significant deviation (gap of -2.5% of GDP according to the programme). Similarly, the Commission projects the growth rate of government expenditure, net of discretionary revenue measures, to be well above the benchmark rate, also pointing to a significant deviation (gap of -2.7% of GDP based on the Commission 2016 spring forecast). To sum up, there is a risk of a significant deviation from the MTO in 2016. This assessment is confirmed over 2015-2016, when both pillars point towards a significant deviation, based both on the Commission forecast and the convergence programme.

In 2017, 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 (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, pointing to significant deviation (gap of -0.9% of GDP). Similarly, according to the Commission, in 2017 a further structural deterioration of 0.6% of GDP is projected, pointing to a significant deviation from the MTO (gap of -1.1% of GDP from the required adjustment of 0.5% of GDP). The growth rate of government expenditure, net of discretionary revenue measures, is forecast by the Commission to be well above the benchmark rate, also pointing to a significant deviation (gap of -1.8% of GDP). Therefore, there is a risk of significant deviation from the MTO in 2017. This assessment is confirmed

over 2016-2017, when both pillars point towards a significant deviation, based on both the Commission forecast and the convergence programme.

Table 4: Compliance with the requirements under the preventive arm

(% of GDP)	2015	2016		2017	
Initial position ¹					
Medium-term objective (MTO)	-1.0	-1.0		-1.0	
Structural balance ² (COM)	-0.6	-2	2.8	-3.4	
Structural balance based on freezing (COM)	-0.6	-2	2.8	-	
Position vis-a -vis the MTO ³	At or above the MTO	At or abov	e the MTO	Not at MTO	
(% of GDP)	2015	2016		2017	
, ,	COM	CP	COM	CP	COM
Structural balance pillar					
Required adjustment ⁴	0.0	0	0.0		.5
Required adjustment corrected ⁵	-0.8	-0.4		0	.5
Change in structural balance ⁶	-0.5	-2.2	-2.2	-0.2	-0.6
One-year deviation from the required adjustment ⁷	0.4	-1.8	-1.8	-0.7	-1.1
Two-year average deviation from the required adjustment ⁷	0.4	-0.7	-0.7	-1.2	-1.5
Expenditure benchmark pillar					
Applicable reference rate ⁸	4.9	3	3.6		.0
One-year deviation ⁹	0.1	-2.5	-2.7	-0.9	-1.8
Two-year average deviation ⁹	0.7	-1.2	-1.3	-1.7	-2.2
Conclusion					
Conclusion over one year	Compliance	Significant deviation	Significant deviation	Significant deviation	Significant deviation
Conclusion over two years	Compliance	Significant deviation	Significant deviation	Significant deviation	Significant deviation

Notes

Source:

Convergence Programme (CP); Commission 2016 spring forecast (COM); Commission calculations.

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

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

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

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

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

⁶ Change in the structural balance compared to year t-1. Expost assessment (for 2014) is carried out on the basis of Commission 2015 spring forecast.

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

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

⁹ Deviation of the growth rate of public expenditure net of discretionary revenue measures 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.

5. FISCAL SUSTAINABILITY

Romania does not appear to face fiscal sustainability risks in the short run.³

Based on Commission forecasts and a no-fiscal policy change scenario beyond forecasts, general government debt, at 38.4% of GDP in 2015, is expected to steadily rise to 56.2% in 2026, thus remaining below 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 debt on a broadly stable path by 2026.

The medium-term fiscal sustainability risk indicator S1 is at 0.7 pps. of GDP, primarily related to the high 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 -1.5 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 3.8 % of GDP. In the long-term, Romania therefore appears to face medium fiscal sustainability risks, primarily related to high initial budgetary position. The projected ageing costs, in particular related to health care and long-term care, also contribute negatively. Full implementation of the programme would put the S2 indicator at 2.5 pps. of GDP, leading to a somewhat lower level, but still similar category of long-term risk.

Implementing reforms to contain the projected age-related increase in spending could improve fiscal sustainability over the long term. This includes completing the pension reform and implementing the second pension pillar. Under national legislation, the completion of the second pillar requires the financing of privately managed pension funds to reach 6 percentage points of the employees' contribution to the pension system. Contrary to the original provisions, the 2016 budget provides for transfers corresponding to only 5.1 percentage points of contributions, in effect delaying the implementation of the pension reform. The convergence programme provides for further delay in 2017, when the part of the contributions accruing to the second pillar will increase to 5.5 percentage points.

_

This conclusion is based on the short-term fiscal sustainability risk indicator S0, which incorporates 14 fiscal and 14 financial-competitiveness variables. The fiscal and financial-competitiveness sub-indexes (reported in table 5) are based on the two sub-groups of variables respectively. For sustainability risks arising from the individual variables, by country, see the Commission's Fiscal Sustainability Report 2015 (page 67).

Table 5: Sustainability indicators

Time horizon				y Change nario	Stability / Convergence Programme Scenario		
Short Term			LOV	V risk			
SO indicator [1]			0	0.2			
Fiscal subindex (2015)			0.1	LOW risk			
Financial & competitiveness subindex (2015)			0.2	LOW risk			
Medium Term			MEDII	JM risk			
DSA ^[2]			MEDI	UM risk			
S1 indicator ^[3]		0.7	MEDIUM risk	-1.5	LOW risk		
of which				•			
	IBP		1.9		0.1		
	Debt Requirement		-1.5		-1.9		
	CoA		0.2		0.2		
Long Term			MEDIUM risk		MEDIUM risk		
S2 indic	ator ^[4]		3.8		2.5		
of w	vhich						
	IBP		2.3		1.1		
	CoA		1.5		1.4		
	of which						
		Pensions	C).1	0	0	
		нс	0).6	0	5	
		LTC	0).6	0	5	
		Other	0).3	0	3	

Source: Commission services; 2016 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 2016 forecast until 2017. 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 reflects up to date evidence on the role played by fiscal and financial-competitiveness variables in creating potential fiscal risks. It should be stressed that the methodology for the S0 indicator is fundamentally different from the S1 and S2 indicators. S0 is not a quantification of the required fiscal adjustment effort like the S1 and S2 indicators, but a composite indicator which estimates the extent to which there might be a risk for fiscal stress in the short-term. The critical threshold for the overall S0 indicator is 0.43. For the fiscal and the financial-competitiveness sub-indexes, thresholds are respectively at 0.35 and 0.45.

[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. See Fiscal Sustainability Report 2015.

[3] The medium-term sustainability gap (S1) indicator shows the upfront adjustment effort required, in terms of a steady adjustment in the structural primary balance to be introduced over the five years after the forecast horizon, and then sustained, to bring debt ratios to 80% of GDP in 2030, including financing for any additional expenditure until the target date, a rising from an ageing population. The following thresholds were used to assess the scale of the sustainability challenge: (i) if the S1 value is less than zero, the country is assigned low risk; (ii) if a structural adjustment in the primary/balance of up to 0.5 p.p. of GDP per year for five years after the last year covered by the spring 2015 forecast (year 2017) is required (indicating an cumulated adjustment of 2.5 pp.), it is assigned medium risk; and, (iii) if it is greater than 2.5 (meaning a structural adjustment of more than 0.5 p.p. of GDP per year is necessary), it is assigned high risk.

[4]The long-term sustaina bilitygap (S2) indicator shows the immediate and permanent adjustment required to satisfyan inter-temporal budgetary constraint, including the costs of ageing. The S2 indicator has two components: i) the initial budgetary position (IBP) which gives the gap to the debt stabilising primary balance; and ii) the additional adjustment required due to the costs of ageing. The main assumption used in the derivation of S2 is that in an infinite horizon, the growth in the debt ratio is bounded by the interest rate differential (i.e. the difference between the nominal interest and the real growth rates); therebynotnecessarily implying that the debt ratio will fall below the EU Treaty-60% debt threshold. The following thresholds for the S2 indicator were used: (i) if the value of S2 is lower than 2, the country is assigned low risk; (ii) if it is between 2 and 6, it is assigned medium risk; and, (iii) if it is greater than 6, it is

6. FISCAL FRAMEWORK

The fiscal framework⁴ in Romania is sound in its provisions but is not applied effectively in practice. It requires 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) and that in case of deviation the structural balance should converge towards this level at the path agreed with the Commission. Moreover, public debt cannot exceed 60 % of GDP.

In 2015 Romania overperformed the structural balance target and public debt was well below the level of 60 % of GDP.

The convergence programme reflects the provisions of the 2016 budget and the 2016-2018 medium-term fiscal strategy both adopted in December 2015 in breach of the structural deficit rule. Namely, the convergence programme foresees that the structural balance will deteriorate in both 2016 and 2017 and will fall significantly below the MTO of -1% of GDP. In 2018-2019, the programme foresees the structural balance to improve, but to still remain below the MTO. Public 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 Council⁵, "the construction of the draft budget for 2016 (and its medium-term projection) is 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 (...) The draft budget for the year 2016 is characterized by a deliberate and large deviation from all fiscal rules imposed by both national legislation and the European treaties signed by Romania and induces a significant vulnerability for the position of the public finances."

In conclusion, based on the information provided in the convergence programme, the planned fiscal performance in Romania appears not to comply with the requirements of the applicable national numerical fiscal rules.

7. CONCLUSIONS

In 2015, Romania's structural balance remained above the MTO. However, Romania plans a significant deterioration of the structural balance in both 2016 and 2017. This path implies a deviation of above 0.5% of GDP from the required adjustment path towards the MTO in 2016 and in 2017. Therefore, based both on the information from the programme and according to the Commission 2016 spring forecast, there is a risk of significant deviation both in 2016 and 2017.

Moreover, although the programme projects the headline deficit to remain at 2.9% of GDP in 2017, according to the Commission's spring 2016 forecast Romania's deficit is projected to exceed the 3% of GDP reference value in 2017 based on a no-policy change assumption.

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

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

8. **ANNEX**

Table I. Macroeconomic indicators

	1998-	2003-	2008-	2013	2014	2015	2016	2017
	2002	2007	2012	2013	2017	2015	2010	2011
Core indicators								
GDP growth rate	2.1	6.6	0.5	3.5	3.0	3.8	4.2	3.7
Output gap ¹	-3.3	4.3	-1.4	-3.1	-2.1	-1.1	0.0	0.3
HICP (annual % change)	41.5	9.5	5.8	3.2	1.4	-0.4	-0.6	2.5
Domestic demand (annual % change) ²	3.2	11.3	-0.8	-0.1	3.1	5.3	6.4	4.9
Unemployment rate (% of labour force) ³	7.3	7.3	6.6	7.1	6.8	6.8	6.8	6.7
Gross fixed capital formation (% of GDP)	19.8	26.3	29.0	24.7	24.2	24.7	24.7	25.2
Gross national saving (% of GDP)	15.5	16.7	22.5	24.9	25.4	24.7	23.4	23.2
General Government (% of GDP)	10.0	10.7		2.1.5		2	2011	20.2
Net lending (+) or net borrowing (-)	-3.5	-1.7	-6.2	-2.1	-0.9	-0.7	-2.8	-3.4
Gross debt	22.2	16.1	27.6	38.0	39.8	38.4	38.7	40.1
Net financial assets	38.5	15.7	-4.4	-19.4	-19.6	n.a	n.a	n.a
Total revenue	33.2	32.9	32.9	33.1	33.5	34.8	31.8	31.5
Total expenditure	36.8	34.6	39.1	35.2	34.3	35.5	34.6	34.9
of which: Interest	3.8	1.2	1.4	1.7	1.7	1.6	1.7	1.7
Corporations (% of GDP)								
Net lending (+) or net borrowing (-)	-7.5	-2.8	6.2	-1.5	15.3	14.0	12.8	11.3
Net financial assets; non-financial corporations	-85.2	-92.3	-90.2	-93.8	-91.5	n.a	n.a	n.a
Net financial assets; financial corporations	-0.1	-1.9	3.5	4.9	4.1	n.a	n.a	n.a
Gross capital formation	14.7	19.8	17.7	15.0	15.6	16.6	17.7	18.7
Gross operating surplus	23.6	25.7	28.5	31.1	32.6	32.2	32.8	32.4
Households and NPISH (% of GDP)								
Net lending (+) or net borrowing (-)	6.9	-4.0	-5.6	5.2	-11.1	-10.2	-9.1	-8.4
Net financial assets	34.8	43.9	29.8	46.5	49.7	n.a	n.a	n.a
Gross wages and salaries	31.0	30.6	30.3	26.7	27.5	27.7	28.8	29.3
Net property income	6.3	0.7	0.2	15.1	0.0	-0.3	0.3	0.5
Current transfers received	14.8	14.8	14.9	13.0	12.6	12.5	12.4	12.1
Gross saving	-1.7	-6.8	-3.8	9.4	-7.8	-8.2	-7.0	-6.3
Rest of the world (% of GDP)								
Net lending (+) or net borrowing (-)	-4.1	-8.6	-5.3	1.5	2.8	1.5	0.1	-0.7
Net financial assets	14.8	36.5	63.9	63.8	59.4	n.a	n.a	n.a
Net exports of goods and services	-6.1	-10.5	-7.3	-0.8	-0.3	-0.5	-1.6	-2.5
Net primary income from the rest of the world	-1.0	-3.1	-1.2	-1.9	-0.8	-1.8	-1.7	-1.4
Net capital transactions	0.2	0.5	0.6	2.1	2.6	2.4	2.2	2.1
Tradable sector	60.6	56.0	51.5	50.2	49.9	48.8	n.a	n.a
Non tradable sector	29.2	32.7	37.3	37.9	38.5	39.0	n.a	n.a
of which: Building and construction sector	5.5	7.3	9.2	7.0	7.2	7.4	n.a	n.a
Real effective exchange rate (index, 2000=100)	71.4	84.5	99.2	89.8	91.7	87.7	88.4	88.9
Terms of trade goods and services (index, 2000=100)	72.0	83.1	99.7	101.6	103.2	106.1	108.7	109.2
Market performance of exports (index, 2000=100)	65.4	89.9	100.3	127.9	133.6	133.9	134.2	133.7

Source:
AMECO data, Commission 2016 spring forecast

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

² The indicator on domestic demand includes stocks.

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