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Brussels, 29 December 2020
PL/as, Ares(2020)s8942238

Dear Minister,

Let us first congratulate you on your appointment and wish you great success in the uniquely challenging time that lies ahead. We look forward to working with the newly appointed Government on its many tasks and responsibilities, not least those required to address the COVID-19 pandemic, support the recovery and build a more sustainable and resilient economy.

As a matter of priority, the purpose of this letter is to recall the view of the European Commission on Romania's fiscal situation and inform you about the current state of play of our fiscal surveillance processes, in particular in relation to the ongoing excessive deficit procedure (EDP) of Romania. We propose to engage at your earliest convenience in a policy dialogue about Romania's fiscal situation and the forthcoming 2021 budget, which will be of key importance in this regard.

Following years of fiscal slippage, the fiscal situation in Romania continued to deteriorate substantially in 2020. On 18 November 2020, the Commission published a Communication on Romania's fiscal situation.[1] According to our analysis, the large general government deficit and rapidly growing debt ratio are largely the result of policy decisions adopted by Romania before the COVID-19 outbreak. These decisions include the pro-cyclical fiscal policy between 2016 and 2018, when the government deficit was close to 3% of GDP notwithstanding a favourable economic situation, as well as the large unfunded pension increases that lead to a permanent increase in the budget deficit. The deterioration in the fiscal position is therefore only to a limited extent due to the necessary fiscal measures taken by Romania to combat the COVID-19 pandemic. The Annex provides a synthesis of our analysis.

In light of the continued exceptional uncertainty created by the COVID-19 pandemic and its extraordinary macroeconomic and fiscal impact, the Commission considered that no decision

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[1] Communication from the Commission to the Council: Fiscal situation in Romania (COM(2020) 752 final).

on further steps under Romania's EDP could be taken in the context of the autumn package 2020. The Commission will reassess Romania's budgetary situation in spring 2021 and, if appropriate, will propose new steps under the EDP. Our assessment will take into account 2020 budgetary outturn data, the upcoming 2021 budget, the Commission 2021 spring forecast as well as the medium-term setting of fiscal policy that the Government will lay down in its political programme and your forthcoming convergence programme.

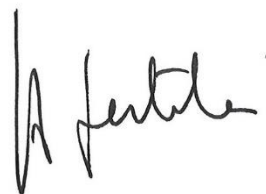
Against this background, we would like to engage with the Romanian Government to discuss the necessary action, both immediately and in the medium-term, to bring Romania's fiscal situation onto a sustainable path. This corrective action need not and should not undermine the necessary efforts to support the health system and the economy in order to effectively combat the pandemic and its economic and social consequences. As highlighted in our previous letter to Minister of Public Finance Cîtu of 19 September 2020, the measures to support the recovery throughout 2021 should be tailored to Romania's specific situation and should be well-targeted and temporary.

We, as well as the Commission services, are available to discuss the interaction between the 2021 budget and the ongoing EDP. We would welcome further efforts by the Government to limit any structural negative budgetary impact of the measures taken. At the same time, Romania should avoid introducing new measures with a permanent negative impact on the budget balance. Given the seriousness of the fiscal situation, we would also strongly encourage you to consider further fiscal policy initiatives already as of 2021 and on both the revenue and expenditure sides. These initiatives should, as part of a concerted medium-term fiscal strategy, set the deficit on a declining path and prevent a steep increase in the debt-to-GDP ratio.

Romania is expected to benefit from substantial amounts of grants and loans under the Recovery and Resilience Facility (RRF), which will provide a significant boost to the economy. We would like to underline that effective action in the context of an EDP and overall sound macroeconomic policies are conducive to productive public investment and the effective use of the available EU financing, including in the context of the RRF. In addition, the recovery and resilience plan of Romania is expected to contribute to effectively addressing the challenges identified in the relevant country-specific recommendations. Overall, Romania's policy strategy for the coming years should pay due attention to implementing the country-specific recommendations as an integral part of the Government's commitment to preserve current and future growth and ensure fiscal sustainability.

We are confident that such a policy strategy will allow Romania to fully reap the benefits of the available EU financing, while restoring sound public finances. We look forward to engaging in fruitful cooperation with the Romanian authorities and to supporting you in this process through exchanges at both political and technical level, including in the near future in context of the preparation of the 2021 budget.

Yours sincerely,



Valdis DOMBROVSKIS

Paolo GENTILONI

cc. Ms Cosmina Manolescu, EFC Member for Romania

ANNEX

ROMANIA'S BUDGETARY OUTLOOK: ASSESSMENT AND FORECAST

Based on a recommendation from the Commission of 4 March 2020[2], the Council adopted on 3 April 2020 a Recommendation under Article 126(7) of the Treaty on the Functioning of the European Union[3] (the "Recommendation"). That recommendation was adopted on the basis of a planned 2019 deficit that was above and not close to the 3% of GDP reference value. The excess over the reference value was also not exceptional and not temporary.

According to the notification of 14 October 2020[4], validated by Eurostat, the general government deficit in Romania was 4.4% of GDP in 2019, while debt stood at 35.3% of GDP. The Commission 2020 autumn forecast projects a general government deficit of around 10¼% in 2020, 11¼% in 2021 and 12½% in 2022 under a no-policy change assumption. The structural deficit, which was around 5% of GDP in 2019, is expected to deteriorate by 3.6 pps. of GDP in 2020, 1.4 pps. of GDP in 2021, and 1.6 pps. of GDP in 2022.

These large and growing budget deficits partly result from the combined effect of the severe economic downturn, and the measures to combat the COVID-19 pandemic and its economic and social consequences. These include additional spending on employment support schemes and support to the health sector, as well as some tax incentives. The total cost of COVID-19 related support measures (both expenditure and revenue) is 1.4% of GDP, out of which 0.4 pps. is financed by EU funds. Note that in the absence of a budget for 2021, the Commission 2020 autumn forecast assumes the expiry of the employment support measures and wages bonuses in 2021, which in the meantime have been extended.

However, according to the Commission analysis, the main drivers of the large and growing projected deficits are some of the pre-existing expansionary measures. This is also evidenced by the sizeable structural deficit in 2019. The measures notably include expenditure on old-age pensions which are set to rise considerably, driven by the full-year effect of a 15% pension increase that came into effect with the new 2019 pension law in September 2019 and a further increase of 40% from September 2020. Consequently, expenditure on old-age pensions is projected by the Commission to increase by 1.9 pps. of GDP in 2020. Pension increases alone will also contribute to a deterioration in the budget deficit by 2.2 pps. of GDP in 2021 and a further 1.1 pps. of GDP in 2022. There has been also a law doubling the child allowance as of February 2020, with an annualised budgetary cost of 0.6% of GDP. In both cases, the legislators did not provide for a source of financing of the measures. The Government has tried to mitigate the impact of both legislations, but the Parliament rejected the Government

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[2] Recommendation for a Council Recommendation with a view to bringing an end to the situation of an excessive government deficit in Romania (COM/2020/91 final).

[3] Council Recommendation of 3 April 2020 with a view to bringing an end to the situation of an excessive government deficit in Romania (OJ C 116, 8.4.2020).

[4] Pursuant to Regulation (EC) No 479/2009 as amended by Council Regulation (EU) No 679/2010 and by Commission Regulation (EU) No 220/2014, Member States have to report to the Commission, twice a year, their planned and actual Government deficit and debt levels. The most recent notification of Romania can be found at: https://ec.europa.eu/eurostat/web/government-finance-statistics/excessive-deficit-procedure/edp-notification-tables

proposals and the Government has challenged the parliamentary decisions at the Constitutional Court. In the case of pensions the Court has not yet published its decision and in the case of child allowance it has ruled against the Government's proposal. The Commission 2020 autumn forecast, in line with the standard no-policy-change assumption, takes account of the parliamentary vote. For 2020 and for 2021 onwards, therefore, it incorporates the increases mandated by the pension law currently in force.

On the revenue side, the authorities enacted in December 2019 some tax changes, including the reduction of excise duties on fuel and a lowering of social security contributions on part-time workers with an overall estimated revenue loss of 0.3% of GDP in 2020. Tax revenues are also set to be negatively affected by the adverse macroeconomic outlook and some tax incentives as part of the COVID-19 support measures (0.1% of GDP).

The forecast does not include any expenditure related to the RRF[5], as the Government has not yet indicated expenditure to be financed under the RRF in 2021. The evolution of the deficit in 2021 could also turn out to be more favourable than forecast as a result of higher economic growth from the swift implementation of measures financed by the RRF.

In November 2020 the Government adopted the third amendment for the 2020 budget. The new budget revised the growth projection from -3.8% to -4.2% and the general Government deficit in cash terms from 8.6% of GDP to 9.1% of GDP in 2020. The deterioration of deficit projections are mainly due to lower expected revenues than estimated in August (previous budget amendment). Budget execution up to October 2020 confirms the sharp deterioration of general government balance, which in the ten months of the year has reached more than 7% of GDP.

In order to assess medium-term sustainability risks, the Commission has conducted an ad-hoc debt sustainability assessment based on its standard approach. Due to a high primary deficit and relatively high interest rates compared to other sovereigns, the debt-to-GDP ratio is set on a steep upward path. Under a no-policy-change scenario, debt is projected by the Commission to exceed 60% in 2022 and go beyond 100% of GDP in 2027, remaining above that level until the end of the projection period in 2031.[6] Based on the Commission's assessment, overall risks to debt sustainability appear high over the medium term.[7] This risk level indicates that there are significant fiscal vulnerabilities that need to be addressed by appropriate policy measures. If the lower increases in pensions and child allowance proposed by the Government for 2020 were adopted, this would mitigate expenditure in the short term but would not fundamentally affect the longer term risks to debt sustainability in the absence of further measures for 2021 and beyond. This risk assessment will be updated and further complemented, when the Commission reassesses Romania's budgetary situation in spring 2021.

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[5] The treatment of the Recovery and Resilience Facility (RRF) in the Commission's 2020 autumn forecast is explained in detail in Box I.4.3 of the European Commission's Economic Forecast Autumn 2020 (https://ec.europa.eu/info/sites/info/files/economy-finance/ip136_en.pdf).

[6] In this scenario, it is assumed that the structural primary balance would be progressively adjusted over the projection period to converge back to its pre-crisis forecasted level (i.e. the level forecasted by the Commission services in the autumn forecast 2019 for the year 2021), hence presupposing a progressive unwinding of the extraordinary negative impact of the COVID-19 crisis on public finances. Other assumptions are in line with the Commission standard DSA approach (see Debt Sustainability Monitor 2019).

[7] This assessment includes the consideration of additional stress test scenarios, as defined in the Commission standard DSA approach (see Debt Sustainability Monitor 2019).