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REPORT FROM THE COMMISSION TO THE COUNCIL

Commission report to the Council pursuant to Article -11(2) of Regulation (EC) No 1466/97 on the enhanced surveillance mission in Romania, of 27-28 September 2018

This report on an enhanced surveillance mission to Romania is transmitted to the Council pursuant to Article -11(4) of Regulation (EC) No 1466/97¹. As foreseen by Article -11(5) of Regulation (EC) No 1466/97, the provisional findings of that mission have been previously transmitted to Romanian authorities for comments.

Romania – Significant Deviation Procedure enhanced surveillance mission, 27-28 September 2018

Report

1. Introduction

Romania has been under significant deviation procedures since spring 2017. Romania was the first Member State subject to a significant deviation procedure (SDP). The first SDP was launched in spring 2017 as a consequence of Romania's observed significant deviation from its medium-term budgetary objective (MTO) in 2016, when the structural deficit increased to 2.1% of GDP, from 0.2% in 2015. In June 2017 the Council issued a recommendation asking Romania for a structural adjustment of 0.5% of GDP in 2017, the standard matrix-based requirement in "normal times". In December 2017, the Council decided that Romania had not taken effective action in response to its recommendation of June 2017, with efforts solely focused on avoiding breaching the 3% of GDP headline deficit reference value. In December 2017 the Council issued a second SDP recommendation in which it asked for a structural adjustment of 0.8% of GDP in 2018. In June 2018 the Council again decided that Romania had not taken effective action in response to its recommendation of December 2017. Regulation (EC) No 1466/97 does not foresee a repeated revised recommendation under a single SDP. Therefore, as in December 2017, in June 2018 the SDP expired with another Council decision establishing non-effective action.

As a consequence of Romania's significant deviation from the adjustment path to its medium-term budgetary objective in 2017, a new SDP has been launched in spring 2018. On 23 May 2018, the Commission issued a warning to Romania and recommended to the Council to launch a new SDP. In its recommendation, approved on 22 June 2018, the Council asked Romania to take the necessary measures to ensure that the nominal growth rate of net primary government expenditure does not exceed 3.3% in 2018 and 5.1 % in 2019. They correspond to an annual structural adjustment of 0.8 % of GDP in each year, above the standard matrix-based requirement of 0.5% of GDP for both years. In its 2018 fiscal Country Specific Recommendation the Council directly referred to that new SDP recommendation. Romania has reported to the Council on action taken in response to the SDP recommendation on 16 October 2018. The assessment of action taken by Romania was adopted by the Commission on 21 November 2018.

¹ Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies, OJ L 209, 2.8.1997, p. 1

This report presents Commission's findings from the enhanced surveillance mission to Romania that took place on 27 and 28 September 2018. The mission was carried out on the basis of Article -11(2) of Regulation (EC) 1466/97. It met the Minister of Finance, Mr. Eugen Teodorovici, the Deputy-Governor of the National Bank of Romania, Mr. Liviu Voinea, members of the Senate's and Chamber of Deputies' committees on budget and fiscal policy, and the head of the Fiscal Council of Romania, Mr Ionut Dumitru. As with previous similar missions, the aim was to discuss the fiscal actions planned by the authorities, stress the existence of fiscal risks, and encourage compliance with the SDP recommendation. This report is based on information obtained until and during the mission.

2. Findings of the mission

The Romanian authorities maintain the 2018 headline deficit target of just below 3% of GDP and thus do not intend to act upon the SDP recommendation. The 2018 budget amendment ("rectification"), published 3 September 2018, maintains the original 2018 target of a headline deficit of 2.97% of GDP in cash, which translates into 2.96% in ESA (accrual) terms, slightly higher than the 2017 deficit outturn. However, the general government cash deficit for January-August 2018 amounted to around 1.5% of GDP, more than double that from the equivalent period of 2017, which was itself already above the execution in previous years. The Minister of Finance confirmed the official 2018 budgetary targets. He explained that the main new measure being considered for 2018 is a reclassification of public investment already concluded under the National Plan for Local Development (investments by local authorities which are financed by the central government). The objective is that these investments would obtain co-financing from European Union funds, thus increasing government revenues. The Minister expected to discuss that plan with the relevant Commission services. The Minister added that he also hoped to receive Union reimbursement of swine flu related expenditures from Union animal health funds as well as of emergency spending on this year's floods from the Union Solidarity Fund. The authorities are also considering a tax amnesty. According to the Minister, those measures might allow to reduce the deficit targeted for 2018. The mission stressed that the report on action taken, due by 15 October 2018, must contain details and quantification of the planned measures.

The government plans to lower the headline deficit in 2019 relative to 2018, but the measures remain to be specified. The Minister of Finance confirmed that the government's fiscal targets for 2019 were a headline deficit of 2.58% in cash and 2.38% in ESA (accrual) terms, the same as specified in the 2018 Convergence Programme. The draft 2019 budget, to be adopted by the government in mid- to end-November, will contain the details on how to achieve those targets. The Minister is considering further cuts to VAT and excise duties, namely a lowering of the VAT rate for restaurants and hotels and a reversal of the past increase of excise duties on fuel. The Minister believes that, thanks to the second-round effects, those indirect tax cuts would not have a significant impact on government deficit. He argued that this was the case of the VAT rate reduction from 24% to 9% for agro-food products in mid-2015.

A draft pension law poses a significant upward risk to the fiscal deficit in 2020 and beyond. The draft law has been recently published for consultation by the Ministry of Labour. It specifies the timetable of the increases of the pension point (the main parameter used for pension indexation), starting in 2019, thus implementing the government's programme. The draft law would also revise upwards the other pension parameters from 2021. As a result, according to the government's own calculations, public expenditure on old-age pensions would more than double in 2022 (to around 13.4% of GDP in 2022 compared to 6.8% of GDP in 2018).

The mission exchanged views with the National Bank of Romania (NBR) on the fiscal, macroeconomic and financial situation. The NBR Board works under the assumption that the public deficit would not increase above 3% of GDP in 2018. The Deputy-Governor also pointed out that consumer inflation reached its peak in May-June, earlier than expected, and was projected by the NBR to fall to 3.5% in 2019 and 3.0% in 2020, i.e. within the inflation target. He also stressed that the financial sector in Romania was much stronger than ten years ago.

The mission exchanged views on the fiscal policy with members of the parliament's committees on budget and fiscal policy. The chair of the joint committees explained that the fiscal expansion since 2015 was aimed at spurring economic growth, which was successful given that Romania was among the fastest-growing economies in the Union. He added that the government's priority was to reverse and prevent further outflow of skilled workers, by increasing wages in the health and education sectors. On the other hand, the chair shared the Commission's concern regarding the fall of public investment in recent years. The mission replied that the Commission shared those goals but disagreed on the methods. The mission expressed concern at the pace of the fiscal expansion and pointed out that those goals could be achieved by improving the efficiency of public spending. A representative of the opposition expressed similar concerns.

The Fiscal Council expressed its concern at the fiscal outlook. According to the Fiscal Council, there are significant risks of exceeding the headline deficit target and thus the 3% of GDP Treaty threshold in 2018 in the absence of countervailing fiscal measures. The Fiscal Council's opinion on the draft budget September revision, which is public, stresses that the 2018 deficit may exceed the 2.97% headline deficit target by RON 6 billion (0.6% of GDP). The Fiscal Council is also concerned about the structure of public spending. Current expenditures, in particular personnel spending, have been rapidly expanding at the cost of public investment, which fell in 2017 to a post-accession low as a share of GDP. That spending structure raises concerns as to its impact on long-term growth. Moreover, increases to public wages and to old-age pensions are politically difficult to reverse.