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REPORT FROM THE COMMISSION TO THE COUNCIL

**Commission report to the Council pursuant to article 11(2) of regulation EC 1466/97 on
the enhanced surveillance mission in Romania**

This report on an enhanced surveillance mission in 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 Romania for comments.

Romania – Significant Deviation Procedure Enhanced surveillance mission, 26-27 September 2017

Report

1. Introduction

As a consequence of the significant deviation from its medium-term budgetary objective (MTO) in 2016, a Significant Deviation Procedure (SDP) was launched for Romania in spring 2017. The Member State's structural deficit increased to 2.5% of GDP in 2016, from below 1% in 2015, due to significant cuts in indirect taxes and increases in public sector wages. As a consequence, on 22 May 2017, the Commission issued a warning to Romania and proposed to the Council to launch a SDP. In its SDP recommendation, approved on 16 June 2017, the Council asked Romania to take measures to ensure that the nominal growth rate of net primary government expenditure does not exceed 3.3% in 2017. This corresponds to an annual structural adjustment of 0.5% of GDP, which is the minimum effort required under the preventive arm of the Stability and Growth Pact (SGP). It translates into a need for corrective measures equivalent to 1.8% of GDP in 2017, as compared to the baseline from the Commission's spring 2017 economic forecast. Romania has reported to the Council as asked on the action taken in response to the Council recommendation by 15 October 2017. The Commission is now assessing the content of Romania's submission.

The enhanced surveillance mission by the Commission took place on 26-27 September 2017. The mission was carried out on the basis of Article -11(2) of Regulation (EC) 1466/97. The mission met the Minister of Finance Ionuț Mișa, the governor of the National Bank of Romania Mugur Isărescu, members of the Fiscal Council of Romania and members of the budgetary committees of the Romanian Parliament. The aim of the mission was to learn in detail about the fiscal actions planned by the Romanian authorities, to increase the visibility of the fiscal risks and to encourage compliance with the SGP. The mission also assessed fiscal developments and budget execution in 2017.

2. Findings of the mission

It was understood that the Romanian authorities do not intend to act upon the SDP recommendation. The Minister of Finance confirmed that the target for 2017 remains the headline deficit of 3% of GDP, while a structural adjustment in 2017 is not a priority. In the 2017 budget rectification, adopted by the government in mid-September 2017, the headline deficit target has been kept at 2.96% of GDP, while the underlying macroeconomic projection

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

improved. This indicates a deterioration of the underlying structural deficit as compared to the original 2017 budget, which already planned an expansionary fiscal stance. The Minister of Finance argued that the SDP recommendation came late in the year, leaving limited scope to implement the recommended structural adjustment.

The recently adopted 2017 budget rectification also raises concerns as to the quality of public finances. The main elements of the budget rectification are: (i) an upward revision of GDP growth from 5.2% to 5.6%; (ii) the public deficit (cash) target to be kept at 2.96% of GDP; (iii) tax revenues revised downwards (driven by a downward revision of VAT and corporate profit tax), (iv) social contributions and non-fiscal revenues (i.e. dividends from State-owned enterprises (SOEs)) revised upwards. The increase in dividends from SOEs is partially due to a new request for dividends from profits retained in previous years; (v) on the expenditure side, capital expenditures were reduced by roughly a quarter; (vi) while public sector wages and social benefits were increased. In terms of budget composition, Romania has adopted policies that increase consumption in the short term (indirect tax cuts, increases of public wages) and are difficult to reverse, rather than policies aimed at boosting long-term economic growth, such as improving the absorption of EU funds or increasing the quality of public investment.

The authorities aim to maintain a headline deficit of 3% of GDP in 2018. The Minister of Finance stated two objectives for 2018: a primary objective of maintaining a headline deficit of 3% of GDP, and, as a secondary objective, a reduction in the structural deficit by 0.5% of GDP. The mission observed that, given the positive and increasing output gap, keeping the headline deficit at 3% of GDP in 2018 would imply a deterioration in the structural fiscal position.

According to the Commission projections, following the usual no-policy change scenario, the headline deficit is likely to increase in 2018 to substantially above 3% of GDP, driven by further significant increases in public wages. In June 2017, the Romanian parliament approved the Unified Wage Law. That law seeks to harmonise the currently fragmented public sector wage grids and defines the salary for each public sector position. It defines the path to reach that goal and defines 2022 as the year for the full implementation of the new wage system. Wages will be increased by 25% for all government employees in January 2018, with annual increases of 25% of the difference between the January 2018 salary and the target 2022 salary thereafter. The health and education sectors will receive additional increases in 2018, on top of the general 25% increase of January 2018. As a consequence, based on the no-policy change scenario, the headline deficit is likely to increase significantly above 3% of GDP, possibly to somewhat above 4% of GDP (a more exact estimate will be obtained during the autumn forecast exercise). Therefore, to achieve the stated 2018 targets, let alone to comply with the preventive arm of the SGP, the authorities need to adopt further measures.

The authorities plan to shift social contributions entirely onto employees, in order to cushion the fiscal impact of the Unified Wage Law. The intention is to increase the social contributions rate paid by employees on their gross wages. The government plans to accompany that shift with a cut of the overall social contributions rate, from the current

22.75% for employers and 16.5% for employees to 36% for employees, and to cut the Personal Income Tax rate from 16% to either 12% or 10%. The government is also seeking a legal solution that would ensure that private sector employers increase the gross wages of their employees so that their net wages do not bear the cost of the social contributions shift.

The government is also considering a reversal of the 2008 pension reform, which introduced the second pension pillar. The authorities are considering a reduction of the transfer of social contributions to the second pension pillar, which under European System of Accounts (ESA) rules is classified outside of general government. Those transfers amount to around 0.8% of GDP annually. Such a measure would decrease the fiscal deficit in the short term. However, that fiscal gain would dissipate in the long term as the social contributions diverted from the second pillar would be accompanied by an obligation to pay old-age pensions in the future. In addition, such a reversal could have negative implications for the viability of the pensions system and for the development of capital markets. The mission cautioned against enacting such profound changes to the pension system in a hasty way, without proper analysis and only for short-term, deficit-reducing reasons. Nationalisation of the assets accumulated in the second pillar, which under ESA rules would not affect the government deficit, does not seem to be considered at this point.

The mission also discussed the recently adopted split VAT payment mechanism. At the end of August 2017 the government adopted an emergency ordinance amending the Fiscal Code. The ordinance, aimed at improving tax compliance, obliges all VAT payers to use separate accounts for VAT purposes from January 2018. The mission stressed that such an obligatory mechanism may require a prior derogation from the VAT Directive². The Ministry of Finance disputed the need for a derogation and argued that the Commission does not have accurate information about that measure.

The National Bank of Romania confirmed the pro-cyclical fiscal policy, contributing to the Commission's concerns regarding the current policy-mix. Romania is in the middle of a large economic upswing, which is the ideal time to rebuild fiscal buffers for an eventual downturn. However, the fiscal position of Romania has been highly expansionary. From this perspective, Romania's fiscal policy appears imprudent and strongly conditions monetary policy.

The mission exchanged views with members of the Romanian parliament's committees on budget and fiscal policy. Members from both the ruling coalition and the opposition shared concerns regarding the composition of the budget, in particular regarding public investment cuts, and their impact on long-term growth. The chair of the joint committees seemed to consider there was a need to change the direction of fiscal policy and start a structural adjustment in 2018.

The Fiscal Council shared the Commission's concerns regarding the fiscal outlook. According to the Fiscal Council, the structural deficit will substantially deteriorate in 2018 and the headline deficit is projected to breach the 3% of GDP threshold in the absence of countervailing fiscal measures.

² Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax, OJ L 347, 11.12.2006, p. 1.

STATISTICAL ANNEX

(Forecast data based on the European Commission 2017 spring forecast) ³

Table 1: Key economic indicators overview 2009-2018

	2009	2010	2011	2012	2013	2014	2015	2016	2017*	2018*
Gross Domestic Product	<i>(annual percentage change, unless otherwise indicated)</i>									
Nominal GDP (in bn RON)	511	534	565	595	637	668	711	761	806	860
Real GDP	-7.1	-0.8	1.1	0.6	3.5	3.1	3.9	4.8	4.3	3.7
Private Consumption	-10.1	1.0	0.8	1.2	0.7	4.7	6.0	7.4	7.5	5.6
Public Consumption	3.7	-4.9	0.6	0.4	-4.6	0.8	0.1	4.5	3.7	3.0
Gross fixed capital formation	-36.6	-2.4	2.9	0.1	-5.4	3.2	8.3	-3.3	0.7	3.2
Exports	-5.3	15.2	11.9	1.0	19.7	8.0	5.4	8.3	6.9	6.2
Imports	-20.7	12.6	10.2	-1.8	8.8	8.7	9.2	9.8	9.3	8.1
Contribution to GDP growth										
Domestic demand	-19.9	-0.9	1.4	0.9	-1.7	3.8	5.7	4.4	5.3	4.7
Inventories	5.9	0.2	-0.2	-1.4	1.6	-0.3	-0.2	1.1	0.3	0.0
Net exports	6.9	-0.1	-0.1	1.1	3.6	-0.3	-1.6	-0.7	-0.5	-0.3
Prices										
HICP inflation (average)	5.6	6.1	5.8	3.4	3.2	1.4	-0.4	-1.1	1.1	3.0
HICP inflation (year-end, quarterly)	4.5	7.8	3.4	4.7	1.3	1.4	-1.0	-0.1	2.0	3.0
Labour market										
Total employment	9181	9156	9082	8645	8569	8635	8558	8481	8543	8573
Unemployment rate (harmonised:15-74)	6.5	7.0	7.2	6.8	7.1	6.8	6.8	5.9	5.4	5.3
General Government Accounts	<i>(in percent of GDP)</i>									
Government deficit, cash definition **	-7.1	-6.3	-4.2	-2.5	-2.5	-1.7	-1.4	-2.4	-3.0	-3.0
Government deficit, ESA2010 definition	-9.5	-6.9	-5.4	-3.7	-2.1	-1.4	-0.8	-3.0	-3.5	-3.7
Gross debt, general government, ESA2010 definition	23.2	29.9	34.2	37.3	37.8	39.4	38.0	37.6	39.3	40.9
Balance of payments	<i>(in percent of GDP)</i>									
Current account balance ***	-4.1	-4.5	-4.4	-4.2	-0.6	-0.1	-0.6	-2.4	-2.8	-2.9
Trade balance***	-6.4	-6.1	-5.6	-5.0	-0.8	-0.4	-0.6	-0.9	-1.9	-2.3
Capital and financial account balance	-3.9	-4.2	-3.0	-1.1	3.3	4.7	3.9	3.4	n.a.	n.a.
FDI balance	-2.8	-1.8	-1.3	-1.9	-2.0	-1.8	-1.8	-2.7	n.a.	n.a.
Net international investment position	-62.1	-62.3	-64.2	-67.9	-61.6	-56.8	-53.8	-49.4	-47.8	n.a.
Foreign exchange reserves (in bn Euro)	28.3	32.4	33.2	31.2	32.5	32.2	32.2	34.2	35.2	n.a.
Gross external debt	67.4	72.9	74.1	75.5	68.0	63.0	57.5	54.8	53.2	n.a.
Monetary and exchange rate developments										
Broad money M3 (annual % change, end of the period)	9.0	6.9	6.6	2.7	8.8	8.4	9.3	9.7	11.7	n.a.
NBR policy rate (in %, end of period)	8.00	6.25	6.00	5.25	4.00	2.75	1.75	1.75	1.75	n.a.
Exchange rate (lei/euro, end of period)	4.23	4.28	4.32	4.43	4.48	4.48	4.52	4.54	4.60	n.a.
REER (Unit Labour Costs deflator, % change)	-13.03	0.99	-6.54	-5.14	0.86	3.43	-6.45	1.12	n.a.	n.a.

Notes:

* Forecasts or latest values

** 2017 and 2018 are projections from the Romanian authorities.

*** Current account and trade balances are reported based on the latest Commission forecast using National Accounts Data.

Source: BNR and European Commission

³ The Commission forecast will be updated in November 2017.

Table 2: General government accounts 2015-2018

	ESA code	2015	2016	2017*	2018*
1. Taxes on production and imports	D2	13.3	11.3	10.5	10.5
2. Current taxes on income and wealth	D5	6.6	6.5	6.4	6.6
2a. - of which, paid by households and NPISH		3.6	3.6	3.5	3.5
2b. - of which, paid by corporations		3.0	2.9	2.9	3.0
3. Social contributions	D61	8.1	8.1	8.5	8.4
4. Sales and other current revenue		4.4	4.3	3.7	3.9
5. Total current revenue (1+2+3+4)		32.4	30.2	29.1	29.4
6. Compensation of employees	D1	7.7	8.2	8.7	8.7
7. Intermediate consumption	P2	5.7	5.3	5.2	5.2
8. Social transfers in kind supplied via market producers		0.9	0.9	0.9	0.9
9. Social transfers other than in kind	D62	10.6	10.7	11.1	11.3
10. Interest	D41	1.6	1.5	1.6	1.6
11. Subsidies	D3	0.5	0.4	0.4	0.4
12. Other current expenditure		2.5	2.5	1.9	2.2
13. Total current expenditure (6+7+8+9+10+11+12)		29.4	29.5	29.7	30.3
14. Gross saving (5-13)	B8g	2.9	0.7	-0.6	-0.9
15. Capital Transfers, received	D9	2.7	1.5	1.6	2.1
16. Gross fixed capital formation	P51	5.2	3.6	3.5	3.9
17. Other capital expenditure		1.2	1.6	1.0	1.0
18. Total government revenue (5+15)	TR	35.0	31.7	30.6	31.5
19. Total government expenditure (13+16+17)	TE	35.8	34.7	34.1	35.2
20. Net lending (+) / net borrowing (-) (18-19)	EDP B9	-0.8	-3.0	-3.5	-3.7

Note:

* European Commission spring 2017 forecast

Source: European commission

Table 3: General government balance cyclical adjustment

	2009	2010	2011	2012	2013	2014	2015	2016	2017*	2018*
Government balance (ESA-2010)	-9.5	-6.9	-5.4	-3.7	-2.1	-1.4	-0.8	-3.0	-3.5	-3.7
Primary balance	-8.0	-5.4	-3.8	-1.9	-0.3	0.3	0.9	-1.5	-2.0	-2.0
Cyclically adjusted balance	-8.8	-5.5	-4.1	-2.0	-1.0	-0.5	-0.3	-3.0	-3.8	-3.9
Cyclically adjusted primary balance	-7.3	-4.0	-2.5	-0.2	0.8	1.1	1.3	-1.5	-2.2	-2.3
Structural government balance		-5.6	-2.9	-2.5	-1.0	-0.6	-0.6	-2.6	-3.9	-4.0
GDP growth	-7.1	-0.8	1.1	0.6	3.5	3.1	3.9	4.8	4.3	3.7
Potential growth	1.9	1.3	1.1	1.8	1.7	2.1	2.8	3.5	3.5	3.6
Output gap	-2.0	-4.0	-4.0	-5.0	-3.3	-2.4	-1.3	-0.1	0.7	0.8

Note:

* European Commission spring 2017 forecast

Source: European commission