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COMMISSION STAFF WORKING DOCUMENT
Accompanying the document

Recommendation for a

COUNCIL RECOMMENDATION

**with a view to correcting the significant observed deviation from the adjustment path
toward the medium-term budgetary objective**

in Romania

{COM(2017) 802 final}

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1. INTRODUCTION

Since 2013 Romania has been subject to the preventive arm of the Stability and Growth Pact, which requires sufficient progress towards the medium-term budgetary objective (MTO). Romania is not subject to the debt rule as its general government debt remains below 60% of GDP.

On 16 June 2017 the Council decided in accordance with Article 121(4) of the Treaty on the Functioning of the European Union ("TFEU") that a significant observed deviation from the MTO occurred in Romania in 2016. In view of the established significant deviation, the Council on 16 June 2017 issued a recommendation for Romania to take the necessary measures to ensure that the nominal growth rate of net primary government expenditure¹ does not exceed 3.3% in 2017, corresponding to an annual structural adjustment of 0.5% of GDP². It recommended Romania to use any windfall gains for deficit reduction, while budgetary consolidation measures should ensure a lasting improvement in the general government structural balance in a growth-friendly manner. The Council established a deadline of 15 October 2017 for Romania to report on action taken in response to the recommendation. Romanian authorities delivered their report on action taken in response to Council Recommendation of 16 June 2017 (hereafter: "the report") within this deadline. Moreover, on 26 and 27 September 2017 the Commission undertook an enhanced surveillance mission in Romania for the purpose of on-site monitoring under the Article -11(2) of Council Regulation (EC) No 1466/97 and subsequently reported to the Council on 24 October 2017 and made its findings public.

Section 2 of this document presents macroeconomic developments and outlook in 2017-18. Sections 3 and 4 present fiscal developments in 2017 and updated budgetary projections for 2018 respectively. Section 5 assesses compliance with the Council Recommendation of 16 June 2017 in 2017, while Section 6 proposes an adjustment path for 2018. Section 7 concludes.

¹ Net government expenditure is comprised of total government expenditure excluding interest expenditure, expenditure on Union programmes fully matched by Union funds revenue and non-discretionary changes in unemployment benefit expenditure. Nationally financed gross fixed capital formation is smoothed over a four-year period. Discretionary revenue measures or revenue increases mandated by law are factored in. One-off measures on both the revenue and expenditure sides are netted out.

² Council Recommendation of 16 June 2017 with a view to correcting the significant observed deviation from the adjustment path toward the medium-term budgetary objective in Romania (OJ C 216, 6.7.2017, p. 1).

2. MACROECONOMIC DEVELOPMENTS AND OUTLOOK 2017-2018

Following 4.8 % in 2016, real GDP growth is projected to reach 5.7 % in 2017, a new post-crisis peak. Private consumption has been the main contributor to growth in 2017, supported by wage hikes both in the public and the private sectors, indirect tax cuts, and low rates of inflation. Investment remained subdued as a recovery in private investment, driven mainly by housing construction, could only partially compensate for a sharp drop in public investment. The booming private consumption also drove an acceleration of imports in 2017. As a consequence, net exports worked as a drag on real GDP growth, despite relatively strong export growth.

Looking ahead, private consumption is forecast to decelerate in 2018, as wage growth slows down and higher rates of inflation increasingly weigh on real disposable income, but is expected to remain the main driver of growth. The projected strengthening of public investment on the back of a pick-up in the implementation of projects financed by EU funds is expected to only partially compensate for the deceleration of private consumption. Thus, real GDP growth is projected by the Commission to somewhat slow down to 4.4% in 2018.

The Commission growth forecast for 2017 and 2018 has been revised upwards compared to the spring 2017 forecast. This mainly reflects the stronger than projected GDP growth in the first half of 2017, when real GDP increased by 5.8% y-o-y.

Table 1. Comparison of macroeconomic developments and forecasts

	2016	2017			2018		
		CP	PR	COM	CP	PR	COM
Real GDP (% change)	4.6	5.2	6.1	5.7	5.5	5.5	4.4
Private consumption (% change)	7.4	7.3	8.8	8.6	6.4	6.5	4.8
Gross fixed capital formation (% change)	-3.5	6.9	2.0	1.6	7.9	7.9	6.5
Exports of goods and services (% change)	8.3	6.8	9.6	8.3	6.3	6.5	7.3
Imports of goods and services (% change)	9.8	8.5	10.8	9.9	7.9	7.9	8.1
<i>Contributions to real GDP growth:</i>							
- Final domestic demand	4.4	6.3	6.3	6.1	6.2	6.2	4.9
- Change in inventories	0.9	-0.3	0.4	0.3	0.0	0.0	0.0
- Net exports	-0.7	-0.8	-0.6	-0.8	-0.7	-0.6	-0.5
Output gap ¹	n.a.	-0.1	n.a.	0.7	0.4	n.a.	1.1
Employment (% change)	-0.9	0.7	n.a.	0.7	0.9	n.a.	0.4
Unemployment rate (%)	5.9	5.7	5.0	5.3	5.5	4.8	5.1
Labour productivity (% change)	5.5	4.4	n.a.	4.9	4.5	n.a.	4.0
HICP inflation (%)	-1.1	1.2	n.a.	1.0	2.5	n.a.	2.9
GDP deflator (% change)	2.2	2.0	4.2	2.0	2.1	2.1	3.2
Comp. of employees (per head, % change)	10.9	5.8	n.a.	13.2	5.9	n.a.	10.9
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	-1.3	0.4	n.a.	-1.6	0.8	n.a.	-1.5
Note:							
¹ In percent of potential GDP, with potential GDP growth recalculated by Commission services on the basis of the programme scenario using the commonly agreed methodology.							
Sources:							
Convergence Programme 2017 (CP), Romanian Prognosis Commission's autumn forecast (PR), European Commission 2017 autumn forecast (COM)							

3. GENERAL GOVERNMENT DEFICIT DEVELOPMENTS IN 2017

On 26 and 27 September 2017 the Commission undertook an enhanced surveillance mission in Romania for the purpose of on-site monitoring under the Article -11(2) of Council Regulation (EC) No 1466/97. After having transmitted its provisional findings to the Romanian authorities for comments, the Commission reported its findings to the Council on 24 October 2017 and made its findings public. The Commission report finds that the Romanian authorities do not intend to act upon the Council Recommendation of 16 June 2017. The authorities stated that their target for 2017 remains a headline deficit of 3% of GDP. Given the positive and increasing output gap this would amount to a deterioration of the structural deficit in 2017, contrary to the Council Recommendation.

In their report on action taken, the authorities maintain the general government deficit target from the 2017 Convergence programme of 2.96% of GDP in 2017, close to the outturn in 2016. The report does not contain projections of individual budgetary items or categories. The authorities provide a list of taken or planned discretionary measures, without providing their

estimated impact. Moreover, the list only includes measures with a positive impact on the budget. Adopted or announced measures which will reduce revenues or increase expenditures were not included. The table below (Table 2) presents only measures listed in the report with a significant budgetary impact (defined as impact above 0.1% of GDP) in either 2017 or 2018. The estimates of the fiscal impact in the table come from the subsequent exchanges with the authorities, following the reception of the report. Based on these estimates, the only measure listed in the report with a significant budgetary impact in 2017 is an increase of excise duties for energy products back to their 2016 level (i.e. a reversal of a previously adopted excise duties cut which entered into force in January 2017).

Table 2. Discretionary fiscal measures listed in the report

		2017	2018
Revenues	Autumn forecast 2017	Impact on revenue (% GDP)	
Increasing excise duties for energy products back to their 2016 level as of October 2017 (i.e. reversing a previous cut which entered into force in January 2017)	Yes	+0.1%	+0.3%
Payment of social contributions at the level of the minimum wage for part time employees earning less than the minimum wage	Yes		+0.1%
Increasing the taxation base for companies for unemployed persons with disabilities from September 2017	Yes		+0.1%
Making the contributions to the second pension pillar optional (no date nor details of the opt-out specified)	No		+0.4%
Introducing a split-payment system in VAT, optional from October 2017 and obligatory from January 2018	No		+0.5%
Expenditures		Impact on expenditure (% GDP)	
Limiting the indexation of special pensions to inflation rate	Yes		-0.2%
<u>Note:</u> The budgetary impact in the table as estimated by the national authorities. A positive sign implies that revenue / expenditure increases as a consequence of this measure.			

Table 3. Discretionary revenue measures included in the Commission autumn 2017 forecast (fiscal impact in % of GDP)

Title	2017	2018
Removal of 5 average wages cap from the tax base for social contributions	+0.1%	
Increase of dividends from SOEs from 50% to 90% of profits	+0.1%	
Increasing excise duties for energy products back to their 2016 level as of October 2017 (i.e. reversing a previous cut which entered into force in January 2017)	+0.1%	+0.3%
Payment of social contributions at the level of the minimum wage for part time employees earning less than the minimum wage		+0.1%
Exemption of pensions income from health contributions	-0.1%	
Abolishment of special constructions tax	-0.1%	
PIT: increase of tax-free threshold for pension income	-0.1%	
Tax on microenterprises: rate cut, base up	-0.2%	
Standard VAT rate cut from 20% to 19%	-0.3%	
Cut of excise duties for energy products	-0.4%	
Social contributions shift on the employees		0.9%
PIT rate cut from 16% to 10%		-1.5%
<p>Note:</p> <p>The budgetary impact in the table as included in the Commission Autumn 2017 forecast. A positive sign implies that revenue increases as a consequence of this measure. The table includes measures with a fiscal impact of at least 0.1% of GDP.</p>		

Based on the Commission autumn 2017 forecast, which takes into account the measures described in the report from the authorities to the extent they are already enacted or credibly announced in sufficient detail, as well as information from all available sources, the general government deficit is projected to remain at 3% of GDP in 2017.

Tax cuts, which entered into force at the beginning of the year (in particular a cut of the standard VAT rate by 1 percentage point and cut of excise duties on fuel) have reduced tax revenues. Their impact was partially mitigated by a reversal of the excise duties cut from October 2017, leading to an overall fall of indirect tax revenues relative to GDP by 0.8 percentage points compared to 2016.

On the expenditure side, public wages and social benefits were considerably increased as compared to 2016 (by 1.0 and 0.4 percentage points relative to GDP, respectively). At the same time, public investment was cut significantly in the September's budget rectification raising further concerns regarding the composition of public expenditure, leading to an overall fall by 0.6 percentage points relative to GDP compared to 2016. Since the output gap has turned positive in 2017 a general government deficit that remains at 3% of GDP implies a

further deterioration of the structural deficit in 2017 as opposed to the required reduction of 0.5% of GDP. This reflects a clearly expansionary fiscal policy. The composition of the budget and its adjustments in nominal and structural terms are presented in Table 3.

Table 4. Composition of the budgetary adjustment

(% of GDP)	2016	2017		2018	
		CP	COM	CP	COM
Revenue, of which:	31.0	32.2	30.8	32.3	31.7
- Taxes on production and imports	11.3	11.0	10.5	11.0	10.8
- Current taxes on income, wealth, etc.	6.5	6.6	6.2	6.8	5.0
- Social contributions	8.1	8.7	8.8	8.7	10.1
- Other (residual)	5.1	5.9	5.2	5.8	5.7
Expenditure, of which:	34.0	35.1	33.8	35.2	35.5
- Primary expenditure, of which:	32.5	33.7	32.3	33.7	34.0
Compensation of employees	8.2	8.4	9.2	8.3	10.1
Intermediate consumption	5.3	5.1	5.0	5.0	5.0
Social payments	10.7	11.7	11.1	12.0	11.1
Subsidies	0.4	0.4	0.4	0.5	0.4
Gross fixed capital formation	3.6	4.3	3.0	4.0	3.5
Other (residual)	4.2	3.8	3.7	3.9	3.9
- Interest expenditure	1.5	1.4	1.5	1.5	1.6
General government balance (GGB)	-3.0	-2.9	-3.0	-2.9	-3.9
Primary balance	-1.5	-1.6	-1.6	-1.4	-2.3
One-off and other temporary measures	-0.4	0.0	0.0	0.0	0.0
GGB excl. one-offs	-2.6	-2.9	-3.0	-2.9	-3.9
Output gap ¹	-1.2	-0.1	0.7	0.4	1.1
Cyclically-adjusted balance ¹	-2.6	-2.9	-3.3	-3.0	-4.3
Structural balance (SB)²	-2.2	-2.9	-3.3	-3.0	-4.3
Structural primary balance ²	-0.7	-1.5	-1.8	-1.5	-2.7
Notes:					
¹ 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.					
² Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary					
<i>Sources: Commission 2017 autumn forecast (COM), Convergence Programme 2017 (CP)</i>					

4. UPDATED BUDGETARY PROJECTIONS FOR 2018

In the report, the authorities repeat the general government deficit target from the 2017 Convergence Programme of 2.9% of GDP in 2018. The report does not contain a detailed fiscal forecast for 2018. For the measures listed in the report with a positive fiscal impact in 2018, please see Table 2 above.

According to the Commission autumn 2017 forecast, the general government deficit is set to increase to 3.9% of GDP in 2018. The main drivers of this deterioration are a projected

decrease of the revenues from income taxes and an increase of expenditures on compensation of public employees. The unified wage law, enacted in summer 2017, is set to increase all public wages by 25% in January 2018 and contains additional increases for doctors and teachers in March 2018. As a result, the expenditures on compensation of public employees are projected to increase by 0.9 percentage points relative to GDP. Moreover, the personal income tax (PIT) rate will be cut from 16% to 10% (with a fiscal impact of -1.5 percentage points of GDP). These measures are to be partially compensated by an announced shift of social security contributions from the current 22.75% for employers and 16.5% for employees to 2.25% (so-called solidarity contribution) and 35% respectively, which is set to have a positive impact of 0.9 percentage points of GDP on revenues from social security contributions. None of these measures are listed in the report. However, they were publicly announced by the authorities and thus taken into account in the Commission forecast. These changes to social contributions and to the PIT were subsequently enacted by an emergency ordinance amending the fiscal code, which was adopted by the government on 8 November. Therefore, the Romanian authorities are set to continue an expansionary fiscal policy in 2018.

In the report, the authorities state their intention to make the second pension pillar optional, although without giving the details of this opt-out. Due to the lack of sufficient information, this opt-out is not taken into account in the Commission's autumn 2017 forecast. After the closing date of the Commission forecast the government adopted an emergency ordinance cutting the rate of social contributions transferred to the second pension pillar from the current 5.1% to 3.7% in 2018, without reference to the mandatory character of the contribution to this pension pillar as in the report. Since the second pension pillar is classified outside the general government, such a cut would have a positive impact on the general government revenues and thus on the general government balance of around 0.2-0.3% of GDP in 2018.

5. COMPLIANCE WITH THE COUNCIL RECOMMENDATION FOR 2017

On 16 June 2017 the Council recommended Romania to take the necessary measures to ensure that the nominal growth rate of net primary government expenditure does not exceed 3.3% in 2017, corresponding to an annual structural adjustment of 0.5% of GDP.

In 2017, based on the Commission autumn 2017 forecast, the corresponding growth of government expenditure, net of discretionary revenue measures and one-offs amounted to 4.9%, well above the expenditure benchmark. The structural balance is set to deteriorate by 1.1 % of GDP, reaching a deficit of 3.3% in 2017, pointing to the opposite direction of the recommended structural improvement of 0.5% of GDP. This deterioration compared to 2016 was driven by cuts to indirect taxes (in particular to VAT and excise duties) which entered into force at the beginning of the year and increases to public wages and social benefits introduced through the year.

Since the Council Recommendation of 16 June, the increase of excise duties for energy products back to their 2016 level as well as a cut in public investment in September's budget rectification had a positive impact on the public deficit. Their effect was largely offset by increases to public wages contained in the budget rectification.

Table 5. Romania under the preventive arm of the SGP, as compared to the Council Recommendation of 16 June 2017

(% of GDP)	2016	2017
Initial position¹		
Medium-term objective (MTO)	-1.0	-1.0
Structural balance ² (COM)	-2.2	-3.3
Structural balance based on freezing (COM)	-2.5	-3.2
Position vis-a-vis the MTO³	At or above the MTO	Not at MTO
Structural balance pillar		
Required adjustment ⁴	0.0	0.5
Required adjustment corrected ⁵	-0.5	0.5
Change in structural balance ⁶	-2.1	-1.1
<i>One-year deviation from the required adjustment⁷</i>	-1.6	-1.6
<i>Two-year average deviation from the required adjustment⁷</i>	-0.6	-1.6
Expenditure benchmark pillar		
Applicable reference rate ⁸	4.5	1.0
<i>One-year deviation adjusted for one-offs⁹</i>	-2.0	-2.6
<i>Two-year average deviation adjusted for one-offs⁹</i>	-1.1	-2.3
<i>PER MEMORIAM: One-year deviation¹⁰</i>	-2.6	-2.3
<i>PER MEMORIAM: Two-year average deviation¹⁰</i>	-2.6	-2.5
Conclusion		
Conclusion over one year	Significant deviation	Significant deviation
Conclusion over two years	Significant deviation	Significant deviation
Notes		
<p>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.</p> <p>² Structural balance = cyclically-adjusted government balance excluding one-off measures.</p> <p>³ Based on the relevant structural balance at year t-1.</p> <p>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.).</p> <p>⁵ Required adjustment corrected for the clauses, the possible margin to the MTO and the allowed deviation in case of overachievers.</p> <p>⁶ Change in the structural balance compared to year t-1. Ex post assessment (for 2016) was carried out on the basis of Commission 2017 spring forecast.</p> <p>⁷ The difference of the change in the structural balance and the corrected required adjustment.</p> <p>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.</p> <p>⁹ 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.</p> <p>¹⁰ 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.</p>		
<i>Source: Commission 2017 autumn forecast, Commission calculations</i>		

6. PROPOSED ADJUSTMENT PATH FOR 2018

On 11 July 2017 the Council recommended Romania to pursue a substantial fiscal effort in line with the requirements of the preventive arm of the Stability and Growth Pact, in order to further adjust towards its medium-term budgetary objective of a structural deficit of 1 % of GDP. According to the commonly agreed adjustment matrix under the Stability and Growth Pact, that adjustment translated into a requirement of a nominal growth rate of net primary government expenditure not exceeding 4.3% in 2018. It would correspond to a structural adjustment of 0.5 % of GDP.

Based on the 2017 autumn forecast, Romania's structural balance in 2017 is estimated to be at -3.3% of GDP, away from its MTO of -1% of GDP. Romania will remain in normal economic times (as its projected output gap of 0.7% in 2017 and 1.2% in 2018 is between -1.5% and 1.5% of potential GDP). General government debt is set to remain below the 60% of GDP threshold. The required structural effort prescribed by Regulation (EC) No 1466/97 and the adjustment matrix³, which factors in the prevailing economic circumstances and possible sustainability concerns, amounts to 0.5% of GDP, in line with what was recommended by the Council on 11 July 2017.

Moreover, an additional effort necessary to bring Romania back on an appropriate consolidation path following the slippages in 2016 and 2017 can complement the minimum SGP-required adjustment. Romania's structural deficit is projected by the Commission to increase by 1.1% of GDP in 2017, while the Council Recommendation asked for a structural decrease of at least 0.5% of GDP. An additional effort of 0.3% of GDP seems appropriate given the magnitude of the observed significant deviation from the recommended adjustment path towards the MTO and it will accelerate adjustment back towards the MTO. The proposed adjustment would contribute to a strengthening of macroeconomic fundamentals. Given the current strong cyclical position of the economy, GDP growth would remain robust despite the fiscal correction, particularly if the adjustment is carried out in a growth friendly manner.

Based on the Commission forecast, the above-mentioned 0.8% of GDP structural adjustment target is consistent with a nominal growth rate of net primary government expenditure of 3.3% in 2018, compared to the growth rate of 5.8% projected by the Commission.

The structural improvement of 0.8% of GDP in 2018 translates into a need to adopt measures of a total yield of 1.8% of GDP in structural terms as compared to the current 2018 baseline from the Commission 2017 autumn forecast given projected further deterioration of the structural balance in 2018.

Additionally, Romania is projected to remain at the 3% of GDP deficit reference value of the Treaty in 2017 but is forecast to breach it by a significant margin in 2018 based on the Commission autumn 2017 forecast. The required structural adjustment of 0.8% of GDP compared to the projected outcome for 2017 would also ensure that Romania respects the 3% of GDP general government deficit threshold in 2018 with a margin, which is crucial in view of the existing risks and the forecast for significant breach in 2018.

³ “Commonly agreed position on Flexibility within the SGP”, formally endorsed by ECOFIN Council on 12 February 2016, available at: <http://data.consilium.europa.eu/doc/document/ST-14345-2015-INIT/en/pdf>

Table 6. Comparison of key indicators under unchanged policy and under the new recommended adjustment path

	Structural balance (% of GDP)		Nominal growth rate of net primary government expenditure	
	2017	2018	2017	2018
Autumn 2017 forecast	-3.3	-4.3	+4.9	+5.8
New recommended adjustment path	-3.3	-2.5	+4.9	+3.3

* approximated by transforming the structural deficit target into headline deficit using the 2018 output gap from the Commission autumn 2017 forecast

7. CONCLUSION

Romania has not delivered the recommended improvement in the structural balance nor has it contained the net primary government expenditure in 2017.

An improvement in Romania's structural balance by 0.8% of GDP in 2018 relative to the 2017 outturn would put Romania on an adjustment path towards the MTO. Such an improvement is consistent with the nominal growth rate of net primary government expenditure not exceeding 3.3% in 2018. This translates into a need to adopt measures of a total structural yield of 1.8% of GDP compared to the current 2018 baseline from the Commission 2017 autumn forecast. Such an adjustment also seems appropriate to ensure that Romania respects the 3% of GDP general government deficit threshold in 2018 with a margin.