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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

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1. INTRODUCTION

The Council abrogated its decision on the existence of an excessive deficit in Romania on 21 June 2013, on account of the correction of Romania's excessive deficit in 2012, which, based on the Commission 2013 spring forecast, appeared durable.

Since then 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 12 July 2016, the Council addressed recommendations to Romania in the context of the European Semester[1]. In particular, in the area of public finances the Council recommended Romania to limit the deviation from the MTO in 2016 and achieve an annual fiscal adjustment of 0.5% of GDP in 2017 unless the MTO is respected with a lower effort.

Based on the Commission 2017 spring forecast, Section 2 of this document presents macroeconomic and fiscal developments in 2016-17. Section 3 presents an assessment of compliance with the obligations stemming from the Stability and Growth Pact, including an overall assessment of the reasons for the deviation from the requirements of the preventive arm. Section 4 proposes a fiscal effort for 2017 to address the significant deviation, including a new applicable expenditure benchmark rate compatible with the suggested annual improvement in the structural balance. Section 5 provides the overall conclusions.

2. MACROECONOMIC AND FISCAL DEVELOPMENTS IN 2016

In 2016, real GDP growth rose to an eight-year high of 4.8%, driven mainly by consumption, which was boosted by expansionary fiscal policy and wage hikes. Investment, by contrast, contracted as public investment fell following a slow uptake of new projects financed by EU funds in the 2014-2020 programming period. The contribution of net exports to growth was negative, as imports outpaced exports on the back of strong consumption growth.

An additional, sizeable although smaller fiscal stimulus planned in 2017 is projected to continue to support domestic demand and growth, but at a slower pace as the transitory effects of the fiscal impulse of 2016 wear out. Growth is expected to remain consumption-driven, boosted by tax cuts and increases in public wages and pensions. Investment is forecast to make a modest contribution to growth as the implementation of projects financed from EU funds gradually picks up.

The labour market continued to improve in 2016 on the back of strong real GDP growth. Unemployment dropped to a historical low in 2016. Low unemployment, combined with a

[1] OJ C 299, 18.8.2016, p. 73.

shrinking labour force and persistent skills shortages, led to a tighter labour market and economy-wide wage increases. Total employment decreased in 2016 as the decline in self-employment more than offset the increasing number of employees. Total employment is set to increase at a moderate pace in 2017 and 2018 due to high inactivity rates and negative demographics, driven by strong growth, while the unemployment rate is projected to continue to decline. The growth of compensation per employee accelerated in 2016, on the back of increases in the minimum wage and public sector wages.

The main risk to the outlook is the possibility of a further fiscal stimulus in line with the government programme, which may boost domestic demand in the short-run, but at the expense of posing additional risk to the sustainability of public finances. In the absence of structural reforms to support competiveness, potential growth would be constrained.

Table 1. Macroeconomic developments and forecast

	2015	2016		2017		
	Outturn	**CP 2016**	**Outturn**	**CP 2016**	**CP 2017**	**COM**
Real GDP (% change)	3.9	4.2	4.8	4.3	5.2	4.3
Private consumption (% change)	6.0	6.3	7.4	5.3	7.3	6.9
Gross fixed capital formation (% change)	8.3	6.6	-3.3	6.9	6.9	1.3
Exports of goods and services (% change)	5.4	4.5	8.3	5.6	6.8	6.9
Imports of goods and services (% change)	9.2	8.7	9.8	7.8	8.5	8.6
Contributions to real GDP growth:						
- Final domestic demand	5.7	6.0	4.4	5.3	6.3	5.1
- Change in inventories	-0.2	0.0	1.1	0.0	-0.3	0.0
- Net exports	-1.6	-1.8	-0.7	-1.0	-0.8	-0.8
Output gap[1]	-1.3	-0.4	-0.1	0.0	-0.1	0.7
Employment (% change)	-0.9	0.2	-0.9	0.6	0.7	0.1
Unemployment rate (%)	6.8	6.7	5.9	6.6	5.7	5.4
Labour productivity (% change)	4.9	4.0	5.8	3.7	4.4	4.2
HICP inflation (%)	-0.4	-0.5	-1.1	2.3	1.2	1.1
GDP deflator (% change)	2.4	2.0	2.2	2.1	2.0	1.5
Comp. of employees (per head, % change)	0.9	5.6	10.3	5.2	5.8	9.5
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	1.8	0.7	-1.5	0.5	0.4	-1.3

Note:

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

Source :

Commission 2017 spring forecast (COM); Convergence Programme (CP).

In 2016, the general government deficit rose to 3% of GDP, from 0.8% of GDP in 2015, while the economy grew above its potential. Tax cuts, particularly a four percentage point cut in the standard VAT rate, had a negative effect on tax revenues. On the expenditure side, public wages were considerably increased. The 2016 budget outcome was slightly worse than the 2016 Convergence Programme target of a deficit of 2.9% of GDP. Both the revenues and the expenditures turned out lower than planned in the 2016 Convergence Programme. On the revenue side, the indirect tax revenues target was not achieved. On the expenditure side, public investment was significantly lower than planned.

The Commission 2017 spring forecast projects the headline deficit to increase to 3.5% of GDP in 2017. The standard VAT rate was cut by an additional one percentage point. Moreover, part of the excise duty on fuel and a special construction tax were abolished. The 2017 budget contains significant increases of public wages and social benefits, including an additional pension increase of 9%, scheduled for July 2017, on top of the standard indexation.

The Romanian authorities in the 2017 Convergence Programme plan a headline deficit of 2.9% of GDP in 2017. The overall revenues and expenditures ratios are higher than in the Commission forecast. The underlying macroeconomic projection of 5.2% of real GDP growth is more optimistic than the Commission projection, with a positive impact on tax revenues. The projection of revenues from all categories of taxes and social contributions is higher than in the Commission forecast (see Table 2). On the expenditure side, public wages and social contributions are lower than in the Commission forecast, while planned public investment is significantly higher. The lower public investment projection in the Commission forecast takes into account (i) a systematic under-execution in the previous years, (ii) the weak budgetary outturn in the first quarter of 2017, and (iii) a more prudent assumption on the military equipment deliveries in 2017.

The planned unified wage law (UWL), currently debated by the parliament, poses a significant risk to the fiscal forecast in 2018 and beyond, with a potential impact on the general government balance of up to -2% of GDP in 2018. Its final form and implementation schedule were not known at the cut-off date of the Commission spring 2017 forecast. Therefore, the UWL has not been included in the Commission spring 2017 forecast, nor in the 2017 Convergence Programme projection.

Table 2. Composition of the budgetary adjustment

(% of GDP)	2015	2016		2017		
	Outturn	CP 2016	Outturn	CP 2016	CP 2017	COM
Revenue	**35.0**	**32.5**	**31.7**	**31.7**	**32.2**	**30.6**
of which:						
- Taxes on production and imports	13.3	12.0	11.3	11.2	11.0	10.5
- Current taxes on income, wealth, etc.	6.6	6.5	6.5	6.6	6.6	6.4
- Social contributions	8.1	8.1	8.1	8.1	8.7	8.5
- Other (residual)	7.0	5.9	5.8	5.8	5.9	5.2
Expenditure	**35.8**	**35.4**	**34.7**	**34.6**	**35.1**	**34.1**
of which:						
- Primary expenditure	34.2	33.8	33.2	33.0	33.7	32.6
of which:						
Compensation of employees	7.7	8.1	8.2	7.9	8.4	8.7
Intermediate consumption	5.7	5.6	5.3	5.5	5.1	5.2
Social payments	10.6	11.4	10.7	11.2	11.7	12.0
Subsidies	0.5	0.5	0.4	0.5	0.4	0.4
Gross fixed capital formation	5.2	4.6	3.6	4.5	4.3	3.5
Other (residual)	4.6	3.6	5.0	3.4	3.9	2.9
- Interest expenditure	1.6	1.6	1.5	1.6	1.4	1.6
General government balance (GGB)	**-0.8**	**-2.9**	**-3.0**	**-2.9**	**-2.9**	**-3.5**
Primary balance	**0.9**	**-1.3**	**-1.5**	**-1.2**	**-1.6**	**-2.0**
One-off and other temporary measures	0.3	0.0	-0.4	0.0	0.0	0.1
GGB excl. one-offs	**-1.0**	**-2.9**	**-2.7**	**-2.9**	**-2.9**	**-3.6**
Output gap[1]	-1.3	-0.4	-0.1	0.0	-0.1	0.7
Cyclically-adjusted balance[1]	-0.3	-2.7	-3.0	-2.9	-2.9	-3.8
Structural balance[2]	**-0.6**	**-2.7**	**-2.6**	**-2.9**	**-2.9**	**-3.9**
Structural primary balance[2]	1.1	-1.1	-1.1	-1.3	-1.5	-2.3

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 measures.

Source :

Convergence Programme (CP); Commission 2017 spring forecasts (COM); Commission calculations.

Table 3. Debt developments

(% of GDP)	2015	2016		2017		
	Outturn	CP 2016	Outturn	CP 2016	CP 2017	COM
Gross debt ratio[1]	**38.0**	**39.1**	**37.6**	**39.8**	**38.0**	**39.3**
Change in the ratio	-1.4	0.7	-0.4	0.7	0.4	1.7
Contributions[2] *:*						
1. Primary balance	**-0.9**	**1.3**	**1.5**	**1.2**	**1.6**	**2.0**
2. "Snow-ball" effect	**-0.7**	**-0.6**	**-1.0**	**-0.7**	**-1.2**	**-0.5**
Of which:						
Interest expenditure	1.6	1.6	1.5	1.7	1.3	1.6
Growth effect	-1.5	-1.5	-1.7	-1.6	-1.8	-1.5
Inflation effect	-0.9	-0.7	-0.8	-0.8	-0.7	-0.5
3. Stock-flow adjustment	**0.2**	**0.0**	**-1.0**	**0.2**	**0.1**	**0.3**

Notes:

[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.

Source :

Commission 2017 spring forecast (COM); Convergence Programme (CP), Comission calculations.

In 2016, the general government debt-to-GDP ratio decreased by 0.4% of GDP, reaching 37.6% and is projected by the Commission to increase to 40.9% of GDP by 2018.

3. COMPLIANCE WITH THE ADJUSTMENT TOWARDS THE MTO

Romania's MTO is a deficit of 1% of GDP in structural terms.

On 12 July 2016, the Council addressed recommendations to Romania in the context of the European Semester. In the area of public finances the Council recommended Romania to limit the deviation from the MTO in 2016 and achieve an annual fiscal adjustment of 0.5 % of GDP in 2017 unless the MTO is respected with a lower effort. That recommendation is in line with the earlier Council recommendation from 14 July 2015, which required Romania to remain at the MTO in 2016.

On 22 February 2017 Vice-President Valdis Dombrovskis and Commissioner Pierre Moscovici sent a joint letter[2] to the Romanian authorities in which they recalled that Romania was estimated to have significantly deviated from its MTO in 2016, while the Commission forecast pointed to further deterioration of the structural balance in 2017 and 2018. The letter

[2] https://ec.europa.eu/info/sites/info/files/letter_to_romanian_mof.pdf

also pointed to a clear risk, based on the Commission forecast for 2017 and 2018, that the deficit criterion for the purposes of the Treaty and of Regulation (EC) No 1467/97 would not be fulfilled. The letter recalled that the Commission would reassess Romania's compliance with its obligations under the Stability and Growth Pact on the basis of the Commission 2017 Spring Forecast, including the budgetary data for 2016 and Romania's 2017 Convergence Programme. It recalled the importance that the necessary measures to ensure compliance with the deficit criterion and with the adjustment path towards the MTO were credibly announced by that time.

In 2016, from a position of -0.6% of GDP in 2015, i.e. above the MTO, the structural balance deteriorated to -2.6% of GDP, pointing to a significant deviation from the recommended structural adjustment by a large margin (deviation of 1.6% of GDP). The growth of government expenditure, net of discretionary revenue measures and one-offs, was well above the expenditure benchmark, also pointing to a significant deviation by a large margin (deviation of -2.0% of GDP). The difference in the indicators is mainly explained by different annual nominal potential GDP growth rates used in their computation. Irrespective of that difference, both indicators confirm a significant deviation from the requirements in 2016.

Table 4. Compliance with the MTO or the required adjustment towards it

(% of GDP)	2016	2017		2018	
Initial position[1]					
Medium-term objective (MTO)	-1.0	-1.0		-1.0	
Structural balance[2] (COM)	-2.6	-3.9		-4.0	
Structural balance based on freezing (COM)	-2.5	-3.9		-	
Position vis-a -vis the MTO[3]	At or above the MTO	Not at MTO		Not at MTO	
(% of GDP)	**2016**	**2017**		**2018**	
	COM	**CP**	**COM**	**CP**	**COM**
Structural balance pillar					
Required adjustment[4]	0.0	0.5		0.5	
Required adjustment corrected[5]	-0.5	0.5		0.5	
Change in structural balance[6]	-2.1	-0.5	-1.2	-0.2	-0.2
One-year deviation from the required adjustment [7]	-1.6	-1.0	-1.7	-0.7	-0.7
Two-year average deviation from the required adjustment [7]	-0.6	-1.2	-1.7	-0.8	-1.2
Expenditure benchmark pillar					
Applicable reference rate[8]	3.9	1.0		4.3	
One-year deviation adjusted for one-offs[9]	-2.0	-1.1	-1.7	-0.7	-1.1
Two-year deviation adjusted for one-offs[9]	-1.1	-1.6	-1.9	-0.9	-1.4
PER MEMORIAM: One-year deviation [10]	-2.9	-0.7	-1.2	-0.7	-1.1
PER MEMORIAM: Two-year average deviation [10]	-1.4	-1.0	-2.1	-0.7	-1.2
Conclusion					
Conclusion over one year	Significant deviation	Significant deviation	Significant deviation	Significant deviation	Significant deviation
Conclusion over two years	Significant deviation	Significant deviation	Significant deviation	Significant deviation	Significant deviation

Notes

[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. Ex post 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, 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.

[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.

Source :
Convergence Programme (CP); Commission 2017 spring forecast (COM); Commission calculations.

4. NEW ADJUSTMENT PATH TO THE MTO AND REQUIRED FISCAL EFFORT

Based on the 2017 spring forecast, Romania is in normal economic times (as its output gap of 0.7% is between -1.5% and 1.5% of potential GDP). Romania's debt is below the 60% of GDP threshold. Romania's structural balance in 2016 is estimated to have been 1.6% of GDP away from its MTO of 1% of GDP.

The minimum required structural effort prescribed by Regulation (EC) No 1466/97 and the adjustment matrix[3], which factors in the prevailing economic circumstances and possible sustainability concerns, amounts to 0.5% of GDP.

The Commission 2017 spring forecast projects a further deterioration of the structural balance by 1.3% of GDP in 2017. Therefore, a minimum structural improvement of 0.5% of GDP in 2017 relative to the 2016 outturn translates into a need to adopt structural consolidation measures of a total yield of 1.8% of GDP in 2017 for the year as a whole, relative to the current 2017 baseline from the Commission spring 2017 forecast. Given the significant size of the required structural consolidation effort resulting from the minimum SGP-required adjustment, no additional required adjustment on top of the minimum 0.5% requirement would appear warranted.

Based on the Commission forecast, the above-mentioned 0.5% of GDP structural adjustment target is consistent with a nominal growth rate of net primary government expenditure of 3.3% in 2017, compared to the growth rate of 7.5% projected by the Commission.

5. OVERALL CONCLUSION

In 2016, GDP growth reached an eight-year high of 4.8%, driven mainly by consumption, which was boosted by pro-cyclical fiscal policy and wage hikes. The headline deficit more than tripled, to 3% from 0.8% of GDP in 2015, due to significant tax cuts and public wage increases. The structural deficit increased to 2.6% of GDP, from 0.6% of GDP in 2015, and deviated from Romania's MTO. The debt-to-GDP ratio remained below 60% of GDP.

Both the structural balance and the expenditure benchmark pillars point to a significant deviation in 2016. An overall assessment appears to confirm that the observed deviation from the MTO in 2016 is significant.

An improvement in Romania's structural balance by 0.5% of GDP in 2017 relative to the 2016 outturn would put Romania on an appropriate 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 2017. Such an adjustment seems also appropriate to ensure that Romania respects the 3% of GDP general government deficit threshold in 2017.

[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