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COMMISSION STAFF WORKING DOCUMENT
Accompanying the documents

Recommendation for a Council decision establishing that no effective action has been taken by Romania in response to the Council recommendation of 5 December 2017

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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COMMISSION STAFF WORKING DOCUMENT

Accompanying the documents

Recommendation for a Council decision establishing that no effective action has been taken by Romania in response to the Council Recommendation of 5 December 2017

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

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.

This staff working document has a double purpose. First, to explain the reasons behind the Commission recommendation of a Council decision on non-effective action in 2018 in response to the Council Recommendation addressed to Romania on 5 December 2017. Second, to support the Commission 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 in 2017, as adopted by the Commission on 23 May 2018.

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.

On 5 December 2017 the Council found that Romania had not taken effective action in response to the 16 June 2017 recommendation and issued a revised recommendation. In the new recommendation 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, corresponding to an annual structural adjustment of 0.8% of GDP³. It recommended Romania to use any windfall gains for reduction of its deficit, while budgetary consolidation measures should ensure a lasting improvement in the general government structural balance in

¹ Net primary 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).

³ 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).

a growth-friendly manner. The Council established a deadline of 15 April 2018 for Romania to report on the action taken in response to the recommendation. The Romanian authorities submitted their report on action taken in response to Council recommendation (hereafter: "the report") on 20 April. i.e. after the deadline set by the Council. Moreover, on 10 and 11 April 2018, 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 [23] May 2017 and made its findings public.

Based on the Commission 2018 spring forecast, Section 2 of this document presents macroeconomic developments and outlook in 2017-19. Section 3 presents fiscal developments in 2017 and updated budgetary projections for 2018-2019. Section 4 presents an assessment of compliance with the obligations stemming from the Stability and Growth Pact in 2017, including an overall assessment of the reasons for the deviation from the requirements of the preventive arm. Section 5 assesses compliance with the Council Recommendation of 5 December 2017. Section 6 proposes a fiscal effort for 2018 and 2019 to address the significant deviation, including a new applicable expenditure benchmark rate compatible with the suggested annual improvement in the structural balance. Section 7 provides overall conclusions.

2. MACROECONOMIC DEVELOPMENTS AND OUTLOOK IN 2017-2019

Romania's economic boom intensified in 2017, with real GDP increasing by 6.9%, a post-crisis high. The main driver of growth continued to be private consumption, which expanded by around 10% in real terms. The private consumption boom was spurred by an expansionary fiscal policy, including cuts to indirect taxes and public sector pay rises. After contracting in 2016, investment returned to growth in 2017 on the back of rising private investment in both machinery and equipment and residential construction. Public investment, however, fell sharply for the second consecutive year. The contribution of net exports to growth was negative, as imports outpaced exports on the back of strong consumption growth.

Looking ahead, growth is expected to decelerate but to remain robust. Private consumption is forecast to slow down starting in 2018, as nominal wage growth moderates and inflation increasingly weighs on real disposable income, but it will remain the main driver of growth. Investment, however, is expected to further strengthen driven by a pick-up in the implementation of projects co-financed by EU funds. Imports are projected to continue rising faster than exports. Accordingly, net exports will remain a drag on real GDP growth. Overall, real GDP is projected by the Commission to increase by 4.5% in 2018 and 3.9% in 2019.

The current account deficit has been widening progressively since 2014, when it was close to zero, mainly on account of a weakening trade balance. It amounted to 3.5% of GDP in 2017 and is forecast to increase further, to 3.6% of GDP in 2018 and 3.9% in 2019.

The labour market continued to tighten in 2017 on the back of strong real GDP growth, with unemployment dropping to a 20-year low of 4.9%. The low unemployment rate, together with a 16% minimum wage hike in February 2017 and substantial public sector pay rises, led to an acceleration of wage growth. Compensation per employee increased by 15% in real terms in 2017. Wages are expected to continue to grow in 2018, albeit at a slower pace, due to further increases in public wages and an additional 9% increase in the net minimum wage which took effect in January 2018.

After two consecutive years of falling consumer prices, inflation turned positive in 2017, despite being dampened by a standard VAT rate cut and lower excise duties on fuel. Inflation started to accelerate in the second half of the year mainly on account of rising food and energy prices. Inflation further accelerated in early 2018 as the effect of the January 2017 tax cuts faded away, reaching 4% by March. Inflation is forecast at 4.2% for 2018 as a whole and to decline to 3.4% in 2019 as energy price inflation moderates.

There are several risks to Romania's macroeconomic outlook. The gradual tightening of the central bank's monetary policy in response to emerging inflation pressures and a widening output gap could dampen private investment. Investment could also be adversely affected if further cuts to public investment were to take place. A continuing increase in unit labour costs, due to wage growth outpacing productivity growth, may also curtail Romania's exports. More generally, uncertainty regarding the government's policies could hamper growth.

Table 1. Macroeconomic developments and forecast

| | 2016 | 2017 | | 2018 | | | 2019 | | |
|---|---------|---------|---------|---------|---------|------|---------|---------|------|
| | Outturn | CP 2017 | Outturn | CP 2017 | CP 2018 | COM | CP 2017 | CP 2018 | COM |
| Real GDP (% change) | 4.8 | 5.2 | 6.9 | 5.5 | 6.1 | 4.5 | 5.7 | 5.7 | 3.9 |
| Private consumption (% change) | 7.6 | 7.3 | 10.1 | 6.4 | 6.5 | 4.9 | 6.2 | 6.1 | 4.2 |
| Gross fixed capital formation (% change) | -2.0 | 6.9 | 4.7 | 7.9 | 7.9 | 7.4 | 8.4 | 8.4 | 6.9 |
| Exports of goods and services (% change) | 8.7 | 6.8 | 9.7 | 6.3 | 7.4 | 7.5 | 6.9 | 6.9 | 6.8 |
| Imports of goods and services (% change) | 9.8 | 8.5 | 11.3 | 7.9 | 8.5 | 8.2 | 8.1 | 8.0 | 7.4 |
| <i>Contributions to real GDP growth:</i> | | | | | | | | | |
| - Final domestic demand | 4.6 | 6.3 | 7.5 | 6.2 | 6.7 | 5.0 | 6.2 | 6.2 | 4.4 |
| - Change in inventories | 0.7 | -0.3 | 0.2 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| - Net exports | -0.5 | -0.8 | -0.7 | -0.7 | -0.6 | -0.5 | -0.6 | -0.6 | -0.5 |
| Output gap ¹ | -1.5 | -0.1 | 1.2 | 0.4 | 0.8 | 1.4 | 1.1 | 1.2 | 1.1 |
| Employment (% change) | -0.9 | 0.7 | 2.6 | 0.9 | 2.4 | 0.9 | 1.0 | 1.8 | 0.1 |
| Unemployment rate (%) | 5.9 | 5.7 | 4.9 | 5.5 | 4.8 | 4.5 | 5.4 | 4.6 | 4.4 |
| Labour productivity (% change) | 5.8 | 4.4 | 4.2 | 4.5 | 3.6 | 3.6 | 4.6 | 3.8 | 3.9 |
| HICP inflation (%) | -1.1 | 1.2 | 1.1 | 2.5 | 3.8 | 4.2 | 2.3 | 2.8 | 3.4 |
| GDP deflator (% change) | 2.1 | 2.0 | 5.3 | 2.1 | 2.1 | 5.2 | 1.9 | 1.9 | 4.0 |
| Comp. of employees (per head, % change) | 10.1 | 5.8 | 16.0 | 5.9 | 8.1 | 8.7 | 6.0 | 7.0 | 6.7 |
| Net lending/borrowing vis-à-vis the rest of the world (% of GDP) | -1.1 | 0.4 | -1.9 | 0.8 | -1.4 | -2.1 | 0.9 | -0.9 | -2.1 |
| <i>Note:</i> | | | | | | | | | |
| 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. | | | | | | | | | |
| <i>Source:</i> | | | | | | | | | |
| Commission 2018 spring forecast (COM); Convergence Programmes (CP). | | | | | | | | | |

3. FISCAL DEVELOPMENTS AND OUTLOOK IN 2017-2019

In 2017, the general government deficit decreased slightly to 2.9% of GDP, from 3.0% of GDP in 2016, while the economy grew significantly above its potential. The decrease of the headline deficit was cyclical in nature and not due to fiscal consolidation measures. Tax cuts, in particular, a 1pp. cut to the standard VAT rate, had a negative effect on tax revenues. On the expenditure side, compensation for employees considerably increased (by 0.8% of GDP). At the same time, public investment dropped significantly (by 0.8% of GDP). Given that the output gap increased significantly and turned positive, the structural deficit increased to 3.3% of GDP in 2017, from 2.1% in 2016.

The 2017 general government deficit outcome of 2.9% of GDP fulfils the target from the 2017 Convergence Programme. Both the revenues and the expenditures turned out lower than planned in the 2017 Convergence Programme. On the revenue side, the target for both indirect and direct tax revenues was not achieved. On the expenditure side, public investment was significantly lower than planned.

On 10 and 11 April 2018 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 [23] May 2018 and made its findings public. The Commission report finds that the Romanian authorities do not intend to act upon the Council recommendation of 5 December 2017. The authorities confirmed that their target for 2018 remains the headline deficit of just below 3% of GDP. Given a positive and increasing output gap, this indicates a further deterioration of the underlying structural deficit, contrary to the Council recommendation.

In their report on action taken, the authorities target a general government deficit of 2.96% of GDP in 2018, a slight increase compared both to the 2017 outturn and to the 2018 target in the 2017 Convergence programme of 2.9%. The report does not contain projections of individual budgetary items or categories. The authorities provide a list of taken discretionary measures. The list only includes measures with a positive impact on the budget balance. Adopted measures which reduce revenues or increase expenditures (such as a cut of the flat Personal Income Tax rate from 16% to 10% or significant increases to public sector wages) were not included. Table 2, below, presents the measures listed in the report with a significant budgetary impact as estimated by the authorities (defined as an impact of at least 0.1% of GDP). On the expenditure side, the listed measures (e.g. limiting new hires in public administration, indexation of special pensions only by inflation) are not quantified in the report. The fiscal impact of the reported measures falls significantly short of the requirement stated in the Council Recommendation.

Table 2. Discretionary fiscal measures listed in the report (impact above 0.1% of GDP)

| Title | Reported impact on government balance | Comments |
|---|---------------------------------------|---|
| 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) | +0.3 | |
| Increasing the dividends from state-owned companies from 50% to 90%, similarly to 2017 | +0.1 | An extension of a measure in force since 2017 |
| Increasing the taxation base for companies for unemployed persons with disabilities from September 2017 | +0.1 | |
| Payment of social contributions at the level of the minimum wage for part time employees earning less than the minimum wage | +0.1 | |
| Starting the procedure for selling 5G licences | +0.1 | According to the accounting rules used in Commission forecasts (ESA-2010), the impact of this measure should be |

| | | |
|---|------|---------------------------------|
| | | smoothed out over several years |
| Introducing a split-payment system in VAT, mandatory by companies in insolvency or with VAT arrears, optional to the rest | +0.3 | |
| Other measures to decrease tax evasion and increase tax collection | +0.2 | |
| Note: | | |
| The budgetary impact in the table as reported by the national authorities in the report on action taken. The table includes measures with a reported fiscal impact of at least 0.1% of GDP. | | |

Table 3. Discretionary revenue measures included in the Commission 2018 spring forecast (fiscal impact in % of GDP)

| Title | 2017 | 2018 | 2019 |
|--|------|------|------|
| 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 their profits | +0.1 | | -0.1 |
| 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 | | |
| Increase of Personal Income Tax-free threshold for pension income | -0.1 | | |
| Changes to the turnover tax on microenterprises | -0.2 | | |
| Standard VAT rate cut from 20% to 19% | -0.3 | | |
| Cut of excise duties for energy products | -0.4 | | |
| Increasing excise duties for energy products back to their 2016 level as of October 2017 (i.e. reversing the previous cut) | +0.1 | +0.3 | |
| Social contributions shift almost entirely on the employees | | +1.2 | |
| Cut of flat Personal Income Tax rate from 16% to 10% and increase of tax allowances | | -1.5 | |
| A decrease of the share of social contributions transferred to the second pension pillar | | +0.2 | |
| Note: | | | |
| The budgetary impact in the table as included in the Commission 2018 spring 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. | | | |

Based on the Commission spring 2018 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 increase to 3.4% of GDP in 2018. The unified wage law, enacted in summer 2017, increased gross public wages by 25% as of January 2018 and contains additional wage increases in health and education sectors, leading to an increase of the spending on compensation of employees by 0.7 percentage points relative to GDP. The fiscal cost of these increases of gross wages is set to be partially compensated by a shift of social security contributions from 22.75% for employers and 16.5% for employees to 2.25% and 35% respectively. Moreover, the government partially reversed the past systemic pension reform by lowering the proportion of the social contributions transferred to the second pension pillar (which is classified outside of the general government) from 5.1% to 3.75% of gross wages. At the same time, the flat personal income tax (PIT) rate was cut from 16% to 10%. As a consequence of these measures, the revenue from social contributions is set to increase by 1.4 percentage points of GDP while the revenue from direct taxes is set to decrease by 1.3 percentage points. The general government deficit is projected by the Commission spring 2018 forecast to reach 3.8% of GDP in 2019, driven by increases in social payments and public investment (increase of expenditure on both categories by 0.2 percentage points of GDP). As a consequence of the fiscal easing described above, Romania's structural deficit is projected by the Commission to increase from 3.3% of GDP in 2017 to 3.8% in 2018 and 4.3% in 2019. The composition of the budget and its adjustments in nominal and structural terms are presented in Table 3 below.

The Romanian authorities in the 2018 Convergence Programme plan a headline deficit of 2.95% of GDP in 2018⁴. Total revenues as a share of GDP are higher than in the Commission forecast (difference of 0.4 percentage points), while the expenditure ratio is the same as projected by the Commission. The underlying macroeconomic projection of 6.1% of real GDP growth is more optimistic than 4.5% forecasted by the Commission, with a positive impact on tax revenues. The projection of revenues from all main categories of taxes and social contributions is higher than in the Commission forecast (see Table 2). On the expenditure side, current expenditures (in particular social benefits and intermediate consumption) are somewhat lower while capital expenditures somewhat higher than projected by the Commission.

⁴ The slight difference of the 2018 deficit target compared to the 2.96% of GDP from the report on action taken in response to Council recommendation of 5 December 2017 is due to the revised underlying macroeconomic projection.

Table 4. Composition of the budgetary adjustment

| (% of GDP) | 2016 | 2017 | | 2018 | | | 2019 | | |
|--|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| | Outturn | CP 2017 | Outturn | CP 2017 | CP 2018 | COM | CP 2017 | CP 2018 | COM |
| Revenue | 31.6 | 32.2 | 30.5 | 32.3 | 31.3 | 30.9 | 32.8 | 31.3 | 31.1 |
| <i>of which:</i> | | | | | | | | | |
| - Taxes on production and imports | 11.3 | 11.0 | 10.3 | 11.0 | 10.8 | 10.4 | 11.0 | 10.8 | 10.5 |
| - Current taxes on income, wealth, etc. | 6.5 | 6.6 | 6.1 | 6.8 | 4.9 | 4.7 | 7.0 | 4.9 | 4.8 |
| - Social contributions | 8.8 | 8.7 | 9.3 | 8.7 | 10.9 | 10.7 | 9.0 | 10.9 | 10.6 |
| - Other (residual) | 5.1 | 5.9 | 4.8 | 5.8 | 4.7 | 5.0 | 5.8 | 4.7 | 5.2 |
| Expenditure | 34.6 | 35.1 | 33.4 | 35.2 | 34.3 | 34.3 | 35.4 | 34.3 | 34.9 |
| <i>of which:</i> | | | | | | | | | |
| - Primary expenditure | 33.1 | 33.7 | 32.0 | 33.7 | 32.9 | 32.9 | 33.9 | 32.9 | 33.4 |
| <i>of which:</i> | | | | | | | | | |
| Compensation of employees | 8.9 | 8.4 | 9.7 | 8.3 | 10.3 | 10.4 | 8.1 | 10.3 | 10.3 |
| Intermediate consumption | 5.3 | 5.1 | 4.9 | 5.0 | 4.7 | 4.9 | 5.0 | 4.7 | 4.9 |
| Social payments | 11.5 | 11.7 | 11.6 | 12.0 | 11.4 | 11.6 | 11.7 | 11.4 | 11.8 |
| Subsidies | 0.4 | 0.4 | 0.4 | 0.5 | 0.4 | 0.4 | 0.5 | 0.4 | 0.4 |
| Gross fixed capital formation | 3.6 | 4.3 | 2.8 | 4.0 | 2.9 | 2.9 | 4.5 | 2.9 | 3.1 |
| Other (residual) | 3.3 | 3.9 | 2.6 | 4.1 | 3.1 | 2.8 | 4.2 | 3.1 | 2.9 |
| - Interest expenditure | 1.5 | 1.4 | 1.3 | 1.5 | 1.4 | 1.4 | 1.5 | 1.4 | 1.4 |
| General government balance (GGB) | -3.0 | -2.9 | -2.9 | -2.9 | -3.0 | -3.4 | -2.5 | -3.0 | -3.8 |
| Primary balance | -1.5 | -1.6 | -1.6 | -1.4 | -1.5 | -2.0 | -1.0 | -1.5 | -2.4 |
| One-off and other temporary measures | -0.4 | 0.0 | 0.0 | 0.0 | 0.0 | -0.1 | 0.0 | 0.0 | 0.0 |
| GGB excl. one-offs | -2.6 | -2.9 | -2.9 | -2.9 | -3.0 | -3.3 | -2.5 | -3.0 | -3.8 |
| Output gap ¹ | -1.5 | -0.1 | 1.2 | 0.4 | 0.8 | 1.4 | 1.1 | 0.8 | 1.1 |
| Cyclically-adjusted balance ¹ | -2.5 | -2.9 | -3.3 | -3.0 | -3.3 | -3.9 | -2.9 | -3.3 | -4.2 |
| Structural balance² | -2.1 | -2.9 | -3.3 | -3.0 | -3.3 | -3.8 | -2.9 | -3.3 | -4.2 |
| Structural primary balance ² | -0.6 | -1.5 | -2.0 | -1.5 | -1.9 | -2.3 | -1.4 | -1.9 | -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 measures. | | | | | | | | | |
| Source: | | | | | | | | | |
| Convergence Programmes (CP); Commission 2018 spring forecasts (COM); Commission calculations. | | | | | | | | | |

Table 5. Debt developments

| (% of GDP) | 2016 | 2017 | | 2018 | | | 2019 | | |
|--|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| | Outturn | CP 2017 | Outturn | CP 2017 | CP 2018 | COM | CP 2017 | CP 2018 | COM |
| Gross debt ratio¹ | 37.4 | 38.0 | 35.0 | 38.3 | 35.4 | 35.3 | 38.1 | 35.8 | 36.4 |
| Change in the ratio | -0.3 | 0.4 | -2.3 | 0.3 | 0.4 | 0.2 | -0.2 | 0.4 | 1.2 |
| <i>Contributions²:</i> | | | | | | | | | |
| 1. Primary balance | 1.5 | 1.6 | 1.6 | 1.4 | 1.5 | 2.0 | 1.0 | 1.0 | 2.4 |
| 2. “Snow-ball” effect | -0.9 | -1.2 | -2.7 | -1.2 | -1.1 | -1.7 | -1.2 | -1.1 | -1.1 |
| <i>Of which:</i> | | | | | | | | | |
| Interest expenditure | 1.5 | 1.3 | 1.3 | 1.5 | 1.5 | 1.4 | 1.5 | 1.4 | 1.4 |
| Growth effect | -1.7 | -1.8 | -2.3 | -1.9 | -2.0 | -1.4 | -2.0 | -1.9 | -1.3 |
| Inflation effect | -0.7 | -0.7 | -1.8 | -0.7 | -0.7 | -1.6 | -0.6 | -0.6 | -1.3 |
| 3. Stock-flow adjustment | -0.8 | 0.1 | -1.1 | 0.1 | 0.0 | 0.0 | 0.0 | 0.5 | 0.0 |
| <i>Notes:</i> | | | | | | | | | |
| 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. | | | | | | | | | |
| <i>Source:</i> | | | | | | | | | |
| Commission 2018 spring forecast (COM); Convergence Programmes (CP), Commission calculations. | | | | | | | | | |

In 2017, the general government debt-to-GDP ratio decreased by 2.4% of GDP, on the back of the high nominal GDP growth, reaching 35.0% of GDP. It is projected by the Commission to increase to 36.4% of GDP by 2019.

4. COMPLIANCE WITH THE ADJUSTMENT TOWARDS THE MTO IN 2017

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

On 16 June 2017 the Council issued a recommendation for 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, the growth of net primary government expenditure was well above the expenditure benchmark, pointing to a significant deviation by a large margin (deviation of 3.3% of GDP). The structural balance deteriorated to -3.3% of GDP from a position of -2.1% of GDP in 2016, also pointing to a significant deviation from the recommended structural adjustment by a large margin (deviation of 1.7% of GDP). The size of deviation indicated by the structural balance is positively impacted by a higher point estimate for potential GDP growth compared to the medium-term average underlying the expenditure benchmark while the drop in public investment is smoothed out in the expenditure benchmark. Taking into account these factors, the overall assessment confirms a significant deviation from the Council recommendation. This assessment is also in line with the earlier conclusion of 5 December 2017, in which the Council found that Romania had not taken effective action in response to the Council recommendation of 16 June 2017 and issued a revised recommendation.

5. COMPLIANCE IN 2018 WITH THE COUNCIL RECOMMENDATION OF 5 DECEMBER 2017

On 5 December 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 2018, corresponding to an annual structural adjustment of 0.8% of GDP.

Based on the Commission 2018 spring forecast, the growth of net primary government expenditure amounts to 10.8%, which is well above the expenditure benchmark of 3.3%. The structural balance is set to deteriorate by 0.4 % of GDP, reaching a deficit of 3.8% in 2018. This is the opposite of the recommended structural improvement of 0.8% of GDP relative to 2017. Therefore, both pillars point to a deviation from the recommended adjustment by a wide margin. The expenditure benchmark points to a deviation of 2.4% of GDP. The structural balance confirms this reading, indicating a somewhat smaller deviation of 1.8% of GDP. The size of the deviation indicated by the structural balance is negatively impacted by the higher underpinning estimate of potential GDP growth compared to the medium-term average underlying the expenditure benchmark. Taking this into account, the overall assessment confirms the deviation from the recommended adjustment by a wide margin.

The deterioration compared to 2017 is largely driven by increases in expenditure on the compensation of public employees, enacted in summer 2017 and which entered into force in January 2018. Since the Commission autumn 2017 forecast, which was the basis for the Council recommendation of 5 December 2017, the authorities have partially reversed the past systemic pension reform by lowering the proportion of social contributions transferred to the second pension pillar (which is classified outside the general government) from 5.1% to 3.75% of gross wages. This cut is set to have a positive short-term effect on government revenues and thus on government balance. However, that fiscal gain is set to dissipate in the long term as the social contributions diverted from the second pillar are accompanied by an obligation to pay old-age pensions in the future. In addition, this reversal will result in less diversified retirement income. It could also have negative implications for the development of capital markets

Additionally, the headline deficit in Romania is projected to increase to 3.4% of GDP in 2018 and 3.8% of GDP in 2019 according to the Commission spring 2018 forecast and thus breach the 3% of GDP deficit reference value of the Treaty.

Table 6. Compliance with the MTO or the required adjustment towards it

| (% of GDP) | 2017 | 2018 | | 2019 | |
|---|-----------------------|-----------------------|-----------------------|-----------------------|-----------------------|
| Initial position¹ | | | | | |
| Medium-term objective (MTO) | -1.0 | -1.0 | | -1.0 | |
| Structural balance ² (COM) | -3.3 | -3.8 | | -4.2 | |
| Structural balance based on freezing (COM) | -3.3 | -3.8 | | - | |
| Position vis-a-vis the MTO³ | Not at MTO | Not at MTO | | Not at MTO | |
| (% of GDP) | 2017 | 2018 | | 2019 | |
| | COM | CP | COM | CP | COM |
| Structural balance pillar | | | | | |
| Required adjustment ⁴ | 0.5 | 0.8 | | 0.8 | |
| Required adjustment corrected ⁵ | 0.5 | 0.8 | | 0.8 | |
| Change in structural balance ⁶ | -1.2 | -0.4 | -0.4 | 0.5 | -0.4 |
| <i>One-year deviation from the required adjustment⁷</i> | -1.7 | -1.2 | -1.2 | -0.3 | -1.2 |
| <i>Two-year average deviation from the required adjustment⁷</i> | -1.7 | -1.5 | -1.5 | -0.8 | -1.2 |
| Expenditure benchmark pillar | | | | | |
| Applicable reference rate ⁸ | 1.0 | 3.3 | | 5.1 | |
| One-year deviation adjusted for one-offs ⁹ | -3.3 | -0.7 | -2.0 | -0.2 | -1.1 |
| Two-year deviation adjusted for one-offs ⁹ | -2.7 | -2.0 | -2.7 | -0.5 | -1.6 |
| <i>PER MEMORIAM: One-year deviation¹⁰</i> | -3.0 | -0.7 | -2.1 | -0.2 | -1.0 |
| <i>PER MEMORIAM: Two-year average deviation¹⁰</i> | -2.8 | -1.9 | -2.6 | -0.5 | -1.6 |
| Conclusion | | | | | |
| Conclusion over one year | Significant deviation | Significant deviation | Significant deviation | Overall assessment | 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 2017) is carried out on the basis of Commission 2018 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 2018 spring forecast (COM); Commission calculations. | | | | | |

6. PROPOSED ADJUSTMENT PATH TO THE MTO AND REQUIRED FISCAL EFFORT

Based on the Commission 2018 spring forecast, Romania's structural balance is estimated to be at -3.8% of GDP in 2018 and at -4.2% in 2019, increasingly away from its MTO of -1% of GDP. Romania is projected to remain in normal economic times (as its projected output gap of +1.4% in 2018 and +1.1% in 2019 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 matrix of requirements⁵, which factors in the prevailing economic circumstances and sustainability concerns, amounts to 0.5% of GDP in both 2018 and 2019.

An additional and persistent effort necessary to correct for the cumulated deviations and to bring Romania back on an appropriate consolidation path following the repeated slippages since 2016 can complement the minimum adjustment requirement. Romania's structural deficit has increased by 2.1% of GDP in 2016 and by 1.2% of GDP in 2017, to 3.3% of GDP in 2017. 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 in both years is consistent with a nominal growth rate of net primary government expenditure of 3.3% in 2018 and 5.1% in 2019, compared to the respective growth rates of 10.8% and 8.4% projected by the Commission.

The Commission 2018 spring forecast projects a further deterioration of the structural balance by 0.5% of GDP in 2018 and by a further 0.4% of GDP in 2019. Therefore, a structural improvement of 0.8% of GDP in both 2018 and in 2019 translates into the need to adopt measures of a total structural yield of 1.3% of GDP in 2018 and additional measures of a structural yield of 1.2% of GDP in 2019 compared to the current baseline in the Commission 2018 spring forecast.

Moreover, according to the Commission spring 2018 forecast Romania is projected to breach the 3% of GDP deficit reference value of the Treaty, both in 2018 and in 2019, based on the. The required structural adjustment of 0.8% of GDP in both years would also ensure that Romania respects the 3% of GDP deficit reference value of the Treaty with a margin, which is crucial in view of the existing risks and the forecast breach in 2018 and 2019.

7. CONCLUSIONS

Romania has not contained the net primary government expenditure nor has it delivered the improvement in the structural balance as recommended by the Council on 5 December 2017.

In 2017, GDP growth reached a post-crisis high of 6.9%, driven mainly by consumption, which was boosted by an expansionary, pro-cyclical fiscal policy, including wage hikes. The structural deficit increased to 3.3% of GDP, from 2.1% of GDP in 2016. Both the structural balance and the expenditure benchmark pillars point to a significant deviation from the

⁵ “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>

recommended adjustment path towards the MTO in 2017. An overall assessment confirms that the observed deviation in 2017 is significant.

An improvement in Romania's structural balance by 0.8% of GDP both in 2018 and in 2019 relative to the 2017 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 2018 and 5.1% in 2019. This translates into a need to adopt measures of a total structural yield of 1.3% of GDP in 2018 and additional measures of a structural yield of 1.2% of GDP in 2019 compared to the current 2018 baseline from the Commission 2018 spring forecast.

Such an adjustment seems also appropriate to ensure that Romania respects the 3% of GDP deficit reference value of the Treaty in 2018 and 2019 with a margin.