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Country Report Romania 2019
Including an In-Depth Review on the prevention and correction of macroeconomic imbalances

Accompanying the document

COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT, THE EUROPEAN COUNCIL, THE COUNCIL, THE EUROPEAN CENTRAL BANK AND THE EUROGROUP

2019 European Semester: Assessment of progress on structural reforms, prevention and correction of macroeconomic imbalances, and results of in-depth reviews under Regulation (EU) No 1176/2011

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EXECUTIVE SUMMARY

Romania's economic growth model, based on consumer spending, affects the country's ability to reach EU living standards in a sustainable way. The near halving of GDP growth in 2018, largely due to a slowdown in consumer spending, has revealed the limits of Romania's economic growth model. Strong wage increases, a decreasing work force and skills shortages risk undermining the country's ability to compete internationally. Moreover, investors' confidence is being eroded by persistent legislative instability, unpredictable decision-making, low institutional quality and the continued weakening of the fight against corruption. Inequality and poverty remain high, with increasing regional disparities. Ensuring continuity with past reforms and shifting the growth model to investment could set the economy on a sustainable path towards convergence with EU living standards and help reduce inequality ([1]).

Despite the substantial slowdown in 2018, growth remains robust. After a 7 % advance in 2017, real GDP growth (i.e. adjusted for inflation) slowed down to an estimated 4 % in 2018. Higher inflation dented disposable income and consumer spending, which is the main driver of economic growth. Strong growth in imports of consumer goods, which outpaced exports, caused the country's current account deficit to continue to widen.

The labour market is under increasing stress. The lowest unemployment rate in a decade (3.8 %), a declining labour force and persistent skills shortages have brought Romania close to full employment, which makes recruitment difficult and drives wage growth. Employees' earnings are low compared to the EU average but the strong growth since 2016, also driven by hikes in the minimum wage and public-sector wages, risk putting pressure on competitiveness if not accompanied by corresponding productivity increases.

The public deficit has been increasing, driven mostly by spending on wages and tax cuts. Tax rates have been repeatedly cut while public wages have significantly increased since 2015 and are set to increase further. At the same time, public investment fell to a post-EU accession low in 2017 and is set to rebound only slowly. As a result, the public deficit has substantially increased since 2015 and is forecast to break the 3 % of GDP threshold required under the Stability and Growth Pact, pushed up also by increases to pensions. In June 2018 the Council launched a new significant deviation procedure addressed to Romania ([2]). The structural deficit is projected to remain broadly stable at around 3.4 % until 2019 and to increase considerably in 2020.

Financial sector stability has been put under strain. Recent parliamentary and government measures have created risks to the stability of the financial sector. These could negatively impact lending and limit the impact of monetary policy, and may reverse several years of continuous improvement. In addition, changes to the rules on privately managed pensions increased unpredictability and may have undermined their long-term viability. This in turn may curtail the development of capital markets and deprive the economy of an important source of long-term investment financing.

Public and private investment in infrastructure, education, healthcare, social inclusion and innovation would improve productivity and long-term growth. Public investment has been subdued in recent years and is expected to recover only slowly while private investment could be affected by increasing uncertainty. Investments in transport, energy and environmental infrastructure would strengthen the economy's long-term growth potential and would have a positive impact on the population's standard of living. The education system does not sufficiently prepare people for employment and better social integration. Making

([1]) This report assesses Romania's economy in light of the European Commission's Annual Growth Survey published on 21 November 2018. In the survey, the Commission calls on EU Member States to implement reforms to make the European economy more productive, resilient and inclusive. In doing so, Member States should focus their efforts on the three elements of the virtuous triangle of economic policy – delivering high-quality investment, focusing reforms efforts on productivity growth, inclusiveness and institutional quality and ensuring macroeconomic stability and sound public finance. At the same time, the Commission published the Alert Mechanism Report that initiated the eighth round of the macroeconomic imbalance procedure. The Alert Mechanism Report found that Romania warranted an in-depth review, which is presented in this report.

([2]) https://www.consilium.europa.eu/en/press/press-releases/2018/06/22/hungary-and-romania-called-on-to-correct-significant-budgetary-deviations/

sure that Romania's work force achieves its full potential means investing also in social inclusion and healthcare. Increased public and private financing of innovation would help Romania's economy move towards higher value added activities. Annex D identifies key priorities for support by the European Regional Development Funds, the European Social Fund Plus and the Cohesion Fund over 2021-2027, building on the analysis of investment needs and challenges outlined in this report.

Romania has made limited [3] progress in addressing the 2018 country-specific recommendations. There has been limited progress in the following areas:

- Efforts to strengthen tax compliance and collection were limited to updating the guidance on the registration of certified cash registers and the use of risk assessment to audit taxpayers.
- On public procurement, the creation of a central purchasing body and the transition to e-procurement are welcome developments, but other reform commitments were stopped or even reversed;
- Social dialogue remains largely formalistic.
- Access to quality education is very unequal and the acquisition of basic and digital skills is limited;
- In the healthcare system, the roll-out of community care centres suffered further delays, limiting prospects for shifting to outpatient care;
- Limited progress was made on public investment project preparation and prioritisation, while the take-up of EU funds is slow.

There has been no progress in the following areas:

- Fiscal policy, including the adoption of the annual budget, continues to depart from the requirements under the national fiscal framework,
- The minimum wage continues to be set by the government in an ad hoc manner, while the law setting a minimum inclusion income is not yet in force;
- The decision-making process remains highly unpredictable, with complex and sometimes controversial legislation being adopted through emergency decrees, without impact assessment or stakeholder consultation;
- The corporate governance of state-owned enterprises is at risk of being weakened.

Regarding progress towards its national targets under the Europe 2020 strategy, Romania is performing well on employment rates, national greenhouse gas emissions, renewable energy, energy efficiency and tertiary education. R&D investment and early school leaving remain some distance away from their respective targets.

Romania performs poorly on most of the indicators of the Social Scoreboard supporting the European Pillar of Social Rights. The high economic growth has translated into better job prospects and increased household disposable incomes. However, Romania still has a high number of early school leavers and, although decreasing, a high number of young people not in education, employment or training. This raises concerns about equal opportunities and access to employment. Romania has not yet achieved a mature social dialogue, and its Social Scoreboard performance indicates a critical situation on reducing poverty.

The main findings of the in-depth review in this report and the related policy challenges are as follows.

- **Romania's current account deficit has been widening and its composition raises concerns.** From a nearly balanced position in 2014, the current account deficit increased to 3.2 % of GDP in 2017 and is forecast to deteriorate further. Imports of consumer goods have increased much faster than those of capital and intermediate goods. This means that

([3]) Information on the level of progress and actions taken to address the policy advice in each respective subpart of a country-specific recommendation is presented in Annex A.

the deterioration in the current account is driven more by consumption than investment, which will not support long-term economic growth.

- **Rising labour costs may hurt Romania's ability to compete internationally.** The cost of labour per unit of goods and services produced has increased strongly since 2016, as wage increases have outpaced productivity growth, albeit less so in industrial sectors open to international trade. Coupled with the gradual depreciation of the national currency, the impact on Romania's cost competitiveness has so far been limited and has allowed it to gain export market shares. Nevertheless, the pressure on private-sector wages due to high levels of employment, minimum wage hikes and spillovers from public wage increases may make Romania's economy less competitive in the future. In addition, trade tensions may weaken demand for Romania's exports.

- **Risks to the financial sector have substantially increased.** The functioning and stability of the financial sector and the long-term financing of the economy may be harmed by recent legislative initiatives including a retroactive cap on mortgage interest rates and a tax on banks' assets linked to the interbank interest rate. Moreover, new rules targeting privately managed pensions may hinder the development of what is still a very small capital market in Romania.

- **The business environment and investment decisions are being hurt by unpredictable policymaking.** Consultation of relevant stakeholders is limited and impact assessments are lacking or are of low quality. Recent legislation on the financial sector, privately managed pensions and the energy and telecommunication sectors could hinder future investment opportunities and increase uncertainty, making the economy less attractive to national and international investors.

Other key structural issues analysed in this report, which point to particular challenges for Romania's economy, are the following.

- **Labour and skills supply are not keeping up with the fast-changing needs of the economy.** The limited availability of skilled labour, population ageing, weak internal mobility and continued emigration are limiting economic growth. Despite labour shortages, certain social groups, including the Roma, have difficulties entering the labour market. Schemes to help people into work provide little focus on comprehensive solutions, including upskilling and reskilling. Minimum wage levels continue to be set without a comprehensive predictable mechanism and the number of collective wage bargaining agreements is low, especially at sector level.

- **Despite recent improvements, poverty and income inequality remain high, and regional disparities are deepening.** One in three Romanians is still at risk of poverty and social exclusion, with particular groups such as children, the Roma, people with disabilities and the elderly being more affected. Income inequality is one of the highest in the EU, reflecting in part the low redistributive capacity of the tax and benefit system. Inequality of opportunity is also high. Social services have insufficient quality and coverage, and uneven territorial distribution. The limited integration of employment, education, health and social services does not allow for a sustainable inclusion of diverse disadvantaged groups enter employment and escape social exclusion. After repeated delays, the law which will increase the adequacy of the minimum inclusion income is expected to enter into force in April 2019.

- **The insufficient capacity of the public administration limits development opportunities.** Red tape and the lack of quality public services continue to harm investment, but the reform of the public administration is progressing only slowly. The public procurement system requires enhanced transparency, monitoring and supervision. Scattered resources, fragmented responsibilities between different services and levels of the public administration lead to ineffective delivery of public services. Funding of public services is uneven across regions, counties and smaller administrative units, while local authorities' revenues lack stability and predictability.

- **The weak performance of the education and training system is not helping Romania to catch up with the EU.** Spending on education remains one of the lowest in the EU. Low participation in early childhood education hampers the development of cognitive and social skills. Early school leaving remains high, and attainment levels in basic skills are low and not improving. Rural-urban disparities persist and vulnerable groups, including the Roma, continue to have limited access to quality inclusive mainstream education. The quality and labour market relevance of higher education and vocational education and training face challenges, while access to adult learning is limited.

- **The healthcare system faces many challenges.** Low funding and an inefficient use of public resources limit the effectiveness of the health system. Continued migration has resulted in a sizeable shortage of doctors and nurses. Health infrastructure and the prevalence of informal payments remain sources of concern. Access to healthcare services for those living in rural areas and for vulnerable groups is limited. These in turn have a negative impact on the population's health status.

- **Despite significant public investment after EU accession, physical infrastructure remains underdeveloped.** The general condition and reliability of the road and rail networks are very poor. In addition, energy, waste, water and waste water infrastructure continue to show deficiencies. Substantial challenges remain over climate change adaptation, risk prevention, disaster resilience and air pollution.

- **Romania's modest performance in research and innovation limits growth prospects.** The country lacks a coherent strategy to help firms move towards higher value added activities. Public and private spending on research and development is one of the lowest in the EU, resulting in a low quality of the public science base and a low innovative capacity. Links between science and business are underdeveloped, while technology imports are not being substituted by home-grown innovation.

- **The corporate governance of state-owned enterprises is only loosely applied.** The legislation in this field could be weakened through forthcoming legislative amendments before Parliament. Appointments of interim boards are a recurrent practice, departing from the spirit of the corporate governance laws.

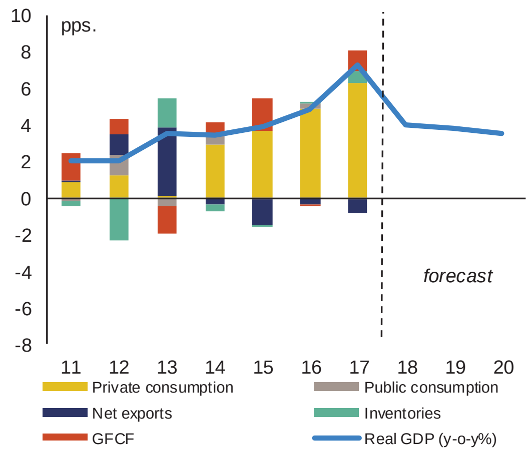
- **Progress in the fight against corruption has suffered significant setbacks.** The independence of judges and prosecutors has been weakened by recent amendments to the justice laws. The key anti-corruption institutions have come under increased pressure, raising concerns about their ability to continue the fight against corruption. The ongoing amendments to the Criminal Code and Code of Criminal Procedure could further weaken the fight against corruption and other serious crimes, undermining progress achieved over the past 10 years.

1. ECONOMIC SITUATION AND OUTLOOK

GDP and potential growth

Economic growth has slowed down but remains robust. Real GDP is estimated to have grown 4 % in 2018, down from a peak of 7 % in 2017 (Graph 1.1). The slowdown has been driven mainly by a deceleration in private consumption due to high inflation, fuelled by energy prices, and the fading of the effects of public policies aimed at increasing disposable income. However, private consumption continued to be the main driver of growth. Investment remained broadly stable and net exports became more negative as exports continue to decelerate faster than imports, affected by price hikes and the slow-down of external demand.

Graph 1.1: **GDP growth and demand-side components**

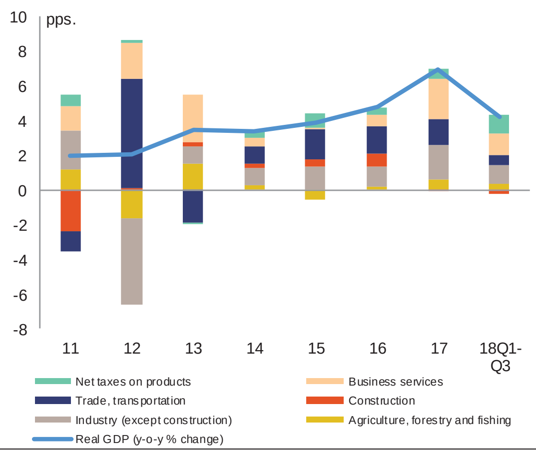


Source: European Commission

Growth is expected to remain broadly stable in the medium run. Real GDP is projected to remain below 4 % in 2019 and 2020 (Graph 1.1). Private consumption is set to continue being the main driver of economic activity, although slower increases in wages and a tighter credit environment could restrain its evolution. The contribution of the external sector to growth is forecast to remain negative but to improve as the growth of exports remains broadly stable while import growth is projected to decrease, following the slowdown in consumption. Investment is expected to increase somewhat more than in 2018.

On the supply side, the economic deceleration was more evenly distributed across sectors. For the first three quarters of the year, business services accounted for a stable 38 % of GDP. Industry and trade represented 24 % and 18 %, respectively. In terms of contribution to growth, business services are estimated to have accounted for 1.3 pps, followed by industry with 1 pp. and trade with 0.6 pps (Graph 1.2). The slowdown in exports registered in 2018 is taking a particular toll on the performance of trade and industry.

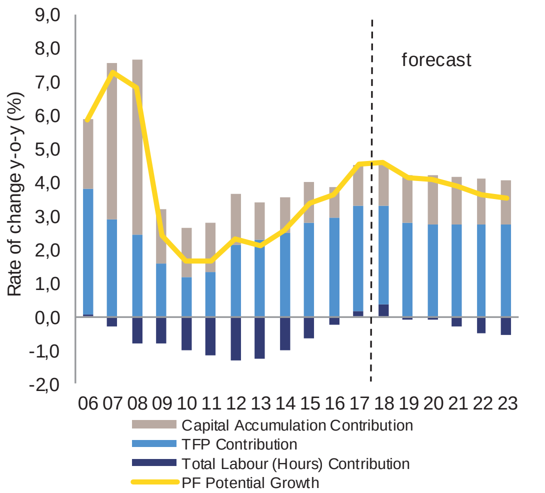
Graph 1.2: **GDP growth and supply-side components**



Source: European Commission

Potential growth has been driven mainly by total factor productivity. Potential GDP growth has strengthened in recent years, to reach 4.5% in 2017. (Graph 1.3). It is estimated to have remained strong in 2018, but is forecast to decrease progressively. Total factor productivity has been the main contributor to potential growth, despite a slight slow down in 2018. Labour made a modest but positive contribution in 2018 due to lower structural unemployment and a higher labour participation rate. After 2018 however, total factor productivity is expected to slow down and labour's contribution to potential growth to worsen due to slower growth of the working age population.

Graph 1.3: **Contribution to potential growth**



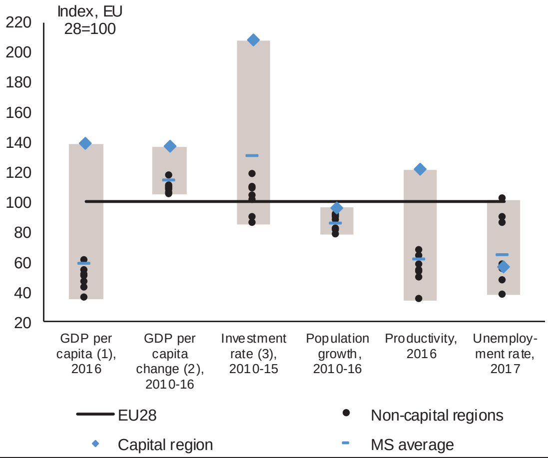
Source: European Commission

Regional disparities

Despite convergence towards the EU average, disparities within the country are still significant. Romania's GDP per capita has increased from slightly more than 40 % at EU accession, in 2007, to more than 60 % of the EU average in 2017. Differences across regions are substantial. In 2016, the Bucuresti-Ilfov region recorded a GDP per capita in Purchasing Power Standards of EUR 40 400, 1.4 times the EU average and almost 4 times that of the Nord-Est region, the country's poorest region. Excluding the capital region, GDP per capita is half the EU average. Bucuresti-Ilfov also registers twice the EU average in terms of investment as a percentage of GDP and 1.5 times the national average (Graph 1.4 and Section 4.4.4). When considering all EU regions, Romanian regions with initially lower levels of GDP per capita have experienced comparatively higher growth rates since the country's accession.

Disparities are also felt in the labour market. In 2016, labour productivity divergence across regions was one of the highest in the EU. Bucuresti-Ilfov registered the highest productivity (22 % above the EU average), while productivity in the Nord-Est region is only one-third of the EU average (Graph 1.4). Average productivity for all regions excluding the capital is only half the EU average. The regional unemployment rate in 2017 varied significantly, from 2.9 % in Nord-Est to 7.7 % in Sud-Vest Oltenia, despite a reduction in the gap across regions from 6.9 pps in 2016 to 4.8 pps in 2017. Regional socio-economic indicators show a major divide between a growing capital that mainly attracts skilled labour in higher value-added sectors and the rest of the country where employment is concentrated in lower value added sectors in a context of outward migration.

Graph 1.4: **Disparities across Romanian regions**

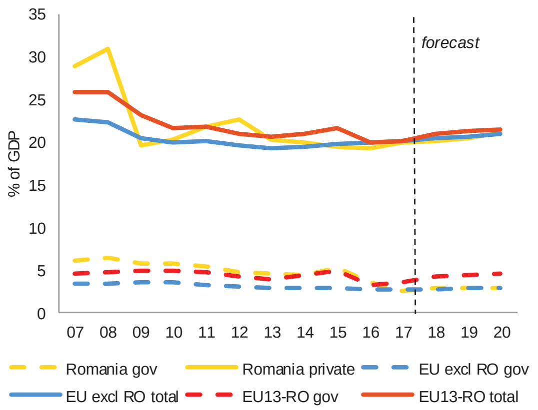


Grey areas represent the range of disparities across regions.
(1) GDP per capita in PPS
(2) Difference in index points
(3) Percentage of GDP
Source: European Commission

Investment

Romania continues to have one of the highest investment ratios in the EU. In 2017, total investment accounted for 22.6 % of GDP, above the EU and neighbouring countries' averages of 20.1 % and 20.2 % respectively. Private investment, which reached 20 % of GDP in 2017, is estimated to have increased somewhat despite concerns about fiscal and legislative instability and unpredictability (see Section 4.4.2). Public investment, by contrast, remains subdued, partly due to the slow uptake of projects under the EU financing period (see Section 4.4.2). In 2017, public investment fell to a post-EU accession low of 2.6 % of GDP, just at the EU average but below neighbouring countries (Graph 1.5). However, it is estimated to have slightly recovered in 2018 and forecast to progressively recover in coming years.

Graph 1.5: **Gross fixed capital formation**



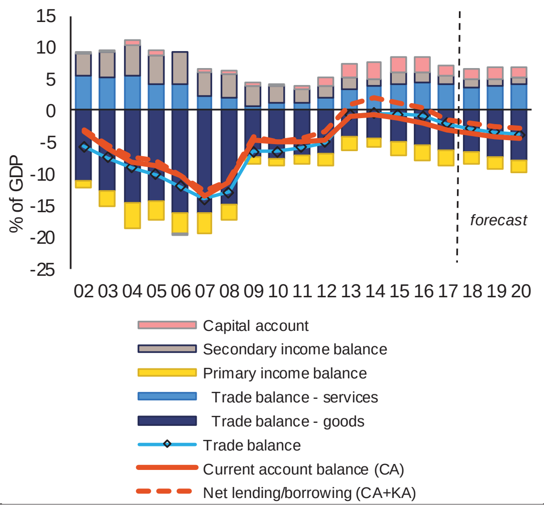
Source: European Commission

Investment could be hit by increasing uncertainty. Levels of investment could be heavily affected by the susceptibility of private investment to more challenging financial conditions and the government's under-execution of initially budgeted projects. The persistent unpredictability of policymaking creates a climate of instability which could hinder business confidence and investment decisions (see Sections 3 and 4.4). Moreover, the recent emergency ordinance ([4]) introducing a set of far-reaching fiscal measures (see Section 3) may affect private investment in energy and communication and the financial sector's capacity to finance the economy.

External position

The current account deficit widened further in 2018. The deficit is estimated to have worsened to 4.3 % of GDP due mainly to the deteriorating trade balance (Graph 1.6). As a result, the current account balance is increasingly diverging from the economy's fundamentals ([5]), which for Romania imply a balanced current account. The export market share is estimated to have remained on a gentle upward path in 2018. This evolution is felt in the net lending/borrowing, which became negative already in 2017 when the current account deficit started to widen markedly and the capital account balance almost halved. By sector, the net borrowing needs come mainly from households and, to a much lesser extent, the government. Corporations are net lenders.

Graph 1.6: **Current account breakdown and capital account**



Source: European Commission

The net international investment position is still improving. Strong nominal GDP growth facilitated a further improvement in the net international investment position to an estimated -47.8% of GDP in 2017 and -44.8 % in Q3-2018. However, progress has slowed down as a result of the widening current account deficit and some deceleration in nominal GDP growth (see Section 4.4).

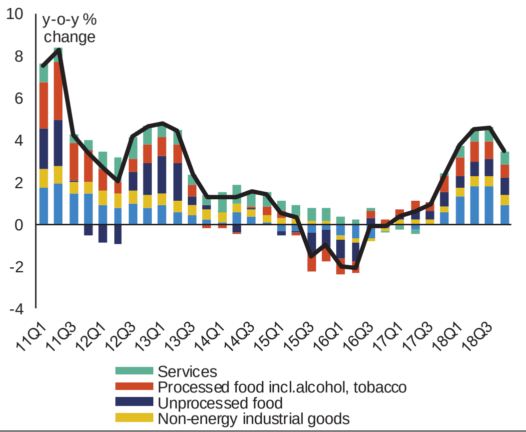
Inflation and monetary policy

Inflation reached a post-crisis peak in 2018. Inflation as measured by the harmonised index of consumer prices turned positive in 2017 and continued to increase throughout 2018, to reach an annual average of 4.1 %. This is the result of both internal and external factors. Internally, inflation accelerated at the beginning of 2018 as the effect of the January 2017 tax cuts faded away. Increases in the excise tax on energy products in autumn 2017 further added to the increasing trend. Internationally, the hike in food prices and, to a larger extent, of energy prices, further spurred headline inflation (Graph 1.7). In 2018, Romania had the highest inflation rate in the EU, well above the euro area average. Headline inflation is expected to moderate to 3.3 % and 3.1 % in 2019 and 2020, respectively, on account of weakening

([4]) Government emergency ordinance 114/2018
([5]) For details regarding the estimation of current accounts' fundamentals, see Coutinho, Turrini and Zeugner (2018).

domestic demand. Core inflation has remained more stable, at an average of 2.7 % for the whole of 2018.

Graph 1.7: **Contributions to headline inflation**



Source: European Commission

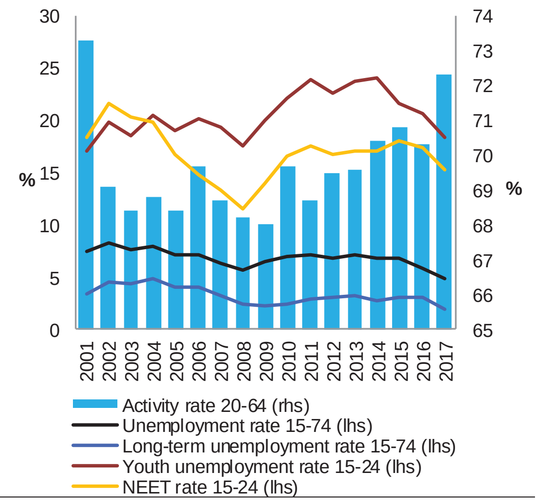
In 2018 the National Bank of Romania tightened its accommodative monetary policy. As inflation increased, the key monetary policy rate was raised three times by a total of 0.75 pps in the first months of 2018, to 2.5 %. These were the first hikes in 10 years. Since May 2018, however, the National Bank of Romania has kept the rates constant, anticipating the return of the annual inflation rate, as measured by the consumer price index, to within the Bank's target of 2.5 %±1 pp, reaching 3.3 % in December 2018.

The conduct of monetary policy is increasingly constrained by fiscal policy measures. The recent introduction of a tax on banks' assets linked to the interbank rate (ROBOR) is likely to limit the room for manoeuvre of the monetary policy. It may also introduce a conflict between the objective of maintaining price stability and that of safeguarding financial stability (see Section 4.2).

Labour market, poverty and social exclusion

Labour market conditions continued to improve, supported by robust economic growth. The activity rate increased to 72.3% in 2017, exceeding the pre-crisis level of 68.7 %. The unemployment rate in December 2018 (3.8 %) is at its lowest level in a decade (Graph 1.8). However, the shrinking workforce in the context of unfavourable demographics represents an obstacle for companies in filling job vacancies and finding the relevant skills on the labour market. As such, it could limit potential GDP growth. The labour market continues to be characterised by weak social dialogue, with a very limited involvement of social partners in policy-making.

Graph 1.8: **Labour market overview**



(1) Activity rate and employment rate (% of population), total, ages 20-64; Unemployment rate and long-term unemployment rate (% of labour force), total, ages 15-74; Youth unemployment rate (% of labour force), total, ages 15-24; NEET: Not in education, employment, or training (% of population), total, ages 15-24

Source: European Commission

Wages and unit labour costs continued to increase at a rapid pace in 2018. The record low unemployment rate, structural labour supply shortages and public policies increasing public and minimum wages ([6]) are forcing a correction in the labour market. Overall, wages are estimated to have increased further in 2018, also due to the impact of the 2017 change in the structure of social contributions, which shifted the burden almost entirely to the employees. As a result, unit labour costs have grown on average 8.1 % annually since 2016. These developments imply the risk of a competitiveness loss given that productivity developments can no longer compensate for such wage increases (see Section 4.4.1).

([6]) The minimum wage rose to RON 1 900 (c. EUR 413) in 2018 (a net increase of 9 % when accounting for the effect of the shift in the social security contribution), and further to RON 2 080 (c. EUR 450) in January 2019. For university graduates with at least one year of work experience the minimum wage was set at RON 2 350 (c. EUR 510) (see Section 4.3.1).

Despite the growing labour shortages, some groups are not fully integrated in the labour market. Participation rates remain particularly low for people with low education attainment, and among women and people with disabilities. The share of young people not in education, employment or training, while on a decreasing path since 2015, remained relatively high in 2017 at 15.2 %. A large part of the long term unemployed either remain unemployed (73.2 %) or fall into inactivity (13.2 %). The active labour market measures in place do not sufficiently address upskilling and integrated service delivery (see Section 4.3.1).

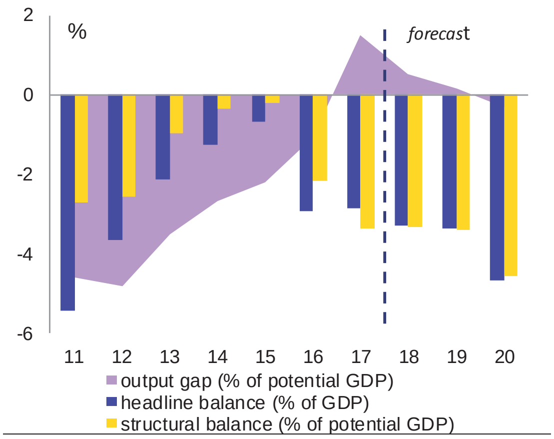
High poverty and inequality rates hamper Romania's ability to achieve inclusive growth. Although decreasing, poverty and inequality rates remain very high. Income inequality has declined over the past 2 years but remains one of the highest in the EU, reflecting in part the weak redistributive capacity of the tax and benefit system. More than 1.5 million people earn under EUR 3 per day (Friedrich-Ebert-Stiftung, 2018) and 3.9 million people suffer from severe material deprivation. Opportunities are unequal, in many respects. High poverty levels are associated with unemployment, low education attainment, high intergenerational transmission of poverty and regional disparities. The share of children living in poverty or social exclusion (4 out of 10) is one of the highest in the EU. Socioeconomic status greatly affects students' performance, deterring sustainable growth in the long-run (see Section 4.3.3). The education and care systems are not conductive to sufficiently independent living and to the employability of people with disabilities (see Section 4.3.2).

Public finances

The public deficit is projected to widen, mostly due to increases in current spending. In its 2018 Autumn Forecast, the Commission projected the headline deficit to increase from 2.9 % of GDP in 2017 to 3.3 % of GDP in 2018, mostly driven by public wage increases. The headline deficit was projected to increase slightly further in 2019, to 3.4 %, and then to jump to 4.7 % in 2020 due to significant increases to old-age pensions. The pension point, i.e. the main parameter used for pension indexation, is set to increase by 15 % in September 2019 and by 40 % in September 2020.

The structural deficit [7] is projected to remain broadly stable at around 3.3 % to 3.4 % of potential GDP until 2019 and to increase to 4.5 % in 2020 (Graph 1.9). In June 2018 the Council launched a new significant deviation procedure addressed to Romania.

Graph 1.9: **General government balance and output gap**

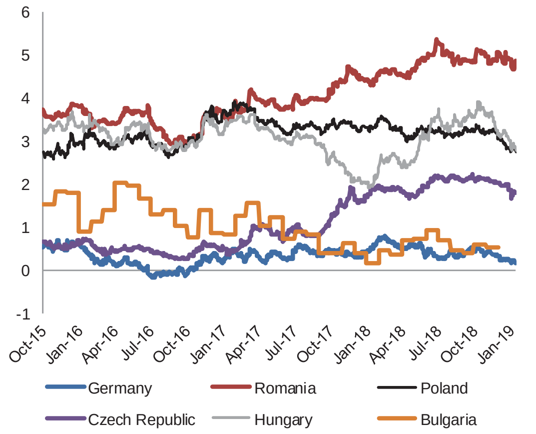


Source: Eurostat, European Commission 2018 Autumn Economic Forecast

The tax cuts and expenditure increases are being financed with public debt. Because of the widening of the public deficit, the general government debt is projected to increase from 35.1 % of GDP in 2018 to 38.2 % of GDP in 2020. Assuming no policy change, public debt is projected to increase to above 60 % of GDP in 2029 (see Section 4.1.4). The financing cost of public debt has been steadily increasing since mid-2017 to levels well above those observed for peer countries (Graph 1.10).

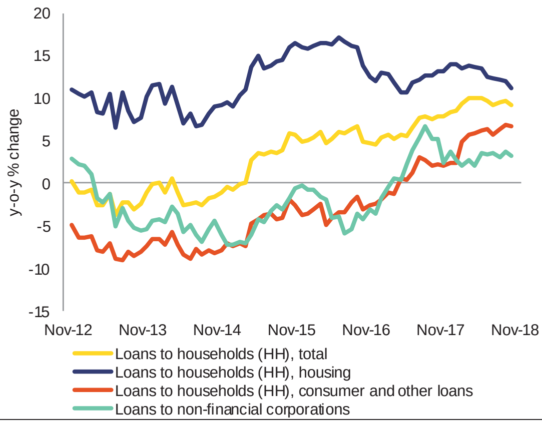
(7) Defined as the deficit corrected for the business cycle and one-off operations.

Graph 1.10: **10 year government bond yield: Romania and peers**



Source: European Commission

Graph 1.11: **Loans to households and non-financial corporations**



Source: National Bank of Romania

Financial sector

Consumer credit accelerated in 2018. The stock of loans denominated in Romanian lei (RON) continued to increase for both households and corporations. The domestic currency increased its share of the loans' stock to 65.9 % in November 2018, up from a low of 35.6 % in May 2012. Credit to non-financial corporations, albeit still increasing, has somewhat decelerated in 2018 compared to 2017 (Graph 1.11). Meanwhile, household lending has picked up on the back of an increase in the growth of consumer credit and mortgage lending, although the latter registered a slight slowdown. As of January 2019, a new macro prudential regulation limits the level of households' indebtedness (see Section 4.2).

Banking sector stability is threatened by recent legislative changes. Capital adequacy at system level continued to increase and stood at almost 20 % at the end of September 2018. As banks increased locally collected deposits and reduced dependency on parent funding, the loan-to-deposit ratio declined to around 76 % at end-September 2018. The share of non-performing loans in total loans fell below 6 %, but sales of impaired assets declined significantly as of March 2018 following changes to the Fiscal Code. Moreover, in December 2018, Parliament adopted several laws, not yet enacted (including retroactively capping interest rates in loan contracts), which are expected to hamper the disposal of non-performing loans and negatively impact the already very low level of financial intermediation in Romania. More worryingly, the newly introduced tax on banks' assets could have a long- lasting damaging effect on banks' ability to finance the economy, on the conduct of monetary policy and ultimately on economic growth (see Section 4.2).

The second pension pillar was further weakened. In December 2018, the government significantly increased the minimum capital requirements for second pillar pension funds' management companies operating in Romania, while substantially reducing the allowed level of the administration fees. Moreover, participants with at least 5 years of contributions are now allowed to opt out of the second pillar. These changes, following a 2018 reduction in the proportion of the contributions accruing to the second pension pillar, significantly weaken the second pension pillar, with negative consequences for future pension adequacy, the development of the local capital market and the long-term financing of the economy (see Section 4.2).

Housing market

The growth rate of house prices is slowing down, but developments vary at sub-national level. Housing demand has been adversely affected by higher lending costs and overall higher prices. House prices increased by 5.7 % in Q3-2018, less than the same period of the previous year (6.2 %). The deceleration continued in the first quarters of 2018 on the back of volatile demand, especially in the residential segment, due to the tightening of both public (the *Prima Casă* programme) and private credit conditions. Substantial regional differences persist. House prices advanced by less than 6 % in Bucharest in Q3-2018, but some counties saw double-digit increases.

Table 1.1: **Key economic, financial and social indicators - Romania**

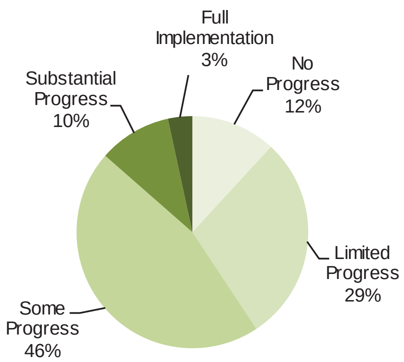
						forecast		
	2004-07	2008-12	2013-15	2016	2017	2018	2019	2020
Real GDP (y-o-y)	6.8	0.7	3.6	4.8	7.0	4.0	3.8	3.6
Potential growth (y-o-y)	5.7	2.9	2.7	3.6	4.5	4.6	4.1	4.1
Private consumption (y-o-y)	13.2	0.0	3.6	7.9	10.0	.	.	.
Public consumption (y-o-y)	-2.4	1.2	0.1	2.2	2.6	.	.	.
Gross fixed capital formation (y-o-y)	23.2	-3.7	1.6	-0.2	3.5	.	.	.
Exports of goods and services (y-o-y)	9.9	7.0	10.7	16.0	10.0	.	.	.
Imports of goods and services (y-o-y)	22.3	1.4	8.5	16.5	11.3	.	.	.
Contribution to GDP growth:								
Domestic demand (y-o-y)	14.4	-1.1	2.5	5.1	7.5	.	.	.
Inventories (y-o-y)	-1.4	0.0	0.3	0.0	0.2	.	.	.
Net exports (y-o-y)	-6.4	1.3	0.6	-0.3	-0.7	.	.	.
Contribution to potential GDP growth:								
Total Labour (hours) (y-o-y)	-0.4	-1.0	-1.0	-0.2	0.2	0.4	-0.1	-0.1
Capital accumulation (y-o-y)	2.1	2.2	1.1	0.9	1.3	1.3	1.4	1.5
Total factor productivity (y-o-y)	3.9	1.7	2.5	3.0	3.1	2.9	2.8	2.7
Output gap	6.2	-1.4	-2.8	-1.1	1.5	0.5	0.2	-0.3
Unemployment rate	7.2	6.6	6.9	5.9	4.9	4.3	4.2	4.1
GDP deflator (y-o-y)	13.2	6.2	2.6	2.5	4.7	6.5	3.8	3.5
Harmonised index of consumer prices (HICP, y-o-y)	8.1	5.7	1.4	-1.1	1.1	4.1	3.3	3.1
Nominal compensation per employee (y-o-y)	15.8	7.9	4.3	15.0	12.3	13.0	6.7	6.7
Labour productivity (real, person employed, y-o-y)	7.4	2.3	4.1	6.0	4.0	.	.	.
Unit labour costs (ULC, whole economy, y-o-y)	7.8	5.5	0.2	8.5	8.0	9.3	2.5	3.0
Real unit labour costs (y-o-y)	-4.8	-0.6	-2.3	5.9	3.1	2.7	-1.2	-0.5
Real effective exchange rate (ULC, y-o-y)	9.5	-2.7	-0.5	6.7	6.3	6.8	-1.1	0.7
Real effective exchange rate (HICP, y-o-y)	8.5	-2.9	0.9	-1.2	-1.7	2.4	-0.4	0.8
Savings rate of households (net saving as percentage of net disposable income)	-22.3	-5.4	-9.6	-8.1	-7.6	.	.	.
Private credit flow, consolidated (% of GDP)	13.9	3.0	-1.2	0.6	1.7	.	.	.
Private sector debt, consolidated (% of GDP)	43.3	70.6	62.7	55.6	51.0	.	.	.
of which household debt, consolidated (% of GDP)	11.9	21.4	18.2	16.7	16.2	.	.	.
of which non-financial corporate debt, consolidated (% of GDP)	31.5	49.3	44.4	38.9	34.8	.	.	.
Gross non-performing debt (% of total debt instruments and total loans and advances) (2)	1.4	.	14.8	7.7	5.1	.	.	.
Corporations, net lending (+) or net borrowing (-) (% of GDP)	-2.8	0.4	7.6	7.8	7.7	8.3	6.5	6.6
Corporations, gross operating surplus (% of GDP)	25.9	28.2	31.8	31.1	31.7	31.4	32.0	32.5
Households, net lending (+) or net borrowing (-) (% of GDP)	-4.7	0.2	-4.3	-4.0	-6.4	-6.9	-5.3	-4.6
Deflated house price index (y-o-y)	.	.	-1.4	5.2	3.3	.	.	.
Residential investment (% of GDP)	2.0	2.9	2.5	2.6	4.2	.	.	.
Current account balance (% of GDP), balance of payments	-10.2	-6.2	-1.0	-2.1	-3.2	-4.3	-4.5	-4.7
Trade balance (% of GDP), balance of payments	-11.3	-7.4	-0.6	-0.9	-2.1	.	.	.
Terms of trade of goods and services (y-o-y)	4.3	1.0	1.8	-0.3	-1.5	0.6	-0.2	0.0
Capital account balance (% of GDP)	0.5	0.6	2.4	2.5	1.2	.	.	.
Net international investment position (% of GDP)	-37.2	-61.7	-58.2	-49.0	-47.8	.	.	.
NIIP excluding non-defaultable instruments (% of GDP) (1)	-5.0	-22.2	-16.5	-6.7	-5.8	.	.	.
IIP liabilities excluding non-defaultable instruments (% of GDP) (1)	35.8	57.7	50.7	40.0	37.4	.	.	.
Export performance vs. advanced countries (% change over 5 years)	84.0	70.5	24.0	20.1	30.9	.	.	.
Export market share, goods and services (y-o-y)	.	.	7.0	8.6	3.1	.	.	.
Net FDI flows (% of GDP)	-7.1	-2.8	-1.9	-2.6	-2.4	.	.	.
General government balance (% of GDP)	-1.7	-6.1	-1.4	-2.9	-2.9	-3.3	-3.4	-4.7
Structural budget balance (% of GDP)	.	.	-0.6	-2.2	-3.4	-3.3	-3.4	-4.6
General government gross debt (% of GDP)	14.6	27.0	38.2	37.3	35.1	35.1	35.9	38.2
Tax-to-GDP ratio (%) (3)	28.5	27.3	27.6	26.5	25.8	26.2	26.2	26.2
Tax rate for a single person earning the average wage (%)	27.2	28.5	25.6	.	.	.	.	.
Tax rate for a single person earning 50% of the average wage (%)	22.7	25.5	22.9	.	.	.	.	.

(1) NIIP excluding direct investment and portfolio equity shares
(2) domestic banking groups and stand-alone banks, EU and non-EU foreign-controlled subsidiaries and EU and non-EU foreign-controlled branches.
(3) The tax-to-GDP indicator includes imputed social contributions and hence differs from the tax-to-GDP indicator used in the section on taxation.
Source: Eurostat and ECB as of 31-1-2019, where available; European Commission for forecast figures (Winter forecast 2019 for real GDP and HICP, Autumn forecast 2018 otherwise)

2. PROGRESS WITH COUNTRY-SPECIFIC RECOMMENDATIONS

Since the start of the European Semester in 2011, 59 % of all country-specific recommendations addressed to Romania have recorded at least 'some progress". 41 % of country-specific recommendations recorded 'limited' or 'no progress' (Graph 2.1). Overall, Romania has advanced in implementing its country-specific recommendations since 2013, and some reforms have been pursued even during economically challenging times. However, the reform momentum appears to have waned over the past few years. In several policy areas subject to country-specific recommendations action has slowed down or even been reversed and significant efforts are still needed to achieve tangible results on implementing reforms.

Graph 2.1: **Overall multiannual implementation of 2013-2018 CSRs to date**



(1) The overall assessment of the country-specific recommendations related to fiscal policy exclude compliance with the Stability and Growth Pact.
(2) The multiannual CSR assessment looks at the implementation since the CSRs were first adopted until the February 2019 Country report
Source: European Commission

On fiscal adjustment, past progress has been gradually undone. Since 2009, Romania has pursued a significant fiscal consolidation which led to achieving its medium-term objective in 2014 and 2015. However, since 2016 the authorities have been pursuing an expansionary fiscal policy that led to a substantial departure from that objective.

Progress on labour market and social assistance reforms has stalled since 2016. The minimum wage continues to be set by the government in an ad-hoc manner, without applying a set of objective criteria. Social dialogue remains ineffective, while the role of certain important institutions has been recently weakened. The implementation of the minimum inclusion income law, adopted in 2016, stalled in 2017 and is now expected to be enforced only as of April 2019. Active labour market policies are not comprehensively looking to individual needs and are insufficiently focused on upskilling.

Access to quality and inclusive education is highly insufficient. Early school leaving remains problematic and the acquisition of basic and digital skills faces substantial challenges. Ensuring equal opportunities for students from poor households and the Roma community remains a challenge. The limited availability of nurseries and their uneven distribution does not support children's early cognitive and social development and women's return to the labour market. The labour market relevance of education is limited. Forecasting and anticipation of skills needs remains unused, hampering the adaptation of the education system to labour market needs.

The healthcare system is faced with multiple challenges. Progress of reforms in key areas such as the development of integrated community care centres and the building of regional hospitals has been delayed, while in other priority areas the measures taken by the authorities appear insufficient. The administrative capacity of the Ministry of Health continues to be very limited, while poor investment planning and lack of political commitment further hamper the progress of reforms. The shift to outpatient care remains at an early stage, with most efforts concentrated on hospital care.

The conduct of public policy continues to be highly unpredictable. Important and sometimes complex legislative changes are still adopted without proper consultation of stakeholders, while impact assessments are often lacking. This often results in additional legislative changes being necessary to correct the unintended effects of emergency ordinances adopted on very short notice. Contradictory public statements about the

Table 2.1: **Assessment of 2018 CSR implementation**

Romania	**Overall assessment of progress with 2018 CSRs: Limited progress**
CSR 1: *Ensure compliance with the Council recommendation of … June 2018 with a view to correcting the significant deviation from the adjustment path toward the medium-term budgetary objective. Ensure the full application of the fiscal framework. Strengthen tax compliance and collection.*	**Limited progress** • No progress was made in ensuring that the national fiscal framework is implemented • Limited progress was made in strengthening tax compliance and collection.
CSR 2: *Complete the minimum inclusion income reform. Improve the functioning of social dialogue. Ensure minimum wage setting based on objective criteria. Improve upskilling and the provision of quality mainstream education, in particular for Roma and children in rural areas. Improve access to healthcare, including through the shift to outpatient care.*	**Limited progress** • No progress was made in completing the minimum inclusion income reform. • Limited progress was made on improving social dialogue. • No progress was made on minimum wage setting. • Limited progress was made on upskilling and improving access to quality mainstream education. • Limited progress was made on shifting to outpatient care
CSR 3: *Increase the predictability of decision-making by enforcing the systematic and effective use of regulatory impact assessment and stakeholder consultation and involvement in the design and implementation of reforms. Improve the preparation and prioritization of large infrastructure projects and accelerate their implementation, particularly in the transport, waste and waste water sectors. Improve the transparency and efficiency of public procurement. Strengthen the corporate governance of State-owned enterprises.*	**No progress** • No progress was made on improving the predictability of decision making. • Limited progress was made on strengthening project prioritization and preparation in public investment. • Limited progress was made on implementing the national public procurement strategy. • No progress was made on improving the corporate governance of State owned enterprises.

(1) This does not include an assessment of compliance with the Stability and Growth Pact.
Source: European Commission

future of important reforms also contribute to the overall climate of unpredictability of policy making, negatively affecting the business environment.

Overall, Romania made limited progress ([8]) in addressing the 2018 country-specific recommendations. There was limited progress on tax compliance and collection, upskilling and education, social dialogue, outpatient care, public investment prioritisation and public procurement. No progress was made on the fiscal framework, minimum wage setting, minimum inclusion income, predictability of decision-making and the corporate governance of state-owned enterprises.

([8]) Information on the level of progress and actions taken to address the policy advice in each respective subpart of a country specific recommendation is presented in the overview table in Annex A.

Box 2.1: EU funds and programmes contribute to addressing structural changes and to fostering growth and competitiveness in Romania

Romania is a large beneficiary of EU solidarity. EU funds allocated to Romania amount to EUR 30.8 billion for the 2014-2020 programming period, potentially representing around 2.4 % of GDP annually. As of the end of 2018, around EUR 20.8 billion was allocated to selected projects. EUR 7.9 billion of the total allocation was paid to Romania. In addition, EUR 1.2 billion was allocated to specific projects on strategic transport networks through the Connecting Europe Facility. Furthermore, Romanian research institutions, innovative firms and individual researchers benefited from other EU funding instruments, notably Horizon 2020.

EU funds can help address policy challenges identified in the 2018 country-specific recommendations. Actions financed include investments in transport, energy, water and waste management infrastructure, education, employment and social policies, strengthening healthcare, extending broadband access and developing public administration and inter-operable e-government services. As a result, 315 km of TEN-T railway lines and 378 km of TEN-T roads are under construction; almost 140 000 additional households will have access to broadband of at least 30 Mbps; around 750 000 additional people could benefit from improved water supply and more than 2.5 million people are set to be served by improved wastewater treatment. In addition, 1 793 micro-enterprises and 688 SMEs have received direct support to strengthen their competitiveness. The SME Initiative has generated EUR 361 million of loans supporting 1 344 SMEs. Moreover, the European Social Fund is currently supporting ongoing active labour market measures for about EUR 473 million, while other EU funds will also enable the hiring of 174 new researchers. Despite some progress, implementation is still delayed in several sectors including for smart, sustainable, social and connectivity investments. The reform of the public administration, a precondition for EU funding support, is progressing at a slow pace. In addition, the implementation of some key country specific recommendations and related reforms is severely delayed (see Section 2).

In addition, the Commission can provide tailor-made technical support upon a Member State's request via the Structural Reform Support Programme to help Member States implement growth-sustaining reforms to address challenges identified in the European Semester process or other national reforms. Romania, for example, is receiving support for the establishment of a national promotional bank. The Commission is also assisting the authorities in their efforts to develop an economically and environmentally sustainable water and waste water sector, to modernise the health service delivery model and to reinforce the administrative capacity of the National Agency for Fiscal Administration to improve tax compliance and revenue collection. In addition, in 2018, work has started on assisting the National Institute of Administration in introducing modern methods of training of public administration, on conducting the first evaluation of state aid schemes to assess market outcomes and optimise their design in the future, and on creating a mechanism of early detection/warming and intervention for identifying children at risk of repeated school drop-out.

EU funding can contribute to the mobilisation of private investment. Out of the total European Regional Development Fund financing, EUR 350 million is to be delivered via financial instruments and is expected to leverage additional private investment of around EUR 1 billion. European Social Fund financial instruments should support in particular the creation of new jobs and investments in the social economy. However, implementation has not started. Romania is advancing in the take up of the European Fund for Strategic Investments, with total financing amounting to EUR 652 million and expected to trigger EUR 2.7 billion in additional private and public investments ([1]). A Romanian project backed by the European Fund for Strategic Investments is "Agricover Loan for Small and Medium-sized Enterprises", for which the European Investment Bank provides a EUR 15 million loan to Agricover Credit IFN to finance small projects in the agricultural sector.

EU actions are intended to strengthen national, regional and local authorities and civil society. Around EUR 1 billion has been allocated to strengthen the capacity of the public administration at different levels and encourage cooperation with relevant stakeholders. The Coal Regions in Transition Initiative seeks to improve socio-economic and technological transformation processes in the Jiu Valley mining region.

https://cohesiondata.ec.europa.eu/countries/RO#

([1]) https://ec.europa.eu/commission/sites/beta-political/files/romania-investment-plan-factsheet-17x17-dec18_en.pdf

3. OVERALL FINDINGS REGARDING IMBALANCES, RISKS AND ADJUSTMENT ISSUES

Introduction

The 2019 Alert Mechanism Report concluded that a new in-depth review should be undertaken for Romania to examine the possible existence of imbalances (European Commission, 2018i). An in-depth review was not prepared for Romania in 2018 and no imbalances have been identified. This chapter summarises the findings of the analyses in the context of the Macroeconomic Imbalances Procedure (MIP) in-depth review that is contained in various sections in this report ([9]).

3.1. IMBALANCES AND THEIR GRAVITY

The current account deficit has been widening markedly. From being nearly balanced in 2014, the current account registered a deficit of 3.2 % of GDP in 2017 and is estimated to have deteriorated further to 4.3 % of GDP in 2018. This evolution implies an increasing divergence from the economy's fundamentals, which point to a close to balanced current account. This is mainly the result of an increasing deficit of the trade in goods, spurred on by the private consumption boom against the backdrop of an expansionary fiscal policy in times of high GDP growth. The net international investment position, in turn, has improved to -47.8 % of GDP in 2017. The 20 pps correction since 2012 has been mainly due to the strong nominal GDP growth more than offsetting the widening current account deficit. The capital account surplus added further relief.

Unit labour costs have been growing strongly. Despite significant productivity gains in recent years, which are to some extent a catching-up effect from a low starting point, wage increases have been significantly outpacing productivity growth since 2016, leading to a marked acceleration of unit labour costs. This in turn has led to an appreciation of the unit labour costs-based real effective exchange rate (see Section 4.4.1).

Public and minimum wages have been increasing at a rapid pace, with potential spillovers to the private sector and negative implications for competitiveness. Public wages are on a marked upward trend. The more subdued evolution of wages in the tradeable sector in recent years, as well as relatively robust productivity developments, have allowed exports to remain competitive so far and helps explain the more limited loss in cost competitiveness in tradeables. Nevertheless, empirical evidence shows that the public sector has a leading role in wage determination in Romania. Therefore recent and future wage increases in the public sector may lead to substantially higher private sector wages, including in the tradeable sector, undermining competitiveness. Also the unilateral government-set increases in the statutory minimum wage, starting in 2015 and due to continue into 2019, have added to wage pressures and reinforce the potential negative effect on competitiveness.

Recent legislative initiatives risk threatening the normal functioning of the financial sector. These include a parliamentary law retroactively capping mortgage interest rates and a government emergency ordinance imposing a tax on banks' assets linked to interbank interest. Furthermore, measures aimed at the second pension pillar, also passed into law by the emergency ordinance, may strongly hinder the development of capital markets, which are already very shallow in Romania. The new risks to the banking sector, the weakening of institutional investors and the increasing unpredictability of policy making may also dent private investment.

3.2. EVOLUTION, PROSPECTS AND POLICY RESPONSES

The current account deficit is on a deteriorating trend, with its composition being a concern. Prospects imply a further deterioration in 2019 and 2020, to close to 5% of GDP according to the Commission's 2018 Autumn Forecast. Romania is one of the very few Member States whose current

([9]) Analyses relevant for the in-depth review can be found in the following sections: Public finances and taxation (Section 4.1); Financial sector (Section 4.2), Labour market (Section 4.3), Competitiveness reforms and investment (Section 4.4). Some of the elements relevant for the in-depth review came into existence only after the publication of the 2019 Alert Mechanism Report.

account deficit is worsening. Changes in composition are also a concern, as growth in imports has been substantially higher for consumer goods than for intermediate or capital goods. This means that the import spree is not adding much to the potential future growth of the economy or improving living standards in a sustainable way.

Recent improvements in the net international investment position may stall. GDP growth, while still robust, has slowed in 2018 and is expected to slow further in 2019 and 2020, while the current account is forecast to continue to deteriorate. That could end the substantial improvement of the net international investment position observed over the past 5 years. The composition of the net international investment position, with a small debt weight, may mitigate risks. Overall, however, recent and prospective developments on the external side expose the economy to growing risks, especially in times of a more uncertain and weakening world economy.

While the export performance is still strong, fast-growing unit labour costs can hurt competitiveness and the country's external position. Romania's export market shares continued to increase in 2017 despite increasing RON-denominated export prices. The gradual depreciation of the national currency over the past 2 years has somewhat reduced the pressure on the price competitiveness of exports. However, private sector wages are under pressure from a very tight labour market, repeated minimum wage increases, and possible spillovers from strong public sector wage hikes. This could trigger competitiveness losses, including in the sectors more exposed to external competition.

Threats to the external performance also arise from the current policy trajectory and the external environment. These could increase macroeconomic volatility, undermine the capacity to withstand adverse shocks, and eventually slow down convergence toward the standards of living in other EU countries. Uncertainty over policy and legislative decisions, including those with potential impact on investment and production decisions, contributes to the overall perception of unpredictability in public policy making. The main external risks to the economic outlook include an abrupt shift in global risk appetite against the backdrop of continued monetary policy normalisation in the EU, as well as trade tensions leading to weaker external demand. If these developments were to materialise, they would have a negative impact on investment and exports.

3.3. OVERALL ASSESSMENT

Romania faces increasing risks in the form of a deteriorating current account deficit and accelerating unit labour costs. The current account deficit has been widening since 2014 mainly due to a growing deficit of the trade in consumer goods. Despite a good export performance and significant export market share gains since 2012, growth in imports has persistently outpaced that of exports. Repeated increases of the minimum wage and public sector wages have put unit labour costs under growing pressure. The impact of the wage policies on cost competitiveness has so far been mitigated by a number of factors: productivity gains, a slow pass-through to the tradeable sector of the rising economy-wide unit labour costs, and currency depreciation. However, the continuation of this trend entails potential competitiveness losses, leaving the country vulnerable to external shocks.

Policy measures adopted so far may exacerbate the risks of imbalances. Government decisions on public and minimum wages have played a major role in increasing risks to cost competitiveness. Also, an expansionary fiscal stance limits the room to cushion potential shocks. The persistence of these trends can further harm the confidence of economic players, reduce the economy's capacity to adapt to shocks that may arise at home or spill over from abroad, and affect the economy's growing external financing needs as measured by the high and worsening external deficit.

Recent government decisions have increased risks in the financial sector and may negatively affect private investment. These decisions could lead to a lower availability of credit, fewer long-term investors, and an unstable and unpredictable policy-making environment. In light of the economy's limited debt tolerance, strong reliance on foreign investment and past record of capital flows volatility, addressing the ongoing trends would prevent a reversal of investors' sentiment in a context of slowing economic activity and increased uncertainty in the economic outlook.

Box 3.1: MIP assessment matrix (*) – Romania 2019

	Gravity of the challenge	Evolution and prospects	Policy response
	Imbalances (unsustainable trends, vulnerabilities and associated risks)		
Financial sector and investment (see Section 4.2)	Recent legislative initiatives may hurt the functioning of the financial sector, international capital flows and private investment, and might constrain the conduct of monetary policy. These legislative initiatives include: (i) a parliamentary law retroactively capping mortgage interest rates; (ii) a government emergency ordinance imposing a tax on banks' assets linked to the interbank interest rate; and (iii) measures weakening the second pension pillar and the development of capital markets.	The banking sector's capital adequacy and quality continued to improve in 2018. However, the financial sector's ability to finance the economy may be impaired and its stability threatened by legislative changes introduced in December 2018, including a retroactive capping of mortgage interest rates, a new tax on banks' assets and changes to the second pension pillar. The December legislation may also hinder foreign and domestic private investment due to tighter credit and a shallower capital market with weaker institutional investors. Unclear implementation details blur the potential overall effect in the economy, adding to the already beleaguered business environment, affected by political and legislative uncertainty and unpredictability.	Parliamentary and governmental legislation for the financial sector, the second pension pillar and energy and communications companies have increased risks to the financial sector and investment.
External balance (see Section 4.4.1)	The current account deficit has persistently deteriorated, to an estimated 4.3 % of GDP in 2018. The widening deficit has been driven mainly by a worsening trade deficit in goods, which went from 4.3 % of GDP in 2014, when the current account was close to balance, to 6.7 % in 2018.	The trade deficit will continue to widen, pushing the current account deficit to an estimated 4.5 % of GDP in 2019 and 4.7 % in 2020. The deterioration is taking place in a context of buoyant foreign demand and strong gains in export market shares. Less favourable external conditions could lead to an even stronger than forecast worsening of the current account. At the same time, the NIIP is expected to improve at a slower pace or even to worsen from levels that are already behind what is suggested by economic fundamentals. The consumption-led widening of the current account deficit is not supportive of potential GDP growth. The trade deficit in goods worsened in spite of a strong export performance (the export market share has increased by more than a third since 2012). The change in the composition of imports is also worrisome. The trade balance in consumer goods shifted from a small surplus in 2014 to a deficit of 2.3 % of GDP in 2017. Imports of consumer goods are growing significantly faster than other imports. Consumer goods imports increased by 14 % in the last 3 years, twice as much as imports of intermediate and capital goods.	The widening of the current account deficit is in large part linked to Romania's private consumption, which expanded, in real terms, by 7.9 % in 2016, 10.1 % in 2017, and 4.6 % in 2018. A persistently expansionary fiscal policy has been fostering this consumption boom through successive indirect tax cuts and substantial public and minimum wage hikes. Public investment, however, contracted sharply in both 2016 and 2017, although is estimated to have slightly increased in 2018, indicating that the government's fiscal stance encourages growth in the short-run to the detriment of its long-term prospects.

	Gravity of the challenge	Evolution and prospects	Policy response
Competitiveness (see Section 4.4.1)	After a modest evolution in the aftermath of the crisis, unit labour costs (ULCs) in Romania have started to pick up in recent years. In 2017, economy-wide ULCs grew by 8 %, the highest increase in the EU. The ULC acceleration has been driven entirely by wage growth, with productivity continuing to improve at strong rates, while nominal compensation per employee increased by an average of 15 % between 2016 and 2018. As a result, the ULC-based real effective exchange rate (REER) has appreciated continuously since 2016 while the export-price-based REER also started appreciating in 2018. For the future, the impact of these cost and price competitiveness losses may be exacerbated in an environment of trade tensions and slowing external demand.	Net wages increased by 13 % in the first 11 months of 2018. They remained higher in the public sector (19 % year-on-year) followed by both industry and market services which still grew at a robust pace (around 10.5 % year-on-year). Public wage developments may further spill over into the private sector and trigger lagged competitiveness losses. The impact of increasing ULCs on price competitiveness has been limited so far. Export prices, however, resumed growth in 2017 and the corresponding REER started to appreciate in 2018, signalling risks to price competitiveness. Competitiveness continues to be tied to non-cost factors such as deficient infrastructure, particularly in poorer regions, and a cumbersome business environment, fuelled by political and legislative uncertainty and unpredictability, which hinder long-term economic decisions and hurt business confidence and investment.	Repeated ad hoc public wage and minimum wage hikes have driven the acceleration of wages in the overall economy. The gross minimum wage almost doubled from RON 1 050 in July 2015 to RON 2 080 in January 2019, resulting in a highly compressed wage distribution. The share of workers earning the minimum wage, which was below 10 % until 2012, has grown to 37 % in 2017. Wages in the public sector grew by more than 75 % between 2015 and 2018, significantly outpacing the private sector. Further substantial increases have been approved for the coming years.

Conclusions from the IDR analysis

- The current account balance is deteriorating as the growth of imports continues to persistently outpace that of exports. This is despite export market share gains. Cost competitiveness has been deteriorating on the back of strong wage growth. Recent parliamentary and governmental decisions may hurt the functioning of the financial sector and have added to the prevailing perception of an unpredictable policy-making environment.
- The deterioration of the current account balance is expected to continue in the medium term, reflecting the ongoing private consumption boom. Imports of consumer goods have been a major driver of the current account deterioration, spurred by fiscal-led private consumption. Spillovers from public sector wages to the private sector and a deterioration of external conditions due to increasing trade tensions could further trigger a significant worsening of the country's current account. Recent legislation affecting the financial sector may distort the functioning of the sector, erode international capital flows and impact private investment.
- Policy action has contributed to the accumulation of vulnerabilities for the Romanian economy on several accounts. The expansionary fiscal policy, in a context of high GDP growth, has repeatedly stimulated an already fast growing economy and led to the widening of the current account deficit. The recent increase in unit labour costs, triggered by successive public and minimum wages increases, may compromise external competitiveness. Recent legislative initiatives have created new risks to the functioning of the financial sector, international capital flows and private investment.

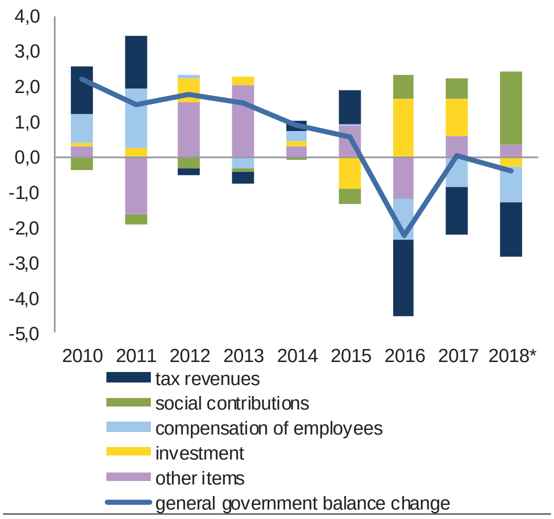
4. REFORM PRIORITIES

4.1. PUBLIC FINANCES AND TAXATION

4.1.1. FISCAL POLICY (*) ([10])

The authorities have been reducing taxes and increasing current spending, while cutting public investment. (Graph 1.1) Tax revenues have been dropping following cuts in consumption tax rates in 2016-2017 and a cut of the flat personal income tax rate as from 2018. On the other hand, collected social contributions significantly increased in 2018 thanks to the social security shift on the employees and to the cut to the proportion transferred to the second pension pillar (Box 4.2.1). On the expenditure side, public wages have been significantly increased in an ad-hoc manner since 2016. The unified wage law, adopted in summer 2017, increased gross wages in the public sector in 2018 and beyond. At the same time, public investment gradually fell to a post-EU accession low in 2017 and is projected to have increased only slightly in 2018. These policies have increased the public deficit and boosted private consumption (see Sections 1 and 4.4.1) to the detriment of long-term growth.

Graph 4.1.1: **Drivers of change of general government balance**



Source: Eurostat, European Commission 2018 Autumn Forecast (for 2018)

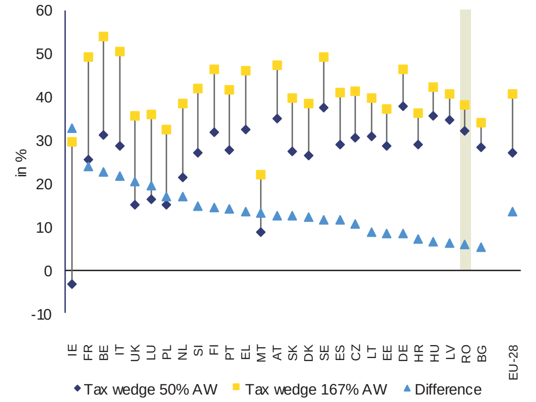
4.1.2. TAXATION

The tax structure is characterised by low levels of revenues, with high reliance on consumption taxes. The tax-to-GDP ratio stood at 24.9 % in 2017, the lowest value since 1996. This represents the second lowest level in the EU – well below the EU average of 39.2 %. The tax structure largely relies on consumption taxes, while the share of tax revenues from labour (including social contributions) is well below the EU-average (European Commission, 2019a).

The power of the tax system to reduce poverty and correct social disparities is limited. Income inequality remains one of the highest in the EU and a third of Romanians are at risk of poverty, the highest rates in the EU (Section 4.3.2). The relatively low level of tax revenues limits Romania's ability to tackle these problems, either via redistribution or through financing public goods and services (Section 4.3.2). In addition, the tax structure relies substantially on consumption taxes, which have no or very little redistributive impact. The design of labour taxation is among the least progressive in the EU, as measured by the difference between the relative tax burden for low- and high-income earners (Graph 4.1.2). This partly explains the limited redistributive impact of the tax and benefit system (Graph 4.1.3). The graph shows that both non-pension social benefits (the distance between the square and triangle) and taxes (the distance between the triangle and the cross) have a low impact on income inequality.

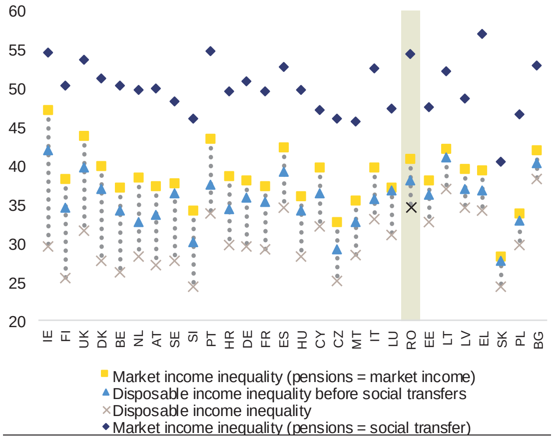
([10]) An asterisk indicates that the analysis in the section contributes to the in-depth review under the MIP (see Section 3 for an overall summary of the main findings.

Graph 4.1.2: **Degree of progressivity of labour income taxation in EU Member States, 2017**



(1) The indicator takes into account personal income taxes, social security contributions and family allowances. (2) The indicator is based on tax wedge data for a variety of family compositions (single, one earner couple, two earner couples, all three without and with two children). Those are then weighted according to their prevalence in the respective Member State (2) The setup of two earner couples combines a person earning 67 % of the average wage with either a person earning 50 % or 167 % of the average wage
Source: European Commission calculations, based on Eurostat and OECD data.

Graph 4.1.3: **Redistributive power of the tax and benefit systems in EU Member States, 2016**



(1) Income data are adjusted for household size (equalisation). (2) Income inequality is measured by the Gini coefficient. The value 0 corresponds to perfect equality (same income to everybody) while 100 corresponds to maximum inequality (all income distributed to only one person and all the others have nothing.) (3) EU-SILC 2016 data are based on income generated in 2015 (with the exception of Ireland and the UK.)
Source: European Commission calculations, based on Eurostat data

The implementation of several environmental taxes has been delayed. The implementation of the landfill tax introduced in 2014 was gradually postponed until 1 January 2017. This tax proved to be short-lived as on 1 July 2017, the government decided to suspend its application until 1 January 2019. However, government emergency ordinance 74/2018 introduced a contribution for the circular economy, imposed at relatively low levels, to be collected by the sanitation/waste collection companies. The government is also planning to introduce in 2019 a pollutants-dependent car registration tax (see Section 4.4.2). Moreover, the mandatory contribution/surcharge for failure to achieve the collection targets by economic operators placing on the market electrical and electronic equipment and portable batteries and accumulators, and by collective organisations has been postponed until 2020.

Tax compliance remains low, as exemplified by the high value added tax (VAT) gap. The VAT gap is defined as the difference between the VAT liability theoretically due and VAT actually collected. It thus represents lost revenue due to evasion, fraud, insolvencies, bankruptcies, administrative errors or legal tax optimisation. The VAT gap in Romania was the largest in the EU in 2016 as a share of VAT theoretically due (CASE et al. 2018). It amounted to around 36 % of VAT theoretically due, compared to the EU average of approximately 12 %. The gap increased by about 2 pps in 2016 compared to the previous year.

The large shadow economy poses additional challenges in terms of tax compliance. The Romanian informal economy is estimated at 22 % of the total economy (2014 estimation based on OECD methodology), with the unregistered workforce the biggest component. The National Institute of Statistics estimates the unobserved economy at about 21 % of GDP in 2017 [11]. According to a recent study (PWC, 2018), 42 % of surveyed organisations reported having been subject to economic crimes (defined as fraud committed by consumers, cybercrime, business misconduct) in the last 24 months, a significant increase compared to the 2016 study (17 %).

Undeclared work in Romania is high. It is estimated to account for around one fifth of labour input and a quarter of gross value added in the private sector (European Commission, 2018m). Although coercive measures were expanded, i.e.

[11] http://www.consiliulfiscal.ro/ionut_site.pdf.

by enlarging the legal definition of undeclared work situations ([12]), the overall number of cases detected by the labour inspectorates is still low. Coordination between the labour inspectorates and the fiscal authorities is, however, improving. Still, "envelope wages" (i.e. underreported salaries) have so far been only treated as a tax collection problem and not as a labour relations issue. The preventive measures are not showing sufficient results and could benefit from stronger cooperation with social partners.

Tax evasion is facilitated by high use of cash payments. According to the National Bank of Romania, cash payments are four times larger than electronic payments. Only 77 % of total bank cards are active, in the context of a relatively low level of financial education ([13]). Only 58 % of Romanian adults hold a bank account compared to 94 % in high-income economies and 63 % in developing countries. About a third of pensioners receive their rights in cash (World Bank, 2017b). All this facilitates the spread of the shadow economy and tax evasion. Law 19/2018, amending government emergency ordinance 193/2002 on the introduction of modern payment systems (the so-called "cashback law") now obliges companies with a minimum turnover equivalent to EUR 50 000 to operate card readers or other modern electronic payment systems. Although a positive development, its ability to reach consumers in rural areas remains to be assessed.

The tax administration has taken some steps on internal reorganisation and processes to enhance tax compliance. The tax administration moved about 24 000 mid-sized contributors/companies from the control of regional tax administrations to county-level ones as of November 2018. The tax administration has recently updated its guidelines on the registration of certified cash registers and the issuing of single identification number for cash registers. It is also in the process of operationalising the use of its risk analysis in order to identify, assess and manage the risk of tax non-compliance. As of July 2018, the Large Taxpayers Office began sending taxpayers formal questionnaires about risk indicators identified in their specific activity which may influence their risk rating. Even though the criteria for risk assessment are not made public, the questionnaires may help the tax administration identify inconsistencies in the VAT reporting obligations of the notified taxpayers ([14]).

4.1.3. FISCAL FRAMEWORK

The Fiscal Responsibility Law sets national numerical fiscal rules which should guide the budgetary process. It contains a structural deficit rule, which requires compliance with or convergence to the medium-term budgetary objective of a structural deficit not exceeding 1 % of GDP ([15]). The national framework also contains several auxiliary rules concerning expenditure and revenue items. Furthermore, the government is required to prepare an update of the fiscal strategy – which sets out the macroeconomic assumptions, medium-term budget planning and expenditure ceilings that should guide the annual budget process – and send it to Parliament by 15 August of the preceding year. The Fiscal Responsibility Law also requires that the Prime Minister and the Minister of Finance sign a joint statement certifying that the draft budget and the fiscal strategy respect the fiscal rules set in the Law, and the principles of fiscal responsibility.

As in previous years, the national fiscal framework has not been respected. According to the national Fiscal Council, the 2018 budget is in flagrant contradiction with the fiscal rules set up by the Fiscal Responsibility Law (Fiscal Council 2017). In particular, the 2018 budget targeted a headline deficit of close to 3 % of GDP, which is inconsistent with the structural deficit rule. The

([12]) False part-time contracts, fake/fraudulent suspension of work and failure to declare/register work contracts in the electronic labour registry at least 24 hours in advance. Done by government emergency ordinance 53/2017, OJ 644 of 7 August 2018, approved through Law 88/2018, OJ 315 of 10 April 2018.

([13]) According to the Standard&Poor's Ratings Services Global Financial Literacy Survey, only 22 % of adults in Romania understand basic financial concepts, against a European average of 52 %. For details, see Klapper et al. (2015).

([14]) In particular, those in relation to their third parties (possible VAT abuse/non-compliance), the registration of a profit margin below the average of the market (possible transfer pricing abuse/non-compliance), as well as abnormal variations of certain financial indicators such as labour productivity, indebtedness, liquidity, rotation speed of fixed assets (financial management implications, possible abuses/non-compliance).

([15]) The path of convergence is defined in agreement with the EU institutions, based on the rules of the Stability and Growth Pact.

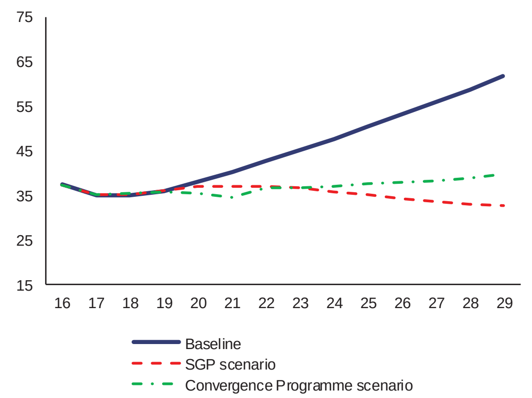
2018 budget amendment from September broke, among others, rules prohibiting increases: (i) of the nominal headline and primary deficit ceilings during the fiscal year; and (ii) in personnel expenditure and total government expenditure excluding EU funds during the fiscal year. The second 2018 budget amendment, published in November, also broke several national fiscal rules. The draft 2019 budget, approved by the government on 8 February, again broke multiple fiscal rules, including the structural deficit rule (Fiscal Council, 2019). Moreover, as in previous years, the authorities did not send an update of the medium-term fiscal strategy to Parliament by the statutory August deadline, thereby undermining its guiding role. Also, as in previous years, the authorities derogated from the requirement to sign a statement that the 2019 budget and the fiscal strategy respect the fiscal rules and principles of fiscal responsibility.

4.1.4. DEBT SUSTAINABILITY ANALYSIS AND FISCAL RISKS

Over the short term, no significant risks of fiscal stress are foreseen. The value of the early-detection indicator of fiscal stress ('S0'), which assesses risk within one year, is below its critical threshold. None of the fiscal and financial competitiveness sub-indexes point to short-term vulnerabilities. Financial markets' perceptions of sovereign risk remain medium-grade, with a 'BBB- stable' or equivalent rating of the sovereign debt from the three major rating agencies. However, the financing cost of public debt has been increasing since mid-2017 (see Section 1).

The public debt ratio is expected to gradually increase, leading to debt sustainability risks in the medium term ([16]). Due to a high structural primary deficit, and assuming no-policy change, the debt-to-GDP ratio is set on an upward path and expected to go beyond the 60 % of GDP Treaty reference value by 2029. Adhering to the existing fiscal rules, i.e. full compliance with the requirements of the preventive arm of the Stability and Growth Pact, would set the government debt ratio on a significantly lower trajectory relative to the baseline scenario at unchanged fiscal policy (Graph 4.1.4). The structure of the government debt in terms of maturity longer than 1 year helps to mitigate vulnerabilities. However, the high share of government debt in foreign currency and the substantial holdings of debt by non-residents could be aggravating factors, as could the negative net international investment position.

Graph 4.1.4: **General government debt projections (% of GDP)**



Source: European Commission calculations.

The high fiscal deficit and increasing ageing costs are set to negatively impact government fiscal sustainability over the long term. The relevant indicator ('S2'), points to a required fiscal adjustment of 5.9 pps of GDP to ensure that the public debt ratio remains sustainable over the long term. This is driven by the initial budgetary position (a contribution of 3.7 pps of GDP) and aging costs, in particular pensions and health care (a contribution of 2.1 pps of GDP).

These projections do not take into account the long-term impact of the new pension law. The law adopted by Parliament in December 2018 changed several parameters used to calculate pension benefits. It will lead to substantially higher long-term pension costs. In particular, the pension point value will rise as the indexation factor for existing pensions would no longer converge to prices but will, instead, remain permanently composed of wages and prices. Moreover, the contributory period used in the calculation of one's pension is now shorter, leading to higher pension expenditure for new pensions. However, the abolishment of the correction index for new pensions (which used to partly link the first pension to wages) will mitigate the overall pension

([16]) For an overview of fiscal sustainability assessment see European Commission (2019b). See also Annex B.

expenditure increase implied by the other parameters.

4.2. FINANCIAL SECTOR

Banking and insurance (*)

Following several years of efforts to strengthen its resilience, the banking sector faces increased stability risks. Banking sector capitalisation has been flat since 2016 at around 19 %, well above the EU average. The common equity tier 1 ratio declined marginally in the first half of 2018, but remained reassuring at 17.5 %. The non-performing loans ratio declined to below 6 % by the third quarter of 2018, while the flow of new non-performing loans has again increased in the first months of 2018, in particular for household loans in local currency. With sovereign bond holdings of roughly 20 % of total assets (compared to 2.2 % in 2008) and a pronounced home bias, the banking sector is heavily exposed to domestic sovereign debt, leaving banks vulnerable to an increase in sovereign spreads and interest rate hikes. Due to their deposit-based funding model, banks have issued few debt instruments. Consequently, compliance with minimum requirement for own funds and eligible liabilities will entail higher costs, in particular in the context of Romania's under-developed capital market.

Tax measures have slowed down sales of non-performing loans by banks. In mid-2017, the government limited as of January 2018 the tax deductibility of expenditures related to non-performing loans sold by banks to third parties to 30 %. Full tax deductibility was previously the rule (European Commission, 2018a). Law 72/2018 introduced an additional tightening of the tax regime for the non-performing loans sold by banks, by taxing both the income from the sale and part of the losses recorded at sale. The law treats 70 % of the difference between the book value of the non-performing loans sold or written-off (covered partially or entirely by loan-loss provisions) and the sale price as being similar to income and, therefore, subject to taxation. This treatment goes against efforts to develop the secondary market for impaired assets in the EU. It discourages the sale of non-performing loans and would hinder balance sheets' repair if these loans were to increase again. The Romanian secondary market for impaired assets, the most dynamic in Eastern Europe in recent years, recorded sales of EUR 8.5 billion in 2015-2017 but has stalled since Q1-2018.

A recently introduced bank tax is likely to create strong headwinds for the banking sector. In December 2018, without impact assessment or consultation of stakeholders, the government adopted an emergency ordinance introducing a new tax for banks (the "tax on greed") levied on total assets and linked to the level of the interbank interest rate (ROBOR). The levy is calculated on a quarterly basis. It increases gradually from 0.1 % to 0.5 % of total assets depending on how much the quarterly average ROBOR surpasses an arbitrarily set threshold of 2 %. The tax is very pro-cyclical and raises calibration concerns, as it inhibits the price-setting mechanism in the banking sector. At the January 2019 level of the ROBOR, it will amount to 1.2 % of total assets per year. Based on a preliminary analysis, the tax is likely to put a strain on financial stability by significantly impacting the solvency and profitability of banks and by worsening further the situation of weaker banks. The impact of the levy on banking sector profitability appears to be much higher than in other EU countries which introduced such taxes in the past, including regional peers. Moreover, the bank levy is likely to constrain credit activity, as banks may deleverage to reduce total assets, further lower banking sector intermediation, and reduce flexibility for monetary policy and hamper its transmission mechanism. Banking sector intermediation in Romania (measured as the ratio of private sector credit to GDP) is currently the lowest in the EU.

Three laws with potential negative impact on the banking sector were recently adopted by Parliament. These laws are still to be enacted. The law capping interest rates in mortgage and consumer loan contracts raises significant concerns. The caps' calibration ([17]) could potentially harm lending activity and financial intermediation ([18]). They may have an adverse impact on the supply of banking services and financial products by credit institutions and hinder

([17]) The law is unclear about the application of caps, as a reference is missing. It can be inferred, however, that the legislator intended to have a cap of 3 pps above the monetary policy rate for mortgage loans, tighter than previously discussed, and 18 % for consumer loans.

([18]) Caps on interest rates exist in other EU Member States, but with the objective to protect consumers from usury practices. Caps are normally linked to an average market interest rate and target mainly consumer loans or loans granted by non-financial institutions. Mortgage loans are less frequently impacted.

access to credit for clients with a higher risk profile. The law capping the value recoverable from non-performing loans sold by banks will further hinder banks' ability to further reduce non-performing loans and continue balance sheet repair. It will negatively impact the revenues of investors in these loans and of debt collection companies, increasing the likelihood of market exits, undermining the secondary market for impaired assets. Furthermore, the right granted to defaulted borrowers to buy the impaired assets from investors at capped values and obtain full debt discharge is likely to induce moral hazard and weaken significantly payment discipline in the banking sector. It may reduce access to credit for some categories of borrowers as banks are likely to become increasingly selective. Moreover, the retroactive application of the laws capping interest rates and banks' receivables from credit agreements concluded in the past will increase legal uncertainty ([19]). Without prejudice to legitimate consumer protection objectives, the law eliminating the writ of execution of loan contracts will prevent the out-of-court repossession of collateral by banks and increase the overall recovery time for collateral. This will further adversely impact non-performing loans resolution and disposal.

Several other legislative initiatives by Parliament are also of concern. The Parliament intends to amend the 2016 law on debt discharge and has discussed the possibility of including the *Prima Casă* loans under the scope of this law. This would make the State guarantee on loans inapplicable, which could be regarded as an attempt by the State to backtrack on its financial obligations under the *Prima Casă* scheme. As such, it could put under strain the country's rating. Attempts to modify the Statute of the National Bank of Romania and remove the legal protection of staff involved in prudential supervision of credit institutions, which go against good international practices, would significantly weaken prudential discipline and the supervision of credit institutions.

The banking sector's exposure to the real estate market has steadily increased in recent years. Banks are the financial intermediaries most exposed to the real estate sector. Real estate lending to households accounts for over one third of total credit to the private sector, with the bulk of loans being granted at variable interest rates. This increased exposure has been markedly supported by the government-sponsored *Prima Casă* programme ([20]). The robust economic growth and developments in the residential real estate market in recent years, could justify a phasing out of the *Prima Casă* programme.

Household indebtedness has increased in recent years, although from low levels. Due to the sustained increase in housing loans since 2015, household indebtedness has increased in absolute terms. Whereas household debt-to GDP stood at just below 17 % in 2017, well below the EU average, the indebtedness level of low-income borrowers constitutes a matter of concern as they are the most exposed segment to an increase in interest rates. To curb the risks from the high indebtedness of individuals with low income, the National Bank of Romania introduced as of January 2019 maximum levels of indebtedness for both RON and foreign currency denominated loans (40 % and respectively 20 % of net income). These levels can be increased by 5 pps for borrowers taking out a mortgage loan for the first time to buy an own occupied dwelling.

The insurance sector is still highly dependent on compulsory car insurance. Insurance activity expanded further in 2017, when gross written premiums increased by roughly 3 % compared to 2016. Meanwhile, insurance penetration ([21]) has remained subdued (1.1 % at the end of 2017) and at low levels compared to EU peers. The insurance sector remains highly dependent on non-life insurance (in particular compulsory car insurance), which generated 79 % of the gross written premiums in 2017. Life insurance, the main driver of the insurance business in the EU, and household insurance have significantly lagged behind. The compulsory car insurance market (motor third party liability insurance) has been dominated by insurers subject in recent years to supervisory measures aimed at restoring compliance with solvency requirements. This market segment could benefit from further efforts to increase

([19]) It is also in breach of the principle of non-retroactivity of civil law, which is one of the reasons for which these laws are being challenged in the Constitutional Court.

([20]) See e.g. European Commission (2017 and 2018a).

([21]) Defined as the share of gross written premiums in a country's GDP.

profitability, through cost-cutting measures and maintaining adequate levels of technical provisions, thus improving the insurers' capacity to meet their obligations towards policyholders.

Access to finance

Retained earnings and asset sales are the main sources of financing for Romanian companies. Access to finance, mainly to bank financing, does not represent a pressing issue for most Romanian companies. In fact, appetite for external financing of their operations is low. According to a recent survey (NBR, 2018b), Small and medium-sized enterprises resort to bank financing less than larger corporations (22 % vs 50 %). They also report lower rates of success in obtaining the full amount requested compared to large companies (19 % vs 44 %). The appetite of small and medium-sized enterprises for non-bank financing has also remained subdued, mainly due to their low level of financial education and burdensome (and often costly) administrative requirements.

Loan demand from non-financial corporations has picked-up in Q2-2018. This trend continued in Q3-2018 and is estimated to have continued in the last quarter, albeit at a slower pace. Credit standards applicable to corporate loans tightened moderately in Q3-2018 following the introduction of macro-prudential measures by the National Bank of Romania. In contrast, credit standards for corporates in the euro area continued to ease in Q3-2018 (NBR, 2018c).

Box 4.2.1: Second pension pillar in Romania

Since 2008, Romania has had a three-pillar pension system, including a second pillar based on defined contributions. The first pillar is a mandatory pay-as-you-go scheme. The second pillar, also mandatory, is fully-funded and is run by private pension funds' management companies. The third pillar consists of voluntary individual pension savings. As of end-November 2018, the seven second pillar funds were managing assets worth RON 48.2 billion (EUR 10.3 billion) for 7.2 million individual participants. Around 63 % of their assets were invested in government bonds, 19 % in equity and 8 % in deposits. While investment in government securities is close to the prudential and legal threshold, exposure to equity remains well below the 50 % maximum limit.

Several government decisions undermine the viability of the second pension pillar. The contributions to the second pension pillar, which were to be progressively raised to 6 % of gross wages by 2016, were just 5.1 % by 2017 and have been reduced to 3.75 % in 2018. Moreover, government emergency ordinance 114/2018, adopted in December, made the second pillar optional, with employees now having the possibility to opt out after contributing for 5 years to the second pillar and transfer future contributions to the first pillar. The government emergency ordinance also significantly increased the minimum capital requirements for pension funds' management companies and reduced the administration fee levied on gross contributions from 2.5 % to 1 %. As such, the funds' management companies can retain only 0.2%, since 0.5% are transferred to the National Pension House and 0.3% to the Financial Supervisory Authority. These changes make the operating environment for pension funds' management companies highly unpredictable, negatively affect their financial results, and increase the likelihood of their market exit. They also reinforce the overall perception of an unpredictable legislative environment.

The short-term budgetary gain from the likely reduction of the transfers to the second-pension pillar will dissipate in the long-term while the retirement income will be less diversified. The second pillar is classified outside of the general government sector. Therefore, the reduction of transfers to the second pillar, following the likely opt-out of some employees entirely to the first pillar, will decrease the general government deficit in the short term. However, this budgetary gain would dissipate in the long term as the diverted social contributions would be accompanied by an obligation to pay the corresponding pensions in the future. Furthermore, the changes to the second pillar are likely to result in even less diversified retirement income and subject pensions to higher political and demographic risks. Past pension cuts and recent significant increases to the pension point have shown a tendency to depart from the statutory pension indexation formula.

The weakening of the second pillar can hamper the development of the capital market. Second pillar funds have invested approximately RON 8.3 billion (c. EUR 1.8 billion) in shares, mainly domestic. This accounts for some 5 % of the market capitalisation of the Bucharest Stock Exchange. In 2016, they were among the top performers in the region (European Commission, 2018a). Direct comparison with the performance of the first pillar is not possible since payments under the first pillar are the result of a political rather than an investment decision. Pension funds can support developing capital markets and boost investment if the assets they manage are allowed to grow and the predictability of the legislative environment is conducive to long-term investments. Empirical literature points to a positive impact of second pillar pension funds on market capitalisation (Enache et al., 2015). The likely market exit of some pension funds due to the recently adopted measures could deprive the Romanian economy of a potential source of investment funding, thus curtailing further development of what is currently a rather small and undeveloped capital market.

4.3. LABOUR MARKET, EDUCATION AND SOCIAL POLICIES

4.3.1. LABOUR MARKET

Employment is growing but labour shortages continue to increase on the back of economic expansion. The employment rate has increased steadily for the past 5 years reaching 65.5 % in 2017, above the pre-crisis level of 64.4 %. The unemployment rate of 3.8 % in December 2018, was the lowest in a decade, pointing to a tight labour market. Meanwhile, the country continues to face serious adverse demographics ([22]) due to fast ageing ([23]), low birth rates and emigration. The contribution of labour to potential GDP remains low but positive, supported by the low unemployment rate and remaining untapped potential in the labour market.

The continued emigration of the labour force challenges sustainable economic growth. In almost three decades Romania lost 23.3 % of its working-age population due to emigration (World Bank, 2018). The decrease in annual GDP growth due to emigration is estimated at 0.6 to 0.9 pps (IMF, 2016). Over 3 million people are estimated to have left the country, with the highest numbers leaving from the larger cities (Roman, 2018). Emigration from poor rural areas and of the young population (15-34 years old) is prominent in the Nord-Est and Sud-Muntenia regions (Roman, 2018). While the main drivers of emigration are higher wages, better working conditions and public services, in particular education and health (European Commission, 2018a), the emigration of people with higher education is also due to the low quality of public governance (IMF, 2016). Some measures aimed at reducing outward labour force migration were adopted in December 2018, notably in the construction sector, by exempting employees from income tax as of January 2019, for a period of 10 years and the adoption of a new specific minimum wage for the sector ([24]) (see Section 4.4).

Internal labour market mobility schemes are used to address labour shortages, but barriers persist. Unemployment rates vary significantly across regions. The capital region and the metropolitan areas in the Vest and Nord-Vest are service-driven regions which offer better labour market opportunities and attract more qualified workers. In contrast, in the regions with a manufacturing economic base, the urban industrial centres attract mainly unqualified workers from the neighbouring rural areas (World Bank, 2017a). Although internal mobility schemes are in place and supported by a national mobility plan, their implementation is lagging behind. Potential beneficiaries complain about the administrative burden related to its implementation and the lack of an integrated solution for the unemployed (such as limited provision of social and education services for family members).

([22]) From -4.7 % in 2010 to -6.2 % in 2017 the population change trend is negative (Eurostat).
([23]) The projected old-age dependency ratio per 100 persons is forecast to reach 35 % in 2030 (25 % in 2015) (Eurostat)

([24]) Government emergency ordinance 114/2018

Box 4.3.1: Monitoring performance in light of the European Pillar of Social Rights

The European Pillar of Social Rights is designed as a compass for a renewed process of upward convergence towards better working and living conditions in the European Union ([1]). It sets out 20 essential principles and rights in the areas of equal opportunities and access to the labour market; fair working conditions; and social protection and inclusion.

Romania still faces a significant number of challenges in the areas covered by the Social Scoreboard supporting the European Pillar of Social Rights. The country has one of the highest early school leaving rates and a high number of people living at risk of poverty or social exclusion. While labour market performance has improved, the overall inactivity and especially inactivity of women remain a concern. The available skills are not keeping up with the needs of the labour market and future work patterns. The lack of basic competences among the Roma and people in vulnerable situations do not allow them to fully benefit from economic expansion and to gain a foothold in the labour market. The design of social inclusion policies, the availability of social services and social transfers are still not fully effective at getting people out of poverty and lack an integrated approach combining employment, health and education measures.

SOCIAL SCOREBOARD FOR ROMANIA		
Equal opportunities and access to the labour market	Early leavers from education and training (% of population aged 18-24)	Critical situation
	Gender employment gap	Critical situation
	Income quintile ratio (S80/S20)	Weak but improving
	At risk of poverty or social exclusion (in %)	Weak but improving
	Youth NEET (% of total population aged 15-24)	Weak but improving
Dynamic labour markets and fair working conditions	Employment rate (% population aged 20-64)	Weak but improving
	Unemployment rate (% population aged 15-74)	Better than average
	Long-term unemployment	On average
	GDHI per capita growth	Best performers
	Net earnings of a full-time single worker earning AW	Weak but improving
Social protection and inclusion	Impact of social transfers (other than pensions) on poverty reduction	Critical situation
	Children aged less than 3 years in formal childcare	To watch
	Self-reported unmet need for medical care	To watch
	Individuals' level of digital skills	Critical situation

Members States are classified according to a statistical methodology agreed with the EMCO and SPC Committees. The methodology looks jointly at levels and changes of the indicators in comparison with the respective EU averages and classifies Member States in seven categories (from "best performers" to "critical situation"). For instance, a country can be flagged as "better than average" if the level of the indicator is close to EU average, but it is improving fast. For methodological details, please consult the draft Joint Employment Report 2019, COM (2018)761 final. Data update of 29 January 2019.
NEET: neither in employment nor in education and training; GDHI: gross disposable

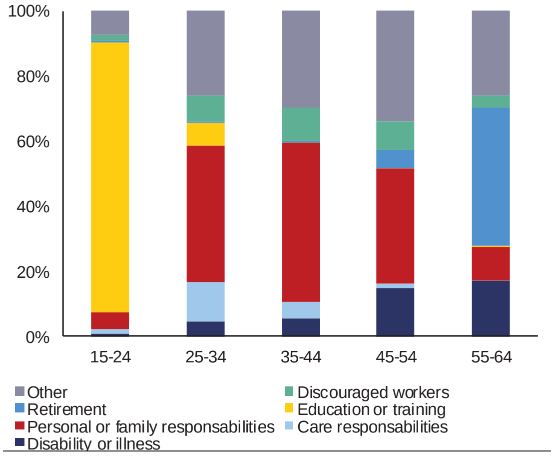
Significant challenges persist on equal opportunities and social protection. Inequality of opportunity persists in education, healthcare and access to social services, with rural areas disproportionately affected. Territorial coverage of existing social services is very uneven, and not correlated with communities' needs. The lack of consistent evidence basis for policymaking and unpredictability of reform timelines are preventing effective implementation and sustainability of results.

Conversely, the de-institutionalisation of children shows some positive results. The coordinated approach linking legislative changes, adequate funding mechanisms and support to the local authorities is showing its first results. The shift towards community-based support is accompanied by individualised assessment of children's needs while capacity-building activities are being developed to support municipalities. Additional efforts are still needed to ensure the availability of foster families across the country and to improve and professionalise their care competences.

([1]) The European Pillar of Social Rights was proclaimed on 17 November 2017 by the European Parliament, the Council and the European Commission. https://ec.europa.eu/commission/priorities/deeper-and-fairer-economic-and-monetary-union/european-pillar-social-rights/european-pillar-social-rights-20-principles_en

The activity rate of women is low despite the overall positive economic conditions. The activity rate of women aged 20 to 64 is 63.7 % (20 pps below that of men). The situation is particularly critical for young and middle-aged women whose inactivity rate is 5 pps above the EU average ([25]), mainly due to personal and family responsibilities ([26]) (Graph 4.3.1). This is primarily due to low participation of children aged 0-3 in formal childcare (15.7 % in 2017). The lack of efficient measures to promote an early return of women to the labour market further aggravates the situation. Regions such as Centru, Sud-Est and Vest have female employment rates below 50 % ([27]). Further investments in childcare facilities could increase the labour market participation of women.

Graph 4.3.1: **Inactive female population by reason for inactivity**

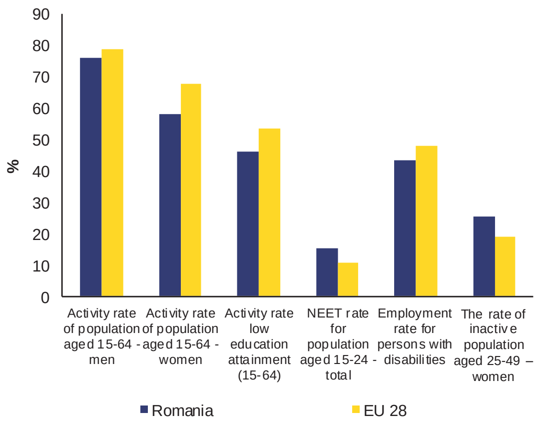


Source: European Commission

The number of young people neither in education, employment or training is steadily decreasing. The share of young people neither in education, employment or training stood at 15.2 % in 2017, down from 18.1 % in 2015 and 17.4 % in 2016, but is still among the highest in the EU. Implementation of the Youth Guarantee shows some signs of improvement. The proportion of beneficiaries taking up an offer within the 4-month target has increased significantly from 25.9 % in 2016 to 40.2 % in 2017. However, the Youth Guarantee coverage of the young people neither in education, employment or training is poor (only 14 % of this group aged 15-24 are registered). This points to the limited outreach measures implemented so far and to ineffective coordination between the education, employment and social sectors. In the meantime, emigration remains very high among young people, with Romania being one of the EU countries with the highest numbers of emigrants aged 15 to 24 (European Commission, 2018b).

Access to the labour market is particularly challenging for certain social categories. The share of long-term unemployment in total unemployment declined from 50 % in 2016 to 41.4 % in 2017. However, a large part of the people in this group either remain unemployed (73.2 %) or fall into inactivity (13.2 %), with only about one in eight (12.3 %) being registered with the public employment service, one of the lowest registration rates in the EU. At the same time, the employment rate for people with disabilities (43.5 %) is slightly below the EU average (48.1 %). The labour market participation of people with low educational attainment, which also include persons from the Roma community, is low, as only 46 % of them are active (Graph 4.3.2). Measures co-financed by the European Social Fund such as targeted employment subsidies and job coaching are planned but their implementation is delayed.

Graph 4.3.2: **Activity and employment rates for selected groups**



Source: European Commission

([25]) The inactivity rates of women aged 25-49 are 24.7 % for RO and 19.7 % for the EU (Q3-2018, Eurostat data)
([26]) 43 % of women aged 25-34 and 48.7 % of those aged 35-44 are inactive for personal reasons or due to family responsibilities (Eurostat).
([27]) National Institute of Statistics, 2017 data

Active labour market policies provide a limited response to the labour market needs. The measures in place still focus mainly on financial incentives for companies rather than on tailor-made approaches addressing the comprehensive needs of the unemployed, notably upskilling and integrated services delivery. Despite the increase in the amount of subsidies for employers who hire young people neither in education, employment or training and other vulnerable groups, the take-up of the measures is slow, pointing to a limited evidence- base behind this policy. Nevertheless, the measure for unemployed people aged over 45 and single parents ([28]) shows some positive results. The excessive administrative burden associated with accessing labour market measures remains unaddressed.

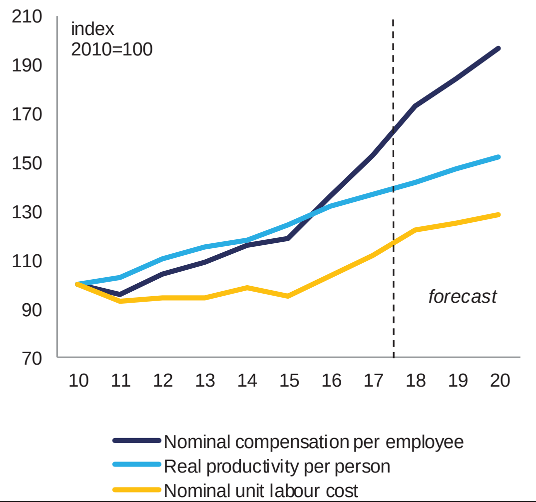
The planned reform of the public employment service has been significantly delayed. The public employment service has a very limited case management approach. The lack of integration of employment, social and education services and the ineffective cooperation with employers remain important barriers. The accumulated delay in the implementation of the European Social Fund co-financed measures is undermining the service's effectiveness as a broker in the labour market delivering services for employers and the unemployed.

Wage increases are large, particularly in the public sector. After years of moderate wage growth, Romania displays one of the fastest wage increases in the EU, strong even for a catching up economy faced with high poverty rates. Between 2011 and 2015, nominal compensation per employee grew at an annual average rate of 3.5 %, below productivity. This relationship reversed in 2016, when compensation per employee increased by 15 % (Graph 4.3.3). Subsequent increases of 12.3 % in 2017 and an estimated 13 % in 2018 are much faster than the pace consistent with an unchanged real effective exchange rate or expected based on inflation, productivity growth and unemployment. Gross wage growth was mainly driven by the public sector (see Section 4.4.1).

([28]) The number of employment subsidies requests for this category increased from 334 in January 2018 (before the subsidies were increased) to 3 470 in September 2018.

The minimum wage was increased again in January 2019 without an objective mechanism. A government decision issued in December 2018 increased the minimum wage from RON 1 900 (EUR 413) to RON 2 080 (EUR 450) from January 2019. Moreover, a higher minimum wage of RON 2 350 (about EUR 510) was introduced for people with a university degree and, in a subsequent emergency ordinance, an even higher level of RON 3 000 (EUR 652) for workers in the construction sector. Previous ad hoc increases of the minimum wage resulted in one in three employees earning the minimum wage in 2017, a rate almost four times higher than in 2011 (Romanian Labour Inspectorate) ([29]).

Graph 4.3.3: **Productivity and labour costs (GDP deflator)**



Source: European Commission

Skills are not evolving in line with the needs of expanding economic sectors. 81 % of employers declare having difficulties filling job vacancies The hardest profiles to fill in are electricians, welders, mechanics and engineers in the chemical, electrical, civil and mechanics sectors (Manpower, 2018). The ICT sector is growing, also based on the development of specialised business clusters i.e. in the Cluj county area, and it represents a valuable future economic potential. However, the number of Romanians aged 20-29 holding a science, technology, engineering and mathematics degree fell from 16.6 per 1 000 individuals in 2014 to 14.4 in 2016 (19.1 in the EU). The available IT

([29]) In 2017, the minimum wage was 44.6 % of average monthly earnings in industry, construction and services.

skills are not keeping up with the emergence of IT hubs, as only 29 % of individuals have basic or above basic digital skills (European Commission, 2018k). Skill mismatch represents an additional challenge for Romanian firms (EIB, 2018).

The upskilling of the labour force would benefit from a comprehensive approach. At present there is neither a global assessment available of skills needs nor one at economic sector level. The labour market relevance of vocational education and training is limited. Some steps have been taken to recognise learning outside formal education and training and to steer the new dual vocational education and training system (see Section 4.3.3), yet important challenges remain. Other important barriers are: (i) the limited offer of non-formal education and training; (ii) limited participation in vocational qualifications' programmes for people with a low level of qualifications[30]; (iii) insufficient coordination between stakeholders; and (iv) insufficient system monitoring, quality assurance and staff training.

Collective agreements coverage is low, particularly at sector level. According to national authorities, around 15 % of employees were covered by collective agreements in 2017. The current delineation of sectors does not facilitate collective bargaining at sector level and only one agreement at this level was in force in 2017. In 24 out of the 30 industrial sectors there is no complete representation of social partners able to negotiate a collective agreement. The authorities have initiated plans to revise the definitions of economic sectors but no agreement has been reached yet. Trade unions consider that employee representatives, who signed 8 out of 10 existing collective agreements, were not selected through a transparent procedure.

Social dialogue is insufficiently used for engaging social partners on policy issues and reforms in a timely and meaningful manner. Beyond the collective bargaining framework, social partners do not enter into a voluntary dialogue to improve labour market conditions. Most social dialogue takes place formally, within the Economic and Social Council and the Social Dialogue Committees. Despite the established framework of dialogue and consultations, the stability and the role of these institutions has weakened over the last year.

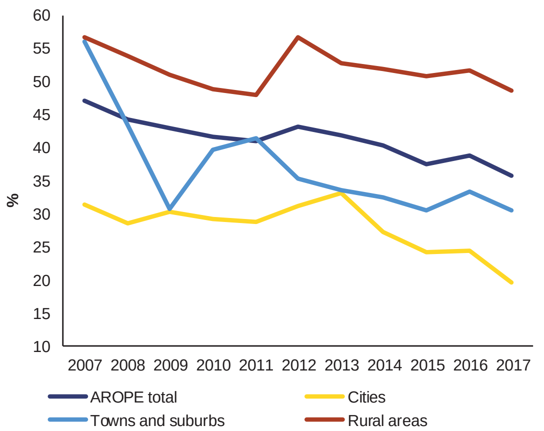
4.3.2. SOCIAL POLICIES

The poverty rate decreased in 2017 but remains very high. One in three Romanians are still at risk of poverty and social exclusion. Despite a decline of 2 pps compared to 2016, monetary poverty is one of the highest in the EU, affecting 23.6 % of the total population in 2017. The main drivers of poverty are inactivity, low education attainment, intergenerational transmission of poverty and lack of inter-regional mobility. Poverty and social exclusion levels in rural areas are more than twice as high as those in cities (Graph 4.3.4). Vulnerable groups in rural areas (children, people with disabilities, members of the Roma community and the elderly) face particularly high poverty rates. Moreover, the country has the highest rate of in-work poverty in the EU (17.4 %).

Income inequality remains high, with regional and gender gaps. Despite a considerable decrease since peaking in 2015, income inequality remains well above the EU average. As shown in the Social Scoreboard accompanying the European Pillar of Social Rights, the income of the top 20 % of the population exceeds by 6.5 times the incomes of the bottom 20 % (EU: 5.1) (Eurostat). High income inequality levels are experienced particularly within the working-age population, and can be attributed more to the poorer being relatively poorer rather than the richer getting relatively richer. The rate of in-work poverty is five times higher for low-educated workers than for university graduates. Men are more exposed to this risk than women. However women are twice as likely as men to be inactive (see Section 4.3.1).

([30]) The legal provisions have been changed recently to allow people with a very low educational attainment to participate in vocational qualification courses.

Graph 4.3.4: **People at risk of poverty or social exclusion by degree of urbanisation**



Source: European Commission

Children living in poverty are more likely to remain poor in their adult life due to inequalities of opportunity. Romania has the highest share of children living in poverty in the EU. The poverty risk for children is indirectly correlated with parents' education level, and this correlation grew stronger in 2017. Moreover, due to shortcomings in the education and health systems, children born today are set to enter the labour market with only 60 % of their real potential, the lowest level in the EU ([31]). Compared to the EU average, families with low incomes report higher difficulties in affording education for their children. The existing offer of public services and the education system do not manage to address this challenge. Growing inequalities of opportunities also affect other vulnerable groups such as young adults and the Roma community.

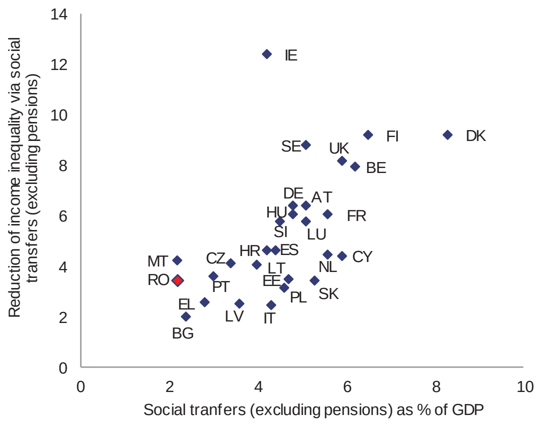
People with disabilities have limited support to achieve independent living and access employment. Care for people with disabilities is mainly focused on providing medical assistance rather than enabling independent active living. Children in this group have limited access to pre-school facilities and drop out of school twice as often as other children. The education system does not prepare them sufficiently for an independent life. Employment quotas have been set to boost employment of people with disabilities, but this reform has not been matched with sufficient and targeted active labour market policies. The lack of synergies between the relevant benefits and the community-based social and employment services aggravates the situation further. A dedicated European Social Fund co-financed project aiming to increase the employability of people with disabilities is under preparation. Preparing the deinstitutionalisation of adults with disabilities is just starting, with the first visible results expected for 2021.

The situation of the Roma community shows very little progress. The living conditions of part of the Roma community are characterised by informal, unhygienic and irregular settlements. Eight in ten Roma live in a house without running water and only one in two has medical insurance. Lack of identification documents and/or property deeds precludes some Roma from accessing public services and claiming their rights. Implementing the National Roma Inclusion Strategy is being hampered by the fact that coordination between line ministries is not always a priority. The implementation of the National Roma Platform is still pending. Several Roma inclusion projects through integrated measures, co-financed by the European Social Fund, are under implementation. Sustainability of the measures is, however, challenging as the existing projects are fragmented and rely heavily on external funding.

According to the European Pillar of Social Rights, social transfers have a low impact on reducing poverty and income inequality. Government spending on social transfers is low (Graph 4.3.5). This contributes to the overall low impact of the tax and benefit system on income inequality (Graph 4.1.3). The social reference index used as a basis for most social benefits has not been updated since its introduction in 2008. It also depreciated considerably in relation to the minimum wage from being almost equal to it in 2008 to roughly five times lower in 2018. As a result, poverty rates for people with low and very low work intensity increased by half since 2010**.** The impact of social transfers on reducing income inequality is also low.

([31]) Human Capital Index 2018, World Bank

Graph 4.3.5: **Redistributive power of social transfers**



(1) Social transfers exclude pensions
(2) Income inequality is measured by the Gini coefficient. The value 0 corresponds to perfect equality (same income to everybody) while 100 corresponds to maximum inequality (all income distributed to only one person and all the others have nothing.)
Source: European Commission

The minimum inclusion income reform is not yet completed. The minimum income benefit in Romania is among the least sufficient in the EU ([32]). A law adopted in 2016 is designed to increase coverage and adequacy of benefits and to pair them with activation measures. Its entry into force has been postponed to April 2019 and is still uncertain. In the meantime, the national authorities have attached stronger activation measures and the tapering of benefits to the current minimum income guaranteed scheme. Following the adjustment, social assistance beneficiaries that refuse one job lose their social benefit for a year. On the other hand, they can cumulate the minimum guaranteed income with income from seasonal activities included in their municipality's plan.

Social security for atypical workers is inadequate. One in three atypical workers is at risk of severe material deprivation. Moreover, self-employed and part-time workers, people in low-qualified jobs and those living in rural areas are most at risk of in-work poverty compared to other employees. Daily and seasonal workers do not have formal access to social security rights covering unemployment, maternity, accidents and occupational injuries (European Commission, 2018n).

The high level of housing deprivation hampers social inclusion. One in seven households faces a serious housing problem (e.g. humidity, lack of sanitary facilities) ([33]). Overall housing deprivation is the highest in the EU. Romania's housing stock is low quality, energy inefficient and deteriorating because of lack of maintenance (Housing Europe, 2017). Post-institutionalised children, the victims of domestic violence and the mentally ill are particularly in need of housing. Social housing policies are being decentralised without a strategic framework, which makes poverty worse in areas that are already poor. Through measures co-financed under the European Social Fund approximately 260 vulnerable communities are currently supported, but not all vulnerable groups are covered.

Social services are characterised by uneven territorial distribution and insufficient coverage and quality. According to the Ministry of Labour and Social Justice only around 20 % of administrative territorial units have licensed social services. Services are usually concentrated around richer or urban areas, while needs exist mostly in poorer, rural areas and regions ([34]). Some vulnerable groups face a severe lack of services, e.g. the homeless, young people leaving institutions, and the elderly. The shortage of social assistants, particularly in rural areas, compounds this issue. Access to the profession is costly and laborious ([35]). Coordination between the local, county and national levels is ineffective, also due to the fragmented distribution of powers and responsibilities. There is no direct link between financing and needs at county and local levels. The underfinancing of private service providers is affecting the continuity of services at local level, as more than two thirds of the current providers are non-public. Use of alternative financing methods, including volunteering and sponsorships, is low as

([32]) According to the Benchmarking Framework on Minimum Incomes conducted within the Social Protection Committee. For details, see the draft Joint Employment Report 2019, COM(2018) 761 final

([33]) National Institute of Statistics, 2017

([34]) According to the Ministry of Labour and Social Justice, more than half of the social service providers are located in towns with more than 100 000 inhabitants.

([35]) After graduation all social assistants need to register with and obtain a certificate from the National College of Social Assistants, a non-governmental entity in charge of a national register of social assistants.

the existing legal incentives are perceived as insufficient (see Section 4.4).

Integration of services is progressing at a slow pace. Social, employment, health and education services are poorly integrated, limiting the effectiveness of activation measures and worsening social conditions. A dedicated EU co-funded project to introduce integrated teams ([36]) in 139 marginalised communities started implementation in the second half of 2018. The project will design integrated case management methodologies that can be scaled up at national level and envisages closer collaboration with employment services.

The old-age pensions have been increasing although some structural challenges remain unaddressed. The elderly have lower poverty rates than other groups. Due to significant increases beyond the standard indexation mechanism, the average old-age pension from the state social insurance increased by 10.0 % in 2017 and 9.4% in 2018 ([37]). The pension law adopted in December 2018 is set to increase pension adequacy but also budgetary costs (see Section 4.1.3). Some structural challenges with an impact on pension adequacy remain unaddressed. The effective average retirement age is close to the EU-average. However, the retirement age is not equal between women and men. Coupled with shorter contributory periods for women, this results in a considerable pension gender gap.

The long-term care sector is not ready to deal with a rapidly ageing population. Romania faces one of the fastest ageing rates in the EU, a trend that is not fully taken into account in the design of current policies or projections of long-term needs. In 2016, homes for the elderly covered only 1 % of the population over 75 years old. There are very few at-home and day-care services. When they do exist they are normally close to areas with higher income. Additional investments appear necessary for the country to keep up with the ageing rate of its population.

4.3.3. EDUCATION

The educational system is underfinanced and administrative capacities to modernise it require strengthening. The acquisition of basic ([38]) and digital skills ([39]) faces significant challenges. Investment in education remains one of the lowest in the EU (3.7 % of GDP compared to 4.7 %). This gap is particularly relevant at pre-primary and primary levels of education ([40]) which are key to preventing early school leaving, ensuring equal opportunities and tackling inequalities later in life. Recent legislative measures postpone until 2022 the legal requirement for allocating the equivalent of 6 % of GDP annually on education. This threshold has never been reached. Strategic planning, aligning system-monitoring to educational priorities and improving the use of results at central, county and school level is faced with challenges (OECD, 2017).

Modernisation of the school network and optimisation to address demographic trends is lagging behind. The number of children in pre-university education decreased by 14 % between 2007 and 2017 (excluding children in nurseries). A recent mapping shows that 10 % of schools are overcrowded, while 58 % have excess capacities ([41]). 38 % of schools in rural areas have outside lavatories, without running water or sewage, compared to 7 % in urban areas. School laboratories and libraries are often lacking and school buses are insufficient. Regular maintenance and rehabilitation are lagging behind due to the lack of funding by local authorities. 58.5 % of kindergartens have excess capacities.

The acquisition of cognitive skills is hampered by low participation in quality early education

([36]) The municipal teams are expected to include social workers, community nurses and the county school counsellors.

([37]) Source: National House of Public Pensions. These growth rates exclude some special pensions schemes such as old-age pensions of farmers, military, lawyers and clergy. Including these categories, the growth rates are 12.3% in 2017 and 9.6% in 2018 (the latter being an estimate).

([38]) Despite efforts to introduce a competence-based school curriculum, almost 40 % of teenagers lack the basic competences in reading, mathematics or science.

([39]) Measures were taken to improve digital skills in schools (European Commission, 2018e), but only 52 % of young people aged 16-19 have basic or above basic digital skills.

([40]) In 2016 Romania invested the equivalent of 0.7 % of GDP on pre-primary and primary education compared to the EU-average of 1.5 %.

([41]) 46 % in urban areas and 63 % in rural areas

and care. The participation of children aged 4 to the starting age of compulsory primary education is below the EU average (88% vs 95% in 2016). Pre-school participation is particularly low in rural areas ([42]) and among Roma ([43]). Only 15.7 % of children aged 0-3 are enrolled in nurseries (EU: 34 %), including due to lack of facilities. The Ministry of Education is in the process of drawing up cost and quality standards and the necessary curricula, together with training for specialised staff. EU funded activities are being implemented but face delays.

Early school leaving remains very high, hampering the development of high skills. The rate of early leavers from education and training stood at 18.1 % in 2017, almost 8 pps above the EU average. The indicator is particularly high in rural areas (27.1 %) and among Roma (77 %, FRA, 2016). The proportion of out-of-school children remains high ([44]). An integrated approach to prevent early school leaving is still missing. There have been only scattered efforts to improve the quality of education in schools with high dropout rates. A project setting up an early warning system to identify pupils at risk of drop out started in 2018. Access to second chance programmes is insufficient and their design is not tailored to the needs of adult learners. The provision of career guidance services is limited.

Teachers' ability to apply a learner-centred approach are not sufficiently developed. Initial teacher education insufficiently focuses on challenges in the classroom, including supporting children with learning difficulties or children at risk of dropping out. The European Social Fund is co-financing the retraining of teachers to support the new competence-based curriculum. However, implementing a learner-centred approach in education is not applied across-the-board. Teachers in rural areas are much more likely to lack the necessary qualifications. In addition, the school funding model and teachers' merit allowances are not sufficiently geared towards improving the outcomes of disadvantaged schools and students.

([42]) 97.4 % in urban areas compared to 85% in rural areas in 2016-2017 (National Institute of Statistics)

([43]) Only 38 % of Roma children attend kindergarten (FRA, 2016).

([44]) In the 2016/2017 school year, the gross enrolment rate was 89 % in primary and 91 % in lower secondary education.

The education system fails to compensate for socio-economic disadvantage, perpetuating already high income inequalities. Parents' socioeconomic status greatly affects school outcomes (PISA, 2016). The transition to upper secondary education is particularly challenging for students from vulnerable groups and those living in rural areas. This is mainly due to financial costs of studying in urban areas where most high schools and professional schools are located. Roma inclusion in education is a significant challenge, including due to poor quality of education in Roma-majority schools.

Dual-vocational education and training education is being rolled out in a bid to address skills shortages. In September 2017, more than 2 400 students (equivalent to 8 % of students in professional schools) were enrolled in dual education, i.e. education incorporating a partnership with employers. Measures are envisaged to revise the school curriculum for vocational education and training, professional qualifications and training standards. However, vocational education and training is still considered a second-choice option by students and parents. Moreover, the employment rate of recent vocational education and training graduates remains relatively low (67 % in 2017, vs. an EU average of 77 %), indicating that labour market relevance is a challenge. Employers complain of vocational education and training graduates' outdated skills, including due to outdated equipment and teaching methods. They report a heavy administrative burden for taking part in dual- vocational education and training programmes.

Higher education is not sufficiently aligned with the labour market. Although tertiary educational attainment has doubled over the decade, it remains low (26 % in 2017 vs. an EU average of 40 %). The number of graduates in science, technology, engineering and mathematics is low, including due to low participation in higher education. Only 4 % of new university entrants have parents with low educational attainment. Employers report that graduates entering the labour market have overly theoretical skills and often lack key soft skills, including problem solving, teamwork and communication. Several Romanian universities have started offering a limited number of online courses ([45]).

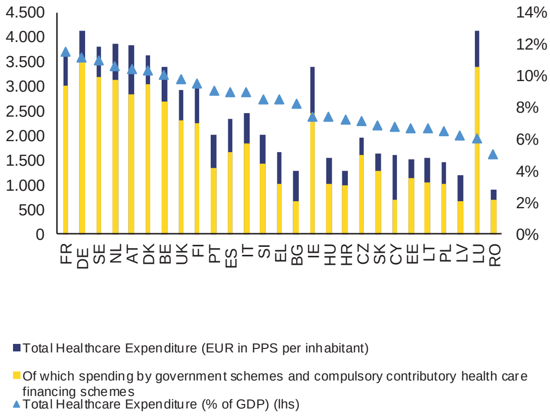
4.3.4. HEALTH POLICIES

The health of the population remains below the EU average, despite recent improvements. Life expectancy at birth was 75.3 years in 2016, compared to 81 years for the EU. ([46]) The amenable mortality rate, i.e. deaths that could have been avoided through optimal quality healthcare, was two and a half times higher than the overall rate in the EU in 2015 and is not converging towards the EU level ([47]). Ongoing initiatives include screening campaigns for oncological and cardiovascular diseases and a legislative initiative on vaccination. In addition, the current national multiannual plan promotes various healthy living initiatives.

Spending on healthcare is comparatively low and staff shortages are an ongoing concern. Spending on preventive care slowly increased in recent years, from 1.3 % of the public healthcare budget in 2011 to 1.6 % in 2016. However, coordination of prevention measures and funding is not progressing fast enough. Provision of key diagnostic and therapeutic medical equipment is very low, particularly in hospitals, despite a high supply of hospital beds. In addition, the coverage of high cost novel medicines, especially in the area of cancer treatment, remains limited, despite recent improvements. A shortage of healthcare staff, coupled with high workforce emigration poses challenges to the proper functioning of the health system. In 2016, there were 56 000 physicians in Romania which in per capita terms was the third lowest number in the EU. In 2013, more than a fifth of the total number of Romanian doctors were working abroad (World Bank, 2018). Recent increases in public salaries in the health sector could increase workforce retention, especially when coupled with complementary measures to improve working conditions.

([45]) https://www.mooc-list.com/countries/romania
([46]) Eurostat general mortality data
([47]) Eurostat causes of death data

Graph 4.3.6: **Spending on healthcare by Member State, 2016**



(1) The data for Denmark, Cyprus, Luxembourg, Netherlands, Slovenia, Slovakia and Finland refer to 2015; there are no data for Malta.
Source: Eurostat System of Health Accounts.

Unmet needs for medical care remain high, especially for vulnerable groups. Despite improvements in recent years, high disparities in the accessibility of healthcare are reported between different groups as well as between urban and rural areas. The rate of unmet healthcare needs due to long travelling distances was the third highest in the EU in 2017 ([48]). The widespread practice of informal payments is a significant impediment to the accessibility of healthcare. The government has taken measures to foster transparency and governance, including by setting up a patient feedback mechanism. A comprehensive assessment of the results is not yet available.

The healthcare system is characterised by inefficiency and limited accessibility. The uptake of ambulatory care (such as one-day surgery) in hospitals has increased. Legal and financial measures were recently taken to incentivise the use of ambulatory care in hospitals and specialised ambulatory services outside of hospitals. However, progress on shifting to outpatient care remains low. The current design of competencies between medical services might lead to gaps in healthcare services coverage, especially in rural areas and marginalised communities. Preparations are under way for the building of the first three of a total of eight planned new regional emergency care hospitals. However, implementation and budgetary challenges for the building of the hospitals remain.

([48]) Eurostat Survey on Income and Living Conditions data

Due attention is needed in preparatory planning efforts to embed these hospitals in regional referral schemes. This would allow for optimised allocation across the spectrum of primary, secondary and tertiary care.

Improvements in community care are much needed but delayed. The roll-out of community care centres delivering integrated care has suffered further delays. Improved community care could reduce the current high level of avoidable hospital admissions for ‘ambulatory care sensitive conditions’ such as diabetes and hypertension (OECD, 2018a). The continued decline of the share of patients’ lists registered with family physicians ([49]) hints at the health system’s decreasing capacity to monitor patients in primary care settings. Various planned policy measures to boost the uptake of e-health solutions across the health system continue to be delayed, including the move to a fully functional operation of electronic health records.

Access to long-term care, rehabilitation and palliative care is poor. Longstanding concerns have not been remedied over patient access to rehabilitation services (WHO, 2016), that typically enable patients to experience a smooth transition out of hospital following surgery. Rehabilitation care is provided in ambulatory and inpatient settings, but access to such care is not adequate and waiting lists are long. Coverage and public spending on long-term care in Romania is among the lowest in EU; only 7.9 % of palliative care needs were covered in 2014.

4.3.5. INVESTMENT

Increased investment in skills, education and training, healthcare and social inclusion is important for improving productivity and long-term inclusive growth. The main obstacles to business investment include high labour force emigration and skills shortages, unfavourable demographics and regional disparities. This points to the need to invest in early childhood education and prevention of early school leaving, improve quality and inclusiveness, and matching education curricula (notably vocational education and training and tertiary education) to local and regional labour market needs, while better anticipating the new skills requirements and introducing more flexible upskilling and reskilling opportunities. Ensuring sustainable growth also requires matching investment in social inclusion, specifically by supporting a wide range of active inclusion measures, and the deinstitutionalisation of children and of adults with disabilities, as well as increasing access to integrated social, education and healthcare services, in particular for children at risk of poverty and vulnerable groups. It is also important to pay due attention to geographical disparities in the availability and quality of these services.

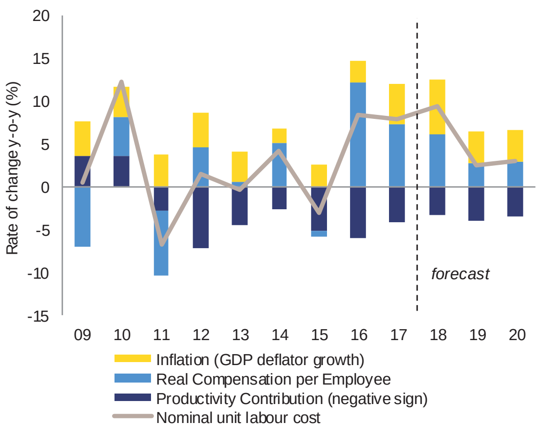
([49]) National Health Insurance Fund, 2017 Activity Report

4.4. COMPETITIVENESS REFORMS AND INVESTMENT

4.4.1. COMPETITIVENESS AND EXTERNAL POSITION (*)

Labour costs have increasingly outpaced productivity developments. Unit labour costs (ULCs) have accelerated strongly. Nominal unit labour costs started to accelerate in 2016 (Graph 4.4.1), growing by 8.5 % in 2016, by 8 % in 2017 and by an estimated 9.3 % in 2018. This acceleration has been driven entirely by compensation per employee, which has been increasing by double digits in nominal terms since 2016. Productivity developments have only partially mitigated such impact. Labour productivity per person grew 6 % in 2016, 4.3 % in 2017 and an estimated 3.3 % in 2018, well above regional peers. In levels, labour productivity amounts to around two thirds of the EU average.

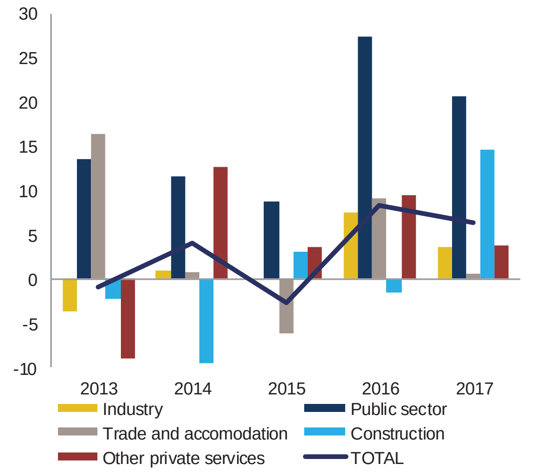
Graph 4.4.1: **Nominal unit labour costs, growth breakdown**



Source: European Commission

So far the rise in nominal unit labour costs stems mainly from the public sector. Overall, unit labour costs increased by almost 70 % between 2014 and 2017. Growth has been stronger and accelerating faster in the public sector, where unit labour costs increased by 27.5 % and 20.7 % in 2016 and 2017, respectively (see Section 1). Unit labour costs in other sectors have experienced milder increases, but those in construction were already showing significant growth in 2017 (14.6 %) while those in industry, Romania's main exporting sector, expanded substantially less, by 7.5 % in 2016 and 3.6 % in 2017.

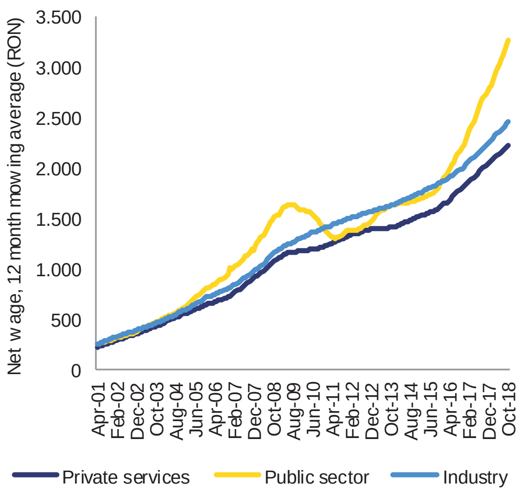
Graph 4.4.2: **Evolution of unit labour costs by sector**



Source: European Commission

The increase in nominal compensation per employee comes mainly from public wage but is also meaningful in the private sector. Public sector compensation per employee is estimated to have grown annually at an average of above 20 % over the last 3 years, whereas private sector compensation increased by an average of around 10 %. A similar decoupling of public wages from private wages took place in the run-up to the 2009 crisis, leading to a strong correction in the following years (Graph 4.4.3). Wage levels in the public and private sectors differ substantially, with public wages 34 % higher than private wages. These cannot solely be explained by the different skill composition in these sectors.

Graph 4.4.3: **Evolution of public and private wages**



Source: National Statistics Institute

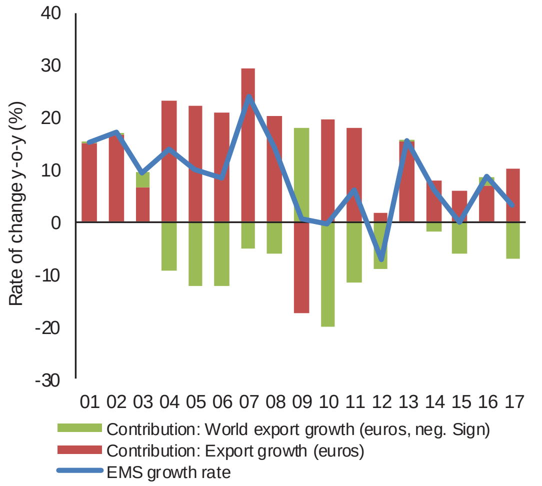
Spillovers of the wages' growth from the public to the private sector may further affect competitiveness. Unit labour costs developments in the tradable sector (mainly industry and ICT in the case of Romania) have been much more moderate than in the overall economy. This has softened the pressure on the country's cost competitiveness and supported the very strong export performance in recent years (Graph 4.4.4). However, wage developments in the public sector can spill-over to other sectors, triggering additional competitiveness losses. Empirical evidence suggests that the public sector in Romania plays a leading role in wage dynamics, with public-wage increases eventually leading to less than proportional wage increases in the private tradable sector, which are in turn fully adapted by the non-tradable sector. A 10 % increase in public wages is estimated to lead to a 6.6 % increase in wages in the tradable sector (Biea et al, 2019). Additional evidence suggests that a 10 % increase in public sector wages leads to a 3.5 % increase in the average wage growth in the industry sector over a year (NBR, 2016).

The profitability of firms has remained robust despite the recent increase in unit labour costs. Profitability deteriorated in the aftermath of the crisis across sectors but has been improving since 2013. 2016 data, the latest available data, suggest robust profit rates in construction, manufacturing and retail. This reflects the fact that labour cost growth for the private sector was relatively subdued up to 2016. However, since then labour costs have been growing faster. Repeated minimum wage increases with additional indirect effects on the wage scale, together with potential spill-overs from public sector wages put additional upward pressure on private wages (see Section 4.3), creating significant pressure on firms' profitability and/or prices.

A number of non-cost factors also affect Romania's competitiveness negatively. The poor state of road and railway infrastructure affects businesses' effectiveness in moving goods and services across borders, limits labour force mobility and aggravates regional disparities (see Section 4.4.2). The economy's low innovative capability is another key factor limiting competitiveness (see Section 4.4.2). A cumbersome business environment, marked by frequent and unpredictable legislative changes, together with excessive red tape and persistent inefficiencies in the public administration undermines investment decisions and risks reducing the country's attractiveness to foreign investors (see Section 4.4.5).

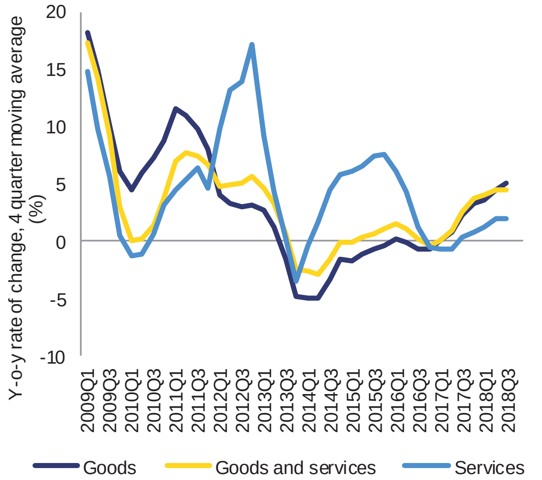
Romania has gained export market share in recent years. Romania's export market share increased by 8.5 % in 2016 and by a further 3.1 % in 2017 (Graph 4.4.4). Over 2012-2017, it increased by 37 %, second in the EU only to Ireland, and significantly above gains in other peer countries. From 2016 to 2017 export market share gains shifted from machinery and equipment, to the vehicle industry and mineral products. Growth in the latter sector was particularly strong, even if from a relatively low base. For services, exports continued to rely on transport and telecommunications. On quality, for the last 10 years, Romania has increasingly specialised in medium high-tech products, which now account for almost 50 % of total manufacturing exports.

Graph 4.4.4: **Export market share growth**



Source: European Commission

Graph 4.4.5: **RON-denominated export price evolution**



Source: European Commission

Romania's strong export performance has been supported by subdued export prices but risks to price competitiveness are emerging. The price of exported goods in the domestic currency (as measured by the export of goods deflator), fell each year between 2013 and 2016 (Graph 4.4.5). It resumed growth in 2017, increasing by 3.5 %. In the first three quarters of 2018 the price of exported goods increased, on an annual average, by 3.7 %, 4.5% and 5 % year-on-year respectively, raising concerns that the country's price competitiveness could start deteriorating. The evolution of the real effective exchange rate deflated by export prices also signals risks. It has been depreciating since 2015 but began appreciating in the first quarter of 2018.

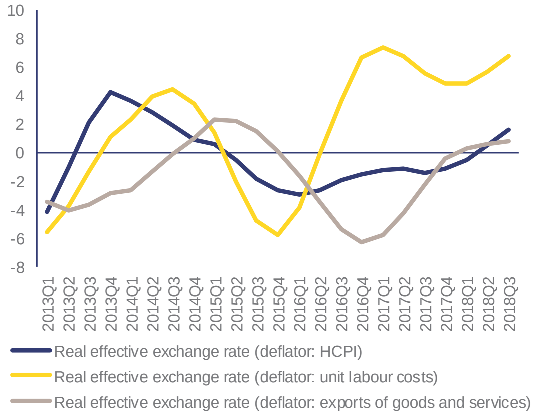
A gradual depreciation of the currency has mitigated the effect of rising export prices. Between December 2016 and December 2018 the RON fell by 3 % against the euro. This depreciation has partially compensated for the rise in export prices and has supported the country's strong export performance in euro area markets.

High unit labour costs might hinder competitiveness. The acceleration of unit labour costs has put pressure on the real effective exchange rate and Romania's cost competitiveness. As a result, the real effective exchange rate, subdued over the last few years, has started to pick up. The inflation-based real effective exchange rate ([50]) depreciated every year between 2014 and 2017 due to the nominal depreciation of the RON. In 2018, however, the stabilisation of nominal exchange rates (see Section 1) allowed an appreciation of the real effective exchange rate by an average of 2.4 % year-on-year, putting pressure on price competitiveness (Graph 4.4.6).

Despite a strong export performance, the current account deficit has persistently deteriorated since 2014. From a balanced position in 2014, the current account reached a deficit of 3.2 % of GDP in 2017 and is estimated to have widened further to 4.3 % in 2018. The widening current account deficit has been driven mainly by a worsening trade balance in goods, triggered by strong growth in imports, which outpaced exports. The deficit in the trade in goods gradually increased from 4.3 % of GDP in 2014 to 6.5 % in 2017.

([50]) Computed using the Harmonized Consumer Price Index and measured against a group of 42 trade partners

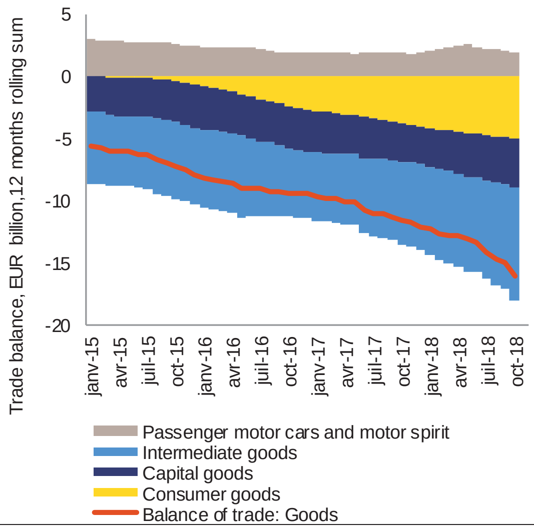
Graph 4.4.6: **Real effective exchange rate growth**



Source: European Commission

Consumer goods imports have substantially outpaced other imports. The change in the composition of imports raises concerns. Imports of consumer goods have been growing significantly faster than those of capital and intermediate goods. The boom has been fostered by an expansionary fiscal policy directed at increasing disposable income, which has driven private consumption. Since 2015, consumer goods imports have increased by an annual average of 13.5 %. The corresponding figures for imports of intermediate goods and those of capital goods were 6.7 % and 9.1 % respectively. As a result, the balance of trade for consumer goods moved from a small surplus in 2014 to a deficit of around 2.1 % of GDP in 2017. In contrast, the trade deficits in capital and intermediate goods deepened slower and the surplus in services has slightly increased since 2015 (Graph 4.4.7). A current account deficit driven by consumption, rather than investment, does not support potential GDP growth (see Section 1).

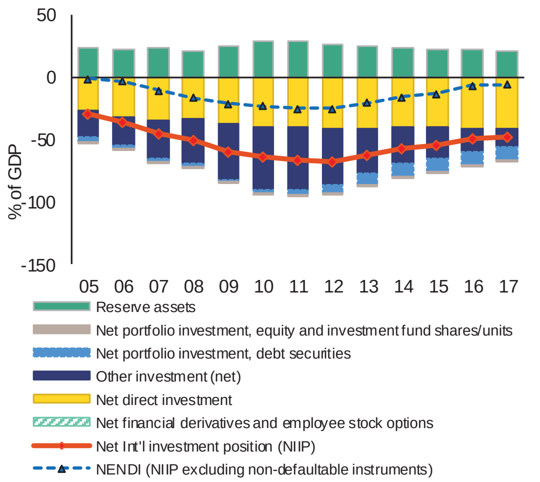
Graph 4.4.7: **Breakdown of the trade balance**



Source: European Commission

The net international investment position (NIIP) is improving at a slower pace. The net international investment position reached -47.8 % of GDP in 2017, almost 10 pps above 2014 (Graph 4.4.8). This improvement has been due to the very strong GDP growth and to a positive capital account. However, progress has slowed down. The net international investment position improved just over 1 pp. in 2017, reflecting a deceleration of GDP growth and a widening current account. By components, net direct investment has remained broadly stable as a share of GDP, averaging -41 % in the last 8 years, but has steadily increased its share in the net international investment position by 36 % in the 8 years up to 2017. The share of other foreign liabilities to GDP declined as Romania repaid external debt.

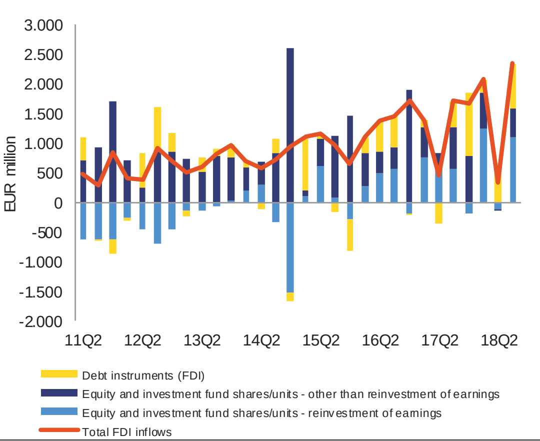
Graph 4.4.8: **Net international investment position**



(1) Merged BPM5/BPM6-ESA 2010 data
Source: European Commission

Foreign direct investment (FDI) flows remain volatile. In 2017, foreign direct investment inflows declined by about 7 % compared to 2016. In the first 11 months of 2018, however, they were nearly 20 % higher than in the same period in 2017 (Graph 4.4.9). The 2018 increase was accounted for by debt instruments (intercompany loans). At the end of 2017, 43 % of the foreign direct investment stock was concentrated in industry, about 15 % in construction and some 12 % in financial intermediation (NBR, 2018a). The main countries of origin for foreign direct investment in Romania are Germany, the Netherlands, Austria, France and Italy.

Graph 4.4.9: **FDI flows by investment type**



Source: European Commission

4.4.2. PRODUCTIVITY AND INVESTMENT

Productivity developments

Productivity has increased substantially over the past two decades, albeit from a low level. Despite being the third lowest in the EU, labour productivity increased from almost 22 % of the EU average in 2000 to nearly 60 % in 2017. Total factor productivity has also increased substantially. It averaged 0.8 % over 2007-2017 (vs. 3.7 % over 1995-2007) but is picking up again. In 2017, Romania recorded the highest total factor productivity growth in the EU despite some factors holding back further gains: low infrastructure, dysfunctionalities in labour and product markets (see Sections 4.3 and 4.4.3), weak innovation capacity, and a cumbersome business environment (see Section 4.4.5).

Labour productivity diverges significantly across firms. The gap between the 10 % least productive and the 10 % most productive firms remains very wide (CompNet database). This gap could be due to large differences between foreign-owned and domestic firms but may also signal the slow spread of technological advances. Exporting firms (mostly multinationals) are more productive than non-exporting ones (ECB, 2017). Large divergences in terms of productivity are translating into high wage dispersions and high inequality.

A National Productivity Board was set up in 2018. Following a 2016 Council Recommendation, in August 2018 Romania announced that the Council of Economic Programming, part of the National Commission for Strategy and Prognosis, would also serve as Romania's National Productivity Board. The board should contribute to addressing the relatively low productivity levels in Romania and boost ownership of structural reforms, as recommended by the Council.

Investment activity

Investments in infrastructure and innovation are particularly needed to set growth on a sustainable path. Romania is poorly connected to the EU's main transport corridors. The low quality of transport infrastructure affects shipping times and limits labour force mobility, resulting in additional costs for businesses. It also undermines business investment decisions and magnifies regional disparities. Investment in the energy infrastructure is necessary to ensure a better integration in regional energy markets and secure the country's energy supply. Romania recycles only a very small part of the waste it produces and a significant part of its population is still not connected to public water supply. Substantial investments in waste and wastewater infrastructure are needed to allow Romania to improve the life quality of its citizens and move towards a greener economy (see Box 4.4.1). Romania's long-term economic prospects depend on the economy's capacity to move from the production of relatively low-technology goods to higher value-added products and services. This requires a significant increase in the financing of research and innovation activities.

Total investment is relatively high. In 2007-2018, total investment represented 26.7 % of GDP on average, well above the EU average (20.3 % of GDP). Private investment accounted for some 80 % of the total. Public investment was strong immediately after EU accession, in 2007 (around 6 % of GDP), but has lost momentum since 2016, dropping below 4 % of GDP on the back of a slowdown in EU funds absorption. While private investment in Romania has constantly outperformed regional peers, public investment started lagging behind as of 2014, except for a slight rebound in 2016.

Private investment would benefit from a qualitative improvement. Private investment is geared towards replacement needs and capacity expansion, and significantly less towards developing new products or services. According to a recent survey (EIB, 2018), firms invest most in machinery and equipment and least in research and development. Asset quality, as measured by the share of state-of-the art machinery and equipment, is significantly below the EU average (28 % vs 44 %).

Policy unpredictability is a key obstacle to investment. Uncertainty about policy and labour and business regulations are cited by firms as the main obstacles to long-term investment (EIB, 2018). A survey by the National Bank of Romania (NBR, 2018b), identifies fiscal unpredictability as the most pressing issue facing Romanian companies in 2017-2018. This is corroborated by Eurobarometer (2018b). For almost half of surveyed companies, the instability of the tax legislation was a major obstacle to investment. In another recent survey (EY, 2018), Romanian companies identified fiscal and legislative instability, political instability and a lack of vision of public policy as the main barriers to increasing their business. 85 % declared that their investment plans have been affected by fiscal and legislative unpredictability. The adoption by the government in December 2018, without any impact assessment or public consultation, of a set of fiscal measures with far-reaching consequences for several economic sectors reinforced the prevailing perception of policy unpredictability ([51]).

EU funds account for a large share of public investment in Romania. Since 2014, capital transfers from the EU accounted for a quarter of public investment spending and 1% of GDP annually. Following a drop caused by the delayed start of new EU-funded projects, absorption improved by the end of 2018 ([52]).

EU funds have been made available to upgrade Romania's infrastructure but their implementation is lagging behind. Recurring bottlenecks and delays have slowed down implementation of EU-funded investment projects. Access to EU funds was conditioned on reforms addressing structural policy challenges. However, these reforms are still at an early stage, hampered by high political volatility, low political buy-in, and the absence of long-term planning. Furthermore, there is no strategic management framework for either nationally-funded or EU-funded public investment. EU funds absorption is also held back by limited administrative capacity to prepare and implement large investment projects coupled with an inefficient application of public investment management rules, a lack of real prioritisation, and lengthy tender procedures. In the 2007-2013 programming period Romania was a major beneficiary of EU funds, having received EUR 17 billion. However, it was not able to absorb about EUR 1.6 billion of its initial EU funds allocation (European Commission, 2018l).

([51]) See section 4.4.5 for a further discussion on the impact on the business environment of public policy-making.
([52]) As of 29 January 2019, the absorption rate stood at 26 % of the total allocation, compared to the EU average of 28 %.

Public-private partnerships are increasingly seen by the government as an alternative to EU funding. The low absorption rate of EU funds notwithstanding, the authorities have announced that they intend to develop major infrastructure works, including several motorways and regional hospitals, using public-private partnerships rather than EU funds. However, the successful implementation of such projects requires strong public institutions and expertise in negotiating public-private partnership contracts, and keeping overall costs under control. The experience of other EU Member States highlights the importance of a strong institutional setting. While in some Member States a good level of service and maintenance was observed, public-private partnerships have often resulted in an inappropriate risk sharing between the public and private sectors, cost overruns and delays (European Court of Auditors, 2018). A move towards public-private partnership contracts unaccompanied by reforms to improve administrative capacity could result in a high future fiscal burden for the State budget.

Research and innovation

The competitiveness gap between foreign-owned and domestic firms has not narrowed. This suggests a gap in the take-up and financing of research and innovation activities. Foreign-owned firms account for two-thirds of Romania's exports of goods (Foreign Investors Council, 2017a) and increased their share of total value added from 39 % in 2008 to 44 % in 2015 (Eurostat). They have a strong presence in key medium-tech and high-tech manufacturing sectors, with their share of value added in the manufacturing of motor vehicles exceeding 90 %. Their labour productivity is also twice that of domestic firms. Conversely, the agro-food sector, dominated by small, domestic holdings, is characterised by very low levels of productivity, which means that Romania is not able to fully exploit its significant agricultural potential (NBR, 2018d).

The innovation gap separating foreign-owned and domestic firms signals that technology imports have not been substituted with home-grown innovation. Several multinationals in the automotive and IT sectors have set up research and development activities in Romania. Most seek experimental development rather than industrial research. However, technology spillovers to domestic firms remain limited, in part because foreign-owned firms primarily source from other foreign companies. Domestic firms mainly supply low value-added components (ACAROM; AKH Romania, 2018). No targeted policy has been developed to leverage technology spillovers from foreign direct investment and promote research and innovation as a driver for future competitiveness (Foreign Investors Council, 2017b; Horobeț & Popovici, 2017).

The economy's overall innovative capacity remains low. Romania ranks last in the EU in terms of innovation and its performance has deteriorated since 2010 (European Commission, 2018c). Furthermore, the start-ups' survival rate beyond 5 years dropped from 60 % in 2009 to 40 % in 2014 (European Commission, 2018d). With the exception of the ICT sector, Romania has few fast-growing firms ([53]).

At sub-national level, research and innovation is more diversified and dynamic. Innovation is modest in all Romanian regions, albeit with a large gap between best and worst performers. Under the 'Catching Up Regions Initiative', smart specialisation strategies and governance structures were set up in two pilot regions (Nord-Est and Nord-Vest), leading to the development of regional entrepreneurial discovery processes ([54]) and a pipeline of projects to be co-financed by EU funds. The initiative is being rolled-out to all Romanian regions.

Investment in research and development (R&D) remains critically low. R&D intensity (i.e. R&D expenditure as a percentage of GDP) has been flat since 2000, at 0.5 % in 2017 vs. 2.7 % in the EU as a whole (Graph 4.4.10). Public R&D intensity fell from 0.32 % in 2011 to 0.21 % in 2017. Despite an increase in recent years, business R&D intensity remains well below the EU average (0.29 % vs. 1.36 % in 2017). This under-investment in business R&D results in a number of researchers per capita in the private sector over six times lower

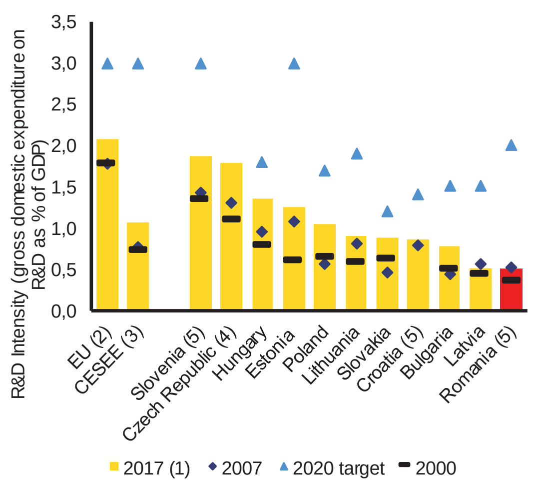
([53]) Enterprises with an average annualised growth in the number of employees of more than 10 % per year over a 3-year period and at least 10 employees at the moment growth began.

([54]) An inclusive and interactive bottom-up method under which participants from government, industry, academia and civil society build connections and partnerships, identify potential investment opportunities and develop project pipelines.

than the EU average and in a very low number of patent applications. In early 2017, government emergency ordinance 3/2017 introduced a 10-year tax exemption for R&D firms, but procedural norms are still in preparation.

Public R&D funding is insufficient and declining. This has translated into an overall stagnant scientific performance ([55]) and a low level of international scientific cooperation ([56]). Although substantial investments are needed, the government has no clear plans to address this issue.

Graph 4.4.10: **R&D intensity 2000, 2007, 2017 and 2020 target**



(1) Estonia: 2016 data; (2) EU: provisional data; (3) CESEE: SI,CZ, HU, EE, PL, LT, SK, HR, BG,LV,RO; (4) CZ: R&D Intensity target for 2020 is not available; (5) HR, SI, RO: Breaks in series occur between 2007 and 2017
Source: European Commission

The economy's research and innovative capacity could be improved by increased science-business cooperation. Higher education institutions do not systematically integrate industry needs into their teaching and research programmes. Knowledge transfer offices are not yet fully operational despite EU funds having been allocated for this. The continued decline in the number of tertiary graduates in science, technology, engineering and mathematics (European Commission, 2018e), further hampers knowledge transfer. Romania is also confronted with a significant migration of skilled people, having one of the largest scientific diasporas among EU countries (European Commission, 2018h). Further investments supporting science-business cooperation and skills are needed.

Romania has not yet developed a coherent vision for moving towards higher value added activities. Existing policies (the Competitiveness Strategy, the National Strategy for research and development and the 2014 Small and Medium-sized Enterprises Strategy) are loosely coordinated and do not provide adequate measures for firms to move up the value chain. Non-financial measures targeting start-ups and innovative small and medium-sized enterprises (e.g. business support services, support to competences) remain underdeveloped, whilst existing schemes (mostly funding measures) are not customer-oriented (European Commission 2018d). The use of financial instruments with an innovation component is limited, even if some equity instruments were set up. The combination of EU funds grants and financial instruments is largely unexplored.

Digitalisation

Digitalisation is a key challenge for boosting innovation and competitiveness. In this respect, Romania presents a very mixed picture. On the one hand, there are elements of excellent connectivity and a proven potential to develop services especially in the ICT sector, which contributes 6-7 % to Romania's GDP. The digital sector is growing, with two major hubs in Bucharest and Cluj-Napoca, as well as significant ICT investments in other cities. On the other hand, Romania scores poorly on all other components of the Digital Economy and Social Index, including digital public services, digital skills of the overall population and digitalisation of businesses (European Commission, 2018k).

([55]) Measured as the share of top 10 % most cited publications in total publications.
([56]) Measured as the share of international co-publications in total publications

Box 4.4.1: **Investment challenges and reforms in Romania**

Macroeconomic perspective

While Romania continues to have one of the highest investment ratios in the EU, its investment performance since the crisis has been volatile. An acceleration of investment in 2015 was followed by a contraction in 2016 as public investment fell due to a slow uptake of projects financed by EU funds under the 2014-2020 programming period. Investment grew again in 2017 on account of an upturn in private investment, but remained subdued in 2018. Public investment inched slightly up in 2018, after having declined for 2 consecutive years, but remains significantly below pre-crisis levels.

Assessment of barriers to investment and ongoing reforms

Public administration / Business environment	Regulatory/ administrative burden	CSR
	Public administration	CSR
	Public procurement /PPPs	CSR
	Judicial system	
	Insolvency framework	
	Competition and regulatory framework	
Labour market/ Education	EPL & framework for labour contracts	
	Wages & wage setting	CSR
	Education	CSR

Financial Sector / Taxation	Taxation	CSR
	Access to finance	
R&D&I	Cooperation btw academia, research and business	
	Financing of R&D&I	
Sector specific regulation	Business services / Regulated professions	
	Retail	
	Construction	
	Digital Economy / Telecom	
	Energy	
	Transport	

	No barrier to investment identified
CSR	Investment barriers that are also subject to a CSR
	No progress
	Limited progress
	Some progress
	Substantial progress
	Fully addressed

The overall business environment presents challenges that are hampering investment. These include continued unpredictability of policymaking, shortages of skilled workforce and the limited labour market relevance of education and training. Some measures have been taken to tackle these issues, but many barriers remain to be addressed to lift growth and accelerate convergence (see Sections 4.3 and 4.4).

Selected barriers to investment and priority actions under way

1. The recurrent legislative uncertainty continues to hamper the business environment. Investment may be held back by frequent and unpredictable legislative changes enacted without proper stakeholder consultation or impact assessment, by the authorities' contradictory declarations about important reforms and by persistent uncertainty over the direction of the fight against corruption (see Section 4.4.5).
2. Despite relatively high public investment spending over the past decade, infrastructure remains deficient in both qualitative and quantitative terms, hampering competitiveness and investment. The development of quality infrastructure is being held back by: (i) comparatively low absorption of EU funds; (ii) low administrative capacity; and (iii) remaining inefficiencies in project preparation, prioritisation and implementation (see Section 4.4.2).

Investment activity could be supported by the forthcoming National Promotional Bank. The institution will be responsible for coordinating the implementation of financial instruments in Romania. It will be well placed to address market failures which have been identified during an *ex-ante* assessment delivered mid-2018. The feasibility study for the new National Promotional Bank and its associated implementation roadmap are expected to be delivered by end of February 2019, enabling the start of the implementation phase.

Romania lacks a clear strategy to digitise businesses. In 2016, the government launched a Manifesto for Digital Romania ([57]) setting out principles aligned with a vision for a digital future. However, a clear national strategy for digitising industry is still missing. The integration of digital technologies by businesses remains very low, with the percentage of firms using electronic information sharing decreasing from 22 % in 2015 to 17 % in 2017 (European Commission, 2018k).

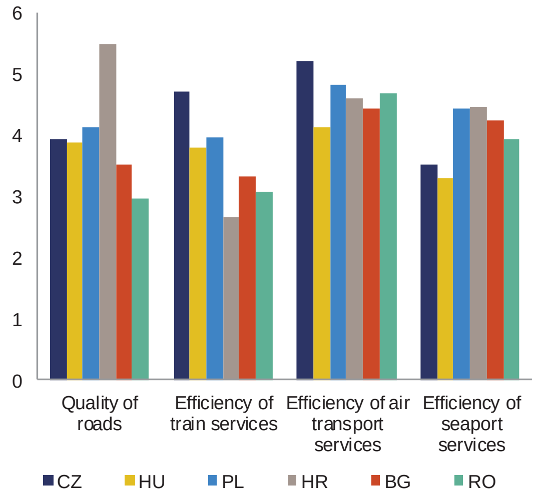
The digitalisation of the Romanian economy could be affected by recent fiscal measures. In December 2018 the government set a minimum price threshold for spectrum licences of 4 % of the 2018 turnover of the telecom sector per year of licencing. The national regulatory authority will launch the 5G spectrum auction by the end of 2019. These measures could endanger the success of the auction and adversely affect the roll-out of 5G networks. The excessive pricing of 5G licences could negatively impact the very competitive pricing of telecommunications services.

Transport

The general condition of the road infrastructure remains poor. The infrastructure is not keeping up with the traffic demand generated by an expanding economy ([58]), despite the availability of significant EU funding. The road network is among the least developed in the EU (Graph 4.4.11). With only 38 km per 1 million inhabitants, Romania has by far the lowest motorway density in the EU. The country ranks also relatively low in the quality of its road infrastructure (WEF, 2018) and has the highest road fatality rate in the EU. The under-developed infrastructure is detrimental to delivery times and road safety and hinders the country's competitiveness. Significant investments would be warranted to increase the quantity and quality of the infrastructure.

The reform of the railway sector is lagging behind. Although the Railway Reform Authority was established and studies have been initiated, the reform continues to be delayed. In addition, heavy underinvestment in maintenance has reduced train speed and affected delivery times of rail freight transport. Upgraded railway lines designed for speeds of 160 km/h are not used to their full potential. The European rail traffic management system is not operational anywhere on the core rail network, affecting safety, reliability, traffic capacity, and accessibility.

Graph 4.4.11: **Quality of public infrastructure index, Romania and regional peers**



Scale: 1-7 (best)
Source: World Economic Forum, The Global Competitiveness Report 2018

Urban mobility is weakly developed across Romania. Urban mobility suffers from chronic underfinancing, poor sector organisation and the weak administrative capacity of local providers. A number of growing agglomerations (Bucharest, Cluj, Iasi, and Timisoara) are facing increased challenges due to the recent expansion of their functional areas and suburbanisation, as well as the poor quality of urban mobility plans and delayed implementation of existing projects. Bucharest is one of the most congested cities in the world ([59]).

Telecoms networks

Romania is lagging behind in rural broadband coverage. Despite outstanding fast broadband take-up, with 53 % of homes subscribing to broadband connections of ≥30Mbps (EU average: 33 %), overall broadband coverage is still below the EU average (74 % vs. 80 %). These figures also hide a large urban-rural digital divide, with

([57]) https://see40.org/2017forum/
([58]) Romania built only 352 km of new Trans-European Transport Networks (TEN-T) roads by the end of 2017.
([59]) https://www.tomtom.com/en_gb/trafficindex/

less than 40 % of rural areas covered (European Commission, 2018k).

EU funds were allocated to bridge the urban-rural digital divide. During the 2014-2020 programming period some EUR 125 million were allocated from EU funds. The RO-NET project supporting the deployment of national broadband infrastructure in 'white areas' ([60]) is expected to be finalised by July 2019. For a significant part of the remaining 'white areas', the Next Generation Network investment projects will be developed by private operators deploying last-mile access infrastructure. Additional public investment may be needed for broadband infrastructure to further increase the coverage of rural areas.

More efforts are needed to improve fixed and 4G broadband coverage. Despite a leap from 45 % in 2016 to 72 % in 2017, mobile 4G broadband coverage is still well below the EU average of 91 %. Fixed broadband coverage is static at around 88 % (EU average: 97 %). Broadband network deployment is particularly affected by the cumbersome authorisation process at local level. A better coordination between ministries, the national communications regulator and local authorities is needed to ensure streamlined assistance to operators interested in investing in broadband. In November 2018, the national communications regulator adopted a decision on maximum tariffs chargeable to network operators for access to public property, which could lower costs in the deployment of communications networks.

Energy and climate

Energy intensity remains above the EU average. While primary energy consumption is broadly stable, final energy consumption increased in 2016 by 1.8%. The legal and operational framework hinders investments, as procedures are considered overly complicated by many project developers. Buildings renovation, investments in district heating systems to improve heating services and develop district cooling systems can significantly contribute to enhancing energy efficiency and support the transition to a low-carbon economy. The development of renewable energy sources and energy efficiency products supports job creation and growth. In the absence of additional measures Romania will not reach the 2030 climate targets, as established through the Effort Sharing Regulation.

A total investment need of around EUR 22 billion on energy and climate for 2021-2030 was indicated by Romania. The draft National Energy and Climate Plan was submitted on 31 December 2018 in line with the Regulation on the Governance of the Energy Union and Climate Action ([61]). In the final National Energy and Climate Plan to be adopted by 31 December 2019, Romania will provide an overview of its investment needs until 2030 for the different aspects of the Energy Union, including renewable energy, energy efficiency, security of supply, and climate mitigation and adaptation. This will further contribute to the identification and assessment of energy and climate-related investment needs.

Recent legislative changes could hamper future investments in the energy sector. Government emergency ordinance 114/2018 may distort the gas market, put at risk investments and delay the development of Romanian offshore gas production in the Black Sea. It may also hamper the development of infrastructure relevant for security of supply and solidarity in the Energy Union (see Section 4.4.3).

Integration in regional gas and electricity markets requires additional investments. In 2017, Romania’s electricity interconnectivity level was 7 %, below the 2020 target of 10 %. With the finalisation of planned projects of common interest on transmission infrastructure pending, the Romanian electricity system is overall well developed. The timely achievement of pending projects will increase Romania’s integration in the regional market and relieve existing congestions in the south-east region while accommodating renewable development in north-east Bulgaria and southeast Romania (the Black Sea Corridor project of common interest). Investments in the gas sector are further needed to enable bi-directional flows, enhance interconnectivity with neighbours and fully exploit the advantage of the Black Sea resources, which would benefit security of supply and competition in the region.

([60]) Areas not covered by telecom networks.

([61]) Regulation (EU) 2018/1999 of the European Parliament and of the Council of 11 December 2018 on the Governance of the Energy Union and Climate Action.

Environment

The waste management system is underdeveloped. Key gaps are insufficient separate collection, the lack of economic incentives to move away from disposal, inefficient producer responsibility schemes for packaging, lack of infrastructure and investments in projects higher up the waste hierarchy and lack of administrative capacity and public engagement. Due to the lack of separate collection, the country's performance continues to be characterised by very low recycling of municipal waste (14 %, including 7 % material recycling and 7 % composting) and very high landfilling rates (70 %) (Eurostat, 2017 data). However, the figure does not include the temporary storage prior to disposal, which, if added, would increase this rate further. This puts into question the achievement of the EU waste targets (European Commission, 2018j). The national waste management plan was adopted in 2017, with the aim of reaching the 50 % recycling target of municipal waste by 2020 and reducing biodegradable municipal waste going to landfills to 35 % ([62]). County waste management plans, which will put the national waste management plan into practice, are still under preparation. Government emergency ordinance 74/2018 introduced some measures which could incentivise the separate collection of municipal waste. These include the pay as you throw principle, minimum service requirements for sanitation companies, a contribution for the circular economy to replace the suspended landfill tax (see Section 4.1.2) and extended producer responsibility. However, its implementation will represent a significant challenge. A pipeline of projects to be financed by EU funds under the current programming period has not yet been developed. An inter-ministerial committee established in October 2018 aims to ensure better governance and coordination of technical aspects in the sector.

The water and waste water infrastructure is also deficient. Connection to the public water supply is incomplete, with only approximately 57 % of the population connected, the lowest rate in the EU. Water infrastructure is being upgraded through EU co-financed regional projects totalling EUR 2.5 billion. Considering the current low level of compliance with collection and treatment requirements, investments in the sector will remain a priority in the medium and long term.

Air quality is very poor. Domestic solid fuel used by households and the energy sector remain the main sources of air pollution. Traffic also has a significant impact. Over 25 000 premature deaths per year are due to air pollution (European Environment Agency, 2018). The abolishment in 2017 of a vehicle registration tax resulted in a surge of second-hand car sales, aggravating air quality. The government is considering introducing a pollutants-dependent car registration tax in 2019.

Romania lags behind on several other components affecting standards of living. This is the case for green infrastructure, climate change adaptation, risk prevention and disaster resilience, the rehabilitation of old contaminated sites and the prevention of floods and other natural hazards. Romania also does not comply with EU limits on the emission of several major pollutants, while the implementation of the EU Nature Directives represents a considerable challenge.

4.4.3. SINGLE MARKET INTEGRATION

Internal market for goods and services

Obstacles to the free movements of goods persist in the retail trade of agricultural and food products, gas and timber. National rules in these areas favour the domestic market, creating a barrier to trade and restricting market access from other countries. For instance, rules issued in 2016 give priority to marketing local food products. In the case of gas, emergency ordinance No 64/2016 envisages an increase of domestically produced gas to be traded on the centralised market. As for timber, priority access is given to local furniture manufacturers to use timber from state-owned forests.

Access to certain professions and services remains restricted by a cumbersome regulatory framework. This is the case for civil engineers, architects, accountants and tourist guides ([63]). For

([62]) Art 5.2(c) of the Council Directive 1999/31/EC of 26 April 1999 on the landfill of waste

([63]) The European Commission has developed a composite indicator on the restrictiveness of most existing barriers to lawyers, the level of restrictiveness is similar to EU levels (Paun et at, 2013). Reducing administrative complexity for businesses and reforming the licensing system are now on the government agenda. A comprehensive reform of the licensing system for services, intended to redesign and simplify the procedures, is scheduled to be implemented in 2019-2020 with the involvement of the Competition Council.

Energy market

Regulatory changes in late 2018 constitute a roll-back from the deregulation of energy prices for households. The process had been completed in 2017 for electricity and was expected to end in 2021 for gas. In addition, regulated gas tariffs, set below the reference price, will also apply to the non-household sector. Retail markets remain highly concentrated, with switching rates below 1 % in 2016 (CEER, 2017) while competition on retail energy markets is not yet fully functional. This is unlikely to change considering the latest backtracking from a competitive and open energy market.

Progress towards competitive and liquid markets in line with the EU regulatory framework appears to have been undone. This is the case particularly for gas. Recent legislative amendments (the Energy Law and government emergency ordinance 114/2018) risk undermining the functioning of the gas market, against its stated objectives, limiting competition, discouraging internal producers and hurting investments. This could have negative repercussions on domestic gas production and on the long-term energy security of Romania and the region. In addition to the provisions of the Offshore Law these could also put at risk the bi-directional Bulgaria-Romania-Hungary-Austria gas corridor (phase 2), thus precluding collateral economic and budgetary benefits from royalties, job creation and infrastructure development in the country.

Collaborative economy

New restrictions to the collaborative economy are being introduced despite strong growth potential. According to a recent survey 23 % of respondents have used a service offered via collaborative platforms, most frequently in transport (49 %) and accommodation (41 %) (Eurobarometer, 2018a). Restrictive requirements have recently been introduced on certain types of platforms intermediating transport services by treating them as taxi dispatchers. Draft legislation on ride-sharing services that would introduce further restrictions is being discussed in Parliament. Following the strong development of this sector, the Competition Council is currently assessing the market, the behaviour of the economic operators and regulation's impact on the sector. A study will be published in 2019.

4.4.4. REGIONAL DISPARITIES

Significant needs remain in infrastructure and human capital in all regions. Despite sustained convergence towards the EU average in the last decade, all regions continue to face socio-economic challenges. Large portions of the country lack the basic conditions for a transition to a dynamic, high-value added, knowledge-oriented economy. Three of the eight Romanian regions remain among the 20 poorest regions in the EU (Eurostat, 2016). Most of the economic development takes place in the capital region, followed by the Vest, Centru and Nord-Vest regions, whereas Sud- Vest Oltenia (GDP at 42 % of the EU average) and Nord-Est (GDP at 36 % of the EU average) are lagging behind. At national level, GDP stands at about 60 % of the EU average (Eurostat, 2017). The Bucharest-Ilfov region displayed one of the highest rates of growth in GDP per capita in the EU over 2007-2015 (Eurostat regional yearbook 2017).

Different development patterns call for tailor-made investment priorities. Fast-growing metropolitan areas are increasingly confronted with development challenges related to suburbanisation, traffic congestion and pollution. Smaller cities and surrounding areas, however, face challenges related to access to the labour market, as well as education, healthcare and other social services. The same applies to areas marked by specific territorial challenges (e.g. remoteness and difficult access, environmental protection) or

the access to and exercise of regulated professions. It is based on data collected from Member States, complemented by desk research.

industrial decline [64]. As a result, the rural-urban divided is increasing. Poverty is mainly concentrated in rural areas, where skills and employability are low and the connectivity to the centres of economic opportunities is poor. Improving the connectivity of less developed rural communities requires substantial additional investments.

Municipalities' low administrative capacity limits development opportunities. The capacity of urban authorities to plan strategically and to coordinate and cooperate efficiently is limited, preventing them from fully exploiting development and financing opportunities. In smaller municipalities, scale is an additional challenge, both in terms of administrative capacity and the potential for efficient provision of public services.

A deficient transport network affects Romania's connectivity and competitiveness. Romanian regions are poorly inter-connected, with the Nord-Est region faring particularly badly. The Romanian sections of the core TEN-T Rhine-Danube and Orient-East Mediterranean corridors are still not completed. The missing links (the Sibiu-Piteşti motorway and the Braşov-Predeal and Timişoara-Craiova-Calafat rail connections) pose significant obstacles to regional, inter-regional and cross-border mobility. Investments in river navigation and multi-modal transport have been modest, not exploiting the full potential of the country's geographic and economic connections.

4.4.5. GOVERNANCE AND INSTITUTIONAL QUALITY

Business environment (*)

The conduct of fiscal and economic policy remains highly unpredictable. A notable example is the government emergency ordinance adopted in November 2017 which shifted the burden of social contributions almost entirely onto employees, which was accompanied by a cut of the flat personal income tax rate from 16 % to 10 %. Both changes entered into force in January 2018 without a proper impact assessment and with limited public consultation. Some unintended effects on the net wages of part-time workers and employees in the IT and the R&D sectors led to additional amendments to the Fiscal Code in February 2018. This practice was repeated in December 2018, when the government passed emergency ordinance 114/2018, immediately applicable as from 1 January 2019, containing a series of measures on taxation, pensions and public investment. On taxation, the ordinance introduced a progressive tax on bank assets (see Section 4.2), tax incentives for the next 10 years in the construction sector [65] and rules affecting the functioning of the energy and telecommunications sectors. The ordinance also undermines the role of second pension pillar funds (see Box 4.2.1)

The business environment is negatively affected by this persistent legislative instability. Important legislative initiatives are often announced by the government just before adoption (such as government emergency ordinance 114/2018) with very limited consultation of relevant stakeholders and limited or no impact assessment. Moreover, legislative initiatives previously invalidated by the Constitutional Court often re-emerge in forms which raise more concerns for investors. Over recent years, contradictory public statements by the authorities on the direction of certain reforms have added to the overall climate of unpredictability, with potential negative implications for firms' investment decisions.

Corruption remains a major issue and hampers the business environment. Corruption as well as patronage and nepotism are identified as obstacles to doing business in Romania by 85 % and 82 % of businesses respectively (EU averages: 37 % and 38 % respectively) (European Commission, 2018a). Romania's position on the incidence of corruption indicator of the 2018 Global Competitiveness Index is stagnating (WEF, 2018) ranking among the last in the EU, but some regions have made significant positive advances in recent years (Charron and Lapuente, 2018).

(64) Such as the Danube Delta or the Jiu Valley mining area.

(65) An exemption from personal income tax and a 3.75 pps reduction in social contributions for employees.

Judicial reform and the fight against corruption

The amended justice laws have undermined the independence of judges and prosecutors and public confidence in the judiciary. The amended laws entered into force in July and October 2018 ([66]). They contain a number of measures weakening the legal guarantees for judicial independence, in particular new provisions on the material liability of magistrates for their decisions, the establishment of a special prosecution section investigating offences committed by magistrates, a new early retirement scheme ([67]), restrictions on freedom of expression for magistrates and extended grounds for revoking members of the Superior Council of Magistracy ([68]), and measures specifically weakening the checks and balances underlying the operational independence of prosecutors. There is a risk that these elements – both on their own and cumulatively – could result in pressure on judges and prosecutors, and ultimately undermine the independence, efficiency and quality of the judiciary. This concern has also been raised by a number of outside observers, notably the Council of Europe Venice Commission (2018a) and the Group of States Against Corruption (GRECO, 2018). The amendments also raise questions as to the capacity of prosecutors to continue the fight against high-level corruption with the same degree of independence (European Commission, 2018f).

The implementation of an action plan for the enforcement of court decisions is progressing. The action plan is advancing and a list of measures was submitted to the government in September 2018 (European Commission, 2018f). Proposals include amendments to the legal framework in order to guarantee timely execution of judgments and a mechanism to supervise and prevent late execution of judgements for which the State is a debtor. The Ministry of Justice and the Superior Council of Magistracy are also advancing on putting in place an IT registry of court decisions in which the State is a debtor or a creditor.

A pattern of pressure on the key anti-corruption institutions has created growing concerns about their continued ability to deliver and on the irreversibility of the fight against corruption. The National Anti-Corruption Directorate has been a particular target of pressure, including heavy public and media criticism from senior politicians (European Commission, 2018f). Both the dismissal of the sitting Chief Prosecutor of the National Anti-Corruption Directorate and the proposed replacement ignored the negative opinion of the Superior Council of Magistracy, raising major doubts over the process. The pressure has extended to the High Court of Cassation and Justice. The steps taken by the government may also be reflected in an apparent reduction in the cooperation with the National Anti-Corruption Directorate, with many public institutions such as ministries, the Court of Accounts and other control bodies reportedly more reluctant to flag up potential fraud and corruption cases.

The ongoing amendments to the Criminal Code and the Code of Criminal Procedure could also undermine the fight against corruption. Amendments adopted by Parliament before the summer of 2018 under an emergency legislative procedure constitute a profound overhaul of the 2014 reform, upsetting the balance between the public interest in sanctioning crime, victims' rights and the rights of suspects. The amendments also reduce the scope of corruption as an offence. This was also highlighted by the Venice Commission (2018b) and may raise questions on whether the amendments are compatible with international conventions ratified by Romania. Many of the changes were ruled unconstitutional in October 2018 (European Commission, 2018f).

The implementation of the national anti-corruption strategy is progressing at technical level, but political developments undermine the credibility of the process. The Technical Secretariat within the Ministry of Justice published its first monitoring report in March 2018 and has continued to organise thematic evaluations of public institutions' corruption prevention measures. In August 2018, the government

([66]) Law 207/2018 amending and completing Law 304/2004 on the judicial organisation entered into force on 20 July. Law 234/2018 for amending and completing Law 317/2004 on the Superior Council of Magistracy entered into force on 11 October. Law 242/2018 amending and completing Law 303/2004 on the statute of judges and prosecutors entered into force on 15 October.

([67]) Emergency ordinance 92/2018 of 15 October 2018 delays for 1 year the entry into force of the early retirement scheme but does not abandon it as recommended by the Venice Commission (2018a).

([68]) Emergency ordinance 92/2018 introduces further changes in the revocation procedure.

adopted standard methodologies for use by institutions at central level when evaluating corruption risks and carrying out *ex-post* evaluation of integrity incidents. The implementation of the strategy appears to have progressed in some important vulnerable sectors, especially in education, internal affairs and at local level, but less obviously in the case of health. At the same time, several ongoing legislative initiatives give a contradictory signal in terms of political support for the continuation of corruption prevention and sanctioning, and raise concerns regarding their potential impact on the strategy's implementation. The ongoing reform of the Administrative Code should also support the implementation of the strategy by strengthening the professionalisation of the national and local public administration and by ensuring the effective implementation of corruption preventive measures, such as the responsibility of managers of public institutions in the prevention and occurrence of integrity incidents. (European Commission, 2018f)

Corporate governance of state-owned enterprises

The performance of state-owned enterprises has improved in a context of strong economic growth. Overall, the economic and financial performance of state-owned enterprises improved in 2017 on the previous year (Fiscal Council, 2018). Total revenue, operational results and profits increased, while arrears and indebtedness decreased. This evolution is largely in line with that of private companies in the same period.

The corporate governance of state-owned enterprises is insufficiently implemented and may be weakened. The relevant legislation([69]) is robust but a number of amendments were approved in December 2017 to exempt some 100 state-owned enterprises from Law 111/2016, including most large ones. The amendments were referred back to Parliament by the Constitutional Court in early 2018, on procedural grounds. However, legislators are preparing their re-introduction ([70]). Also, implementation of the legislation remains sparse. Despite an improvement in the number of state-owned enterprises which have started appointments under Law 111/2016, only a small number had completed the procedures as of mid-2018. The repeated appointment of interim boards is still the norm, and appointments made in accordance with the legislation frequently diverge from its spirit. Furthermore, in 2018 the Ministry of Finance did not meet a legal obligation to publish the annual report on state-owned enterprises' activities and governance ([71]). Nor is the Ministry of Finance fully exercising its powers to request implementation of corporate governance legislation by non-compliant companies beyond some effort to remind non-compliant firms of their obligations to make public accounts and reports.

Several of the larger state-owned enterprises may be transferred to a new Sovereign Fund. In November 2018, the government adopted a framework allowing for the creation of government-owned investment funds. This paves the way for the setting-up of a long announced Sovereign Development and Investment Fund ([72]), to which the government intends to transfer the ownership of some 30 state-owned enterprises. The Fund's goal, governance and potential economic and fiscal impact have yet to be clarified. The framework sets the funds' objectives in very broad terms: job creation, the development of infrastructure, stimulating innovation and increasing competitiveness. The government's intention is that the Fund will be classified outside the budget perimeter. This will have a fiscal impact which cannot be estimated until the Fund is fully set up but which could be substantially negative, in particular in the early years.

Public administration

The reform of the public administration system is advancing at a slow pace. This is particularly the case for the decentralisation process and capacity building of local authorities, public consultation and evidence-based decision-making, as well as implementation of the e-governance

([69]) Namely Law 111/2016 on SOEs corporate governance and the accompanying implementing legislation, which updated the previous relevant legislation, government emergency ordinance 109/2011 (European Commission, 2017a).

([70]) The exemption was again approved by the Senate in June 2018 and is awaiting the vote in the Chamber of Deputies.

([71]) Ministry of Finance (2017: pp.6-7) summarises the Ministry's obligations under Law 111/2016.

([72]) The Parliament approved in June 2018 the creation of the Fund. In July, however, the Constitutional Court ruled that only the government can set up such a fund.

measures [73]. Regulatory impact assessments continue to be formalistic, although their quality and actual use vary across sectors. The development of impact assessment competencies and tools is ongoing. A robust policy monitoring mechanism with a transparent reporting system is lacking, and *ex-post* evaluations are carried out on an ad- hoc basis. The legal and institutional framework for a quality control function of impact assessments at governmental level has not been formally established.

Stakeholders' engagement in policymaking remains limited. The reshuffling of responsibilities for public consultation at government level has stalled progress in this area. The quality of public consultation continues to be hindered by operational factors, such as short periods of consultation (i.e. 10 calendar days or less), late announcement of important legislative initiatives, limited follow-up and feedback to stakeholders during and after the consultation process. The authorities have committed to increasing transparency and better involving citizens through the Open Government Partnership. However, a centralised website for public consultation (consultare.gov.ro), one of the key deliverables of this process, is not consistently used.

The implementation of the strategy for civil servants continues, yet the relevant legal framework has not been adopted. The entry into force of the law transposing the strategy is still pending, delaying the actual implementation of the human management reform at central level. Reform of local public administration will be more limited in scope compared to initial ambitions. The authorities are developing new tools and instruments, including a framework for a national competition for civil servants, with results expected in 2019. The National Institute of Administration became operational in 2018 and is taking steps to develop its organisational strategy and a training programme portfolio for civil servants.

Measures to increase the performance of public administration are not widespread. Wage increases are not correlated with performance evaluation and the delivery of better services to citizens and businesses. Recent legislative measures appear to limit the number of civil servants over 2019-2021, depending on the available approved budget for each institution. This measure could result in uneven quality of public services. The attractiveness of the public administration as an employer remains low for young qualified people (only 3 % of total civil servants are aged below 30, and over 41 % are above 50). The employee turnover rate is among the highest in the EU ([74]). Romania ranks 40th out of 41 among OECD/EU countries in 2018 on executive capacity, down four places on 2017 (Bertelsmann Stiftung, 2018).

The national administration's fragmented IT system increases the administrative burden for citizens and businesses. The GovITHub project, launched in 2016, which entailed a public-private partnership based on fellowships and voluntary work in order to develop public services, has been discontinued. Moreover, the national administration continues to face difficulties in attracting and retaining ICT specialists which can develop digital public services. The lack of coordination between the public institutions in setting up digital public services represents an additional challenge. This limits the benefits of a functioning and interoperable e-government system for citizens and businesses. Investments are necessary to create interoperable digital public services among public institutions and to attract and build IT skills.

Public service delivery

High fragmentation of competencies and resources affects the coherence and availability of services provided. National and regional strategies for different public services are not well translated into integrated measures at regional and local level. Funding of public services is uneven across regions and territorial administrative units and does not correspond to local needs. Factors like a unitary strategic approach per type of service, existing gaps and needs to develop new services are overlooked. National programmes, for example in the health sector, do not benefit from

([73]) As shown by the recent report on the implementation of the 2014-2020 strategy for public administration strengthening

([74]) The employee turnover rate = the rate of employees leaving the civil service, due to other reason than retirement, to the average number of employees (EU pack 2017) multi-annual budgetary planning, and are sometimes delayed or interrupted because of a temporary lack of funding.

Revenues of local administrations lack stability and predictability. Important strategic measures are delayed, such as setting appropriate cost and quality standards for all services and increasing local budgets' resources. Elements like inflation, updated standard costs and the need to develop or improve services are not factored into the budgetary allocation, resulting in a lack of or low quality service delivery. Fiscal decentralisation has stalled and the capacity of local authorities to increase the share of their own resources remains limited. The government plans to beef up the revenues of local authorities by increasing their quota from the revenue taxes from 73 % (in 2018) to 100 %. These changes are planned to be incorporated in the revised Code for Local Public Finances.

The system and mechanisms for delivering a minimum package of integrated public services are not developed. The government programme makes reference to the minimum package of public services to be made available to citizens in rural areas. However, the legal, institutional and other necessary instruments to deliver these services have not yet been developed. There is no integrated framework to ensure a minimum package of services to the citizens, including health, social protection and education. The national programme for local development envisages substantial investments but these are limited to infrastructure related investments. A new development and investment fund will be set up in 2019 to finance priority investment areas at local level, but its operational and financing mechanisms still need to be developed.

The long-envisaged decentralisation of public services continues to progress very slowly. There has been some progress in assessing the opportunities and impact of decentralising competencies in four out of the eight sectors envisaged by the strategy (tourism, youth and sport, education, water and forests). However, the overall progress for all sectors is limited. Limited action has been taken to improve the balance between competencies to be decentralised and the financial resources and ability of local authorities to deliver good quality services. Short-term budgetary solutions were provided for in the 2018 state budget law to ensure the same level of financing of local authorities as for 2016 and 2017 and to compensate for the loss of revenue due to income tax reductions. Additional actions are needed to increase administrative capacity at local level especially for competencies to be decentralised.

Public procurement

Further efforts are needed to increase the capacity of contracting authorities. Despite some initiatives to professionalise procurement and to increase technical and procedural capabilities at the level of contracting authorities, further extensive efforts are required. One such example is the plan to train 4 100 civil servants in 2 years. The share of negotiated procedures without prior publication has remained among the highest in the EU (21 % in 2018). Moreover, about 34 % of contracts awarded by public institutions in 2018 were single bids.

The public procurement system requires enhanced transparency, monitoring and supervision. The recent developments on e-procurement, such as the ongoing transition to a new e-procurement system, have laid the foundation for more transparency in the procurement process. The supervision function needs to be fundamentally strengthened so the authorities can take adequate measures to further increase the transparency of the public procurement system and boost competition in the public procurement market. To that end, the introduction of appropriate key performance indicators will be crucial to achieving a functional and efficient supervision system.

Centralised public procurement is not yet operational. The legislation setting-up a central purchasing body operating at national level was recently adopted. Before expanding centralised procurement to more complex products, it is very important to build on the experience acquired in the procurement of simple products that are subject to demand aggregation. Moreover, there are plans to develop aggregated contracting systems for local contracting authorities within a geographical area.

The *ex ante* external control sample for public procurement has been significantly reduced. The initiative for this control has been transferred to the contracting authorities. Moreover, the responsibility for the *ex-ante* control of EU-funded contracts or agreements was taken over by the managing authorities, which may not be fully prepared in terms of technical expertise and personnel for this shift of responsibilities. These important changes were not linked to or based on the measured performance and reliability of contracting authorities against well-established key indicators, and were not supported by, for instance, an impact assessment. The streamlining of *ex ante* controls is essential for reaching the objectives of the national strategy. However, to achieve an efficient and transparent public procurement system, it is important to couple streamlining with measures to increase the accountability and capacity of the contracting and managing authorities.

The track record of the National Integrity Agency remained steady on investigations of incompatibilities and administrative conflicts of interests. The PREVENT system for systematic ex-ante checks of conflicts of interests is now fully operational and the National Integrity Agency reported positive results. However, the stability of the legal framework on integrity continues to face challenges (European Commission, 2018f).

ANNEX A: OVERVIEW TABLE

Commitments	Summary assessment ([75])
2018 country-specific recommendations (CSRs)	
CSR 1: Ensure compliance with the Council recommendation of … June 2018 with a view to correcting the significant deviation from the adjustment path toward the medium-term budgetary objective. Ensure the full application of the fiscal framework. Strengthen tax compliance and collection.	Romania has made **Limited progress** on addressing CSR 1
Ensure compliance with the Council recommendation of…June 2018 with a view to correcting the significant deviation from the adjustment path toward the medium-term budgetary objective.	The compliance assessment with the Stability and Growth Pact will be included in spring, when final data for 2018 will be available.
Ensure the full application of the fiscal framework.	**No progress.** There was no progress on ensuring the application of the fiscal framework. The 2018 budget did not comply with the deficit rule, which requires compliance with the adjustment path towards the medium-term structural objective. The 2018 budget amendment from September broke, among others, rules prohibiting increases in: (i) the nominal headline and primary deficit ceilings during the fiscal year; and (ii) personnel expenditure and total government expenditure excluding EU funds during the fiscal year. The second 2018 budget amendment, published in November, also broke several national fiscal rules. Moreover, as in previous years, the authorities did not send an update of the medium-term fiscal strategy to Parliament by the statutory

([75]) The following categories are used to assess progress in implementing the country-specific recommendations (CSRs):

No progress: The Member State has not credibly announced nor adopted any measures to address the CSR. This category covers a number of typical situations to be interpreted on a case by case basis taking into account country-specific conditions. They include the following:

no legal, administrative, or budgetary measures have been announced

in the national reform programme,

in any other official communication to the national Parliament/relevant parliamentary committees or the European Commission,

publicly (e.g. in a press statement or on the government's website);

no non-legislative acts have been presented by the governing or legislative body;

the Member State has taken initial steps in addressing the CSR, such as commissioning a study or setting up a study group to analyse possible measures to be taken (unless the CSR explicitly asks for orientations or exploratory actions). However, it has not proposed any clearly-specified measure(s) to address the CSR.

Limited progress: The Member State has:

announced certain measures but these address the CSR only to a limited extent; and/or

presented legislative acts in the governing or legislative body but these have not been adopted yet and substantial further, non-legislative work is needed before the CSR is implemented;

presented non-legislative acts, but has not followed these up with the implementation needed to address the CSR.

Some progress: The Member State has adopted measures

that partly address the CSR; and/or

that address the CSR, but a fair amount of work is still needed to fully address the CSR fully as only a few of the measures have been implemented. For instance, a measure or measures have been adopted by the national Parliament or by ministerial decision but no implementing decisions are in place.

Substantial progress: The Member State has adopted measures that go a long way towards addressing the CSR and most of them have been implemented.

Full implementation: The Member State has implemented all measures needed to address the CSR appropriately.

	August deadline.
Strengthen tax compliance and collection.	**Limited progress** The Romanian tax administration (ANAF) has recently updated its guidelines on the registration of certified cash registers and the issuing of single identification numbers for cash registers. They have been more active in using risk assessment for the management and auditing of taxpayers, mostly for value-added tax (VAT) and corporate income tax purposes. However, the relative weight of the unobserved economy is about 22.5 % while the VAT gap (i.e. the difference between the VAT liability theoretically due and VAT actually collected) remained the highest in the EU in 2016 (at about 36 %). The introduction of the cash registers with an electronic memory connected to the servers of ANAF is slowly being implemented, also due to suppliers' shortages.
CSR 2: Complete the minimum inclusion income reform. Improve the functioning of social dialogue. Ensure minimum wage setting based on objective criteria. Improve upskilling and the provision of quality mainstream education, in particular for Roma and children in rural areas. Improve access to healthcare, including through the shift to outpatient care.	Romania has made **Limited progress** on addressing CSR 2
Complete the minimum inclusion income reform.	**No progress.** The Law on minimum inclusion income is expected to enter into force in April 2019. However, no visible progress has so far been observed.
Improve the functioning of social dialogue.	**Limited progress.** The social dialogue law is currently in being debated in Parliament after a long period of consultation with relevant stakeholders. Another competing proposal, drafted with the help of some social partners, has also been put forward. Both legislative initiatives are being debated together. Currently, most social dialogue takes place formally, within the Economic and Social Council and the Social Dialogue Committees. Despite the established framework of dialogue and consultations, the stability and the role of these institutions weakened in the most recent period.
Ensure minimum wage setting based on objective criteria.	**No progress.** Minimum wage levels continue to be set in an ad-hoc manner, and are not based on a comprehensive and predictable mechanism.
Improve upskilling and the provision of quality mainstream education, in particular for Roma and	**Limited progress.** There has been limited progress in improving the provision of quality inclusive

children in rural areas.	mainstream education, in particular for children in rural areas and Roma. The measures financed by the European Social Fund are in early stages of implementation. Work on developing the early warning mechanism to prevent school dropout continues. The methodology to monitor and prevent school segregation has not been adopted yet. Overall, early school leaving remains very high. Rural-urban disparities and Roma inclusion in education remain problematic. While the authorities are planning some measures, active labour market policies continue to provide limited focus on upskilling. A global assessment of skills needs for various economic sectors still needs to be developed and implemented.
Improve access to healthcare, including through the shift to outpatient care.	**Limited progress.** Since 2018 there have been serious delays in key areas such as integrated community care centres, funding of regional hospitals with related care referral plans, etc. In other relevant areas (such as the uptake of one-day planned surgeries) the effectiveness of previously taken measures remains to be demonstrated.
CSR 3: Increase the predictability of decision-making by enforcing the systematic and effective use of regulatory impact assessment and stakeholder consultation and involvement in the design and implementation of reforms. Improve the preparation and prioritization of large infrastructure projects and accelerate their implementation, particularly in the transport, waste and waste water sectors. Improve the transparency and efficiency of public procurement. Strengthen the corporate governance of State-owned enterprises.	Romania has made **No progress** on addressing CSR 3
Increase the predictability of decision-making by enforcing the systematic and effective use of regulatory impact assessment and stakeholder consultation and involvement in the design and implementation of reforms.	**No progress.** There is still persistent legislative instability and lack of decision-making predictability, which risk eroding investors' confidence. Regulatory impact assessments continue to be formalistic, although their quality and actual use vary across sectors. A robust policy monitoring mechanism with a transparent reporting system is lacking, and ex-post evaluations are carried out on an ad- hoc basis. The legal and institutional framework for a quality control function of impact assessments at government level has not been formally established. Stakeholders' involvement in policy-making remains limited. The quality of public consultation continues to be hindered by operational factors, such as short periods of consultation, late announcement of important legislative initiatives, and limited follow-up and feedback to stakeholders during and after the

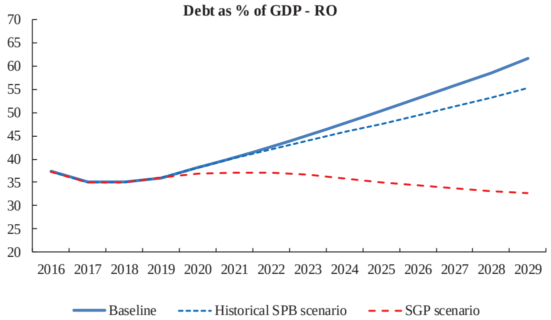
	consultation process.
Improve the preparation and prioritization of large infrastructure projects and accelerate their implementation, particularly in the transport, waste and waste water sectors.	**Limited progress.** Large infrastructure projects are being prepared and sent to the European Commission for approval, due in particular to the increased involvement and cooperation with the European Investment Bank (through the Joint Assistance to Support Projects in European Regions programme and the Project Advisory Support instrument). Implementation, however, continues to lag behind.
Improve the transparency and efficiency of public procurement.	**Limited progress.** There has been limited progress in implementing the national public procurement strategy. The transition to a new e-procurement system and the putting in place of legislation on a Central Purchasing Body to operate at national level are positive examples. However, some reforms started under the Action Plan drafted in the context of the *ex-ante* conditionality that Romanian had to fulfil on public procurement and which were relevant for the implementation of EU funds, have been stopped and, with the recent adoption of the government emergency ordinance no 114/2018, even reversed. Furthermore, important efforts are needed to increase the capacity of contracting authorities and to enhance transparency, monitoring and supervision of the public procurement system, as well as legislative stability and predictability. The streamlining of *ex-ante* control of public procurement should be based on the measured performance and reliability of contracting authorities.
Strengthen the corporate governance of State-owned enterprises.	**No progress.** Corporate governance legislation applicable to state-owned enterprises is robust but only sparsely applied. The exemption of some 100 companies from the legislation, adopted end-2017, has been barred by the Constitutional Court on procedural grounds, but was again approved by the Senate in June 2018 and awaits final approval in the lower house.
Europe 2020 (national targets and progress)	
Employment rate target set in the NRP: 70 %.	The national target of 70 % by 2020 is within reach as the employment rate in the age group 20-64 was at 68.8 % in 2017.
R&D target set in the NRP: 2 % of GDP	Romania's R&D intensity in 2017 was 0.5 % of GDP, the lowest in the EU and representing only a quarter of the national target. Romanian R&D intensity fell annually by 1.1 % between 2007 and 2017. To reach its 2020 target, R&D intensity in

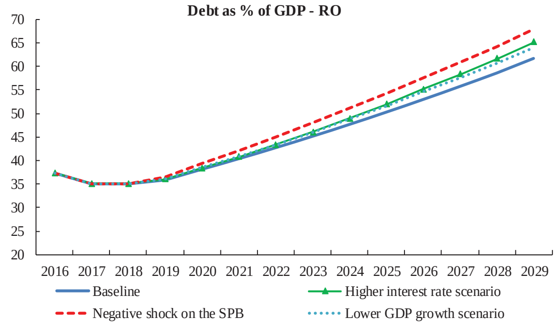
	Romania will need to grow by an average of 58.4 % per year until 2020. In 2017, public R&D intensity increased by 4.8 %, while business R&D intensity increased by 7.4 % compared to 2016. Thus, business R&D intensity reached 0.29 % of GDP in 2017 while public R&D intensity amounted to 0.22 % of GDP.
National greenhouse gas (GHG) emissions target: - 19 % in 2020 compared with 2005 (in sectors not included in the EU emissions trading scheme)	According to preliminary estimates in 2017, greenhouse gas emissions not covered by the EU Emissions Trading Systems (ETS) decreased by 1.7 % between 2005 and 2017. According to the latest national projections based on existing measures, non-ETS emissions will increase by 1.4 % between 2005 and 2020. The target is consequently expected to be met with a margin of 17.6 pps. However, the 2030 target would be missed by a margin of 12.5 % based on existing measures, as emissions are projected to increase above the base year in the long run.
2020 renewable energy target: 24 %	With 24.4 % renewable energy share in gross final consumption in 2017 (Eurostat provisional data), Romania is on track and slightly above in attaining its renewable energy target for 2020. In light of the stable or slightly decreasing share, continued efforts are needed to install more capacity in a context of economic growth.
Energy efficiency, 2020 energy consumption targets: Romania's 2020 energy efficiency target is 43 Mtoe expressed in primary energy consumption (30.3 Mtoe expressed in final energy consumption)	Romania appears to be on track for reaching its 2020 target. However, both primary and final energy consumption increased in 2017, and therefore continued efforts are needed to limit energy consumption in a context of economic growth.
Early leavers from education and training: 11.3 %.	With a rate of 18.1% in 2017, achieving the target by 2020 is not within reach.
Tertiary education target: 26.7 % of population aged 30-34.	With a rate of 26.3% of people aged 30-34 having a tertiary degree in 2017, Romania has almost reached the national target. However, the rate remains significantly below the EU-average of 40%.
Target for reducing the number of people at risk of poverty or social exclusion, expressed as an absolute number of people: 580 000 (base year 2010: 8 425 000).	The national target of 580 000 people is already considered reached. The population taken out of poverty or social exclusion in 2017 was of 2 074 000 persons, considerably higher than in the previous years (e.g. 1 420 000 in 2016, 1 680 000 in 2015).

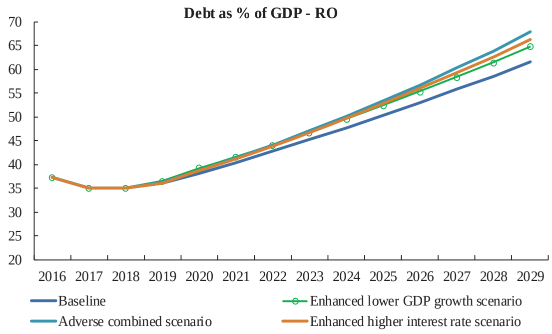
ANNEX B: COMMISSION DEBT SUSTAINABILITY ANALYSIS AND FISCAL RISKS

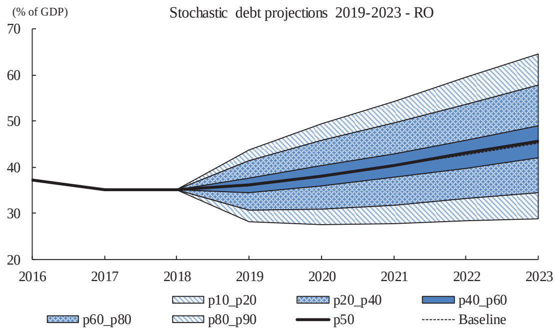
General Government debt projections under baseline, alternative scenarios and sensitivity tests

RO - Debt projections baseline scenario	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029
Gross debt ratio	**35.1**	**35.1**	**35.9**	**38.2**	**40.4**	**42.7**	**45.1**	**47.7**	**50.3**	**53.0**	**55.8**	**58.6**	**61.6**
Changes in the ratio (-1+2+3)	*-2.2*	*0.0*	*0.9*	*2.2*	*2.2*	*2.3*	*2.5*	*2.6*	*2.6*	*2.7*	*2.7*	*2.8*	*3.0*
of which													
(1) Primary balance (1.1+1.2+1.3)	**-1.5**	**-1.9**	**-1.9**	**-3.2**	**-3.2**	**-3.1**	**-3.0**	**-3.0**	**-3.0**	**-3.0**	**-3.0**	**-3.0**	**-3.0**
(1.1) Structural primary balance *(1.1.1-1.1.2+1.1.3)*	***-2.0***	***-1.9***	***-2.0***	***-3.1***	***-3.1***	***-3.0***	***-3.0***	***-3.0***	***-3.0***	***-3.0***	***-3.0***	***-3.0***	***-3.0***
(1.1.1) Structural primary balance (bef. CoA)	*-2.0*	*-1.9*	*-2.0*	*-3.1*	*-3.1*	*-3.1*	*-3.1*	*-3.1*	*-3.1*	*-3.1*	*-3.1*	*-3.1*	*-3.1*
(1.1.2) Cost of ageing					*0.0*	*-0.1*	*-0.1*	*-0.2*	*-0.2*	*-0.2*	*-0.2*	*-0.2*	*-0.2*
(1.1.3) Others (taxes and property incomes)					*0.0*	*0.0*	*0.0*	*0.0*	*-0.1*	*-0.1*	*-0.1*	*-0.1*	*-0.1*
(1.2) Cyclical component	***0.5***	***0.2***	***0.1***	***-0.1***	***-0.1***	***0.0***	***0.0***	***0.0***	***0.0***	***0.0***	***0.0***	***0.0***	***0.0***
(1.3) One-off and other temporary measures	***0.0***	***-0.1***	***0.0***	***0.0***	***0.0***	***0.0***	***0.0***	***0.0***	***0.0***	***0.0***	***0.0***	***0.0***	***0.0***
(2) Snowball effect (2.1+2.2+2.3)	**-2.7**	**-1.9**	**-1.0**	**-0.9**	**-1.0**	**-0.7**	**-0.5**	**-0.4**	**-0.3**	**-0.3**	**-0.2**	**-0.2**	**0.1**
(2.1) Interest expenditure	*1.3*	*1.4*	*1.4*	*1.5*	*1.6*	*1.7*	*1.8*	*1.9*	*2.0*	*2.2*	*2.3*	*2.5*	*2.7*
(2.2) Growth effect	*-2.4*	*-1.1*	*-1.2*	*-1.2*	*-1.4*	*-1.4*	*-1.5*	*-1.4*	*-1.4*	*-1.5*	*-1.5*	*-1.6*	*-1.5*
(2.3) Inflation effect	*-1.6*	*-2.1*	*-1.3*	*-1.2*	*-1.1*	*-1.0*	*-0.8*	*-0.9*	*-0.9*	*-1.0*	*-1.0*	*-1.1*	*-1.1*
(3) Stock-flow adjustments	**-1.1**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**









Short term	Medium term	S1	Debt sustainability analysis (detail)	Baseline	Historical SPB	Lower GDP growth	Higher interest rate	Negative shock on SPB	Stochastic projections	DSA	S2	Long term
LOW (S0 = 0.3)	MEDIUM	MEDIUM (S1 = 1.5)	Risk category	MEDIUM	LOW	MEDIUM	MEDIUM	MEDIUM	MEDIUM	MEDIUM	MEDIUM (S2 = 5.9)	MEDIUM
			Debt level (2029)	61.6	55.3	64.0	65.2	67.8				
			Debt peak year	2029	2029	2029	2029	2029				
			Percentile rank	89.0%	84.0%							
			Probability debt higher						78.7%			
			Dif. between percentiles						35.7			

Note: For further information, see the European Commission Fiscal Sustainability Report (FSR) 2018.

[1] The first table presents the baseline no-fiscal policy change scenario projections. It shows the projected government debt dynamics and its decomposition between the primary balance, snowball effects and stock-flow adjustments. Snowball effects measure the net impact of the counteracting effects of interest rates, inflation, real GDP growth (and exchange rates in some countries). Stock-flow adjustments include differences in cash and accrual accounting, net accumulation of assets, as well as valuation and other residual effects.

[2] The charts present a series of sensitivity tests around the baseline scenario, as well as alternative policy scenarios, in particular: the historical structural primary balance (SPB) scenario (where the SPB is set at its historical average), the Stability and Growth Pact (SGP) scenario (where fiscal policy is assumed to evolve in line with the main provisions of the SGP), a higher interest rate scenario (+1 pp. compared to the baseline), a lower GDP growth scenario (-0.5 pp. compared to the baseline) and a negative shock on the SPB (calibrated on the basis of the forecasted change). An adverse combined scenario and enhanced sensitivity tests (on the interest rate and growth) are also included, as well as stochastic projections. Detailed information on the design of these projections can be found in the FSR 2018.

[3] The second table presents the overall fiscal risk classification over the short, medium and long-term.

a. For the short-term, the risk category (low/high) is based on the S0 indicator. S0 is an early-detection indicator of fiscal stress in the upcoming year, based on 25 fiscal and financial-competitiveness variables that have proven in the past to be leading indicators of fiscal stress. The critical threshold beyond which fiscal distress is signalled is 0.46.

b. For the medium-term, the risk category (low/medium/high) is based on the joint use of the S1 indicator and of the DSA results. The S1 indicator measures the fiscal adjustment required (cumulated over the 5 years following the forecast horizon and sustained thereafter) to bring the debt-to-GDP ratio to 60 % by 2033. The critical values used are 0 and 2.5 pps. of GDP. The DSA classification is based on the results of 5 deterministic scenarios (baseline, historical SPB, higher interest rate, lower GDP growth and negative shock on the SPB scenarios) and the stochastic projections. Different criteria are used such as the projected debt level, the debt path, the realism of fiscal assumptions, the probability of debt stabilisation, and the size of uncertainties.

c. For the long-term, the risk category (low/medium/high) is based on the joint use of the S2 indicator and the DSA results. The S2 indicator measures the upfront and permanent fiscal adjustment required to stabilise the debt-to-GDP ratio over the infinite horizon, including the costs of ageing. The critical values used are 2 and 6 pps. of GDP. The DSA results are used to further qualify the long-term risk classification, in particular in cases when debt vulnerabilities are identified (a medium / high DSA risk category).

ANNEX C: STANDARD TABLES

Table C.1: **Financial market indicators**

	2013	2014	2015	2016	2017	2018
Total assets of the banking sector (% of GDP)[1)]	63.6	60.1	57.6	55.5	52.5	50.6
Share of assets of the five largest banks (% of total assets)	54.4	54.2	57.4	59.1	59.4	-
Foreign ownership of banking system (% of total assets)[2)]	90.0	90.0	90.5	91.4	77.3	74.5
Financial soundness indicators:[2)]						
- non-performing loans (% of total loans)	-	20.7	13.4	9.7	6.6	5.9
- capital adequacy ratio (%)	18.8	17.7	18.9	19.2	19.4	18.6
- return on equity (%)[3)]	0.0	-15.2	11.3	10.6	11.7	15.9
Bank loans to the private sector (year-on-year % change)[1)]	-3.5	-1.3	4.5	3.3	7.1	6.4
Lending for house purchase (year-on-year % change)[1)]	9.7	9.2	15.5	13.4	13.2	11.7
Loan to deposit ratio[2)]	-	67.2	67.6	68.2	69.2	72.1
Central Bank liquidity as % of liabilities[1)]	0.3	-	-	-	-	0.0
Private debt (% of GDP)	66.8	62.1	59.1	55.6	50.8	-
Gross external debt (% of GDP)[2)] - public	20.8	21.8	19.6	19.0	17.9	16.2
- private	30.2	28.9	26.8	28.2	27.9	26.7
Long-term interest rate spread versus Bund (basis points)*	384.4	333.1	297.8	322.9	364.1	427.9
Credit default swap spreads for sovereign securities (5-year)*	180.4	137.4	110.0	105.9	92.5	83.5

(1) Latest data Q3 2018. Includes not only banks but all monetary financial institutions excluding central banks.
(2) Latest data Q2 2018.
(3) Quarterly values are not annualised
* Measured in basis points.
Source: European Commission (long-term interest rates); World Bank (gross external debt); Eurostat (private debt); ECB (all other indicators).

Table C.2: **Headline Social Scoreboard indicators**

	2013	2014	2015	2016	2017	2018 [6]
Equal opportunities and access to the labour market						
Early leavers from education and training (% of population aged 18-24)	17.3	18.1	19.1	18.5	18.1	:
Gender employment gap (pps)	16.3	16.7	17.5	17.6	17.1	18.3
Income inequality, measured as quintile share ratio (S80/S20)	6.8	7.2	8.3	7.2	6.5	:
At-risk-of-poverty or social exclusion rate[1] (AROPE)	41.9	40.3	37.4	38.8	35.7	:
Young people neither in employment nor in education and training (% of population aged 15-24)	17.0	17.0	18.1	17.4	15.2	:
Dynamic labour markets and fair working conditions†						
Employment rate (20-64 years)	64.7	65.7	66.0	66.3	68.8	70.0
Unemployment rate[2] (15-74 years)	7.1	6.8	6.8	5.9	4.9	4.1
Long-term unemployment rate[3] (as % of active population)	3.2	2.8	3.0	3.0	2.0	1.8
Gross disposable income of households in real terms per capita[4] (Index 2008=100)	98.0	99.4	106.1	116.7	129.1	:
Annual net earnings of a full-time single worker without children earning an average wage (levels in PPS, three-year average)	8581	8621	8987	9609	:	:
Annual net earnings of a full-time single worker without children earning an average wage (percentage change, real terms, three-year average)	-0.1	0.3	5.0	8.5	:	:
Public support / Social protection and inclusion						
Impact of social transfers (excluding pensions) on poverty reduction[5]	18.4	12.8	13.3	14.2	16.6	:
Children aged less than 3 years in formal childcare	6.0	2.6	9.4	17.4	15.7	:
Self-reported unmet need for medical care	10.9	9.8	9.4	6.5	4.7	:
Individuals who have basic or above basic overall digital skills (% of population aged 16-74)	:	:	26.0	28.0	29.0	:

(1) People at risk of poverty or social exclusion (AROPE): individuals who are at risk of poverty (AROP) and/or suffering from severe material deprivation (SMD) and/or living in households with zero or very low work intensity (LWI).
(2) Unemployed persons are all those who were not employed but had actively sought work and were ready to begin working immediately or within two weeks.
(3) Long-term unemployed are people who have been unemployed for at least 12 months.
(4) Gross disposable household income is defined in unadjusted terms, according to the draft Joint Employment Report 2019.
(5) Reduction in percentage of the risk of poverty rate, due to social transfers (calculated comparing at-risk-of poverty rates before social transfers with those after transfers; pensions are not considered as social transfers in the calculation).
(6) Average of first three quarters of 2018 for the employment rate, long-term unemployment rate and gender employment gap. Data for unemployment rate is seasonally adjusted (annual series, for EE, EL, HU, IT and UK data based on first three quarters of 2018).
Source: Eurostat.

Table C.3: **Labour market and education indicators**

Labour market indicators	2013	2014	2015	2016	2017	2018 [4]
Activity rate (15-64)	64.9	65.7	66.1	65.6	67.3	:
Employment in current job by duration						
From 0 to 11 months	5.2	5.0	6.2	4.9	5.8	:
From 12 to 23 months	5.8	6.0	7.4	6.4	6.7	:
From 24 to 59 months	21.2	20.0	19.5	20.5	19.8	:
60 months or over	67.8	69.0	66.8	68.2	67.7	:
Employment growth* (% change from previous year)	-0.9	0.8	-1.3	-1.1	2.8	0.2
Employment rate of women (% of female population aged 20-64)	56.5	57.3	57.2	57.4	60.2	60.7
Employment rate of men (% of male population aged 20-64)	72.8	74.0	74.7	75.0	77.3	79.1
Employment rate of older workers* (% of population aged 55-64)	41.8	43.1	41.1	42.8	44.5	45.9
Part-time employment* (% of total employment, aged 15-64)	9.0	8.7	8.8	7.4	6.8	6.6
Fixed-term employment* (% of employees with a fixed term contract, aged 15-64)	1.4	1.5	1.4	1.4	1.2	1.1
Participation in activation labour market policies (per 100 persons wanting to work)	3.1	2.9	3.5	4.5	:	:
Transition rate from temporary to permanent employment (3-year average)	57.7	57.8	56.5	56.1	56.9	:
Youth unemployment rate (% active population aged 15-24)	23.7	24.0	21.7	20.6	18.3	16.2
Gender gap in part-time employment	1.0	1.3	0.7	0.4	0.2	0.6
Gender pay gap[1] (in undadjusted form)	4.9	4.5	5.8	5.2	3.5	:
Education and training indicators	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**
Adult participation in learning (% of people aged 25-64 participating in education and training)	2.0	1.5	1.3	1.2	1.1	:
Underachievement in education[2]	:	:	39.9	:	:	:
Tertiary educational attainment (% of population aged 30-34 having successfully completed tertiary education)	22.9	25.0	25.6	25.6	26.3	:
Variation in performance explained by students' socio-economic status[3]	:	:	13.8	:	:	:

* Non-scoreboard indicator
(1) Difference between the average gross hourly earnings of male paid employees and of female paid employees as a percentage of average gross hourly earnings of male paid employees. It is defined as "unadjusted", as it does not correct for the distribution of individual characteristics (and thus gives an overall picture of gender inequalities in terms of pay). All employees working in firms with ten or more employees, without restrictions for age and hours worked, are included.
(2) PISA (OECD) results for low achievement in mathematics for 15 year-olds.
(3) Impact of socio-economic and cultural status on PISA (OECD) scores. Values for 2012 and 2015 refer respectively to mathematics and science.
(4) Average of first three quarters of 2018. Data for youth unemployment rate is seasonally adjusted (annual series, for EE, EL, HU, IT and UK data based on first three quarters of 2018).
Source: Eurostat, OECD

Table C.4: **Social inclusion and health indicators**

	2012	2013	2014	2015	2016	2017
Expenditure on social protection benefits* (% of GDP)						
Sickness/healthcare	4.0	3.9	3.9	3.8	3.9	:
Disability	1.2	1.1	1.1	1.1	1.0	:
Old age and survivors	8.2	8.0	8.0	7.9	7.8	:
Family/children	1.3	1.2	1.2	1.3	1.4	:
Unemployment	0.2	0.2	0.1	0.1	0.1	:
Housing	0.0	0.0	0.0	0.0	0.0	:
Social exclusion n.e.c.	0.2	0.2	0.2	0.2	0.2	:
Total	15.2	14.6	14.4	14.3	14.3	:
of which: means-tested benefits	0.6	0.6	0.6	0.6	0.5	:
General government expenditure by function (% of GDP, COFOG)						
Social protection	12.3	11.5	11.4	11.4	11.6	:
Health	3.8	4.0	4.0	4.2	4.0	:
Education	3.0	2.8	3.0	3.1	3.7	:
Out-of-pocket expenditure on healthcare (% of total health expenditure)	22.4	20.2	20.3	21.3	20.8	:
Children at risk of poverty or social exclusion (% of people aged 0-17)*	52.5	51.4	50.7	46.8	49.2	41.7
At-risk-of-poverty rate[1] (% of total population)	22.9	23.0	25.1	25.4	25.3	23.6
In-work at-risk-of-poverty rate (% of persons employed)	19.0	18.4	19.8	18.8	18.9	17.4
Severe material deprivation rate[2] (% of total population)	31.1	29.8	25.9	22.7	23.8	19.7
Severe housing deprivation rate[3], by tenure status						
Owner, with mortgage or loan	19.9	16.1	4.9	1.6	1.4	1.2
Tenant, rent at market price	19.0	21.2	32.8	53.0	46.0	27.2
Proportion of people living in low work intensity households[4] (% of people aged 0-59)	7.9	7.6	7.2	7.9	8.2	6.9
Poverty thresholds, expressed in national currency at constant prices*	3884	3888	3991	4253	4518	5167
Healthy life years (at the age of 65)						
Females	5.1	5.2	5.7	5.7	5.6	:
Males	5.9	5.8	5.9	6.3	6.2	:
Aggregate replacement ratio for pensions[5] (at the age of 65)	0.7	0.7	0.7	0.6	0.7	0.6
Connectivity dimension of the Digital Economy and Society Inedex (DESI)[6]	:	:	43.9	46.2	49.8	54.1
GINI coefficient before taxes and transfers*	53.2	51.8	52.1	54.1	54.4	52.3
GINI coefficient after taxes and transfers*	33.2	34.0	34.7	37.4	34.7	33.1

* Non-scoreboard indicator
(1) At-risk-of-poverty rate (AROP): proportion of people with an equivalised disposable income below 60 % of the national equivalised median income.
(2) Proportion of people who experience at least four of the following forms of deprivation: not being able to afford to i) pay their rent or utility bills, ii) keep their home adequately warm, iii) face unexpected expenses, iv) eat meat, fish or a protein equivalent every second day, v) enjoy a week of holiday away from home once a year, vi) have a car, vii) have a washing machine, viii) have a colour TV, or ix) have a telephone.
(3) Percentage of total population living in overcrowded dwellings and exhibiting housing deprivation.
(4) People living in households with very low work intensity: proportion of people aged 0-59 living in households where the adults (excluding dependent children) worked less than 20 % of their total work-time potential in the previous 12 months.
(5) Ratio of the median individual gross pensions of people aged 65-74 relative to the median individual gross earnings of people aged 50-59.
(6) Fixed broadband take up (33%), mobile broadband take up (22%), speed (33%) and affordability (11%), from the Digital Scoreboard.
Source: Eurostat, OECD

Table C.5: **Product market performance and policy indicators**

Performance indicators	2012	2013	2014	2015	2016	2017
Labour productivity per person[1] growth (t/t-1) in %						
Labour productivity growth in industry	-6.38	3.98	0.19	8.52	2.17	4.34
Labour productivity growth in construction	9.01	4.72	2.70	6.84	5.37	-3.25
Labour productivity growth in market services	35.86	3.85	0.64	3.10	3.59	5.03
Unit Labour Cost (ULC) index[2] growth (t/t-1) in %						
ULC growth in industry	19.86	-3.55	0.59	-0.06	7.24	3.55
ULC growth in construction	-1.54	-3.96	-12.10	4.96	-2.90	13.85
ULC growth in market services	-18.71	3.01	5.72	-0.17	10.65	3.04
Business environment	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**
Time needed to enforce contracts[3] (days)	512	512	512	512	512	512
Time needed to start a business[3] (days)	8.0	8.0	8.0	8.0	12.0	12.0
Outcome of applications by SMEs for bank loans[4]	:	0.99	0.94	0.46	0.36	0.69
Research and innovation	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**
R&D intensity	0.48	0.39	0.38	0.49	0.48	0.50
General government expenditure on education as % of GDP	3.00	2.80	3.00	3.10	3.70	:
Employed people with tertiary education and/or people employed in science and technology as % of total employment	24	24	24	26	27	27
Population having completed tertiary education[5]	14	14	14	15	15	15
Young people with upper secondary education[6]	80	80	80	80	80	80
Trade balance of high technology products as % of GDP	-1.79	-1.96	-1.66	-1.75	-1.60	-1.87
Product and service markets and competition				**2003**	**2008**	**2013**
OECD product market regulation (PMR)[7], overall				:	:	1.69
OECD PMR[7], retail				:	:	1.80
OECD PMR[7], professional services				:	:	:
OECD PMR[7], network industries[8]				:	:	1.97

(1) Value added in constant prices divided by the number of persons employed.
(2) Compensation of employees in current prices divided by value added in constant prices.
(3) The methodologies, including the assumptions, for this indicator are shown in detail here:
http://www.doingbusiness.org/methodology.
(4) Average of the answer to question Q7B_a. "[Bank loan]: If you applied and tried to negotiate for this type of financing over the past six months, what was the outcome?". Answers were codified as follows: zero if received everything, one if received 75% and above, two if received below 75%, three if refused or rejected and treated as missing values if the application is still pending or don't know.
(5) Percentage population aged 15-64 having completed tertiary education.
(6) Percentage population aged 20-24 having attained at least upper secondary education.
(7) Index: 0 = not regulated; 6 = most regulated. The methodologies of the OECD product market regulation indicators are shown in detail here: http://www.oecd.org/competition/reform/indicatorsofproductmarketregulationhomepage.htm
(8) Aggregate OECD indicators of regulation in energy, transport and communications (ETCR).
Source: European Commission; World Bank — Doing Business (for enforcing contracts and time to start a business); OECD (for the product market regulation indicators); SAFE (for outcome of SMEs' applications for bank loans).

Table C.6: **Green growth**

Green growth performance		2012	2013	2014	2015	2016	2017
Macroeconomic							
Energy intensity	kgoe / €	0.27	0.24	0.23	0.22	0.21	0.21
Carbon intensity	kg / €	0.96	0.85	0.83	0.80	0.74	-
Resource intensity (reciprocal of resource productivity)	kg / €	3.35	3.26	3.23	3.71	3.43	3.02
Waste intensity	kg / €	1.91	-	1.26	-	1.17	-
Energy balance of trade	% GDP	-3.05	-1.90	-1.41	-0.91	-0.94	-1.31
Weighting of energy in HICP	%	12.5	12.4	12.2	12.3	11.9	12.4
Difference between energy price change and inflation	%	1.3	5.0	0.1	2.8	-1.0	1.6
Real unit of energy cost	% of value added	29.5	27.6	26.5	26.6	26.7	-
Ratio of environmental taxes to labour taxes	ratio	0.18	0.19	0.22	0.24	0.23	-
Environmental taxes	% GDP	2.0	2.0	2.3	2.4	2.3	1.9
Sectoral							
Industry energy intensity	kgoe / €	0.16	0.15	0.14	0.14	0.13	0.12
Real unit energy cost for manufacturing industry excl. refining	% of value added	21.5	21.2	20.6	20.4	20.3	-
Share of energy-intensive industries in the economy	% GDP	11.6	11.4	12.0	12.3	12.4	12.4
Electricity prices for medium-sized industrial users	€ / kWh	0.08	0.09	0.08	0.08	0.08	0.08
Gas prices for medium-sized industrial users	€ / kWh	0.03	0.03	0.03	0.03	0.03	0.03
Public R&D for energy	% GDP	0.01	0.01	0.02	0.01	0.02	0.01
Public R&D for environmental protection	% GDP	0.02	0.02	0.01	0.01	0.01	0.01
Municipal waste recycling rate	%	14.8	13.2	13.1	13.2	13.3	13.9
Share of GHG emissions covered by ETS*	%	44.6	38.0	38.2	37.7	35.2	-
Transport energy intensity	kgoe / €	0.60	0.54	0.53	0.48	0.43	0.42
Transport carbon intensity	kg / €	1.68	1.53	1.52	1.35	1.21	-
Security of energy supply							
Energy import dependency	%	22.3	18.1	16.4	16.4	21.6	23.1
Aggregated supplier concentration index	HHI	12.4	12.8	14.2	17.8	19.9	-
Diversification of energy mix	HHI	0.23	0.23	0.23	0.23	0.23	0.23

All macro intensity indicators are expressed as a ratio of a physical quantity to GDP (in 2010 prices)
Energy intensity: gross inland energy consumption (Europe 2020-2030)(in kgoe) divided by GDP (in EUR)
Carbon intensity: greenhouse gas emissions (in kg CO2 equivalents) divided by GDP (in EUR)
Resource intensity: domestic material consumption (in kg) divided by GDP (in EUR)
Waste intensity: waste (in kg) divided by GDP (in EUR)
Energy balance of trade: the balance of energy exports and imports, expressed as % of GDP
Weighting of energy in HICP: the proportion of 'energy' items in the consumption basket used for the construction of the HICP
Difference between energy price change and inflation: energy component of HICP, and total HICP inflation (annual % change)
Real unit energy cost: real energy costs as % of total value added for the economy
Industry energy intensity: final energy use in industry (in kgoe) divided by gross value added of industry, including construction (in 2010 EUR)
Real unit energy costs for manufacturing industry excluding refining : real costs as % of value added for manufacturing sectors

Share of energy-intensive industries in the economy: share of gross value added of the energy-intensive industries in GDP
Electricity and gas prices for medium-sized industrial users: consumption band 500–20 00MWh and 10 000–100 000 GJ; figures excl. VAT.
Recycling rate of municipal waste: ratio of recycled and composted municipal waste to total municipal waste
Public R&D for energy or for the environment: government spending on R&D for these categories as % of GDP
Proportion of GHG emissions covered by EU emissions trading system (ETS) (excluding aviation): based on GHG emissions (excl land use, land use change and forestry) as reported by Member States to the European Environment Agency.
Transport energy intensity: final energy use in transport sector including international aviation, (in kgoe) divided by transport industry gross value added (in 2010 EUR)
Transport carbon intensity: GHG emissions in transport sector divided by gross value added of the transport activities
Energy import dependency: net energy imports divided by gross inland energy consumption plus consumption of international maritime bunkers
Aggregated supplier concentration index: Herfindahl-Hirschman index for net imports of crude oil and NGL, natural gas and hard coal. Smaller values indicate larger diversification and hence lower risk.
Diversification of the energy mix: Herfindahl-Hirschman index of the main energy products in the gross inland consumption of energy
* European Commission and European Environment Agency
Source: European Commission and European Environment Agency (Share of GHG emissions covered by ETS); European Commission (Environmental taxes over labour taxes and GDP); Eurostat (all other indicators)

ANNEX D: INVESTMENT GUIDANCE ON COHESION POLICY FUNDING 2021-2027 FOR ROMANIA

Building on the Commission proposal for the next Multi-Annual Financial Framework for the period 2021-2027 of 2 May 2018 (COM (2018) 321), this Annex D ([76]) presents the preliminary Commission services views on priority investment areas and framework conditions for effective delivery for the 2021-2027 Cohesion Policy. These priority investment areas are derived from the broader context of investment bottlenecks, investment needs and regional disparities assessed in the report. This Annex provides the basis for a dialogue between Romania and the Commission services in view of the programming of the cohesion policy funds (European Regional Development Fund, Cohesion Fund and European Social Fund Plus).

Policy Objective 1: A Smarter Europe – Innovative and smart industrial transformation
Romania's expenditure on research and innovation is significantly below the EU average and the country displays a stagnant research and innovation performance and low technological outputs. High priority investment needs ([77]) are identified to **enhance research and innovation capacities and skills and the uptake of advanced technologies**, in all Romanian regions, including in the capital region, taking into account the results of the Catching Up Regions Initiative and in particular to: • support collaboration between public research institutions and innovative industries, increase the attractiveness and performance of research and development organisations and encourage applied research through innovation hubs and joint national and transnational investments in early product validation, commercialisation, patenting, start-up formation and technology transfer; • support Entrepreneurial Discovery Processes and Project Development Labs at national and regional level and provide training on skills for beneficiaries on marketing research results and developing project and business plans in order to strengthen the preparation and implementation of smart specialisation projects; • strengthen research and innovation performance and foster productivity growth by identifying smart specialisation areas on the basis of national and regional needs and potential; • reinforce the current research and innovation infrastructures, capacities and skills to ensure participation in Horizon and other EU programmes and initiatives, to integrate international, cross border networks and transnational clusters and set-up joint research and education programmes and co-financing schemes; • link higher education and vocational centres to the national and regional innovation and smart specialisation reskilling system; • support the capacities and skills development of regional and national stakeholders, involved in the design and implementation of smart specialisation strategies and projects, in close cooperation with beneficiaries.

([76]) This Annex is to be considered in conjunction with the Proposal for a Regulation of the European Parliament and of the Council on the European Regional Development Fund and on the Cohesion Fund COM(2018) 372 and the Proposal for a Regulation of the European Parliament and of the Council on the European Social Fund Plus COM(2018) 382, in particular as regards the requirements for thematic concentration and urban earmarking outlined in these proposals.
([77]) The intensity of needs is classified in three categories in a descending order - high priority needs, priority needs, needs.

Romania performs significantly below the EU average in terms of digital public services and the integration of digital technologies by businesses. Priority investment needs are identified to **reap the benefits of digitisation for citizens, companies and governments**, and in particular to:

- strengthen the Information and Communications Technology up-take by small and medium-sized enterprises, including investments in infrastructures, foster digital skills and services and further support digital innovation hubs, living labs, etc.;

- increase measures for e-government, including the introduction and consolidation of Europe wide interoperable services, e-inclusion, e-health, e-learning, e-skilling.

Romania's share of innovative companies is behind the EU average and the country is confronted with a persistent low level of business investment in research and innovation. Priority investment needs are identified to **enhance growth and competitiveness of small and medium-sized enterprises**, and in particular to:

- support the creation of new companies (start-ups, scale-ups), increase their survival rates and raise their degree of competitiveness and internationalisation;

- increase the innovation capacities of companies, by introducing product, organisational or marketing innovations, by providing training on innovation management and smart specialisation specific skills, marketing research results skills, by supporting key enabling technologies and acceleration of market access and by supporting industrial cluster development and integration into industry-research driven cooperation networks, including cooperation with the EU Strategy for the Danube Region countries;

- facilitate access to finance for small and medium-sized enterprises, including by encouraging seed and early stage finance for high-potential innovative start-ups.

Policy Objective 2: A low carbon and greener Europe – Clean and fair energy transition, green and blue investment, circular economy, climate adaptation and risk prevention ([78])

Energy intensity in Romania remains above the EU average and energy poverty affects one household out of four. Priority investment needs are identified to **promote energy efficiency measures and renewable energy**, and in particular to:

- support energy efficiency renovation of public and residential buildings;

- support energy efficiency measures in district heating systems, together with the promotion of renewable energy into the district heating and cooling;

- promote small-scale renewable energy in combination with energy efficiency renovation of buildings;

- strengthen the capacity of managing authorities, project developers and public authorities.

Romania is lagging behind regarding measures for tackling climate change adaptation, the rehabilitation of old contaminated sites and the prevention of floods and other natural hazards. Priority investment needs are identified to **promote climate change adaptation, risk prevention and disaster resilience**,

([78]) While outside of the scope of the ERDF and the Cohesion Fund (art. 6, paragraph 1(h), COM (2018)372), energy interconnectors could be financed by the Connecting Europe Facility in line with its objectives (art. 3, paragraphs 1 and 2 (b), COM(2018) 438).

and in particular to: • support measures for emission reduction, elimination (exchange) of energy sources for district heating, complementary to the energy efficiency investments; • implement the risk prevention strategies and address climate change and natural risks (floods, drought, forest fires, landslides, earthquakes), as prioritised nationally and in cross-border and transnational coordination and cooperation.
Water and wastewater infrastructure is largely insufficient and high priority investment needs are identified to **promote sustainable water management**, and in particular to: • promote regional water management schemes, including through capacity building; • support schemes for addressing water pollution (dispersed sources) and maintaining/improving the status of water bodies; • cooperate in international programmes for the Danube region and the Black Sea.
The waste management system in Romania is one of the least developed in the EU, with high landfilling rates and the poor quality of waste infrastructure. High priority investment needs are identified to complete the waste management system, to **promote the transition to a circular economy**, and in particular to: • invest in capacity-building for all stakeholders involved in the transition to circular economy, and promote circular economy in small and medium sized enterprises; • expand the waste management schemes at county level in order to increase reuse and recycling, to prevent waste generation and divert waste from landfilling; • support the administrative and management capacity at the national and county level on waste prevention, separate collection and recycling.
Important gaps remain in reaching the EU's objectives in the areas of maintaining biodiversity, restoring ecologically damaged areas and reducing pollution, in particular in highly sensitive areas. Priority investment needs are identified to **enhance biodiversity, green infrastructure in the urban environment, and reducing pollution**, and in particular to: • support management and conservation measures in protected areas, in line with the EU environmental legislation for areas such as the Danube basin, the Black Sea and the Carpathians, in cooperation with the EU Strategy for the Danube Region countries; • support ecological restoration and develop new municipal green areas connected with emission reduction objectives; • accelerate the closure and rehabilitation or the remaining incompliant landfills, storage and dumping sites and the decontamination and rehabilitation of contaminated industrial sites.

Policy Objective 3: A more connected Europe – Mobility and regional Information and Communications Technology connectivity
The general condition and reliability of road and rail infrastructure in Romania are poor and its transport networks remain among the least developed in the EU, without tackling geographical obstacles to traffic, such as the Carpathian Mountains and crossing the Danube to Bulgaria. High priority investment needs are identified to develop a **sustainable, climate resilient, intelligent, intermodal Trans-European Networks for Transport, including improved access to Trans-European Networks for Transport, national, regional and cross border mobility**, and in particular to: • develop core and comprehensive Trans-European Networks for Transport road and rail networks, notably links with peripheral regions across the Carpathian Mountains e.g. the north-east and to the Danube Delta, and unlock industrial centres e.g. around Piteşti; • put the European Railway Traffic Management System into operation on the core rail Trans-European Networks for Transport; • implement the adopted traffic safety strategy and carry out road safety measures to reduce the high road accident fatality rate and mitigate environmental damage; • improve the navigability of the Danube River in cooperation with the Danube region Member States; • support the administrative capacity building of the major transport beneficiaries i.e. the national rail and road companies, other transport authorities, and the Ministry of Transport; • develop core and comprehensive Trans-European Networks for Transport cross border connections e.g. realising additional transport connections across the Danube, either by constructing new bridges or improving ferry connections.
Sustainable multimodal mobility in urban areas is poorly developed. High priority investment needs are identified to **promote sustainable multimodal urban mobility,** based on sustainable multimodal urban mobility plans, in particular to: • develop sub-urban rail and multi-modal connections in and around larger urban centres; • promote sustainable and accessible modes of transport, such as low-carbon collective public transport, active modes of transport, that will reduce congestion, emissions, traffic accidents, etc.; • support development of urban transport systems in less-developed regions, such as light rail, metro and tram lines, cycling friendly infrastructure.
Even though Romania has one of the highest shares of subscriptions to fast broadband in the EU, the coverage of fixed and mobile (4G) broadband networks remains one of the lowest in the EU, with a very pronounced urban-rural divide. Investment needs are identified to **enhance digital connectivity**, and in particular to: • support white spots in densely populated areas or surroundings of urban areas and in rural areas ; • reduce the cost of deploying high-speed electronic communications networks;

• improve the capacity of the programme authorities and beneficiaries.
Policy Objective 4: A more social Europe – Implementing the European Pillar of Social Rights
Unfavourable demographics, high labour force emigration, lack of relevant skills, lead to tight labour market conditions. High priority investment needs are therefore identified **to improve access to employment through active labour market policies, anticipate skills needs and support labour market transitions and mobility** and in particular to: • improve the design of active labour market policies, by a better integration with education and social services to ensure tailor-made assistance to jobseekers; • consolidate and support social entrepreneurship and social economy; • support the improvement of working conditions, provision of flexible working arrangements, as well as ensure employability of persons with disability and older workers; • build robust skills anticipations systems, implement targeted upskilling and reskilling measures that meet labour market needs; reinforce participation in adult learning in collaboration with relevant stakeholders, and develop services on lifelong guidance to foster career transition; • address local and regional labour market shortages and labour force migration, by improving the internal mobility measures and supporting new type of businesses matching local economic opportunities;
The education system is characterised by low attainment levels in basic, digital and soft skills, high early school leaving, and low labour market relevance of vocational education and training and higher education. High priority investment needs are therefore identified **to improve the quality, effectiveness and labour market relevance of education and training systems; promote equal access to inclusive education and lifelong learning,** and in particular to: • improve the accessibility, quality and affordability of early childhood education and care, including related infrastructure; • prevent early school leaving, by introducing a learner-centred approach for children at risk, and flexible second chance programmes, accompanied by relevant counselling and career guidance. Improve teachers’ skills to address children from vulnerable groups; • improve access to quality inclusive education, in non-segregated facilities, in particular for Roma, learners with disabilities and in rural areas, including relevant infrastructure; • improve quality of vocational education and training to adapt to labour market developments, including necessary trainings and provision of equipment; • improve labour market relevance of tertiary education, in particular for professions with high labour market demand, including joint training actions and traineeships in companies; • support development of innovative and effective teaching methods and technologies.
Poverty, social exclusion and inequalities remain among the highest in the EU, with significant regional and local disparities in quality and access to social and healthcare services. High priority investment needs are therefore identified **to foster active inclusion, to promote socio-economic integration of**

Roma community, to enhance access to quality services and address material deprivation, and invest in housing, health care and long-term care infrastructure and in particular to:

- develop and consolidate individualised integrated services, in particular in marginalised areas; initiate targeted measures to support children at risk of poverty and social exclusion;
- increase quality and availability of social services and develop tailored family-based approach;
- improve access of Roma community to integrated support and mainstream services.
- support the upskilling of social, health-care and long-term care workers and tackle territorial disparities;
- support deinstitutionalisation of children and of adults with disabilities, including relevant training, services, and infrastructure;
- develop social housing services and infrastructure for vulnerable groups, in a comprehensive way, to reduce spatial segregation, including by urban regeneration projects;
- address material deprivation through food and basic material assistance to the most deprived;
- increase access to primary health services and prevention; develop outpatient care and e-health solutions, in particular at community level and for vulnerable groups; support health infrastructure with emphasis on primary/ambulatory care and intermediate care facilities;
- develop home care, long-term care and community-based services and infrastructure, in particular for the elderly and people with disabilities; support effective national active ageing measures

Policy Objective 5 – A Europe closer to citizens by fostering the sustainable and integrated development of urban, rural and coastal areas and local initiatives

Growth is mainly confined to strong agglomerations and is marked by increasing sub-urbanisation challenges. Smaller cities and surrounding territories face different challenges related to access to labour market, education, healthcare and other social services. High priority investment needs are identified, a compulsory urban earmarking is introduced and a coordinated approach to investments from all policy objectives is needed to **foster the integrated development and security in urban areas**, and in particular to:

- invest in metropolitan areas (growth drivers) marked by strong growth and on-going sub-urbanisation with a view to strengthen the planning and coordination capacity to steer integrated urban investments for driving growth, innovation and productivity, in line with a coordinated functional area approach;
- support sustainable urban development of county capitals in order to ensure access to new jobs and basic public services at local level, in line with their growth potential and a more tailor-made and differentiated approach needed for these cities;
- increase the administrative capacity and cooperation possibilities of urban authorities in the programming and the implementation phase.

Disparities between regions, between rural and urban areas and between citizens remain very strong and call for tailor-made investment priorities based on specific territorial and socio-economic needs and

development potential. High priority investment needs are identified to **foster the integrated social, economic, cultural and environmental local development and security** and in particular to: • support integrated territorial strategies in structurally challenged areas, e.g. the counties of Vaslui, Teleorman and Mehedinti; • support specific territorial initiatives aimed at the reconversion of the economy in regions affected by industrial decline and mining, such as the Jiu Valley (taking into account the results of the Coal and Carbon-Intensive Regions in Transition Initiative); • support sensitive areas of specific environmental importance, such as the current Danube Delta Integrated Territorial Investments; • increase the administrative capacity of the local authorities in the programming and the implementation phase.
Factors for effective delivery of Cohesion policy • improved and simplified procedures in order to eliminate excessive documentation and over-bureaucratic requirements; enhanced use of simplified costs options; • increased capacities of EU Funds managing authorities, intermediate bodies, final beneficiaries, and other bodies to prepare and implement projects, especially in waste, roads, railways, education, health sectors and for regional and local public authorities in preparation of their integrated territorial development strategies and project applications; • development and implementation of a roadmap on administrative capacity building necessary for the effective administration and implementation of the EU Funds; • improved and more efficient measures to prevent and address conflict of interest, fraud and corruption; • strengthened social dialogue and capacity of social partners and of the civil society organisations, to participate to the development, implementation, monitoring and evaluation of public policies and projects, especially by supporting coordination and networking structures; • continued adequate capacity building of local authorities to increase quality of services' delivery (especially in social, education and health sectors); • investments and programming under the five policy objectives, taking into account the relevant national and/or regional and local strategies and investment plans and results from the Catching-up Regions Initiative and the Coal Regions in Transition Initiative; • improved public procurement performance, in particular by reducing the rate of "single-bidding" instances or "no calls for bids" numbers; • broader use of financial instruments and /or contributions to Romania's compartment under InvestEU for revenue-generating and cost-saving activities.

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