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From:	Mr Eugen Orlando TEODOROVICI, Minister of Public Finance, Romania Ministry of Public Finance
date of receipt:	23 April 2019
To:	Mr Jeppe TRANHOLM-MIKKELSEN, Secretary-General of the Council of the European Union
Subject:	Romania: Report on effective action, as laid down in Article 6(2) of Council Regulation (EC) 1466/97 on action taken by Romania in response to the Council recommendation of 4 December 2018 under Article 121(4) TFEU

Delegations will find attached the Report on effective action, as laid down in Article 6(2) of Council Regulation (EC) 1466/97 on action taken by Romania in response to the Council recommendation of 4 December 2018 under Article 121(4) TFEU.

E-MAIL / MM

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ROMANIA
MINISTRY OF PUBLIC FINANCE
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To Mr. Valdis DOMBROVSKIS,
Vice-President, EU Commissioner for the Euro and Social Dialogue

To Mr. Pierre MOSCOVICI,
EU Commissioner for Economic and Financial Affairs, Taxation and Customs

To Mr. Jeppe TRANHOLM-MIKKELSEN,
Secretary General, General Secretariat of the EU Council

Bucharest, April 2019

Dear Mr. Dombrovskis,
Dear Mr. Moscovici,
Dear Mr. Tranholm-Mikkelsen,

On 21st of November 2018, the European Commission issued a recommendation to the Council with a view to correcting the significant observed deviation from the adjustment path toward the medium-term objective (under Article 121(4) TFEU and Article 10(2) of Regulation (EC) No 1466/97).

Following the debates at the committees' level, the Council issued, in December 2018, a recommendation with a view to correcting the significant observed deviation from the adjustment path toward the medium-term budgetary objective in Romania.

In this context, please find enclosed the report to the Council on the action taken by the Romanian Government in response to the recommendation.

Yours sincerely,

Eugen Orlando TEODOROVICI
Minister of Public Finance

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Report regarding *European Union Council's Recommendation in the view of correcting the significant deviation from the adjusting trajectory towards the medium term budgetary objective, detected in Romania*

Economic developments in 2018 and in first part of 2019

In 2018, Romania recorded a robust GDP growth of 4.1% in real terms, one of the highest growth rates among EU member states. Given that the euro area economic growth in 2018 was only 1.8%, Romania continued its rapid convergence towards the level of development and welfare of this area.

In 2018, the value of the gross domestic product was 944.2 billion lei, which is an increase of 87.5 billion lei from 2017, compared with an increase of 91.6 billion lei in 2017 and 52.5 billion lei in 2016.

Domestic demand grew by 5.7% in 2018, with final consumption increasing by 4.5%, while household consumption, on the background of higher inflation and a more restrictive monetary policy, has tempered the growth ween in the last 2 years increasing by only 5.3%. Significantly, gross capital formation (gross investment plus inventory accumulation) accelerated to 9.6% in 2018 (from 4.2% in 2017).

Investments in the economy, i.e. gross capital formation, reached 200.4 billion lei in 2018 compared to only 175 billion in 2017, up by 14.5%. Within the structure, gross fixed capital formation decreased by 3.2% compared to 2017. At the same time, stock changes recorded a positive contribution of 2.9 percentage points.

Exports of goods and services increased in real terms by 5.4%, while imports of goods and services increased by 9.1%. Within the structure, exports of services grew by 8.5% and imports of services by 14.4%, so that the surplus in foreign trade of services remained above 4% of GDP. These developments have made net exports have a negative contribution to GDP growth by 1.7 percentage points.

From the domestic supply point of view, the industry represented the engine of this evolution, contributing to the real growth of GDP by 1 percentage point, the added value of this sector increasing by 4.1%. The sector "Trade, transport, storage, hotels and restaurants" had a contribution of 0.7 percentage points.

Agriculture has also contributed substantially. The gross added value increased by 10.0% compared to 2017, the contribution being 0.4 percentage points.

A second defining element is the evolution of modern services with a high gross value added, namely IT, scientific and technical branches. The information and communications sector recorded a dynamics of 7.2% and a contribution of 0.4 percentage points. The "Professional, scientific and technical activities; administrative service activities and support service activities" increased its gross value added by 5.7%, which meant a contribution of 0.4 percentage points to an economic growth of 4.1%.

Overall, four sectors of the economy (industry, agriculture, information and communications as well as scientific and technical services) accounted for almost 54% of economic growth (2.2 percentage points out of 4.1%).

The high economic growth has reduced Romania's development gap compared to other EU countries. According to the Governance Program, it is envisaged "to exceed 70% of the EU average GDP per capita at purchasing power standard in 2021". In 2018, GDP per capita at purchasing power standard (PCS) is projected to have exceeded the 65% threshold.

Outstanding results, deriving from the increased competitiveness of Romanian enterprises, have also been achieved in terms of export of goods. In 2018, Romanian exports increased by 8.1%, being 3.5 percentage points above the 4.6% increase registered at EU 28 level.

It is important that the structure of exports is dominated by about 50% by the high-value added-value machinery and equipment group which, in 2018, amounted to 32.1 billion euros, up by 10.4%, and generating a trade surplus of 618 million euro.

Foreign direct investment amounted to 5.0 billion euro in 2018, which is twice the size recorded in 2010, when it amounted to 2.3 billion euro. This value is a post 2009 record, and most of the foreign capital placed in Romania comes mainly from developed EU countries, namely the Netherlands, Germany and Austria.

Romania's exports recorded a record high of 11.4 billion euros at the end of the first two months of 2019, up by 4.8% over the same period of the previous year. Intra-EU exports increased by 6.1%, the share of intra-Community shipments accounting for 77.9% of total exports. At the same time, extra-EU exports increased by 0.3%.

The machinery and transport sector recorded a surplus of 433.8 million euro, which covered 18.0% of the total trade balance deficit in the first two months of 2019.

In the first two months of 2019, exports of services increased by almost 600 million euro, (17.5%), which made this export category record a trade surplus of 1.3 billion euro. Services with a significant export contribution include IT, professional and transport, higher added value services.

Also, in the first two months of 2019, foreign direct investments amounted 1.0 billion euro, up 47.2% over the same period in 2018. This is the post-crisis record of foreign direct investments in Romania in the first two months of the year and fully covers the current account deficit.

In the same period, the volume of industrial production increased by 1.0% compared to the same period of 2018. Significant is the fact that this dynamics was almost entirely due to the positive results of the manufacturing industry, which registered an 1.3% growth. Moreover, in February 2019 manufacturing output increased by 3.1% in real terms compared to February 2018.

The economic activity in the first two months of 2019 was characterized by a significant increase of construction activity, with a recorded growth of 4.7%.

The modern services recorded strong dynamics in the first month of this year. Thus, the volume of turnover in the services sector provided to the population increased by 14.2% in January 2019 compared to the corresponding period of the previous year. Turnover value of modern services mainly for enterprises increased by 14.8% in January 2019, due to positive results in the following branches: air transport (+ 31.5%), computer service activities (+ 30.4%), legal and accounting activities (+29.3%), water transport (+29.1%).

In the case of retail, turnover increased in the first two months of 2019 by 8.2%, a growth similar to that recorded in the first two months of 2018.

Fiscal developments

After the period 2016-2018, ESA's budget deficit sustained economic growth within the maximum allowed by the Treaty on the Functioning of the European Union, (ESA budget deficit marginally below 3% of GDP), the year 2019 marks the entrance to a gradual adjustment.

For 2018, the cash deficit was estimated at 2.91% of GDP, with an estimated ESA deficit of 2.96% of GDP. The ESA budget deficit for 2019 is set at 2.78% of GDP, to reach 2.45% of GDP in 2021. Budgetary planning for 2019-2021 is influenced by the fiscal relaxation measures started in 2015-2016 in order to stimulate economic growth and continued through the normative acts adopted in 2017 (regulating measures in the field of salaries of the personnel in the budgetary sector, social legislation, pension legislation, with additional impact on staff and social assistance expenditures) and budgetary fiscal measures taken during the year 2018.

According to the EU methodology, Government debt to GDP ratio was 35.1% at the end of 2018 (operating data), similar to 2017.

The estimated level of medium-term gross government debt (2019-2022) is below 38.0% of GDP.

Budget execution for 2018

The execution of the general budget, based on operational execution data for 2018, ended up with a cash deficit of 27.3 billion lei, 2.9% of GDP respectively, below the annual target of 2.97% of GDP.

The revenues of the general consolidated budget amounted to 295.1 billion lei, accounting for 31.1% of GDP, compared to 29.4% of GDP in 2017. In nominal terms, the revenues were 17.2% higher than in 2017.

There were increases compared to the previous year in the case of social contributions (+36.8%), influenced by the increase in the number of employees in the economy, the gross average earnings, the minimum wage on the economy, as well as the the legal conditions for the transfer of contributions from the employer's burden to the employee. However, revenue from tax on wages and income fell by 24.8% due to the reduction of income tax rate from 16% to 10% as of 1 January 2018, which was reflected starting February 2018 .

Regarding VAT revenue, an increase of 11.3% was recorded in 2018 compared to the previous year, amounting to 59.6 billion lei in 2018, mainly due to the revenues colected in the second half of the year (starting from May).

Revenues registered from excises increased by 7.2% compared to the previous year, to the amount of 28.5 billion lei, reprezenting 3% of GDP.

Income tax and property taxes also increased by 2% compared to 2017, and earnings from non-tax revenues increased by 24%, positively influenced by dividend payments.

The amount from European Union in the account of payments made were 27.1 billion lei, increased by 57.8% compared to 2017.

The expenditures of the general consolidated budget amounted to 322.4 billion lei, 16.8% higher than in the previous year.

The personnel spending are 23.7% higher than in 2017, the increase being determined by the salary increases granted under the *Law no. 153/2017 on the remuneration of staff paid out of public funds*.

Expenditure on goods and services increased by 9.8% over the previous year. Significant increases are recorded both in local budgets and in the budget of the national health insurance fund and in the budgets of public institutions funded from own revenues and budget subsidies.

Subsidies are 7.6% higher than in 2017, remaining at the same level as a percentage of GDP, i.e. 0.7%.

Interest rates are 27.8% higher than last year, accounting for 1.4% of GDP, as in October 2018 there was a peak in interest payments, considering the aggregation of interest payments related to several benchmark government securities.

Social assistance expenditures increased by 9.5% compared to the previous year, mainly influenced by the 9% increase of the pension point as of 1st July 2017 (reaching 1000 lei) and 10% as of 1st July 2018 (reaching 1100 lei), the increase of the social allowance for pensioners from 520 lei to 640 lei, as well as the increase and modification of the way of setting the monthly child allowance and the insertion incentive.

Expenditures for investments, including capital expenditures, as well as those related to development programs financed from domestic and foreign sources, amounted to 34.2 billion lei, 27.9% higher than in 2017.

Budgetary and fiscal measures in 2019:

- increase of the gambling taxes;
- increase of excise duties for tobacco products;

- implementing in 2019 the measure to distribute at least 90% of the net profit to the state or local budget in the case of autonomous state enterprises or dividends in the case of national companies and companies with full or majority share capital owned by the state;
- reduction of labor taxation for construction companies;
- selling of licenses for 5G technology;
- maintaining of bonuses, allowances, compensations, premiums and other elements that, according to the law, are part of the gross monthly salary, at the level of the amount granted for December 2018 for staff paid by public funds;
- increase of child allowance;
- granting food allowance to all civil servants.

Also, when determining the personnel expenditures for 2019, were applied some of the measures aimed at limiting the expenditures approved in previous years, as follows:

- Additional work performed over normal working hours or off-days will be compensated only with free time, with some exceptions for staff in the areas of defense, security and public order, or staff with special status;
- In 2019-2021, public institutions and public authorities will not award prizes to staff, with some exceptions for athletes and coaches, students and teachers;
- In 2019-2021, no allowances will be granted in the case of retirement, reserve retirement, termination of employment of public servant;
- In 2019-2021, no tickets will be granted, except for nursery tickets regulated by the Law 165/2018.

Structural Reforms

Romania pays particular attention to structural reforms and to absorption of European funds as important requirements for the sustainability of public finances and for accelerating the process of convergence and compatibility of the economy with the Euro Area economy.

In this context, it is important to point out that Romania has exceeded the real convergence threshold of 60% in 2017, which is in fact an important progress in real convergence.

For 2018, the Government has taken as a priority measures of a series of structural reforms, which mainly concern: (i) reduce bureaucracy and improving the efficiency of public administration (ii) labor market reform and policies to create new jobs; (iii) improving investment mechanisms and boosting public investment (iv) improving competitiveness through both business support programs and public policies to improve access to finance SMEs.

Regarding the central public administration reform, as a necessity to improve the quality of the services offered to the citizens and the business environment, we highlight:

- Entry into force of the Administrative Code, which contains the Statute of the Civil Servant, modified in order to emphasize and stimulate performance, as well as clear delineation of liability provisions so that the process of public policy implementation becomes more efficient and less bureaucratic.
- Introduction of performance contracts in the central administration, which will include about 5 indicators that are sufficiently expressive for the activity of managerial and quantifiable civil servants, as well as criteria for assessing the quality of their activity according to the degree of satisfaction of the public with the services provided;
- Modernization of the public administration, with the scope of reducing bureaucracy for the flow of opinions and decisions, but especially of the implementation of the digitization process of the institutions (the priority and the legality of the electronic documentation);
- Local Public Finance Law.

A central point of the structural reforms in 2019 will be the programs and public policies in the field of labor as follows:

- Amending the Labor Code and the Law on Social Dialogue;
- The Disability Program, which aims at improving their active participation in the labor market and reducing social exclusion;
- Support through a state aid scheme with complex and interconnected objectives to stimulate the private sector to develop businesses for skilled personnel in areas with high unemployment;
- Support young people for education and improve their employment with a direct effect on reducing unemployment.

In 2019 one of the most important objectives of the structural reform package to be implemented by the Government is to improve the investment mechanisms as well as to diversify and orientate the strategic areas of investor support.

In this context, we want to mention that the Government has already approved the establishment of a centralized public investment unit in public-private partnership within the National Strategy and Forecast Commission and that in the second quarter it should offer to the investors a new law on public- private partnerships.

We underline that the private sector (SMEs included) access to finance according to the Governance Program will be stimulated by new state aid schemes designed for strategic areas such as:

- state aid scheme to stimulate Romanian innovation and creativity;
- investment support for the development of licensed industrial activities;
- spa resorts development program;
- a state aid scheme to help the construction of housing dwellings for employees in order to support investors in securing their labor force needs and improving labor market mobility.

Medium-term budgetary planning

Both the cash and the ESA deficits are planned for 2019-2021 within the 3% of GDP threshold.

The government send a draft budget for 2019 to the parliament with a cash deficit target of 2.55%, but following the parliamentary approval of raising children's allowances, the cash deficit was raised to 2.76%.

Revenue, Expenditures and Balance of General Consolidated Budget (% of GDP)				
	2018 Estimates	**2019** Estimates	**2020** Estimates	**2021** Estimates
Cash deficit	-2,91	-2,76	-2,33	-2,01
ESA deficit	-2,96	-2,78	-2,68	-2,45
Structural deficit	-3,03	-2,97	-3,03	-2,77

Source: MPF si CNSP

Romania has one of the highest potential increases among Member States. According to the most recent EC estimate, Romania's potential GDP growth was 4.6% in 2018, the third largest in the EU. In the medium term, potential GDP growth will be around 5%.