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REPORT FROM THE COMMISSION TO THE COUNCIL

Commission report to the Council pursuant to Article -11(2) of Regulation (EC) No 1466/97 on the enhanced surveillance mission in Romania, of 14-15 March 2019

This report on an enhanced surveillance mission to Romania is transmitted to the Council pursuant to Article -11(4) of Regulation (EC) No 1466/97¹. As foreseen by Article -11(5) of Regulation (EC) No 1466/97, the provisional findings of that mission have been previously transmitted to Romanian authorities for comments.

**Romania – Significant Deviation Procedure
enhanced surveillance mission, 14-15 March 2019
Report**

1. Introduction

Romania has been under significant deviation procedures since spring 2017. Romania was the first Member State subject to a significant deviation procedure (SDP). The first SDP was launched in spring 2017 as a consequence of Romania's observed significant deviation from its medium-term budgetary objective (MTO) in 2016, when the structural deficit increased to 2.6% of GDP, from 0.6% in 2015. On 16 June 2017 the Council issued a recommendation asking Romania for a structural adjustment of 0.5% of GDP in 2017, which is the Stability and Growth Pact preventive arm matrix-based requirement in "normal times". In autumn 2017, the Council concluded that Romania had not taken effective action in response to that recommendation, with efforts solely focused on avoiding breaching the 3% of GDP headline deficit reference value. In December 2017 the Council issued a revised SDP recommendation in which it asked for a structural adjustment of 0.8% of GDP in 2018. In spring 2018 the Council again concluded that Romania had not taken effective action. Regulation (EC) No 1466/97 does not provide for a further revised recommendation under a single SDP. Therefore, in June 2018 that SDP expired.

Immediately afterwards, a new SDP was launched in 2018 as a consequence of the significant deviation in 2017 from the adjustment path to the medium-term budgetary objective. In its recommendation of 22 June 2018 the Council asked Romania to take the necessary measures to ensure that the nominal growth rate of net primary government expenditure does not exceed 3.3% in 2018 and 5.1% in 2019, corresponding to an annual structural adjustment of 0.8% of GDP both in 2018 and in 2019. On 4 December 2018 the Council concluded that the authorities did not intend to act upon that recommendation, with their efforts solely focused on avoiding breaching the 3% of GDP headline deficit reference value. On that basis, the Council issued a revised recommendation in which it asked Romania to take the necessary measures to ensure that the nominal growth rate of net primary government expenditure does not exceed 4.5% in 2019, corresponding to a structural adjustment of 1.0% of GDP in 2019. Romania was asked to report by 15 April 2019 to the Council on action taken, possibly as part of its Convergence Programme. The Commission's

¹ Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies, OJ L 209, 2.8.1997, p. 1

assessment of the report sent by Romania is being published as part of the European Semester package.

This report presents the findings from the enhanced surveillance mission to Romania that took place on 14 and 15 March 2019. The mission was carried out on the basis of Article -11(2) of Regulation (EC) 1466/97. The mission team met the Minister of Finance, Mr. Eugen Teodorovici, the governor of the National Bank of Romania (NBR), Mr. Mugur Isărescu, and the head of the Fiscal Council of Romania, Mr Ionuț Dumitru, accompanied by their respective staff. As with previous similar missions, the aim was to discuss the fiscal measures planned by the authorities, stress the existence of fiscal risks, and encourage compliance with the SDP recommendation. This report is based on information obtained until and during the mission.

2. Findings of the mission

The 2018 headline deficit was around 3% of GDP, which implies no compliance with the 2018 fiscal consolidation requirement. The 2018 government deficit amounted to 2.9% of GDP in cash terms, a slight increase from 2.8% of GDP in 2017. The deficit in accrual (ESA) terms, which is the relevant figure under the Stability and Growth Pact, was going to be available on 23 April 2019. Some revenue items, such as super-dividends from state-owned companies or reimbursements (at the end of 2018) of Union funds for projects executed before 2018, improved the 2018 cash revenues but will most likely not be part of the accrual figures for 2018. On the other hand, VAT refunds were atypically low in January 2019, with a positive impact on 2018 revenues in accrual terms (thanks to the one-month adjustment method of cash data), but negative impact on 2019. In addition, the difference between paid for and delivered military equipment should decrease the 2018 expenditures in accrual terms. The Ministry of Finance seemed confident that the 2018 deficit in accrual terms will be just below 3% of GDP, while the Fiscal Council stressed a risk of the 2018 deficit slightly breaching that threshold.

The authorities target a marginal structural adjustment in 2019 and thus do not intend to act upon the SDP recommendation. The Minister of Finance confirmed that the government has no intention to comply with the Council Recommendation of 4 December 2018. The authorities continue to focus on maintaining the headline deficit below the 3% of GDP Treaty threshold, thus aiming to avoid the corrective arm of the Stability and Growth Pact. The parliament adopted the 2019 budget and multiannual fiscal strategy with a substantial delay, on 14 March 2019. The budget targets a cash deficit of 2.76% of GDP, above the target initially proposed by the government of 2.55% due to a parliament decision to increase social spending (child allowance) without compensatory measures. The corresponding accrual deficit target is close to 2.8% of GDP. Based on the government's own estimates at the time of the mission, that headline would entail a structural adjustment of around 0.1% compared to 2018, significantly short of the Council's Recommendation (a structural adjustment of 1% of GDP).

There are risks to achieving the 2019 budget target. The Minister of Finance stated that the tax administration (ANAF) would soon announce the measures underlying the tax revenue projections from the 2019 budget. According to the Minister of Finance, the government is working on measures concerning customs control and transfer pricing on the revenue side and increased control of monthly spending by government entities on the expenditure side. The mission team reminded the Minister that the report on action taken, due by 15 April 2019, should contain details of the planned measures and the quantification of the expected fiscal impact per measure, including for the measures to improve tax compliance. According to the Fiscal Council, the macroeconomic assumptions concerning the labour market (number of employees and gross wage dynamics in the private sector) seem very optimistic, leading to a possible overestimation of revenue from social contributions. Additionally, the budget assumes a significant improvement of VAT compliance without providing specific measures supporting the improvement. The Fiscal Council added that, on the expenditure side, pensions and the contribution to the EU seem to be underestimated. On the other hand, the budget does not include revenue from the new tax on bank assets, nor diversion of social contributions from the second pension pillar. The Fiscal Council argued that, assuming unchanged fiscal and budgetary policies, the risk balance is overwhelmingly inclined towards far higher deficits than those envisaged by the government and significantly higher than the 3% of GDP reference value of the Treaty.

The new pension law poses a significant upward risk to the fiscal deficit in 2020 and beyond. The Minister of Finance stated that the government plans a fiscal adjustment in 2020 and beyond. The multiannual fiscal strategy accompanying the 2019 budget targets a headline deficit of 2.3% of GDP in 2020 and 2.0% of GDP in 2021. However, the Fiscal Council raised concerns over the fiscal impact of the pension law adopted in the end of 2018. It increases the pension point (the main parameter used for pension indexation) by 15% in September 2019 and by 40% in September 2020. The law also revises upwards the other pension parameters from 2021. As such, the Fiscal Council projects the headline deficit to increase to around 4% of GDP in 2020 and above 5% of GDP in 2021, a similar trend to the Commission's projection and contrasting with the objectives of the Ministry of Finance of a fiscal adjustment in those years.

The authorities are working on changes to the new tax on bank assets. In late December 2018, the government adopted an emergency ordinance (GEO 114/2018) containing several fiscal measures, including a tax on banks' assets, substantial changes to the second pension pillar and taxes for energy and telecommunications companies. The new bank asset tax (which the government names "tax on greed") is levied on total assets and is linked to the level of the interbank interest rate (ROBOR). The mission communicated concerns that the tax can strain financial stability, lower banking sector intermediation and indirectly affect the normal, smooth conduct of monetary policy. The Minister of Finance informed the mission that, following discussions with stakeholders, the bank asset tax will be amended before the end of March. The NBR shared the Commission's concerns about the bank asset tax and confirmed that the tax might be subject to changes which would mitigate its negative effects.

The government might modify recent measures weakening the second pension pillar. Based on a systemic reform introduced in 2008, a portion of social security contributions is directed to funded individual accounts (a defined contribution scheme) in privately-managed pension funds (second pension pillar). The contributions to the second pillar, which according to the original reform 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. Ordinance 114/2018 introduced further changes with wide ranging impact. It made the second pillar optional, with employees now having the possibility to opt out after contributing for five years to the second pillar and transfer future contributions to the first pillar. Companies in the construction sector can exempt their employees from the second pension pillar altogether. The Ordinance also significantly increased the minimum capital requirements for pension funds' management companies to well above those in other Member States and reduced the administration fee levied on gross contributions. Those changes make the operating environment for pension funds' management companies highly unpredictable and negatively affect their financial results. All seven managing companies operating in Romania have at some point announced that they are considering exiting the market. During the mission, the Minister of Finance said that government is discussing with the stakeholders and that the new fees and capital requirements might be amended. The mission stressed the importance of predictability of policy-making.

The government is advancing with its plan to establish a Sovereign Fund for Development and Investment (FSDI). On 8 March 2019, the government adopted a decision setting up the FSDI. The FSDI will hold a mix of cash and equity in some of Romania's most profitable State-owned enterprises (SOEs), with the stated objective of generating income to help finance domestic investment. The mission repeated the Commission concerns regarding the FSDI. Those concerns include (i) the extent to which corporate governance rules will be applied to the FSDI itself and the SOEs in its portfolio; (ii) lack of clear investment strategy and (iii) the risks for the state budget. The mission recalled that, if the FSDI is classified outside of the General Government sector, the general government balance would decrease due to foregone dividends from SOEs transferred to the FSDI (amounting to around 0.4 - 0.5% of GDP annually). The Minister clarified that the FSDI will not be created before mid-2019 and thus the foregone dividends would not fully impact the 2019 deficit.