Europaudvalget 2020
KOM (2020) 0091
Offentligt

EUROPEAN
COMMISSION

Brussels, 4.3.2020
SWD(2020) 53 final

COMMISSION STAFF WORKING DOCUMENT

Analysis by the Commission services of the budgetary situation in Romania

Accompanying the document

Recommendation for a

COUNCIL RECOMMENDATION

with a view to bringing an end to the situation of an excessive government deficit in Romania

{COM(2020) 91 final}

1. INTRODUCTION

In June 2013, following the notification of its 2012 headline deficit, Romania exited the excessive deficit procedure (EDP) opened in 2009. Following the abrogation of the EDP, Romania was subject to the preventive arm of the Stability and Growth Pact (SGP).

Romania has been under consecutive Significant Deviation Procedures (SDP) under the preventive arm of the SGP since spring 2017. As a consequence of the significant deviation by Romania from its medium-term budgetary objective (MTO) in 2016, the Council launched an SDP in spring 2017. Since then, the Council has issued bi-annual recommendations to which Romania has not responded with effective action, repeatedly significantly deviating from the recommended adjustment path.

On 10 December 2019 the government adopted and sent to the Parliament its Fiscal-Budgetary Strategy for 2020-22 (the Fiscal Strategy)[1], with a general government deficit target of 3.8% of GDP in 2019. This is well above and not close to the Treaty reference value of 3% of GDP. The report adopted by the Commission in accordance with Article 126(3) of the Treaty on the Functioning of the European Union (TFEU)[2] found that the excess over the Treaty reference value in 2019 is also not exceptional for the purposes of the Treaty and the SGP, as it neither results from an unusual event nor from a severe economic downturn. Moreover, the excess over the 3%-of-GDP reference value is not temporary for the purposes of the Treaty and the SGP. Indeed, the budgetary forecasts by the Commission, and by the government in the Fiscal Strategy, project the deficit to remain above the reference value in 2020 and in 2021. Finally, the analysis presented in the report included the assessment of all relevant factors, which according to the Treaty and SGP are to be taken into account. The relevant factors did not provide mitigating elements.

Accordingly, the report under Article 126(3) TFEU concluded that the deficit criterion of the Treaty is not fulfilled and an EDP is thus warranted.

The Economic and Financial Committee, in its opinion in accordance with Article 126(4) TFEU of 24 February 2020, supported the assessment in the Commission report.

2. MACROECONOMIC DEVELOPMENTS AND OUTLOOK

Romania’s economy has been growing robustly in recent years, with private consumption as its main driver. Real GDP growth amounted to 4.4 % in 2018 and is projected in the Commission 2020 winter forecast to have stood at 3.9% in 2019[3]. Private consumption remained the main growth driver, the result of a tight labour market and high wage increases, particularly in the public sector. Investment is expected to have made a significant contribution to growth in 2019, supported mainly by construction. The contribution of net exports to GDP growth is expected to have been negative, more so than in previous years, as import growth became increasingly more dynamic than export growth. More sluggish external demand was the main driver behind weaker export growth and also led to a decline in

[1] The Fiscal Strategy was promulgated into law on 18 December 2019.
[2] Available at: https://ec.europa.eu/info/files/edp-step-commission-report_en
[3] The flash estimate, published after closing of the Commission forecast, put GDP growth in 2019 at 4.1%.

industrial production. As a result, the current account deficit has steadily increased from a nearly balanced position in 2014 to an estimated 5.1% of GDP in 2019[4].

Based on a no-policy-change assumption, real GDP growth is forecast by the Commission to moderate but remain robust at 3.8% in 2020 and at 3.5% in both 2021 and 2022. On the one hand, the significant fiscal stimulus implied by current policies would continue giving some impetus to private consumption. On the other hand, a continued widening of the fiscal deficit would erode consumers' and investors' confidence in the sustainability of the economy's growth trajectory. As a result, consumption and investment are projected to weaken compared to the previous years, i.a. as private investors take account of increasing macroeconomic imbalances. The contribution of net exports is expected to remain negative over the forecast horizon, as exports continue to be affected by weak external demand while imports are supported by private consumption. This in turn is expected to worsen further the already high current account deficit.

The growth outlook is subject to predominantly downside risks. A continuation of policies that aggravate existing macroeconomic imbalances could affect consumers' and investors' confidence even more strongly. Persistent legislative unpredictability and a delay of structural reforms could also affect the business environment and negatively impact the investment climate. An economic slowdown in some of Romania's main trading partners also represents a downside risk.

According to the Commission's estimates, potential GDP growth is projected to gradually decline from 4.7% in 2018 to 3.6% in 2022. Total factor productivity is set to decelerate, but remain the main contributor to potential GDP growth. The contribution of capital accumulation is projected to remain relatively stable. At the same time, the already modest contribution of labour is forecast to turn negative, mainly due to the trend decrease in the working age population.

The output gap, estimated based on the commonly agreed methodology, is expected to have decreased to 0.1% of potential GDP in 2019, from 0.7% in 2018. It is projected to close in 2020 and turn slightly negative afterwards. Estimates of the output gap are subject to uncertainty. The large and growing current account deficit, as well as high wage and price inflation suggest that the economy may be in a more advanced phase of the cycle than that signalled by the output gap.

3. BUDGETARY DEVELOPMENTS AND OUTLOOK

According to fiscal data notified by the Romanian authorities on 30 September 2019[5] and subsequently validated by Eurostat, the general government deficit in Romania reached 3.0% of GDP in 2018, while debt stood at 35.0% of GDP. Taking into account the revised GDP figures announced by the national statistical office after the publication of Eurostat's press release, the headline deficit in 2018 stood at 2.9% of GDP and debt at 34.7% of GDP. For 2019, the notification planned a general government headline deficit of 2.8% of GDP.

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4 The balance of payment data together with the flash GDP estimate, both published after closing of the Commission forecast, put the current account deficit in 2019 at 4.7% of GDP.

5 Pursuant to Regulation (EC) No 479/2009, Member States have to report to the Commission, twice a year, their planned and actual government deficit and debt levels. The most recent notification of Romania can be found at: https://ec.europa.eu/eurostat/web/government-finance-statistics/excessive-deficit-procedure/edp-notification-tables

On 10 December 2019 the government adopted and sent to the Parliament its Fiscal Strategy, with a revised general government deficit target of 3.8% of GDP in 2019. That revision, up from originally planned 2.8% of GDP, was based on budget execution data for the year to–date. The deterioration compared to the general government deficit of 2.9% of GDP in 2018 stemmed from increased current spending, on compensation of employees and on goods and services. Moreover, capital spending increased from historically low levels of the previous years.

The Commission 2020 winter forecast, extended with fiscal variables until 2022, projects a general government deficit of 4.0% of GDP in 2019, 4.9% in 2020, 6.9% in 2021 and 7.7% in 2022. The structural deficit is projected to deteriorate by 1.0% of GDP in 2019, by further 1.9% in GDP in 2021 and by further 0.8% in 2022. The projected increase in the deficit is mostly driven by significant pension increases enacted in summer 2019, in particular an increase in pensions of 40% scheduled for September 2020 and a further upward recalculation of pensions scheduled for September 2021. The higher government spending on pensions would contribute 0.9 pp. of GDP to the deficit increase in 2020, a further 1.7 pp. of GDP in 2021 and a further 1.1 pp. of GDP in 2022. Moreover, in December 2019 the authorities reduced excise duties on fuel and lowered social security contributions on part-time workers, with an overall estimated revenue loss of 0.4% of GDP. The authorities also doubled the child allowance due to enter into force from August 2020, with an annualised budgetary cost of 0.6% of GDP. Government spending on compensation of employees is projected to fall as a share of GDP, following the Fiscal Strategy.

In the Fiscal Strategy, the government plans a general government deficit of 3.6% of GDP in 2020, 3.4% in 2021 and 2.8% in 2022. Based on government estimates, this would lead to a structural adjustment of 0.3% in 2020, 0.2% in 2021 and 0.6% in 2022. The planned adjustment is mostly expenditure based. In particular, the expenditures on compensation of employees, goods and services and on non-EU capital spending are projected to decrease as a share of GDP. The lower deficit projection in the Fiscal Strategy, compared to the Commission's forecast, stems, in particular, from: (1) more optimistic underlying macroeconomic projections, in particular concerning labour market developments, with a positive effect on projected revenues; (2) the moderation of projected spending on goods and services is not supported by enacted or credibly announced measures and could therefore not be taken into account in the Commission forecast; (3) the fact that the Fiscal Strategy seems not to take into account the full budgetary impact of the enacted pension increases, in particular in 2021 and beyond; (4) the fact that the Fiscal Strategy does not take into account the impact of the tax cuts and of the doubling of the child allowance.

Romania's general government debt amounted to 34.7% of GDP in 2018. Both the Fiscal Strategy and the Commission project general government debt to remain below the Treaty reference value within their forecast horizons (i.e. until 2022). However, due to a high structural primary deficit, the debt-to-GDP ratio is set on a steep upward path. Assuming no-policy change, it is projected by the Commission to exceed 60% in 2025 and go beyond 90% of GDP by 2030[6].

[6] European Commission, Debt Sustainability Monitor 2019, available at: https://ec.europa.eu/info/sites/info/files/economy-finance/ip120_en.pdf

Table 1: Comparison of macroeconomic developments and forecasts

	2018	2019		2020		2021		2022	
	Outturn	COM	FS	COM	FS	COM	FS	COM	FS
Real GDP (% change)	4.4	3.9	4.0	3.8	4.1	3.5	4.2	3.5	4.2
Contributions to real GDP growth:									
- Final domestic demand	4.7	6.3	5.3	5.3	4.9	4.6	4.7	4.5	4.7
- Change in inventories	1.2	-0.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0
- Net exports	-1.4	-2.0	-1.3	-1.5	-0.7	-1.1	-0.5	-1.0	-0.5
Output gap (% of potential GDP)	0.7	0.1	-0.4	0.0	-0.6	-0.3	-0.6	-0.5	-0.5
Employment (% change)	0.2	0.2	0.5	0.1	0.8	0.1	0.9	0.2	1.0
Unemployment rate (%)	4.2	3.9	3.9	4.2	3.8	4.3	3.7	4.5	3.6
Labour productivity (% change)	4.2	3.7		3.7		3.3		3.2	
HICP inflation (%)	4.1	3.9		3.4		3.3		3.3	
GDP deflator (% change)	6.3	6.9	6.0	4.6	4.2	4.4	3.5	4.4	3.0
Comp. of employees (per head, % change)	13.4	9.0		8.9		7.1		6.6	
General government balance (% of GDP)	-2.9	-4.0	-3.8	-4.9	-3.6	-6.9	-3.4	-7.7	-2.8
General government debt (% of GDP)	34.7	35.7	36.4	37.8	37.1	41.9	37.8	46.6	37.7

<u>Source</u>:
Commission 2020 winter forecast, extended with fiscal variables until 2022 (COM), Fiscal Strategy 2020-2022 and the autumn projection of the National Commission for Strategy and Prognosis (FS)

4. PROPOSED ADJUSTMENT PATH

Pursuant to Article 3(4) of Regulation (EC) No 1467/97, a Member State under EDP should be recommended a structural effort of at least 0.5% of GDP as a benchmark. The correction of the excessive deficit should be completed in the year following its identification (in this case by 2021), unless there are special circumstances.

Building on the above-mentioned baseline scenario, different scenarios have been considered in order to assess the time needed for Romania to correct its excessive deficit. Those scenarios took into account the economic conditions and the second-round effects of the required additional consolidation measures.

Simulations conducted by the Commission indicate that correcting the excessive deficit by 2021 would require a too sharp fiscal adjustment and result in a significant output loss. A longer adjustment path, while still requiring substantial annual adjustments, would have a more gradual impact on growth and take into account that the budgetary year 2020 has already started. Structural reforms pursued in parallel with fiscal consolidation will contribute to ensure a durable correction of excessive deficit.

A correction by 2022 would still imply an average effort above the benchmark adjustment of the Regulation of 0.5% of GDP. The scenario with the proposed adjustment path that should lead to a correction of the excessive deficit by 2022 (the EDP scenario) is based on the Commission 2020 winter forecast, extended with fiscal variables until 2022 (the baseline scenario in Table 2).

Table 2 – Forecast of key macroeconomic and budgetary variables under the baseline scenario

Baseline scenario		2019	2020	2021	2022
Real GDP growth	%	3.9	3.8	3.5	3.5
Headline general government balance	% of GDP	-4.0	-4.9	-6.9	-7.7
Structural balance	% of GDP	-3.9	-4.9	-6.8	-7.6
Change in structural balance	% of GDP	-1.1	-1.0	-1.9	-0.8
Net expenditure growth corrected for one-offs (nominal)	%	13.2	12.9	13.7	10.3
Output gap	%	0.1	0.0	-0.3	-0.5

Table 3 summarises the key macroeconomic and budgetary variables under the EDP scenario, in which the excessive deficit is corrected by 2022. The recommended fiscal effort is assumed to impact real GDP growth with a multiplier of 0.3. That multiplier reflects the limited growth impact that the Commission assumes for the fiscal stimulus in the baseline scenario. It reflects the positive impact of restored fiscal prudence on the growth outlook through confidence effects on the decisions of consumers and investors. The fiscal multiplier also takes into account the structural characteristics of the Romanian economy, such as Romania's high trade openness, low labour market rigidities and small automatic stabilisers, which, according to the economic literature, point to low fiscal multipliers.

On the basis of the EDP scenario, Romania's headline general government deficit is set to fall to 3.6% of GDP in 2020, 3.4% of GDP in 2021, and 2.8% of GDP in 2022, similar to the targets set in the government's own Fiscal Strategy. That adjustment path is consistent with an expenditure benchmark, i.e. a nominal growth rate of net primary government expenditure[7], of 8.2% in 2020, 5.5% in 2021 and 5.5% in 2022. Such growth rate of net expenditure will be the primary indicator used to assess the fiscal effort if a careful analysis is needed. This corresponds to an annual structural adjustment of 0.5% of GDP in 2020, 0.8% of GDP in 2021 and 0.8% of GDP in 2022.

Based on the current forecast, those targets still allow for annual increases in real net expenditure. They can, in the Commission services' opinion, be achieved, among others, by reconsidering the large legislated pension increases and other recent measures, which are key drivers of the sharp deterioration of the deficit in the baseline scenario.

Table 3 – Forecast of key macroeconomic and budgetary variables under the EDP scenario

EDP scenario		2019	2020	2021	2022
Real GDP growth	%	3.9	3.3	2.4	2.7
Headline general government balance	% of GDP	-4.0	-3.6	-3.4	-2.8
Structural balance	% of GDP	-3.9	-3.4	-2.7	-1.8
Change in structural balance	% of GDP	-1.1	0.5	0.8	0.8
Net expenditure growth corrected for one-offs (nominal)	%	13.2	8.2	5.5	5.5
Output gap	%	0.1	-0.6	-1.9	-2.8

5. CONCLUSIONS

The Fiscal Strategy, adopted in December 2019, revised the general government deficit target from 2.8% to 3.8% of GDP in 2019, i.e. above the Treaty reference value. Based on the Commission 2020 winter forecast, extended with fiscal variables until 2022, Romania's headline general government deficit is projected to reach 4.9% of GDP in 2020, 6.9% of GDP in 2021 and 7.7% of GDP in 2022 under a no-policy-change assumption.

A credible and sustainable adjustment path to correct the excessive deficit would require Romania to reach a headline general government deficit of 3.6% of GDP in 2020, 3.4% of GDP in 2021, and 2.8% of GDP in 2022. That adjustment path is consistent with an expenditure benchmark, i.e. a nominal growth rate of net primary government expenditure, of 8.2% in 2020, 5.5% in 2021 and 5.5% in 2022 (corresponding to an annual structural

[7] Net primary government expenditure comprises total government expenditure excluding interest expenditure, expenditure on Union programmes fully matched by Union funds revenue and non-discretionary changes in unemployment benefit expenditure. Nationally financed gross fixed capital formation is smoothed over a 4-year period. Discretionary revenue measures or revenue increases mandated by law are factored in. One-off measures on both the revenue and expenditure sides are netted out.

adjustment of 0.5% of GDP in 2020, 0.8% of GDP in 2021 and 0.8% of GDP in 2022). On that basis, Romania's excessive deficit is forecast to be corrected by 2022.