



Brussels, 5.6.2019
SWD(2019) 533 final

COMMISSION STAFF WORKING DOCUMENT
Accompanying the documents

Recommendation for a COUNCIL DECISION establishing that no effective action has been taken by Romania in response to the Council Recommendation of 4 December 2018

Recommendation for a COUNCIL RECOMMENDATION with a view to correcting the significant observed deviation from the adjustment path toward the medium-term budgetary objective in Romania

{COM(2019) 533 final} - {COM(2019) 538 final}

COMMISSION STAFF WORKING DOCUMENT
Accompanying the documents

Recommendation for a COUNCIL DECISION establishing that no effective action has been taken by Romania in response to the Council Recommendation of 4 December 2018

Recommendation for a COUNCIL RECOMMENDATION with a view to correcting the significant observed deviation from the adjustment path toward the medium-term budgetary objective in Romania

1. INTRODUCTION

Since 2013, Romania has been subject to the preventive arm of the Stability and Growth Pact, which requires sufficient progress towards the medium-term budgetary objective (MTO). Romania is not subject to the debt rule as its general government debt remains below 60% of GDP.

This staff working document has a double purpose. First, to explain the reasons behind the Commission recommendation for a Council decision on non-effective action in 2019 in response to the Council Recommendation addressed to Romania on 4 December 2018. Second, to support the Commission recommendation for a Council recommendation with a view to correcting the significant observed deviation from the adjustment path toward the medium-term budgetary objective in Romania in 2018, as adopted by the Commission on 5 June 2019.

On 22 June 2018 the Council found in accordance with Article 121(4) TFEU that an observed significant deviation from the adjustment path toward the MTO occurred in Romania in 2017. In view of the established significant deviation, the Council on 22 June 2018 issued a recommendation for Romania to take the necessary measures to ensure that the nominal growth rate of net primary government expenditure¹ does not exceed 3.3% in 2018 and 5.1% in 2019, corresponding to an annual structural adjustment of 0.8% of GDP in each year².

On 4 December 2018 the Council found that Romania had not taken effective action in response to the 22 June 2018 recommendation and issued a revised recommendation. In the new recommendation the Council asked Romania to take the necessary measures to ensure that the nominal growth rate of net primary government expenditure does not exceed 4.5% in 2019, corresponding to an annual structural adjustment of 1.0% of GDP³. It recommended Romania to use any windfall gains for the reduction of its deficit, while budgetary

¹ Net primary government expenditure is comprised of total government expenditure excluding interest expenditure, expenditure on Union programmes fully matched by Union funds revenue and non-discretionary changes in unemployment benefit expenditure. Nationally financed gross fixed capital formation is smoothed over a four-year period. Discretionary revenue measures or revenue increases mandated by law are factored in. One-off measures on both the revenue and expenditure sides are netted out.

² Council Recommendation of 22 June 2018 with a view to correcting the significant observed deviation from the adjustment path toward the medium-term budgetary objective in Romania (OJ C 223, 27.6.2018, p. 3).

³ Council Recommendation of 4 December 2018 with a view to correcting the significant observed deviation from the adjustment path toward the medium-term budgetary objective in Romania (OJ C 460, 21.12.2018, p. 1).

consolidation measures should ensure a lasting improvement in the general government structural balance in a growth-friendly manner. The Council established a deadline of 15 April 2019 for Romania to report on the action taken in response to the recommendation. The Romanian authorities submitted their report on action taken in response to Council recommendation (hereafter: "the report") on 18 April. i.e. after the deadline set by the Council. Moreover, on 14 and 15 March 2019, the Commission undertook an enhanced surveillance mission in Romania for the purpose of on-site monitoring under the Article - 11(2) of Council Regulation (EC) No 1466/97 and subsequently reported to the Council on 5 June 2019 and made its findings public.

Based on the Commission 2019 spring forecast, Section 2 of this document presents the macroeconomic developments and outlook in 2018-20. Section 3 presents fiscal developments in 2018 and updated budgetary projections for 2019-2020. Section 4 presents an assessment of compliance with the obligations stemming from the Stability and Growth Pact in 2018, including an overall assessment of the reasons for the deviation from the requirements of the preventive arm. Section 5 assesses compliance with the Council Recommendation of 4 December 2018. Section 6 proposes a fiscal effort for 2019 and 2020 to address the significant deviation, including a new applicable expenditure benchmark rate compatible with the suggested annual improvement in the structural balance. Section 7 concludes.

2. MACROECONOMIC DEVELOPMENTS AND OUTLOOK IN 2018-2020

Romania's economic boom started to cool down in 2018. Real GDP grew by 4.1%, compared to 7% in 2017. Private consumption followed the same trend. It grew, nonetheless, 5.2% in 2018 and remained the main contributor to growth thanks to continuous increases in wages, including minimum and public wages. It was, however, somewhat tamed by record levels of inflation, which reached 4.1% on average in 2018. Investment underperformed with a negative growth of 3.2%. This was despite growth of equipment investment and some pick-up in public investment. Net exports also contributed to lower GDP growth, mainly due to a more pronounced slowdown in export relative to import growth, contributing in turn to a further worsening of the current account balance to -4.7% of GDP. Exports were affected by changes in auto emissions testing at the EU level, which led to production disruptions in the motor industry, and a more uncertain European and international environment. Imports remained strong on the back of strong consumption and a pick up in intermediate and capital goods.

In its spring 2019 forecast, the Commission projects the slowdown in growth to continue in 2019 and 2020, with real GDP growing at 3.3% and 3.1%, respectively. Private consumption is forecast to remain strong in 2019, as a lower inflation partially compensates the more moderate increases in nominal wages, and to decelerate in 2020. Investment growth is expected to return to positive territory on the back of sustained improvements in equipment investment and a rebound in construction investment, helped by a pick-up in EU-funded projects. The growth in imports is projected to continue to outpace that of exports despite the overall slow down in both. However, the overall contribution of net exports to growth, while still negative, is projected to improve. The current account deficit is set to continue widening. It is forecast to reach 5.2% of GDP in 2019 and 5.3% in 2020. The worsening trade balance is set to be the main factor behind this development.

Romania's unemployment rate reached a new 20-year low in 2018, at 4.2%. It is forecast to stand at 4.1% and 4% in 2019 and 2020, respectively. The tight labour market is likely to continue exerting pressure on wages. Compensation per employee, which increased by 18.4%

in 2018 is forecast to slow down to single-digit rates by 2020, as increases in overall and minimum wages fade out.

Inflation further accelerated in 2018, reaching an average of 4.1%, the highest in the EU, due to hikes in food and energy prices. It is forecast to decrease to 3.6% for 2019 and 3% in 2020 as energy price inflation moderates.

Romania's positive output gap started to narrow in 2018 and is set to close progressively on the back of decreasing labour and productivity contributions.

Both internal and external uncertainties could take a toll on economic growth. Externally, uncertainties surrounding global demand and the EU economy could have a negative impact on Romania's exports. Internally, a sustained increase in unit labour costs due to wage growth outpacing productivity growth could also curtail exports. The uncertainty and unpredictability of policymaking may also have a negative effect on consumption and investment, hampering growth. Finally, high increases in inflation in the first quarter of 2019 might point to higher price levels than originally expected throughout the year.

Table 1. Macroeconomic developments and forecast

| | 2017 | 2018 | | 2019 | | | 2020 | | |
|---|---------|---------|---------|---------|---------|------|---------|---------|------|
| | Outturn | CP 2018 | Outturn | CP 2018 | CP 2019 | COM | CP 2018 | CP 2019 | COM |
| Real GDP (% change) | 7.0 | 6.1 | 4.1 | 5.7 | 5.5 | 3.3 | 5.7 | 5.7 | 3.1 |
| Private consumption (% change) | 10.0 | 6.5 | 5.2 | 6.1 | 6.4 | 5.2 | 5.8 | 6.2 | 4.5 |
| Gross fixed capital formation (% change) | 3.5 | 7.9 | -3.2 | 8.4 | 6.9 | 1.4 | 8.6 | 7.9 | 2.3 |
| Exports of goods and services (% change) | 10.0 | 7.4 | 5.4 | 6.9 | 6.9 | 4.4 | 7.1 | 7.1 | 3.6 |
| Imports of goods and services (% change) | 11.3 | 8.5 | 9.1 | 8.0 | 7.8 | 6.9 | 7.9 | 7.9 | 4.9 |
| <i>Contributions to real GDP growth:</i> | | | | | | | | | |
| - Final domestic demand | 7.5 | 6.7 | 2.9 | 6.2 | 6.1 | 4.2 | 6.1 | 6.2 | 3.8 |
| - Change in inventories | 0.2 | 0.0 | 2.9 | 0.0 | 0.0 | 0.3 | 0.0 | 0.0 | 0.0 |
| - Net exports | -0.7 | -0.6 | -1.7 | -0.6 | -0.6 | -1.3 | -0.5 | -0.5 | -0.7 |
| Output gap ¹ | 0.8 | 0.8 | 0.9 | 1.2 | 0.1 | 0.6 | 1.6 | 0.7 | 0.2 |
| Employment (% change) | 2.6 | 2.4 | 0.2 | 1.8 | 1.4 | 0.3 | 1.2 | 1.2 | 0.2 |
| Unemployment rate (%) | 4.9 | 4.8 | 4.2 | 4.6 | 4.1 | 4.1 | 4.5 | 4.0 | 4.0 |
| Labour productivity (% change) | 4.3 | 3.6 | 3.9 | 3.8 | 4.1 | 2.9 | 4.4 | 4.4 | 2.9 |
| HICP inflation (%) | 1.1 | 3.8 | 4.1 | 2.8 | 3.5 | 3.6 | 2.6 | 2.6 | 3.0 |
| GDP deflator (% change) | 4.7 | 2.1 | 5.9 | 1.9 | 3.5 | 5.2 | 1.9 | 1.9 | 3.7 |
| Comp. of employees (per head, % change) | 12.6 | 8.1 | 18.4 | 7.0 | 8.1 | 13.5 | 7.5 | 6.1 | 9.0 |
| Net lending/borrowing vis-à-vis the rest of the world (% of GDP) | -1.8 | -1.4 | -3.1 | -0.9 | -1.7 | -3.4 | -0.3 | -0.8 | -3.4 |
| <i>Note:</i> | | | | | | | | | |
| ¹ In % of potential GDP, with potential GDP growth recalculated by Commission services on the basis of the programme scenario using the commonly agreed methodology. | | | | | | | | | |
| <i>Source:</i> | | | | | | | | | |
| Commission 2019 spring forecast (COM); Convergence Programmes (CP). | | | | | | | | | |

3. FISCAL DEVELOPMENTS AND OUTLOOK IN 2018-2020

In 2018, the general government deficit increased to 3.0% of GDP, from 2.7% of GDP in 2017, while the economy grew above its potential. The rise of the deficit was – similarly to previous years – mostly driven by expenditure on compensation for public employees, which increased by 1.1 percentage points of GDP. The unified wage law, enacted in summer 2017, increased gross public wages by 25% as of January 2018 and contained additional wage increases in the health and education sectors. The fiscal cost of these increases in gross wages

was partially compensated by a shift of social security contributions from 22.75% for employers and 16.5% for employees to 2.25% and 35%, respectively. Moreover, the government partially reversed the past systemic pension reform by lowering the proportion of social contributions transferred to the second pension pillar (which is classified outside the general government) from 5.1% to 3.75% of gross wages. At the same time, the flat personal income tax (PIT) rate was cut from 16% to 10%. As a consequence, the revenue from social contributions increased by 2.1 percentage points of GDP while the revenue from direct taxes fell by 1.4 percentage points. Public investment in 2018 remained close to the record low levels as a share of GDP reached in 2017. Thanks to the one-off effect from reimbursements of a car pollution tax, the structural deficit increased only slightly, from 2.9% of potential GDP in 2017 to 3.0% in 2018.

The 2018 general government deficit outcome of 3.0% of GDP fulfils the target defined in the 2018 Convergence Programme. However, both revenues and the expenditures were higher than planned in the 2018 Convergence Programme. On the revenue side, indirect tax revenues were lower than planned, while the target for social contributions was overachieved. On the expenditure side, compensation of employees, intermediate consumption and social benefits were all higher than planned, while public investment was lower.

On 14 and 15 March 2019 the Commission undertook an enhanced surveillance mission to Romania for the purpose of on-site monitoring under the Article -11(2) of Council Regulation (EC) No 1466/97. After having transmitted its provisional findings to the Romanian authorities for comments, the Commission reported its findings to the Council on 5 June 2019. These findings were made public. The Commission report finds that the Romanian authorities do not intend to act upon the Council Recommendation of 4 December 2018. The authorities confirmed to the Commission that the government has no intention to comply with the recommended structural adjustment. They 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 2019 budget targets an accrual deficit of 2.8% of GDP. According to the government's own estimates at the time of the mission, this headline would entail a structural adjustment of around 0.1% compared to 2018, significantly short of the Council recommendation.

In their report on action taken, the authorities target a general government deficit of 2.8% of GDP in 2019, a decrease compared to the 2018 outturn of 3.0%. The 2019 target has been revised upwards relative to the 2.4% of GDP target in the 2018 Convergence programme. The report does not contain projections of individual budgetary items or categories. The authorities provide a list of discretionary measures taken, without estimating their budgetary impact. Some adopted measures (such as new taxes on telecommunication, energy and the banking sectors) are not mentioned in the report. Table 2, below, presents the measures listed in the report with a significant budgetary impact (defined as an impact of at least 0.1% of GDP) as estimated by the authorities and communicated to the Commission in bilateral exchanges. The fiscal impact of the reported measures falls significantly short of the requirement stated in the Council Recommendation.

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

| | Reported fiscal impact in 2019 | Comments |
|--|---------------------------------------|--|
| Revenues | | |
| Dividends from SOEs at 90% of their net profits | +0.1 | Prolongation of a measure in force since 2017 |
| Sale of 5G licences | +0.2 | According to the ESA-2010 accounting rules, the impact of this measure should be smoothed out over several years |
| Increase of gambling taxes and of excise duties on tobacco | +0.1 | |
| Construction sector: exemption from PIT and health contributions | -0.2 | |
| Expenditures | | |
| Increase of child allowance | +0.2 | |
| Measures concerning public wages: Maintaining of bonuses, allowances, compensations, premiums and other elements that, according to the law, are part of the gross monthly salary, at the level granted in December 2018 for staff paid by public funds Granting of food allowance to all civil servants. | n/a | |
| <u>Note:</u> The budgetary impact in the table as estimated by the national authorities in their submission for Discretionary Tax Database or in the subsequent exchanges with the Commission, following the reception of the report. A positive sign implies that revenue/expenditure increases as a consequence of the measure. | | |

Table 3. Discretionary revenue measures included in the Commission 2019 spring forecast (fiscal impact in % of GDP)

| Measure | 2018 | 2019 |
|--|-------------|-------------|
| Social contributions shift almost entirely to the employees, from 22.75% for employers and 16.5% for employees to 2.25% and 35% respectively | +1.2 | |
| Increase of excise duties for energy products as of October 2017 | +0.3 | |
| Decrease of the share of social contributions transferred to the second pension pillar from 5.1% to 3.75% of gross wages | +0.2 | |
| Cut of flat Personal Income Tax rate from 16% to 10% and increase of tax allowances | -1.5 | |
| Construction sector: exemption from PIT and health contributions | | -0.2 |
| Sectoral taxes: turnover tax on telecommunication and energy sectors and tax on bank assets | | +0.1 |
| Remaining revenue measures | +0.1 | +0.1 |
| Total impact | +0.2 | 0.0 |
| Note: The budgetary impact in the table as included in the Commission 2019 spring forecast. A positive/negative sign implies that revenue increases/decreases compared to the previous year. | | |

Based on the Commission spring 2019 forecast, which takes into account the measures described in the report from the authorities to the extent they are already enacted or credibly announced in sufficient detail, as well as information from all available sources, the general government deficit is projected to increase to 3.5% of GDP in 2019. This rise is mostly driven – similarly to recent years – by the compensation of public employees (increase by 0.9 percentage points of GDP). Expenditure on social benefits is also set to rise, as the pension point (the main parameter used for pension indexation) is set to increase by 15% in September 2019. Public investment is also projected to pick up. On the revenue side, social contributions are set to increase due to robust wage growth.

The general government deficit is projected in the Commission spring 2019 forecast to hit 4.7% of GDP in 2020. The main driver of this projected deterioration is expenditure on old-age pensions, driven by the full-year effect of the 15% increase in the pension point of September 2019 and a further increase of 40% in September 2020.

As a consequence of the fiscal easing described above, Romania's structural deficit is projected by the Commission to increase from 3.0% of GDP in 2018 to 3.6% in 2019 and 4.8% in 2020. The composition of the budget and its adjustments in nominal and structural terms are presented in Table 4 below.

The Romanian authorities in the 2019 Convergence Programme plan a headline deficit of 2.8% of GDP in 2019. Both total revenues and total expenditures as a share of GDP are higher than in the Commission forecast. The underlying macroeconomic projection of 5.5% of real GDP growth is more optimistic than 3.3% forecasted by the Commission, with a positive impact on tax revenues. The projection of revenues from indirect taxes and social

contributions is higher than in the Commission forecast (see Table 1). On the expenditure side, current expenditures (in particular social benefits) are lower while gross fixed capital formation is higher than projected by the Commission.

Table 4. Composition of the budgetary adjustment

| (% of GDP) | 2018 | | 2019 | | | 2020 | | |
|--|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| | CP 2018 | Outturn | CP 2018 | CP 2019 | COM | CP 2018 | CP 2019 | COM |
| Revenue | 31.3 | 32.0 | 31.5 | 33.8 | 32.5 | 31.8 | 33.8 | 33.3 |
| <i>of which:</i> | | | | | | | | |
| - Taxes on production and imports | 10.8 | 10.4 | 10.3 | 10.7 | 10.4 | 10.4 | 10.5 | 10.4 |
| - Current taxes on income, wealth, etc. | 4.9 | 4.9 | 5.0 | 4.9 | 5.1 | 5.1 | 5.0 | 5.1 |
| - Social contributions | 10.9 | 11.4 | 11.5 | 12.3 | 11.9 | 11.8 | 12.5 | 12.2 |
| - Other (residual) | 4.7 | 5.2 | 4.7 | 5.9 | 5.2 | 4.5 | 5.8 | 5.5 |
| Expenditure | 34.3 | 35.0 | 33.9 | 36.6 | 36.1 | 33.6 | 36.4 | 38.0 |
| <i>of which:</i> | | | | | | | | |
| - Primary expenditure | 32.9 | 33.8 | 32.6 | 35.4 | 34.8 | 32.2 | 35.1 | 36.7 |
| <i>of which:</i> | | | | | | | | |
| Compensation of employees | 10.3 | 11.0 | 9.9 | 11.7 | 11.9 | 9.7 | 11.4 | 11.9 |
| Intermediate consumption | 4.7 | 5.1 | 4.5 | 5.0 | 5.1 | 4.2 | 4.9 | 5.1 |
| Social transfers | 11.4 | 11.7 | 11.8 | 11.5 | 11.9 | 11.6 | 12.3 | 13.0 |
| Subsidies | 0.4 | 0.4 | 0.4 | 0.4 | 0.4 | 0.4 | 0.4 | 0.4 |
| Gross fixed capital formation | 2.9 | 2.6 | 3.0 | 3.5 | 2.9 | 3.5 | 3.3 | 3.5 |
| Other (residual) | 3.1 | 3.1 | 2.9 | 3.2 | 2.7 | 2.8 | 2.8 | 2.8 |
| - Interest expenditure | 1.4 | 1.2 | 1.3 | 1.2 | 1.2 | 1.4 | 1.3 | 1.3 |
| General government balance (GGB) | -3.0 | -3.0 | -2.4 | -2.8 | -3.5 | -1.8 | -2.7 | -4.7 |
| Primary balance | -1.5 | -1.8 | -1.0 | -1.6 | -2.3 | -0.5 | -1.4 | -3.4 |
| One-off and other temporary measures | 0.0 | -0.3 | 0.0 | -0.1 | -0.1 | 0.0 | 0.0 | 0.0 |
| GGB excl. one-offs | -3.0 | -2.7 | -2.4 | -2.7 | -3.4 | -1.8 | -2.7 | -4.7 |
| Output gap ¹ | 0.8 | 0.9 | 1.2 | 0.1 | 0.6 | 1.6 | 0.7 | 0.2 |
| Cyclically-adjusted balance ¹ | -3.3 | -3.3 | -2.8 | -2.8 | -3.7 | -2.4 | -2.9 | -4.8 |
| Structural balance² | -3.3 | -3.0 | -2.8 | -2.7 | -3.6 | -2.4 | -2.9 | -4.8 |
| Structural primary balance ² | -1.9 | -1.8 | -1.5 | -1.5 | -2.4 | -1.0 | 1.3 | -3.5 |

Notes:
¹Output gap (in % of potential GDP) and cyclically-adjusted balance according to the programme as recalculated by Commission on the basis of the programme scenario using the commonly agreed methodology.
²Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.
Source:
Convergence Programmes (CP); Commission 2019 spring forecasts (COM); Commission calculations.

Table 5. Debt developments

| (% of GDP) | 2017 | 2018 | | 2019 | | | 2020 | | |
|-------------------------------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| | Outturn | CP 2018 | Outturn | CP 2018 | CP 2019 | COM | CP 2018 | CP 2019 | COM |
| Gross debt ratio¹ | 35.2 | 35.4 | 35.0 | 35.8 | 35.4 | 36.0 | 35.4 | 35.4 | 38.4 |
| Change in the ratio | -2.2 | 0.4 | -0.2 | 0.4 | 0.4 | 1.0 | -0.4 | 0.0 | 2.4 |
| <i>Contributions²:</i> | | | | | | | | | |
| 1. Primary balance | 1.4 | 1.5 | 1.8 | 1.0 | 1.6 | 2.3 | 0.5 | 1.4 | 3.4 |
| 2. “Snow-ball” effect | -2.6 | -1.1 | -2.0 | -1.1 | -1.7 | -1.5 | -1.2 | -1.2 | -1.0 |
| <i>Of which:</i> | | | | | | | | | |
| Interest expenditure | 1.3 | 1.5 | 1.2 | 1.4 | 1.2 | 1.2 | 1.3 | 1.3 | 1.3 |
| Growth effect | -2.3 | -2.0 | -1.3 | -1.9 | -1.8 | -1.0 | -1.9 | -1.9 | -1.0 |
| Inflation effect | -1.6 | -0.7 | -1.9 | -0.6 | -1.1 | -1.7 | -0.6 | -0.6 | -1.2 |
| 3. Stock-flow adjustment | -0.9 | 0.0 | 0.0 | 0.5 | 0.6 | 0.3 | 0.4 | -0.2 | 0.0 |

Notes:¹ End of period.² The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual effects.**Source:**

Commission 2019 spring forecast (COM); Convergence Programmes (CP), Commission calculations.

In 2018, the general government debt-to-GDP ratio decreased by 0.2% of GDP, on the back of the high nominal GDP growth, reaching 36.0% of GDP. It is projected by the Commission to increase to 38.4% of GDP by 2020 (see Table 5 above).

4. COMPLIANCE WITH THE ADJUSTMENT TOWARDS THE MTO IN 2018

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

On 22 June 2018, the Council recommended Romania to take the necessary measures to ensure that the nominal growth rate of net primary government expenditure does not exceed 3.3% in 2018, corresponding to an annual structural adjustment of 0.8% of GDP.

In 2018, the growth of net primary government expenditure was well above the expenditure benchmark, pointing to a significant deviation (deviation of 2.4% of GDP). The structural balance remained broadly stable at around 3.0% of potential GDP, also pointing to a significant deviation from the recommended structural adjustment (deviation of 0.8% of GDP). The size of the deviation indicated by the structural balance is negatively impacted by a revenue windfall, by a higher GDP deflator and by a higher underlying estimate of potential GDP growth as compared to the medium-term average underlying the expenditure benchmark. On the other hand, the size of the deviation indicated by the structural balance is positively impacted by low public investment expenditures, which are smoothed out in the expenditure benchmark. Irrespective of that difference, both indicators confirm a significant deviation from the requirements of the preventive arm of the SGP in 2018. This assessment is also in line with the earlier conclusion of 4 December 2018, in which the Council found that Romania had not taken effective action in response to the Council recommendation of 22 June 2018 and issued a revised recommendation.

5. COMPLIANCE IN 2019 WITH THE COUNCIL RECOMMENDATION OF 4 DECEMBER 2018




On 4 December 2018, the Council recommended 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 an annual structural adjustment of 1.0% of GDP.

Based on the Commission 2019 spring forecast, the growth of net primary government expenditure amounts to 11.6%, which is well above the expenditure benchmark of 4.5%. The structural balance is set to deteriorate by 0.7% of GDP, reaching a deficit of 3.6% in 2019. This is the opposite of the recommended structural improvement of 1.0% of GDP relative to 2018. Therefore, both pillars point to a deviation from the recommended adjustment. The expenditure benchmark points to a deviation of 2.1% of GDP. The structural balance confirms this reading, indicating a somewhat smaller deviation of 1.7% of GDP. The size of the deviation indicated by the structural balance is smaller thanks to a revenue windfall and thanks to a higher GDP deflator. Taking this into account, the overall assessment confirms a deviation from the recommended adjustment.

The projected increase of the deficit compared to 2018 is largely driven, similarly to previous years, by increasing expenditures on the compensation of public employees.

According to the Commission spring 2019 forecast, the headline deficit is projected to increase to 3.5% of GDP in 2019 and thus breach the 3% of GDP deficit reference value of the Treaty.

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

| (% of GDP) | 2018 | 2019 | 2020 | | |
|--|------------------------------|------------------|---|------------------|------------------|
| Background budgetary indicators¹ | | | | | |
| Medium-term objective (MTO) | -1.0 | -1.0 | -1.0 | | |
| Structural balance ² (COM) | -3.0 | -3.6 | -4.8 | | |
| Setting the required adjustment to the MTO | | | | | |
| Structural balance based on freezing (COM) | -3.3 | -3.6 | - | | |
| Position vis-a-vis the MTO ³ | Not at MTO | Not at MTO | Not at MTO | | |
| Required adjustment ⁴ | 0.8 | 1.0 | 0.75 | | |
| Required adjustment corrected ⁵ | 0.8 | 1.0 | 0.75 | | |
| Corresponding expenditure benchmark ⁶ | 3.3 | 4.5 | 5.1 | | |
| Compliance with the required adjustment to the MTO | | | | | |
| | COM | CP | COM | CP | COM |
| Structural balance pillar | | | | | |
| Change in structural balance ⁷ | 0.0 | -0.2 | -0.7 | -0.2 | -1.2 |
| One-year deviation from the required adjustment ⁸ | -0.8 | -1.2 | -1.7 | -0.9 | -1.9 |
| Two-year average deviation from the required adjustment ⁸ | -1.3 | -1.0 | -1.2 | -1.1 | -1.8 |
| Expenditure benchmark pillar | | | | | |
| Net public expenditure annual growth corrected for one-offs ⁹ | 11.5 | 11.3 | 11.6 | 7.8 | 10.8 |
| One-year deviation adjusted for one-offs ¹⁰ | -2.4 | -2.0 | -2.1 | -0.8 | -1.8 |
| Two-year deviation adjusted for one-offs ¹⁰ | -2.9 | -2.2 | -2.3 | -1.4 | -2.0 |
| Finding of the overall assessment | Significant deviation | Deviation | Deviation | Deviation | Deviation |
| Legend | | | | | |
| 'Compliance' - the recommended structural adjustment or a higher adjustment is being observed. | | |  | | |
| 'Some deviation' - a deviation from the recommended structural adjustment is being observed, but it is below the threshold for a significant deviation. | | |  | | |
| 'Significant deviation' - a deviation which has reached or breached the threshold for a significant deviation (i.e. 0.5% of GDP over one year, 0.25% of GDP over two years on average). | | |  | | |
| Notes | | | | | |
| ¹ The most favourable level of the structural balance, measured as a percentage of GDP reached at the end of year t-1, between spring forecast (t-1) and the latest forecast, determines whether there is a need to adjust towards the MTO or not in year t. A margin of 0.25 percentage points (p.p.) is allowed in order to be evaluated as having reached the MTO. | | | | | |
| ² Structural balance = cyclically-adjusted government balance excluding one-off measures. | | | | | |
| ³ Based on the relevant structural balance at year t-1. | | | | | |
| ⁴ Based on the position vis-à-vis the MTO, the cyclical position and the debt level (See European Commission: Vade mecum on the Stability and Growth Pact, page 38.). In case of a SDP, the requirement corresponds to the Council recommendation when available, otherwise it refers to the Commission recommendation to the Council. | | | | | |
| ⁵ Required adjustment corrected for the clauses, the possible margin to the MTO and the allowed deviation in case of overachievers. | | | | | |
| ⁶ Reference medium-term rate of potential GDP growth. The (standard) reference rate applies from year t+1, if the country has reached its MTO in year t. A corrected rate applies as long as the country is adjusting towards its MTO, including in year t. | | | | | |
| ⁷ Change in the structural balance compared to year t-1. Ex post assessment (for 2019-1) is carried out on the basis of Commission 2019 spring forecast. | | | | | |
| ⁸ The difference of the change in the structural balance and the corrected required adjustment. | | | | | |
| ⁹ Net public expenditure annual growth (in %) corrected for discretionary revenue measures, revenue measures mandated by law and one-offs (nominal) | | | | | |
| ¹⁰ Deviation of the growth rate of public expenditure net of discretionary revenue measures, revenue increases mandated by law and one-offs from the applicable reference rate in terms of the effect on the structural balance. The expenditure aggregate used for the expenditure benchmark is obtained following the commonly agreed methodology. A negative sign implies that expenditure growth exceeds the applicable reference rate. | | | | | |
| Source: Convergence Programme (CP); Commission 2019 spring forecast (COM); Commission calculations. | | | | | |

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

Based on the Commission 2019 spring forecast, Romania's structural balance is estimated to be -3.6% of GDP in 2019 and -4.8% in of GDP in 2020, increasingly away from its MTO of -1% of GDP. Romania is projected to remain in normal economic times, as its projected output

gap of +0.6% in 2019 and +0.2% in 2020 is between -1.5% and +1.5% of potential GDP. General government debt is set to remain below the 60% of GDP threshold in 2019-2020. The required structural effort prescribed by Regulation (EC) No 1466/97 and the matrix of requirements⁴, which factors in the prevailing economic circumstances and sustainability concerns, amounts to 0.5% of GDP in both 2019 and 2020.

An additional and persistent effort necessary to correct for the cumulated deviations and to bring Romania back on an appropriate consolidation path following the repeated slippages since 2016 should complement the minimum adjustment requirement. Romania's structural deficit increased by 1.7% of GDP in 2016 and by 1.2% of GDP in 2017 and remained broadly stable in 2018. Therefore, an additional effort of 0.5% of GDP in 2019 and 0.25% in 2020 should complemented the matrix requirement. The additional effort seems appropriate given the magnitude of the accumulated deviation from the MTO and from the recommended adjustment path towards it. Such an effort would be in line with the adjustment recommended for 2019 by the Council on 4 December 2018. It would accelerate adjustment back towards the MTO, without putting economic growth at risk.

Based on the Commission forecast, the above-mentioned structural adjustment targets are consistent with a nominal growth rate of net primary government expenditure of 4.5% in 2019 and 5.1% in 2020, in contrast to the respective growth rates of 11.6% and 10.8% projected by the Commission.

The Commission 2018 spring forecast projects a further deterioration of the structural balance by 0.7% of GDP in 2019 and an additional 1.2% of GDP in 2020. Therefore, a structural improvement of 1.0% of GDP in 2019 and of 0.75% in 2020 translates into the need to adopt measures of a total structural yield of 1.7% of GDP in 2019 and additional measures of a structural yield of 1.95% of GDP in 2020 compared to the current baseline in the Commission 2019 spring forecast.

According to the Commission spring 2019 forecast, Romania is projected to breach the 3% of GDP deficit reference value of the Treaty. The required structural adjustment would also ensure that Romania respects the 3% of GDP deficit reference value of the Treaty with a margin, which is crucial in view of the existing fiscal and macroeconomic risks and the projected breach.

7. CONCLUSIONS

Romania has not contained its net primary government expenditure nor has it delivered the improvement in the structural balance recommended by the Council on 4 December 2018. Moreover, both the structural balance and the expenditure benchmark pillars point to a significant deviation from the recommended adjustment path towards the MTO in 2018. An overall assessment confirms that the observed deviation in 2018 is significant.

An improvement in Romania's structural balance by 1.0% of GDP in 2019 and by 0.75% of GDP in 2020 seems appropriate given the magnitude of the accumulated deviation from the MTO and from the recommended adjustment path towards it. Such structural adjustment is consistent with a nominal growth rate of net primary government expenditure of 4.5% in 2019 and 5.1% in 2020. It would accelerate adjustment back towards the MTO without putting

⁴ “Commonly agreed position on Flexibility within the SGP”, formally endorsed by ECOFIN Council on 12 February 2016, available at: <http://data.consilium.europa.eu/doc/document/ST-14345-2015-INIT/en/pdf>

economic growth at risk. This adjustment would also ensure that Romania respects the 3% of GDP deficit reference value of the Treaty with a margin, which is crucial in view of the existing fiscal and macroeconomic risks and the projected breach.