Council of the European Union

Brussels, 18 October 2018
(OR. en)

13279/18

ECOFIN 939
UEM 315

COVER NOTE

From:	Mr Eugen Orlando TEODOROVICI, Minister of Public Finance, Romania Ministry of Public Finance
date of receipt:	17 October 2018
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 18 June 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 18 June 2018 under Article 121(4) TFEU.

E-MAIL / ~~FAX~~

IM 10611 2018
17.10.2018

ROMANIA
MINISTRY OF PUBLIC FINANCE
16, Libertatii Avenue, Bucharest

No. 12677/15.10.2018

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, October 2018

Dear Mr. Dombrovskis,

Dear Mr. Moscovici

Dear Mr. Tranholm-Mikkelsen,

On 23rd of May 2018, the European Commission issued a recommendation to the Council with a view to giving a warning to Romania on the existence of a significant observed deviation from the adjustment path toward the medium-term objective as well as 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 June 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

Annex

Report on the *Recommendation of the Council of the European Union for correction of the significant deviation found in Romania from the adjustment trajectory towards reaching the medium-term bugetary objective*

Economic developments in 2017

In 2017, there was an economic growth of 6.9%, thus ensuring the premises for Romania getting closer to the level of development and welfare of the other European countries.

The gross domestic product of 2017 was of 858.7 billion Lei, which means a plus of 91.3 billion Lei from 2016, compared to an increase of 54.8 billion Lei in 2016. The nominal GDP value of 2017 was more than double the one of 2006, the year prior to Romania's accession to the European Union.

What is significant is that **the industry was the driver of this development**, with an increase of the gross added value of 8.2%, i.e. a contribution of 2 percent to the real increase of the gross domestic product. The "Trade, Transportation, and Storage, Hotels and Restaurants" branch had a contribution of only 1.5 percent.

Also, **agriculture had a substantial contribution.** The added value increased by 18.3% compared to 2016, which is a contribution of 0.7 percent.

Another defining element, in consensus with the Government Program, is **the evolution of modern services, with high gross added value, namely IT and scientific and technical services**. The "Information and Communications" branch had a 10.9% progress and a 0.6 percent contribution. The "Professional, scientific, and technical activities; administrative service and support service activities" increased its gross added value by 9.9%, which meant a contribution of 0.7 percent to the economic growth of 6.9%.

On the whole, it can be assessed that 4 branches (industry, agriculture, "information and communications" and "scientific and technical services") ensured 57% of the economic growth (4.0 out of 6.9%).

In 2017, **gross investments in the economy** (gross fixed capital formation) **increased by 4.7% compared to 2016, when they decreased by 2.1%. The progress of 2017 was the second highest after the crisis. A progress of 7.5% was also registered in 2015.**

In 2017, final consumption increased by 8.4% and population's consumption by 10.2%, but the population's consumption was not the only growth driver, like it was in 2016. Compared to 2016, when population's consumption had an exclusive contribution to economic growth, **in 2017 its contribution was supplemented by the positive contribution of investments (gross fixed capital formation)**. In 2017, the contribution of total final consumption was of 6.5 percent of economic growth. By comparison, in 2016, consumption's contribution was of 5.2 percent of the 4.8% of GDP growth.

Therefore, in 2017, population's consumption had a lower contribution to economic growth than in 2016.

Industrial production volume increased in 2017 by 8.2% compared to the previous year, which is the biggest annual growth of the last ten years. It was mainly due to the processing industry, which registered an 8.9% growth.

The sustainable and modern nature of the economy growth path is also reflected by the production and export of capital assets. In 2017, the capital assets industry increased by 12.4% (also the biggest growth in the last ten years), which brought a 8.9% growth of the whole processing industry. In 2016, the capital assets industry increased by only 2.3%. In 2017, capital assets exports increased by 19.8%, compared to only 6.7% in 2016.

Modern services, which define smart economic growth, like IT, communications, scientific and technical activities, enterprise support services, increased by approximately 10%.

High economic growth reduced Romania's development gaps compared to the other countries of the EU. According to the Government Program, it is considered to "exceed in 2021 the 70% ceiling of the EU average related to GDP per capita in terms of purchasing power standard". **The GDP per capital of 2017 in terms of purchasing power standard (PPS) was of 62.3% of the EU28 average.**

Remarkable results, generated by increased competitiveness of Romanian enterprises, were also obtained with regard to **exports of goods**. In 2017, Romanian exports increased by 9.1%, which is a significant progress (4.0 percentage points) from 2016, when the growth was of 5.1% and 1.7 percentage points above the 7.4% growth registered at EU28 level.

What is significant is the fact that the structure of exports is dominated up to approximately 50% by the transportation machines and equipment group, high added value products, which amounted to 29 billion EUR in 2017, a 7.8% increase, which generated commercial surplus of almost 830 million EUR.

Foreign direct investments of 2017 reached 4.8 billion EUR, which is basically double of what was registered in 2010, when they totaled 2.2 billion EUR. This value is a record since 2009 and most foreign capital invested in Romania comes especially from the developed countries of the EU, namely The Netherlands, Germany, and Austria.

Inflation registered a modest increase in 2017 as annual average, of 1.34%, while annual inflation at year end was of 3.32%. The inflation hike at the end of 2017 was mainly due to price increases in the second part of the year, which had external causes, like the increase of the price of oil per barrel on the international markets, price increases for certain food products (eggs and butter) or the depreciation of the national currency relative to European currency. To this was added the measure of increasing the fuel excise duty in two stages, on September 15 and October 1, 2017.

Main economic results in the first part of 2018

According to the data published by the NIS, **economic growth in the first half of 2018 was of 4.0%,** compared to semester I of 2017 (gross series, provisional data). Economic growth slightly accelerated to 4.1% in Q2 of 2018 compared to the similar period of the previous year, from 4% in Q1 compared to Q1 of 2017.

On supply side, positive developments were registered in the agriculture field (6.9%), industry (4.3%), and services (3.2%), which shows sustainable economic growth, while gross added value from constructions slightly decreased (-0.4%). It is noticeable that the gross added value from industry increased (4.3%) over that of economic growth and the contribution of this branch to real GDP growth was of 1 percentage point. With regard to services on their whole, whose contribution to real GDP growth was of 1.9%, it is noted by far the contribution of the "trade, transportation, and storage, hotels and restaurants" branch of 0.8 percentage points.

Domestic demand, with a 5.7% contribution to GDP growth, was mainly based on the expenses for final household consumption, which, due to increasing inflation and to a deterioration of consumer confidence, as well as to a more restrictive monetary policy, calmed its growth in the last 2 years, increasing by 5.5% in semester I of 2018 compared to semester I of 2017. As part of domestic demand, the purchase of goods increased by 6.6%. At the same time, government consumption (which includes individual and collective public administration consumption) decreased by 2.1% due to the decrease of expenses for individual consumption of public administrations by 5.1%.

Gross capital formation increased by 12.1% compared to semester I of 2017, having a 2.5% contribution to real GDP growth. On components, gross investments (gross fixed capital formation) increased by 0.5%, while stock variation had a positive contribution of 2.4 percent. This evolution of stocks is the result of the tendency of economic agents, manifested as of Q1 of 2018, of creating reserves to respond to market demand.

Net export had a negative contribution of 1.6 percent as a result of the fact that imports of goods and services increased by 9.6%, while the exports of goods and services increased by 6.5%.

In the first seven months of 2018, **industrial production volume** increased by 4.6% compared to the corresponding period of the previous year. This was mainly due to the processing industry which recorded a 5.7% growth.

The turnover volume for retail trade increased in the first seven months of 2018 compared to the same period of the previous year by 6.4%, mainly due to sales of non-food products (+7.4%), as well as of food products (+6.9%).

Exports of goods reached a record value of 39.9 billion EUR in the first 7 months of 2018, registering a 10.4% increase compared to the similar period of the previous year, when the increase was of 9.5%. **Imports of goods** reached 47.5 billion EUR in the first

7 months of 2018, registering a 10.5% increase from the same period of the previous year.

Romania's **trade balance** was closed at the end of the 7 months of 2017 with a FOB-CIF deficit of 7.6 billion EUR.

The average gross salary at national level was of 4,400 Lei in the first 7 months of 2017. The average net salary increased by 13.1%, being of 2,646 Lei.

The average number of employees (monthly averages, according to the NIS) was of 4,920.5 thousand persons **in the first 7 months of 2018,** which is a 2% increase from the corresponding period of 2017 (of 94.0 thousand persons). The highest weight on the economy as a whole is held by the number of employees in the industry field, which reached 28.3%, i.e. 1,390.1 thousand persons.

Unemployment rate was of 3.46% at the end of August, which is 0.74% lower than in August 2017 (4.20%), and 0.56% lower than at the end of December 2017 (4.02).

In the first 8 months of the year, **consumption prices** increased by 4.95% compared to the corresponding period of the previous year. The biggest increase was registered for non-food products (6.86%), followed by food products (3.86%) and services tariffs (2.51%).

Fiscal and budgetary developments in 2018

The State budget of 2018 was built on the observance of a cash deficit of 2.97% of GDP, which corresponds to an ESA deficit of 2.96% and a structural deficit of 3.17% of GDP. The budget rectification adopted in September 2018 maintains the cash deficit at a level of 2.97% of GDP.

2018 budget is influenced by the measures provided by the Government Programme aleady adopted in 2017. They referred to amendments in the field of salaries of public employees, the legislation in the field of social rights, the legislation in the pensions field, the legislation in the field of personal income tax and social contributions. Based on the these measures, the budget deficit of 2018 remained at the same level as the one in 2017, **the significant adjustment thereof being provided to start in 2019**. According to the medium-term budget planning (established by Law no. 269/2017), **the ESA balance will improve by over 0.5pp in 2019, a pace which will be kept for 2020 as well**.

Thus, cash deficit forecasted for 2019 is of 2.58% of GDP, which corresponds to an ESA deficit of 2.38% of GDP and a structural deficit of 2.71% of GDP.

With respect to the structural deficit balance, it will improve to 2.7% in 2019 and will adjust in the following years by 0.5 pp, on average.

Even though the fiscal and budgetary measures that have been adopted have caused a temporary deviation from the medium term objective, it must be emphasized that **the deviation nevertheless occurred at the same time as the maintenance of the share**

of public debt in the GDP below 38%, which decreased from 37.4% in 2016 to 35% in 2017. For July 2018, a level of debt of 34.9% of GDP was estimated.

The estimated level of medium term gross government debt (2017-2018) will be below 38% of GDP.

The execution of the general consolidated budget on the first eight months of 2018 ended with a 14.6 billion Lei deficit, namely 1.54% of GDP.

In the first 8 months of 2018, **the revenues of the general consolidated budget** were 13.7% higher in nominal terms than those of the same period of the previous year. Fiscal revenues were 0.8% higher compared to the similar period of the previous year.

Increases were registered compared to the previous year in the case of revenue from social security contributions (+37.5%) and non-fiscal revenues (+19.8%). As of February, revenue from social contributions was positively impacted by the new legal provisions related to the transfer of contributions from the employer to the employee.

Also, VAT revenues increased by 8.6% compared to those of the same period of 2017, while revenues from excise duties were 8.9% higheras compared to those from the similar period of the previous year.

The decrease in personal income tax revenue (23.9%)is due to the cutin the personal income tax rate from 16% to 10%as of January 1, 2018 a measure which was reflected as of February 2018.

The expenditure of the general consolidated budget in the first eight months of 2018 was 18.0% larger than in the same period of the previous year.

Personnel expenditure is 25.2% higher than in the same period of the previous year, the increase being driven by the public sector wage increases.

Expenditure for goods and services increased by 8.9% compared to the same period of the previous year. Significant increases are registered both for the local budgets and for the budget of the national single fund of health insurance and the budget of public institutions financed from own revenues and budget subsidies.Subsidies are 3.9% higher than in the same period of the previous year.

Interest expendituresis 21.3% larger than in the same period of the previous year, representing 1% of GDP, given the cumulation of interest payment dates corresponding to several benchmark bonds.

Social assistance expenditure increased by 12.8% compared to the previous year, being mainly influenced by the increase of the pension from July 1, 2017, the increase of the social allowance for the retired from Lei 520 to Lei 640, as well as the increase and amendment of the manner of establishment of the monthly allowance for children.

Investments expenditure, which include capital expenditure, as well as those corresponding to development programs financed from domestic and foreign sources, were of 12.8 billion Lei, i.e. 22.5% bigger than in the same period of the previous year.

Measures considered when elaborating the draft budget for 2019

The following measures are provided in order to ensure a cash deficit of 2.58% of GDP in 2019 and to implicitly correct the deviation from the medium-term objective (by reducing the structural balance from 3.17% of GDP in 2018 to 2.71% of GDP in 2019):

Measures on the expenditure side:

- freezing the gross salary for public employees at the level of December 2018 (the law on unitary salaries shall not apply) and giving holiday vouchers at the same level as in 2018, namely of Lei 1450/employee;
- continued postponement of salary related measures with impact on the deficit, as they were postponed in previous years as well;
- keeping the average number of employees in the public sector at the same level as in 2018;
- keeping maintenance and operating expenditure at the level of 2018, so that they should decrease as percentage of the GDP by 0.3pp;
- maintaining the other types of expenditure at the same level as percentage in the GDP (subsidies, interests, other transfers, other expenditure) like in 2018;
- investment expenditure is estimated at around 4% of GDP, similarly to the level plannedfor 2018.

Also, we consider that the projects financed under the National Program for Local Development (program financed from the state budget through the Ministry of Regional Development and Public Administration for local administrations) will be co-financed by European funds, thus there will be additional revenue to the state budget for 2018 as well as additional savings from this co-financing for the coming years.

With regard to the revenues side the main measures are:

- The distribution of at least 90% of the net profits to dividendsfor the state or local budgetsfrom the state owned enterprises.
- The selling of licenses for 5G technology (currently plannedfor 2019; estimated impact of 1.3 billion Lei).
- Maintaining the provisions of the Government Ordinance no. 5/2013 regarding the establishment of special measures for the taxation of the natural monopoly activities in the electricity and natural gas sector, Government Ordinance no.6/2013 on the establishment of special measures for the taxation of the exploitation of natural resources, other than natural gas, and Government Ordinance no. 7/2013 on the taxation of additional revenues obtained as a result of the deregulation of prices in the natural gas sector.

We also mention the following measures that will have a positive impact on the improvement of revenue collection, especially from VAT and excise duties:

- The introduction of electronic cash registers (as of November 1, 2018), a measure which will have a positive impact on the VAT field by increasing the compliance rate and collection of VAT, at the same time as decreasing VAT reimbursementperiod.
- The government adopted the Emergency Government Ordinance no 88/2018 amending and supplementing some normative acts in the field of insolvency and other normative acts. This proposal of amendment of the insolvency legislation is generated by the need to improve the mechanisms of recovery of budgetary claims from the companies undergoing insolvency, while observing their chances of economic recovery.
- Modernization of border crossing points in order to reduce tax evasion and detect counterband goods through the introduction of operational scanning equipment in all border crossing points to detect counterband goods and through the fiscalization of goods in customs, as well as monitoring in collaboration with the customs bodies of imports of high fiscal risk goods, an activity mainly dedicated to the identification of schemes of releasing goods into circulation in Romania in violation of corresponding fiscal obligations.

Given the measures provided above, personnel expenditure will decrease as percentage of the GDP from 9.1% in 2018 to 8.8% in 2019; 8.9% in 2020, and shall reach a level of 8.5% in 2022.

Expenditure for goods and services is expected to decrease to 4.1% of GDP in 2019, which is 0.3 pp lower than in the previous year, followed by 3.9% in 2020, reaching 3.6% in 2022.

Social assistance expenditure decreased by 0.1 percentage points to 10.5% in 2019, and shall increase in the following period due to the increase of the pension point to 11.5% in 2022.

Estimates of public pension expenditure for 2019-2022 did not take into account the provisions of the draft pensions law proposed for debate. Pension expenditure will increase up to 8.1% in 2022.

With regard to pension pillar II, the budget of 2019 assumesa constant transfer rate of 3.75%. The estimated transfers to Pension Pillar II in 2019 are 8.9 billion Lei, representing 0.9% of GDP.

Medium-term budget planning

Both cash and ESA deficit are planned for 2018 to be in line with the limit required by the TFEU, i.e. 3% of GDP, and a significant adjustment in the budget deficit is planned to start in 2019, when the ESA balance will improve by over 0.5pp, a pace to be kept in 2020 as well.

Revenues, Expenditure and Balance of the General Consolidated Budget (% of GDP)				
	2018 Estimates	**2019** Estimates	**2020** Estimates	**2021** Estimates
Cash BALANCE	-2.97	-2.58	-1.89	-1.23
ESA BALANCE	-2.96	-2.38	-1.82	-1.45
Structural BALANCE	-3.17	-2.71	-2.22	-1.71

Source: MPF and NCSP

In 2018-2021, the potential gross domestic product will increase at an annual pace of approximately 5%, which leads to a positive output gap and, as a consequence, to a positive cyclical component of the structural deficit, but below 0.5% of GDP, under conditions of economic growth slightly over the potential.