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COVER NOTE

From:	Mr Ionut MISA, Minister of Public Finance
date of receipt:	13 October 2017
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's recommendation 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's recommendation under Article 121(4) TFEU.

E-MAIL / ~~FAX~~

IM 10617 2017
13.10.2017

ROMANIA
MINISTRY OF PUBLIC FINANCE
17, Apolodor Street, Bucharest

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 2017 , 13

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

On 22nd of May, 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 in 2016, 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, 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, as provided for and in the deadline set in the above mentioned document.

Yours sincerely,

Ionut Misa
Minister of public finance

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English translation

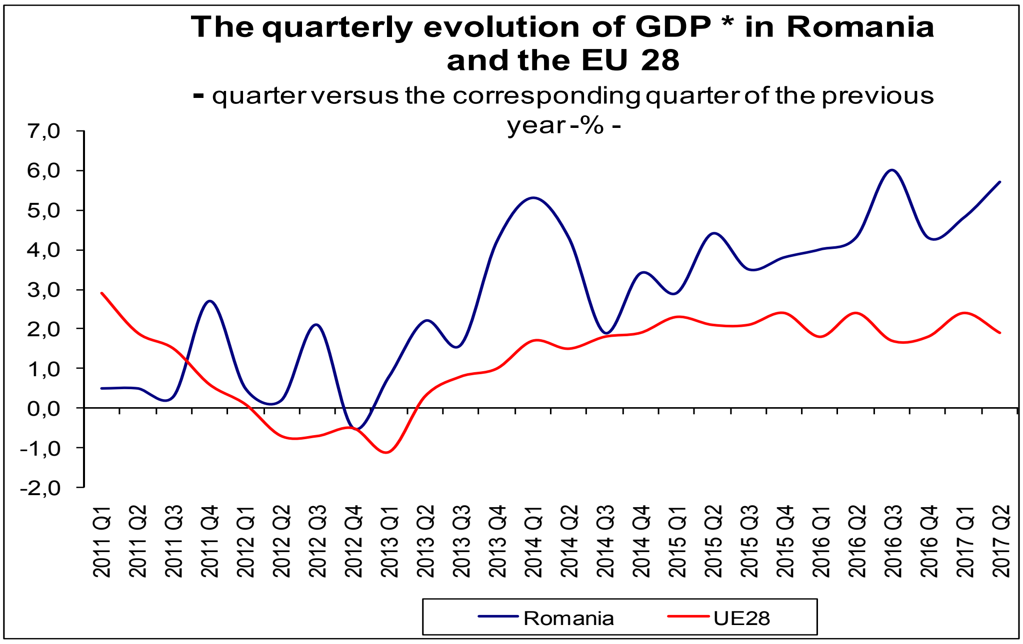
REPORT

on action taken in response to *Council recommendation with a view to correcting the significant observed deviation from the adjustment path toward the medium-term budgetary objective in Romania*

Economic trends in the first half of 2017

The evolution of the main indicators in the first half of 2017 shows that the Romanian economy is favourably placed and the National Commission of Prognosis revised the forecast of the GDP real growth for 2017 at 5.6% according to the preliminary version of the autumn forecast, as compared to the 5.2% estimated in the spring forecast, an estimated level in the preparation of the State budget law for the current year.

In the first semester (S1) of this year the gross domestic product registered a real growth of 5.8% due to consumption, private investments and foreign demand.



Compared to the same period of 2016, **the contributions of different components to the economic growth are much more balanced**, favouring investments and foreign demand. While in S1 of 2016 consumption added 6.5 percentage points to the real growth of 5.2% in GDP, in S1 of this year the final consumption added 5.5 percentage points to the real growth of 5.8% in GDP. Accordingly, the contribution from the gross capital formation increased from 0.8 percentage points in S1 of 2016 to 1.0 percentage points in S1 of 2017, while the negative contribution from net exports was drastically reduced.

Contributions to GDP growth in S1

- percentage points -

	2015	2016	2017
Real GDP	**3.9**	**5.2**	**5.8**
Final consumption	3.3	6.5	5.5
Effective individual consumption	3.5	6.1	5.3
Household final consumption expenditure	3.2	6.3	5.0
Individual consumption expenditure of the public administration and IFSLSG	0.3	-0.3	0.3
Effective collective consumption of the public administration	-0.2	0.4	0.2
Gross capital formation	1.8	0.8	1.0
Gross fixed capital formation	1.5	0.9	0.2
Changes in inventories	0.2	-0.1	0.8
Domestic demand	5.1	7.3	6.5
Net exports	-1.1	-2.1	-0.7
Export of goods and services	3.8	3.4	4.1
Import of goods and services	4.9	5.5	4.8

Romania continues to rank among the EU's top states as regards the investment rate, which demonstrates interest for the Romanian market. **The gross fixed capital formation** amounted to 19.9% of GDP in S1 of 2017, still ranking above the EU average.

As far as supply is concerned, in S1 of 2017, services registered an increase of 6.3% year-on-year, its contribution to economic growth (3.8 percentage points) continuing to increase. In the field of services, the IT&C sector registered a significant growth (12.7%). This trend places our country among the top member states both in terms of growth of gross value added, and in terms of the weight of this sector in the gross domestic product (6% in Romania compared to the 4.5% EU average).

The 10.6% contribution from “professional, scientific and technical activities; administrative services and support services” and the 8.1% contribution from “trade; transport and storage; hotels and restaurants” are also noteworthy.

In S1, industry was the branch that registered the highest growth in gross value added, with a growth of 7.3% year-on-year, adding 1.7 percentage points to the gross domestic product.

The other components that have an impact on growth also had positive trends. The gross fixed capital formation increased by 1.1% in S1 of 2017 year-on-year, while the dynamics of exports of goods and services compared to that of imports of goods and services was more favourable both year-on-year and compared to the one taken into account when the 2017 budget was drafted.

Currently, the 5.8% real GDP growth in S1, based on the 8% growth in Romanian industrial output, and the 6.3% growth in services shows that Government policies focusing on increasing the purchasing power and boosting private investment have already produced the first positive effects. It is worth mentioning that Romania registered high increases in GDP in the last couple of years, namely 3.9% in 2015 and 4.8% in 2016.

During the first seven months of 2017, **the industrial production** increased by 8.0% year-on-year, the highest increase for this period in the last three years. This was primarily due to the manufacturing industry, which registered a 8.6% growth. The production of capital goods registered a significant growth of 12.5% while the turnover also grew by 15.5% year-on-year. The production of electric equipment increased by 25.9% and the production of transport means by 18.5%.

At EU level, in the first seven months of 2017, compared to the same period of 2016, the increase of **industrial production** (adjusted depending on the number of working days) was 8.3%, way above the average registered in EU 28 (+2.5%). This trend was due to the fact that in July 2017, the volume of industrial output in Romania increased by 7.6% year-on-year, way above the EU 28 (+3.1%).

The fiscal and budgetary relaxation measures adopted between 2015 and 2017 encouraged the business environment, which was reflected not only in a higher economic growth compared to the growth registered at EU level, but also in the positive trends on the labour market.

It is worth mentioning that together with the employment growth, there was a significant transfer of labour force from agriculture to the other sectors, which directly affected total factor productivity.

Between 2014 and 2016, the number of people working in agriculture went down by 20.1%, while in services there was a 7.9% increase.

Overall, for the first time since 2014, the working population (BIM methodology) registered a 3.1% increase in S1 of 2017.

Given this context, in Q2 of 2017 **the employment rate of population aged 20 to 64 was of 70.5%, exceeding by 0.5 percentage points the national target of 70% set in Europe 2020 Strategy.**

As far as the number of employees is concerned, the growth remains high. In S1 of 2017, the number of employees (ILO) grew by 3.4%, with more significant increases in the services sector and industry, 4.0% and 3.1%, respectively.

Apart from the trends mentioned above, Romania continued to adjust the imbalance registered by the net international investment position, which dropped from 54.7% in GDP in Q1 of 2015 to 46.9% in GDP in Q1 of 2017.

Fiscal and budgetary trends in 2017

The 2017 budget was built so as the budgetary deficit would not exceed 2.96% of GDP using both ESA and cash methodology, a target which was also maintained in the budget rectification for 2017.

The current budgetary planning was influenced by the measures taken between 2015 and 2016 to boost economic growth (the new fiscal code, the increases of salaries and of certain social security allowances), as well as measures focused primarily on wage increases in the public sector in key fields (health, education, defence).

Assessing the measures taken according to the recommendation of the Council of the European Union, we have to bear in mind that in 2017 Romania reduced the weight of its public debt in the GDP. Romania has one of the lowest levels of public debt-to-GDP in the EU, in terms of percentage of GDP, namely 37.6% in 2016, while the EU average was 83.5% and 89.2% in the Eurozone.

At the end of Q1, Romania ranked 5th among the states with the lowest Government debt-to-GDP after Estonia (9.2%), Luxemburg (23%), Bulgaria (28.6%) and Denmark (36.7%).

On 31st of August 2017, the public debt according to ESA methodology was 37.4% of GDP, decreasing from 37.6% of GDP at the end of 2016 and under the ceiling of 40% of GDP established by Law no. 5/2017 for approving the ceiling for specific indicators mentioned in the fiscal framework for 2017.

At the end August 2017, the composition of the public debt was as follows: 50.9% internal debt and 49.1% external debt.

The medium term forecast (2017-2020) indicated a public debt below 40% of GDP.

The implementation of the general consolidated budget in the first eight months of 2017 ended in a deficit of 6.5 billion RON, namely 0.78% of GDP, compared to the 3.1 billion RON deficit, and 0.41% of GDP registered in the same period of 2016.

In the first 8 months of 2017, **revenues to the general consolidated budget** were 8.9% higher year-on-year. Fiscal revenues were 0.6% higher year-on-year.

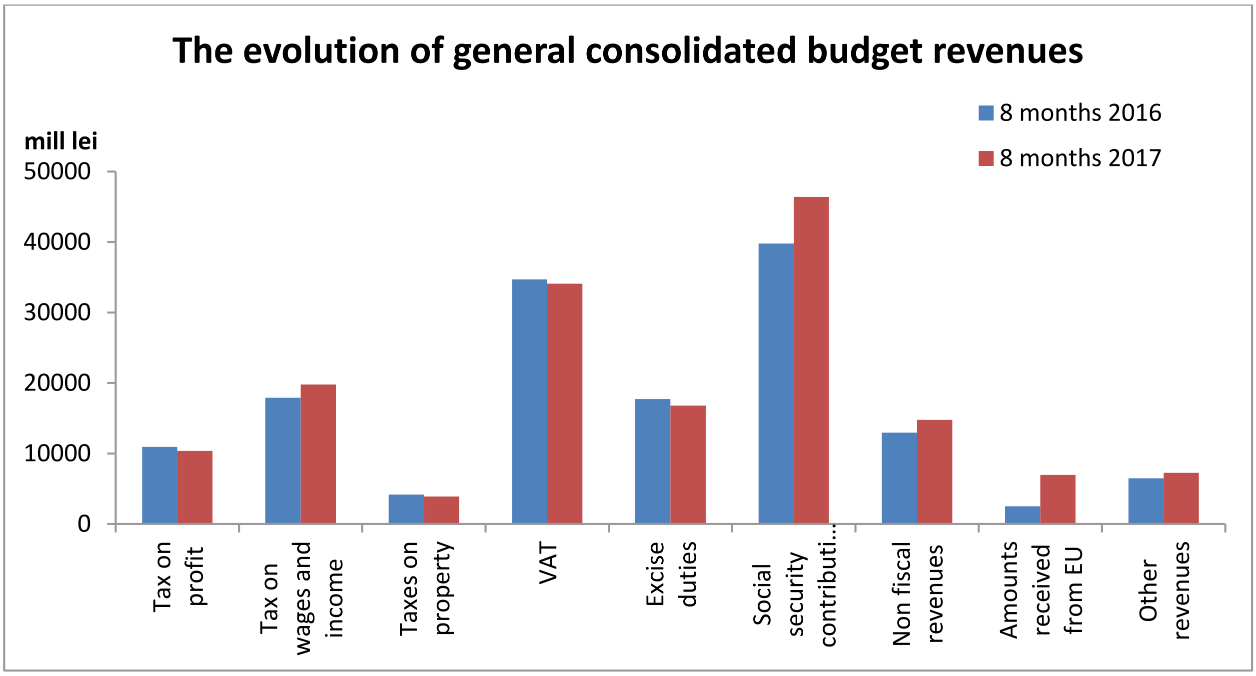
Revenues from income tax increased by 10.4% year-on-year against the background of increase in the average number of employees and in the gross average wage.

As regards VAT revenues, they dropped by 1.7% compared to the first eight months of 2016, against the background of the decrease as from 1 January 2016 in the standard VAT rate from 24% to 20% as from 1st of January 2016, which affected revenues as from February 2016. At the same time, as from February 2017 the effects of the decrease in the standard VAT rate from 20% to 19% will also be reflected in the level of revenues.

Revenues from excise duties were 5.2% lower year-on-year, affected by their reduced rates for some energy products as from 1 January 2017.

Revenues from social security contributions to the general consolidated budget in the first 8 months of 2017 were 16.6% higher than the proceeds registered in the same period of the preceding year, against the background of the increase in the average number of employees and gross average salary.

Non-fiscal revenues registered an increase of 14% compared to the first 8 months of 2016, especially due to the increase in proceeds from dividends and payments from autonomous companies and national companies and undertakings.



The main developments in the budget implementation in the first eight months of 2017 indicate that the revenues to the general consolidated budget exceeded in nominal terms the revenues from the same period of the preceding year

The expenditure of the general consolidated budget in the first eight months of 2017 was 11.0% higher compared to the first eight months of 2016.

Payroll expenses in the first 8 months of 2017 accounted for 5.4% of GDP and increased by 21.4% year-on-year. The increase of payroll expenditure was due to salary increases granted both in 2016 and in 2017 to certain categories of employees in the public system.

Expenditure with goods and services in the first 8 months of 2017 totalled 24.4 billion RON, 4.1% more than the same period of last year.

Interest expenditure decreased by 5.9% as compared to the first 8 months of 2016.

Subsidy expenditure accounted for 0.5% of GDP, 4.6% higher than in the same period of last year. The increase of subsidy expenditure year-on-year was primarily due to payments made to support agricultural producers.

The social security expenditure increased by 11.3% compared to the first eight months of 2016 against the background of an increase in certain social security payments.

Measures to increase budget revenues in 2017-2018

- Increasing the excise duties for tobacco as of July 2017[1];
- Increasing the excise duties for energy products in two stages, namely as of 15 September and as of 1 October 2017[2];
- Payment of contributions at the level of the minimum wage for part-time employees earning less than the minimum salary[3];
- Increasing the dividends distributed by national companies from 50% to 90%, approved by the Government in the Memorandum of 30 January 2017;
- Allocation as dividends/payments to the State budget of the amounts which were allocated in previous years to other reserves and utilised as own funding source according to the GEO 29/2017;
- Increasing the taxation base in the case of payments made by legal entities for unemployed persons with disabilities[4] as of 1 September 2017.
- Amending Law no. 411/2004 on privately managed pension funds, in the sense that the individual contribution to the 2nd Pillar becomes optional.
- Starting the procedure for the sale of 5G licences in 2018.
- In view of a better VAT collection, the split VAT payment will be introduced[5], which will be optional as of 1 October 2017 and mandatory as of 1 January 2018.

[1]Introduced by Law no. 177/2017 approving GEO no. 3/2017
[2]Ordinance no. 25/2017
3Ordinance no. 4/2017
4GEO 60/2017
5Ordinance no. 23/2017

The VAT gap remains high, the latest data published by the European Commission showing that in 2015 it amounted to EUR 7.7 billion (37% of total VAT is not collected). In this regard, the National Agency for Fiscal Administration plans a series of measures to improve collection, including the installation of electronic cash registers which will allow for real-time monitoring and will lead to the reduction of VAT fraud.

Measures to reduce budgetary expenditures in 2017-2018

- Suspension of organisation of competitions or examinations to fill the vacancies or temporary vacancies by public authorities or institutions until 31 December 2017, decided by Ordinance no. 3/2017. It is proposed to prolong the application of this measures in 2018 as well.
- Maintaining the special pensions at the current level for 2017 and afterwards limiting the indexation only to inflation rate, according to GEO no. 59/2017.
- Reduction by at least 35% of the price of innovative drugs that have lost patent, by GD no. 143/2017.
- In view of an efficient utilisation of the budgetary resources allocated for social security payments, the child-care allowance was set at a maximum level of 8,500 RON by GEO no. 55/2017.
- Setting up the Committee for the analysis of institutional organisation and human resources in the central public administration, the purpose of which is to analyse the institutional organisation and the efficient use of human resources in public institutions, by Ordinance no. 3/2017.
- In order to limit the expenditures, it is proposed to forbid the purchases of cars and furniture by public institutions.
- Amendment of insolvency law in the sense of obliging insolvent undertakings to pay social security and income tax related to their payroll expenses.
- Continuation and extension of the centralised procurements of drugs and sanitary materials through the Centralised Procurement Unit of the Ministry of Health.

Structural reforms

Romania pays special attention to structural reforms and the absorption of European funds as essential requirements to accelerate a sustainable economic growth so that the lag compared to other member states can be overcome within a reasonable timeframe.

In 2016, Romania ranked 27th as regards real convergence, registering a gross domestic product per capita at a purchasing power parity of 59.3% of EU average.

The implementation of the structural reforms assumed in the Governing Program and the increase of public investments to upgrade the infrastructure in education, health and transport require significant expenses and are the main cause for higher budgetary deficits.

This year, the Government adopted interconnected packages of structural reforms. Many of these reforms are under implementation. The focus is to create jobs, improve competitiveness and increase growth. The main policies refer to:

- Reform of the labour market;
- Measures for a more efficient public administration;
- Improved access to funding, especially for SMEs; in this regard, support programmes have been developed for start-ups;
- Simplification of the fiscal system; consolidation of fight against tax evasion;
- Reform in the educational system to improve the human capital;
- Improvement of competitiveness through programmes to support both agricultural producers, and exporting companies.

In this regard, the following programmes and measures that require a substantial financial effort with a significant future impact on the growth of the potential gross domestic product and on reducing the lag between Romania and the other European states are worth mentioning:

- The programme to support the internationalisation of SMEs (GEO no. 8/2017); through this programme that supports the internationalisation of businesses, the following activities will be funded by the State budget: individual participation in international fairs and exhibitions, but also in economic missions organised abroad, the building of an SME's visual identity (trademark, logo, slogan); creation of a website/mobile application; employees' training in the country and/or abroad in promoting goods/services on new markets; preparation of studies and surveys, etc.
- Start-up Nation programme, which is a programme that encourages and stimulates the establishment and development of SMEs; the main objective of the de minimis scheme is to stimulate the establishment and development of small-sized and medium-sized undertakings and improve their economic performance, create new jobs, employment of vulnerable people, unemployed and graduates, increase of investments in new and innovative technologies;
- The programme for growing investments in tourism; the masterplan of investments in tourism (GD no. 558/2017);
- The programme for building of regional hospitals; at the beginning of October, the Government approved the legislation regarding the transfer of land to build the regional hospitals in Craiova and Cluj-Napoca.

As is well-known, Romania is implementing the General Transport Master Plan, the objectives of which are: the development of transport infrastructure along the TEN-T network and upgrading the existing infrastructure in order to extend the national and Trans-European connections for the population and the business environment.

The creation of the Sovereign Development and Investment Fund (SDIF) will also be an important project that will manage the State's investments. The objective of the Sovereign Development and Investment Fund is to support economic development through investments in competitive sectors, which will have a multiplier effect in the economy, further to the attraction of capital and sources from the financial markets.

The purpose of the SDIF is both to develop and to fund from own sources and from external sources certain profitable and sustainable investment projects in various economic sectors, through direct participation or through other investment funds or companies, on an individual basis or with other instiutional or private investors, and to manage its own funds in order to make profit.

Potential GDP and structural deficit

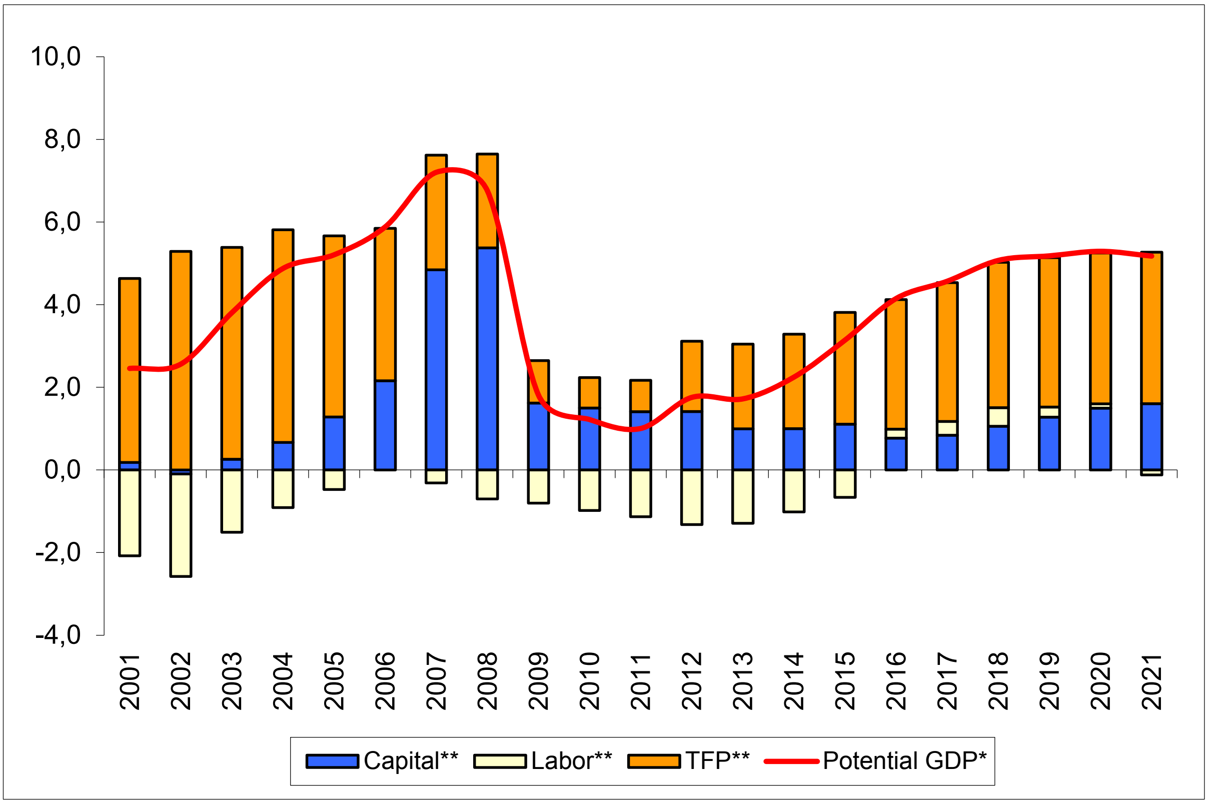
Romania registered in 2016 a general consolidated budget deficit in ESA terms of 3.0% of GDP, while the structural deficit was 2.4% of GDP.

General consolidated budget balance (% GDP)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
ESA Balance	-6.9	-5.4	-3.7	-2.1	-1.4	-0.8	-3.0	-2.96	-2.9	-2.5	-2.0
Structural balance	-5.6	-2.9	-2.5	-1	-0.6	-0.6	-2.4	-2.96	-3.0	-2.8	-2.3

Source: Ameco DGECFIN; Convergence Programme 2017 - 2020,

For the upcoming period, the ESA deficit remains relatively constant in 2017 – 2018, but will decrease to 2.0% in 2020. It is estimated that the structural deficit will be very close to the ESA deficit that will be registered in 2017 and 2018.



*real growth (%) ** contributions to potential growth (percentage points)

Between 2003 and 2016, the output-gap followed two important stages, namely: (i) highly positive values between 2003 and 2008, reaching 7.5% of potential GDP in 2008 and (ii) negative values as of 2009 when the recession came. These negative values were registered despite a considerable loss of potential. Even in times of positive economic growth, the output-gap was negative.

On the medium term, we estimate that Romania will recover its growth potential, which was heavily hit by the economic and financial crisis. According to the preliminary forecast issued by the National Commission of Prognosis for the autumn of 2017, the potential GDP average annual growth rate will be 5.1% between 2017 and 2021, compared to the 2.1% average annual growth rate in 2009 - 2016. Starting with 2018, the potential growth rate will be more than 5%, similar to the rates of 2003 - 2004, but far from the potential growth of 2007 - 2008 of approximately 7%.

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