Council of the European Union

Brussels, 23 April 2018
(OR. en)

8257/18

ECOFIN 354
UEM 125

COVER NOTE

From:	Eugen Orlando Teodorovici, Minister of Public Finance, Ministry of Public Finance
date of receipt:	23 April 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 5 December 2017 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 5 December 2017 under Article 121(4) TFEU.

E-MAIL / ~~FAX~~

IM 04077 2018
23.04.2018

ROMANIA
MINISTRY OF PUBLIC FINANCE
16, Libertății 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, April 2018

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

On 22nd of November 2017, 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 December 2017, 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

Report regarding *European Union Council's Recommendation in the view of correcting the significant deviation from the adjusting trajectory towards the medium term budgetary objective, detected in Romania*

Economic developments in 2017 and the first months of 2018

In 2017, the economic growth reached 6.9%. Thus, the development and welfare level gap between Romania and the other European states is closing, so that the foundation for our catching up process is ensured.

In 2017, **the gross domestic product's value was RON 858.3 billion, namely RON 96 billion more than in 2016**, as compared to a RON 49.7 billion increase in 2016. Moreover, in 2017 the nominal GDP reached more than double of its level from 2006, the year before we joined EU.

It is also significant that **this economic growth was propelled by the industry**, which contributed by 1.9 percentage points to the real GDP's growth. The branch of "Retail, transport and storage, hotels and restaurants" contributed by only 1.5 percentage points. The value added in industry increased by 8%.

The **agriculture also brought a substantial contribution**. The value added increased by 18.3% as compared to 2016, with an afferent contribution of 0.7 percentage points.

A **second crucial element** supporting the government program is **the evolution of the modern, high added value services, such as the IT and the scientific and technical services**. The "Information and communication" branch registered a dynamics of 10.9% and a 0.6 percentage point contribution to GDP growth. The "Professional, scientific and technical activities, administrative activities and services and support services activities" branch increased its added value by 9.9%, which meant a contribution of 0.7 percentage points to the 6.9% economic growth.

As a whole, 4 BRANCHES (industry, agriculture, "information and communication" and "scientific and technical services") can be considered as having provided 55% of the economic growth (3.9 percentage points out of the 6.9% growth).

Data show **that 2017 has been a very good year in respect of investments**:

The net investment in the national economy (which represents a share of the gross fixed capital formation) increased by 6.4% in 2017, as compared to 2016. In 2016 the net investments shrunk by 3.3% y-o-y.

2017 was the first year to exceed the level recorded in 2009 (when the investment had decreased by 30% as compared to 2008). Significantly, 33.4% of the net investment were don in industry and 25% in construction sector.

Therefore, in 2017 **the gross investments in economy** (gross fixed capital formation) **increased by 4.7% compared to 2016, when they dropped by 2%.**

The dynamics in 2017 was the second highest post crisis. There was also a 7.4% mentionable dynamic registered in 2015. The gross fixed capital formation is one of the main factors improving potential GDP.

It is worth mentioning that **capital accumulation** (gross capital formation which also includes inventories) records presently a dynamics of 5.2%, up from 4.9% in the first estimation, while total final consumption dynamics is now 8.4%, from 8.6%.

In 2017, the final consumption increased by 8.4% and the household consumption by 10.2%, though the household consumption was not the single growth driver, as in 2016. Unlike 2016, when the household consumption had an exclusive contribution to the economic growth, **in 2017, its contribution was complemented by the positive contribution of the investment (gross fixed capital formation)**. In 2017 the total final consumption's contribution to economic growth was 6.4 percentage points. For comparison, in 2016 the consumption contributed by 5.2 percentage points to the 4.8% GDP growth.

Consequently, the household consumption had a smaller contribution to the economic growth in 2017 than in 2016.

Furthermore, **the agriculture and the industry also had an exceptional evolution** in 2017, as these activities ensure the sustainability of the economic growth. On the overall year, the agricultural production registered a growth of approximately 14.7%.

In 2017**, the volume of the industrial production** grew by 8.2% as compared to the previous year, the highest growth in the last 10 years. This was mainly due to the manufacturing industry, which registered an 8.9% growth. Within this industry, certain branches exceeded this 8.9% increase by far: manufacture of machinery and equipment (+33.6%), manufacture of electrical equipment (+27.2%), printing and reproduction of recorded media (+19%), production of pharmaceutical products (+17.3%), etc.

The dynamic of exports of capital goods reflects sustainable and

The sustainability and also the modern characteristics are further defined by the production and export of capital goods. In 2017, the industry of capital goods grew by 12.4% (also the most considerable growth in the last 10 years), leading to an 8.9% dynamics for the entire manufacturing industry. In 2016, the industry of the capital goods had increased by only 2.3%. In 2017, the capital goods export increased by 19.8%, compared to only 6.7% in 2016.

The **modern services**, which define the intelligent economic growth, such as IT, communications, scientific and technical activities, support services for companies have increased by approximately 10%.

The high economic growth has diminished the development gap between Romania and the other EU states. The Government program sets an objective for Romania to "exceed 70% of the EU average regarding GDP per capita at purchasing power standard, by 2021". **The GDP per capita at purchase power standard is estimated to be above the 60% in 2017**.

Remarkable results, coming from the increased competitiveness of the Romanian enterprises, have also been achieved in terms of **export of goods**. In 2017, the Romanian exports increased by 9.1%, which represents a significant advance (4.0 percentage points) as compared to 2016, when the growth was of 5.1%, exceeding by 1.7 percentage points the 7.4% increase registered at EU28 level.

Moreover, the structure of exports is significantly dominated by the group of machinery and transport equipment (about 50%), high value added products which in 2017 amounted to EUR 29 billion, equal to a 7.8% increase, which generated a commercial surplus of almost EUR 830 million.

Foreign direct investments exceeded EUR 4.5 billion in 2017, almost double than the value recorded in 2010, when it amounted to EUR 2.2 billion. This value represents a record since 2009, while most of the foreign capital comes mainly from the developed EU economies (i.e. Netherlands, Germany and Austria)

During the first quarter of 2018, the economic activity was equally dynamic. The recent data published by the National Institute for Statistics show a **further positive development**. The public investment rebounded, the industrial production keeps its dynamics high, while retail sales slowed down.

In January 2018, the volume of the industrial production increased by 8.5% y-o-y, were as the growth in January 2017 was 5.3% y-o-y. More importantly labor productivity in industry advanced with 6.8% in January 2018 y-o-y, as compared to 3.9% a year ago.

As for the retail, the turnover has increased during the first two months of 2018 by 8.3%, compared to a 13.5% growth in 2016 and a 10.7% growth in 2017.

Regarding the investment, it is worth mentioning that activity in constructions increased by 7.8% in January, while the capital expenditure has been almost 4 times higher in the first quarter 2018, than in the first quarter of 2017.

Fiscal developments

The state budget for 2017 and 2018 has been built around a deficit of 2.96% of GDP, according to both methodologies, cash and ESA.

The current budgetary planning has been influenced by the measures taken during 2015-2016 in order to stimulate economic growth (the new Tax Code, wage and welfare increases), and also further wage increases in key budgetary areas (health, education and defense).

In assessing the actions undertaken according to the Council's recommendation, it should be taken into account the fact that Romania`s share of public debt to GDP has decreased in 2017. Romania had one of the lowest debt to GDP ratio in the EU in 2016, 37.6%, while the EU and Eurozone averages were 83.5% and 89.2% respectively.

According to the EU methodology, Government debt to GDP ratio was 35.2% at the end of 2017 (operating data), down from 37.6% at the end of 2016, and below the ceiling of 40% set by the Law 5/2017 for the approval of the ceilings for specified indicators within the fiscal-budgetary framework for 2017.

The estimated level of medium-term gross government debt (2017-2020) is below 40.0% of GDP.

Budget execution for 2017

The execution of the consolidated general budget, based on operational execution data for 2017, ended up with a cash deficit of 24.3 billion lei, 2.83% of GDP respectively, below the annual target of 2.96% of GDP. Preliminary data show an ESA deficit of 2.92% for 2017. Thus, Romania succeeded in accommodating all the measures impacting the budget in 2017, while respecting the limit for ESA budgetary deficit set out in the Treaty on the Functioning of the European Union.

The revenues of the general consolidated budget amounted to 251.8 billion lei, accounting for 29.3% of GDP, compared to 29.4% of GDP in 2016. In nominal terms, the revenues were 12.5% higher than in 2016.

The revenues collected on the main four budgets of the general consolidated budget (state budget, social insurance budget, unemployment insurance budget, the budget of the single national health insurance fund) collected by the National Agency for Fiscal Administration (NAFA) represented 100,3% of the revenue program administered by NAFA

The main taxes that lead to larger revenues compared to the previous year were social contributions (revenue increase by RON 10.4 billion, 17% respectively) and personal income tax (revenue increase by RON 2.4 billion, 8.6% respectively). Also, non-tax revenues increased by 21.1%, to RON 3.8 billion.

Revenues from property taxes declined by 9.1% compared to 2016, mainly due to the abolition of special construction tax on 1 January 2017.

Revenues registered from other taxes and duties on goods and services increased by 38.1% compared to the previous year, mainly determined by the increase in revenues related to clawback tax, as well as for the cost-volume/ cost-volume-result financed from the budget of the single national health insurance fund.

Regarding VAT revenue, an increase of 3.6% was recorded in 2017 compared to the previous year, mainly due to the revenues colected in the second half of the year, in the context of the reduction of the standard VAT rate from 24% to 20% as of 1 January 2016, and a subsequent reduction in the VAT rate by one percentage point, to 19%, in February 2017.

The amounts from the European Union in the account of the payments made were RON 17.1 billion.

General government expenditure (RON 276,1 billion) have increased in 2017, in nominal terms, with 14.0% compared to 2016.

Compensation of employees has increased with 22.0% compared to previous year, driven by public sector wage rises in the second half of 2016, respectively the implementation of GEO no.20/2016, starting with August 2016. The GEO no. 20/2016 aim was to change and complete the GEO no. 57/2016 regarding public sector wages and other fiscal budgetary measures. Furthermore, in 2017, the wage dynamics in the public sector was driven by increases in the following areas: (i) public health and education by 15% starting with January 1st, (ii) local administration by 20% starting with February 1st, (iii) national libraries and national museums by 30% starting with June, (iv) military by 15% starting with June, (v) police by 10% starting with October 1st. Also, the hike in minimum wage from RON 1250 to 1450 starting with February 1st and the implementation of the public sector wage Law no.153 / 2017 contributed to the public sector wage growth

Expenditure for goods and services and subsidies decreased by 0.7% and 6.1% respectively, compared to 2016.

Social assistance expenditures have increased by 13.1% over the previous year, mainly driven by the two-step increase of the pension point – by 5,25% starting with January 1st 2017, to RON 917,5, and by 9% starting with July 1st, to RON 1000. The social expenditure increase was also determined by measures adopted during 2016 regarding the increase of the monthly child raising benefit and the insertion incentive.

Investment expenditures, including capital expenditures, as well as those related to development programs financed from domestic and external sources, amounted to RON 26.7 billion, 3.1% of GDP respectively.

Measures to increase budgetary revenues in 2018

- Increasing the excise duties for energy products, in two steps, starting with the 15th of September and the 1st of October 2017[1] (impact of +2.7 billion lei);
- Increasing the dividends distributed by the national companies from 50% to 90%, a measure approved by the Government through the Memorandum on the 30th of January 2017, which also applies in 2018 (impact of +1 billion lei);
- Increasing the tax base in the case of payments due by legal persons for disabled persons[2] starting with the 1st of September 2017 (impact of +0.7 billion lei);
- Starting the procedure for selling 5G licenses in 2018 (impact of +1.3 billion lei);
- Increasing the excise duty on cigarettes from the 1st of April 2018 from 439,94 lei/1,000 cigarettes to 448.74 lei/1,000 cigarettes (impact of +140 million lei);
- Implementing the Council Directive 2016/1164/EU of 12 July 2016 against tax evasion with a direct effect on the functioning of the internal market (ATAD). The Directive has been partly implemented to limit interest deductibility from the 1st of January 2018 following the approval of G.E.O. no. 79/2017 (impact of approx. +200 million lei);
- Introducing the VAT split payment system from the 1st of January 2018, which will be applied mandatory by companies in insolvency or with VAT-related tax arrears, while for the rest of the companies is optional (impact of +2.9 billion lei);
- Measures to reduce tax evasion and increase the budgetary revenue collection, with effect in 2018 (impact of +2 billion lei):
    - Introducing functional scanning equipment at all border crossing points by the end of 2018 for detecting smuggled goods and taxing goods in customs;
    - Carrying out additional evaluations at all levels of the General Anti-Fraud Directorate on possible practices used to hinder the recovery of amounts owed.
    - Elaborating the procedure to connect the electronic fiscal devices to the National Supervisory Information System. Carry out unannounced controls in areas with high non-compliance risk, in order to stimulate the issuance of bills by taxpayers.
    - Enhancing anti-fraud monitoring and control in the area of e-commerce by developing a legal and procedural framework, creating a structure with specialized personnel within the General Antifraud Directorate and developing specific tools for monitoring;
    - Monitoring imports of goods with high fiscal risk, in cooperation with the customs authorities, an activity meant mainly to identify the schemes for free circulation of goods in Romania with a view to fight tax evasion in customs.

[1] G.E.O. no. 25/2017
[2] G.E.O. no. 60/2017

- Improving risk analysis and selection of taxpayers for tax inspection by diversifying the risk criteria used to identify a target taxpayer group, namely an economic branch, a sector of activity or services where a reduction of tax liability was identified;
- Improving enforcement for large tax debtors by investigating affiliated companies, VAT returns, treasury bank transactions, in conjunction with the wealth of individuals implicated in this activity.

Measures to reduce budget expenditures in 2018

- Freezing new hiring process in ministries and subordinated institutions, with the exception of posts approved by the Government through a memorandum, until 31 December 2017, as established by Ordinance no. 3/2017. In 2018, the policy of filling vacant positions within the central public administration is established by Government Emergency Ordinance no. 90/2017, as follows:
    - a post occupied for every two vacant posts in 2018;
    - in duly justified cases, a memorandum approved in the Government meeting may approve the organization of competitions or examinations for other vacant or temporary vacant posts, with a justification for the necessity and observing the personal expenditure ceiling approved in the budget
- Maintaining special pensions at the level currently set for 2017, and updating them annually by indexing them with the average annual inflation rate in accordance with Government Emergency Ordinance no. 59/2017;
- In order to reduce the current expenditures, it is proposed to prohibit public institutions to purchase cars and furniture, as stipulated in Government Emergency Ordinance no. 90/2017;
- Decreasing in 2018 the current expenditures of public institutions by 10% compared to the payments of 2017, as stipulated in the Government Emergency Ordinance no. 90/2017.;
- Continuing and expanding the centralized procurement procedure of medicines and medical supplies through the Centralized Public Procurement Unit of the Ministry of Health.

Structural reforms

Romania pays particular attention to structural reforms and the absorption of European funds, both being seen as important requirements for the sustainability of public finances and for accelerating the convergence process for Romanian economy. In this context, it is worth pointing out that Romania has already reached a level above 60% of the EU average regarding GDP per capita at purchasing power standard in 2017.

For 2018, the Government has prioritized a series of structural reforms, which mainly concern: (i) cutting red tape and improving the efficiency of public administration; (ii) labor market reform and policies aiming to create new jobs; (iii) improving investment mechanisms and boosting public investment; (iv) improving competitiveness both through business support programs and public policies aiming at improvement access to finance for SMEs.

Regarding the central public administration reform, a key measure for the improvement of the quality of the services offered to the citizens and the business environment, we highlight the following:

- the entry into force of the amended Administrative Code, containing the Statute of the Civil Servant, with a view to stimulate performance, as well as improve accountability, make public policy more efficient and less bureaucratic.
- the introduction of performance contracts in the central administration based on 5 quantitative indicator for management and, as well as quality indicator assessed based on the feedback received from the customers of public services
- the modernization of the public administration with a view to streamline approval and decision flows, with a particular focus on the digitalization process of the institutions.
- Local Public Finance Law

The key area of structural reforms in 2018 will be the programs and public policies in labor market area:

- amending the Labor Code and the Social Dialogue Law,
- a Program for people with disabilities, which targets among other things, an improvement in the participation rate of people with disabilities to the labor market and reduce social exclusion;
- state aid schemes to support businesses development for workforce in areas with high unemployment rate;
- support the education of young people in order to boost employability and reducing the unemployment rate.

In 2018, one of the main components of structural reforms package to be implemented by the Government is the improvement of the investment mechanisms, as well as the diversification and orientation towards strategic areas of the support granted for investors. In this context, it should be noted that the Government has already approved the establishment of a centralized unit for investment in public-private partnership. This unit will perform under National Commission for Strategies and Prognosis and will elaborate a new law for public-private partnership in the second quarter of 2018.

According to the Governance Programme, the private sector with a particular focus on SMEs access to finance, will be stimulated by new state aid schemes designed for strategic areas such as:

- innovation and creativity,
- licensed industrial activities
- development program for spa resorts
- construction of service dwellings in order to support the investors to ensure the necessary workforce and improve labor market mobility.

Medium-term budgetary planning

Both the cash and ESA deficits are planned for 2018 with the TFUE target of 3% of GDP, the significant adjustment of the budget deficit being planned to start in 2019 when the ESA balance will improve by more than 0.5pp, a path that will be sustained for 2020 as well.

Revenues, Expenses, and Consolidated General Government Balance (% of GDP) 2018

	2018 Estimates	**2019** Estimates	**2020** Estimates	**2021** Estimates
Cash balance	-2,97	-2,58	-1,89	-1,23
ESA methodology balance	-2,96	-2,38	-1,82	-1,45
Structural balance	-3,17	-2,71	-2,22	-1,71

Source: MPF and NPC

Romania has successfully restored its growth potential, strongly affected by the economic and financial crisis, with potential GDP dynamic returning to values more than 5% annually since 2018. Between 2018 and 2021, potential GDP will grow at an annual average rhythm of 5.3%.