

Surveillance of budgetary positions and surveillance and coordination of economic policies

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The Commission presented a report to the Council pursuant to Article 11(2) of Regulation (EC) No 1466/97 on the enhanced surveillance mission in Romania.

Background: as a consequence of the significant deviation from its medium-term budgetary objective (MTO) in 2016, a Significant Deviation Procedure (SDP) was launched for Romania in spring 2017. The Member State's structural deficit increased to 2.5% of GDP in 2016, from below 1% in 2015, due to significant cuts in indirect taxes and increases in public sector wages.

As a consequence, on 22 May 2017, the Commission issued a **warning** to Romania and proposed to the Council to launch a SDP. In its SDP recommendation, approved on 16 June 2017, the Council asked Romania to take measures to ensure that the nominal growth rate of net primary government expenditure does not exceed 3.3% in 2017. This corresponds to an annual structural adjustment of 0.5% of GDP, which is the minimum effort required under the preventive arm of the Stability and Growth Pact (SGP). It translates into a need for corrective measures equivalent to 1.8% of GDP in 2017, as compared to the baseline from the Commission's spring 2017 economic forecast.

Romania has reported to the Council on the action taken in response to the Council recommendation by 15 October 2017. The Commission is now assessing the content of Romania's submission.

The enhanced surveillance mission by the Commission took place on 26-27 September 2017. The mission met the Minister of Finance Ionu Mia, the governor of the National Bank of Romania Mugur Isrescu, members of the Fiscal Council of Romania and members of the budgetary committees of the Romanian Parliament. The aim of the mission was to learn in detail about the fiscal actions planned by the Romanian authorities, to increase the visibility of the fiscal risks and to encourage compliance with the SGP. The mission also assessed fiscal developments and budget execution in 2017.

Main findings: it was understood that the Romanian authorities **do not intend to act upon the SDP recommendation**. The Minister of Finance confirmed that the target for 2017 remains the headline deficit of 3% of GDP, while a structural adjustment in 2017 is not a priority. In the 2017 budget rectification, adopted by the government in mid-September 2017, the headline deficit target has been kept at 2.96% of GDP, while the underlying macroeconomic projection improved. This indicates a deterioration of the underlying structural deficit as compared to the original 2017 budget, which already planned an expansionary fiscal stance. The Minister of Finance argued that the SDP recommendation came late in the year, leaving **limited scope** to implement the recommended structural adjustment. The recently adopted 2017 budget rectification also raises concerns as to the quality of public finances.

The Minister of Finance stated **two objectives for 2018**:

- a primary objective of maintaining a headline deficit of 3% of GDP;
- a secondary objective, a reduction in the structural deficit by 0.5% of GDP.

The mission observed that, given the positive and increasing output gap, keeping the headline deficit at 3% of GDP in 2018 would imply a deterioration in the structural fiscal position. According to the Commission projections, following the usual **no-policy change scenario**, the headline deficit is likely to increase in 2018 to substantially above 3% of GDP, driven by further significant increases in public wages.

To achieve the stated 2018 targets, the authorities plan to:

- **shift social contributions entirely onto employees**, in order to cushion the fiscal impact of the Unified Wage Law. The intention is to increase the social contributions rate paid by employees on their gross wages;
- accompany that shift with a **cut of the overall social contributions rate**, from the current 22.75% for employers and 16.5% for employees to 36% for employees, and to cut the Personal Income Tax rate from 16% to either 12% or 10%;
- consider a **reversal of the 2008 pension reform**, which introduced the second pension pillar. The authorities are considering a reduction of the transfer of social contributions to the second pension pillar, which under European System of Accounts (ESA) rules is classified outside of general government. Those transfers amount to around 0.8% of GDP annually. Such a measure would decrease the fiscal deficit in the short term. However, that fiscal gain would dissipate in the long term as the social contributions diverted from the second pillar would be accompanied by an obligation to pay old-age pensions in the future. In addition, such a reversal could have **negative implications for the viability of the pensions system** and for the development of capital markets.

According to the Fiscal Council, the **structural deficit will substantially deteriorate in 2018** and the headline deficit is projected to **breach the 3% of GDP threshold** in the absence of countervailing fiscal measures.