Romania

Fiscal Council

Annual Report

2020

Note:

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List of abbreviations

BRF	Budget Reserve Fund
CEE	Central and Eastern Europe
CPI	Consumer Price Index
DESI	Digital Economy and Society Index
EAGF	European Agricultural Guarantee Fund
EC	European Commission
EBRD	European Bank for Reconstruction and Development
EDP	Excessive Deficit Procedure
EMFF	European Maritime and Fisheries Fund
ESA 2010	European System of National and Regional Accounts 2010
ESA 95	European System of Accounts 1995
ESIF	European Structural and Investment Funds
EU	European Union
FC	Fiscal Council
FRL	Fiscal Responsibility Law no. 69/2010
FS	Fiscal Strategy
GCB	General consolidated budget
GCI	Global Competitiveness Index
GDP	Gross Domestic Product
GEO	Government Emergency Ordinance
HICP	Harmonized Index of Consumer Prices
IMF	International Monetary Fund
MIEP	Ministry of Investments and European Projects
MF	Ministry of Finance
MTO	Medium-term objective
NAFA	National Agency for Fiscal Administration
NBR	National Bank of Romania
NCSP	National Commission for Strategy and Prognosis
NIS	National Institute of Statistics
NMS CEE	New EU Member States from Central and Eastern Europe
NPISH	Non-profit institutions serving households
NLDP	National Local Development Program
NREF	Non-reimbursable external funds
NRP	National Reform Program
NRRP	National Recovery and Resilience Plan
OP	Operational Program
OPFMA	Operational Program for Fisheries and Maritime Affairs
OPADP	Operational Program for Assistance to Disadvantaged People
pp	percentage points

RRM	Recovery and Resilience Mechanism
SDP	Significant Deviation Procedure
SGP	Stability and Growth Pact
SME	Small and Medium Enterprises
SSC	Social Security Contribution
TSCG	Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (The Fiscal Compact)
VAT	Value Added Tax
WB	World Bank

Table of contents

List of tables

List of figures

I. Summary

The Fiscal Council (FC) is an independent authority established by the Fiscal Responsibility Law no. 69/2010 (FRL), which supports the Government and the Parliament in designing and implementing fiscal-budgetary policies and promotes the transparency and sustainability of public finances.

According to the FRL, the FC has among its prerogatives to elaborate an Annual Report that analyzes the conduct of fiscal-budgetary policy during the previous year against the framework set out in the Fiscal Strategy (FS) and the annual budget, to assess the macroeconomic and fiscal developments as well as the objectives, targets and indicators included in the FS and in the annual budget.

The economic activity in Romania was severely affected by the COVID-19 pandemic, registering in 2020 a contraction of 3.9% in real terms. The economic decline was mainly determined by the reduction in household consumption and by the negative contribution of net exports, partially offset by the positive evolution of gross fixed capital formation and government consumption. 2020 was characterized by a downward trend in inflation and an increase in the current account deficit which reached 5.2% of GDP at the end of the year. Thus, the average current account deficit registered in the last 3 years exceeded the 4% threshold set by the European Scoreboard. The Romanian economy is characterized by a high level of the twin deficits, which involves important challenges for the country's economic stability.

In 2020, the economic activity in Romania was severely affected by the COVID-19 pandemic, the gross domestic product (GDP) registering a contraction of 3.9% in real terms, compared to an increase of 4.1% in the previous year. On the demand side, gross fixed capital formation (+1.5 pp) and government consumption (+0.4 pp) were the only factors that made a positive contribution to economic growth. Expenditures for the final consumption of households, the main driver of growth in most of the previous years, exerted the largest negative contribution (-3.2 pp) amid restrictions imposed to combat the pandemic. Net exports also had a negative contribution (-1.6 pp), due to the disruption of global supply chains, as well as the change in inventories (-0.9 pp). From the supply perspective, the decline of GDP was determined by almost all branches of the national economy, and especially by industry (-1.9 pp), but it should be noted that constructions and information and communications exhibited positive developments.

2020 was characterized by lower inflation rates, compared to 2019, which followed a predominantly downward trend throughout the year. At the end of December 2020, the inflation rate was 2.06% (compared to 4.04% at the end of 2019), while the overall price increase across the economy, as measured by the GDP deflator, stood at 3.6%. The current account deficit continued its upward trend, increasing from 4.9% in 2019 to 5.2% in 2020, while maintaining a coverage of about 70% through non-debt generating cash flows (the balance of equity investments related to foreign direct investments, including reinvested earnings and that of European funds associated to capital transfers). It should be noted that the average current account deficit recorded in the last 3 years is 4.8% of GDP, exceeding the 4% threshold set by the European

Scoreboard, which highlights an external macroeconomic imbalance and a high vulnerability to shocks. The Romanian economy is characterized by a high level of the twin deficits which involves important challenges for the country's economic stability.

The labor market has not been severely affected by the pandemic due to government support measures, the average number of employees decreasing by 1.4% compared to the previous year, which corresponds to an increase of 1.1 pp in the unemployment rate up to 5%. The average gross earnings continued the upward trend from previous years, registering a 6.4% advance compared to 2019.

The non-governmental credit remained on an upward trajectory, registering an increase of 3.4% in real terms compared to the previous year, due to an increase in the volume of loans granted in lei. The labor market has not been severely affected by the pandemic due to government support measures, the average number of employees decreasing slightly to 5.1 million people (-1.4% compared to 2019) amid the gradual adaptation of companies and of the population to the measures imposed by the pandemic. Thus, the ILO unemployment rate increased by 1.1 pp to 5%. The average gross earnings across the economy was 5,164 lei, representing an increase of 6.4% compared to 2019. Consequently, the average net earnings increased by 6.8% compared to the previous year, while the real earnings recorded an increase of 4%, given an average annual inflation of 2.6%.

In March 2020, based on the results of the 2019 budget execution, the excessive deficit procedure was triggered by the EC.

In the context of the exceptional situation generated by the COVID-19 pandemic, fiscal-budgetary measures aimed at combating its effects have led to an increase in the budget deficit and to a further deepening of the structural deficit.

The very high levels of the budget deficit call for a correction that will lead to a reduction in the medium term, ensuring a sustainable trajectory of fiscal and budgetary policy.

The general consolidated budget for 2020 (elaborated in December 2019) was built on a macroeconomic scenario based on a real GDP growth of 4.1% and established a target of 3.6% of GDP for the cash and ESA budget deficits, maintaining the expansionary character of the fiscal-budgetary policy, despite the imminent risk of entering the Excessive Deficit Procedure (EDP). On March 4, 2020, due to recording an ESA deficit of over 3.8% of GDP in 2019, the EC notified Romania of the triggering of the EDP and recommended the correction of the budget deficit by 2022 at the latest. In April, in the context of the declaration of the COVID-19 pandemic, although fiscal rules at European level were suspended, the decision was maintained, but the "general escape clause" from the provisions of the SGP was applied for the 2020-2021 period with the amendment that *the adjustment of the deficit towards a sustainable level must remain a priority objective of fiscal policy during this period*. The results of the 2020 budget execution were strongly affected by the impact of the pandemic, the cash budget deficit standing at 9.7% and, respectively, at 9.2% of GDP in ESA 2010 terms, due to a massive under-execution of the initially estimated revenues, amid the worsening macroeconomic indicators and the implementation of the facility to postpone the payment of budgetary obligations by economic agents, coupled with the increase of budgetary expenditures in order to finance measures to combat the social and economic effects generated by the pandemic. The structural deficit deteriorated significantly, reaching 7.5% of potential GDP, according to the EC, by 2.8 pp above the previous year's value, deepening the deviation from the medium-term objective.

Investment expenditures continued their upward trend in 2020, registering a level of 5% of GDP, amid an investment recovery that has significantly contributed to the mitigation of the economic downturn. The Fiscal Council considers that, through a good use of the European funds made available to Romania, it is possible to strengthen this investment trend in the coming years.

In 2020, investment expenditures continued their upward trend manifested since 2018, their execution reaching a level of 5% of GDP, which denotes a 0.9 pp increase compared to the previous year. It should be noted that, in the context of extremely high uncertainties generated by the evolution of the pandemic and of the closure of some economic sectors in the first part of the year, by supplementing investment expenditures from domestic funds, the positive evolution of this budgetary aggregate contributed to mitigating the economic downturn in 2020. Achieving a much better absorption of European funds in the 2014-2020 financial framework and in the upcoming 2021-2027 financial framework, as well as attracting the additional resources provided by the facility of the recovery and resilience mechanism, are prerequisites for the investment trend to strengthen significantly in the coming years.

The Fiscal Council advocates stepping up efforts to implement public investment reform measures in order to take full advantage of the extraordinary opportunity to use a significant amount of European funds.

Given the limited progress made in the reform of public investment management, the FC advocates increasing transparency and a better prioritization of public investment, streamlining the allocation and spending of public money, increasing investment in research, development and innovation, in physical and digital infrastructure. In this sense, the *National Recovery and Resilience Plan (NRRP)* developed in line with Romania's key investment priorities will support the consolidation of public investments through the possibility of accessing European funds of over 60 billion euros[1]. It should be emphasized, however, that Romania's contribution to the EU budget corresponding to this period must be subtracted from the above-mentioned volume of resources[2].

In 2020, the collection efficiency index registered a level of 0.85 for direct taxes paid by the population

The collection efficiency index for direct taxes paid by the population registered a level of 0.85 in 2020, compared to 0.78 in 2019. The collection efficiency index for direct taxes paid by

[1] Out of these, 29.2 billion euros through the Recovery and Resilience Mechanism, 30.3 billion euros through the 2021-2027 multiannual financial framework, excluding funds for agriculture which amount to approximately 20.8 billion euros.

[2] Including the supplementary contribution to the EU budget related to the European recovery and resilience mechanism.

(compared to 0.78 in 2019), of 0.20 for direct taxes paid by enterprises (compared to 0.26 in 2019), of 0.71 in the case of VAT (compared to 0.69 in 2019) and remained at 0.76 in the case of social security contributions. Given the significant volume of budgetary obligations deferred from payment by economic agents, data estimates are provisional and the values of the collection efficiency index should be treated with caution.

enterprises recorded a level of 0.20 in 2020, compared to 0.26 in 2019. The analysis of the revenue structure related to this budgetary aggregate indicated a broad decline in the corporate income tax paid by commercial banks. At the same time, it should be noted that, in the context of the significant volume of budgetary obligations deferred from payment by economic agents, the estimates for these categories of taxes (according to the ESA methodology) are provisional and the results should be treated with caution.

In the case of VAT revenues, the collection efficiency index was 0.71 in 2020, compared to 0.69 in 2019. In what concerns the revenues from social security contributions, the collection efficiency index maintained a value of 0.76 both in 2019 and 2020.

Romania has a very low level of both budget revenues and tax revenues relative to GDP, ranking on the penultimate place in the EU in 2020, similar to the 2016-2019 period.

Romania’s budget revenues amounted to 33% of GDP in 2020, according to the ESA 2010 methodology, being 13.1 pp below the European average and among the lowest in the EU27, followed only by Ireland. The level of tax revenues (taxes and social security contributions) was 27.1% of GDP, also on the penultimate place, with a gap of 14 pp compared to the EU27 average. The share of tax revenues in GDP for Romania is significantly lower than the ones recorded by Hungary (36.3%), Slovenia (37.7%), Poland (36.7%) and Czechia (36.1%). This situation is also the result of large-scale fiscal easing which led to a reduction in the share of budget revenues in GDP by 2.4 pp in 2020 compared to 2015, and of tax revenues by 0.9 pp in GDP while, across the EU27, their share increased by 0.3 and 0.6 pp of GDP, respectively.

Regarding the efficiency and streamlining of the tax administration, the reform initiated in Romania in this field seems to stagnate, with unsatisfactory results from the perspective of budget revenues relative to the need for post-pandemic economic recovery and the obligation to reduce the budget deficit, following the placement of our country in the EDP in 2020. The Fiscal Council

Romania's position at the bottom of the ranking from the perspective of collecting budget revenues as a share of GDP in the last 5 years is also the effect of an insufficiently modernized tax administration, reforms initiated in this sense being slow, or being canceled, as in the case of the *Revenue Administration Modernization Project* (initiated in 2013 and abandoned in 2019, a program similar to the one completed in Bulgaria between 2002 and 2008 with very good results). The launch of the *Strengthening the capacity of NAFA to support modernization initiatives* program in 2019, aimed at introducing electronic public services oriented towards the business environment, respectively, the launch in March 2021 of the *2021-2024 Digital Strategy*, can restart a real reform of the tax administration. It should be noted that, from the

considers that sustained efforts are needed to increase investment in the tax administration infrastructure and, particularly, in digital technology.

perspective of the *Digital Economy and Society Index*, according to the Report prepared by the EC in 2020, Romania was placed 26th in the EU28 in 2019. The FC considers that sustained efforts are needed to increase investment in the tax administration infrastructure, and especially in the digital one - which have the potential to improve the functioning of public institutions, with an effect on increasing tax revenues.

Regarding the budgetary reserve fund available to the government, in 2020 there was a significant deterioration in its use, both in terms of the total expenditures incurred and the number of Government decisions adopted in order to allocate amounts from this fund. The total amount of expenditures incurred in 2020 represents the maximum of the analyzed period (2007-2020).

The deterioration of the framework for the use of the reserve fund appears both from the perspective of the total expenditures incurred in 2020, and from the perspective of the number of Government decisions adopted in order to allocate amounts from this fund. Excluding those expenditures generated by the socio-economic effects induced by the pandemic and other urgent expenditures, most of the budgetary reserve fund was used for expenditures that do not fall into the category of urgent and should have been taken into account when elaborating the annual budget. Thus, in 2020, about 8 billion lei were allocated from the budgetary reserve fund (1.9% of total expenditures, respectively 0.8% of GDP), out of which 4.6 billion lei to the central administration and 3.4 billion lei to the local one. Compared to the previous year, the total allocations from the reserve fund increased by 54%, transfers to the central administration by 7.8%, while transfers to local authorities increased 3.6 times.

The Fiscal Council considers that it is necessary to amend the legislation governing the use of the reserve fund.

The FC considers that it is necessary to amend the legislation governing the use of the reserve fund, reiterating the recommendation to explicitly specify the expenditures that can be incurred from the reserve fund together with greater transparency, including by regularly reporting to Parliament on the manner and level of use of the reserve fund.

Starting with 2016, the implementation of discretionary increases in permanent expenditures has led to an increasingly rigid structure of budgetary expenditures.

In 2020, personnel and social assistance expenditures amounted to 94.3% relative to tax

Starting from 2016, with the implementation of the new Fiscal Code which led to a large fiscal relaxation (with effects on reducing budget revenues), the appeal to discretionary increases of permanent expenditures has been perpetuated, resulting in an increasingly rigid structure of budgetary expenditures. It should be noted that the fast increase in public sector wage expenditures has led to Romania occupying, from 2018, the first place in the EU in terms of their share in total fiscal and budgetary revenues. At the same time, the increase of the pension point by 65% between 2017 and 2020 (following discretionary indexations), led to an increase

revenues (including social security contributions). This situation is not sustainable and the very high level of the structural budget deficit requires the initiation of a correction process.

in the share of social assistance expenditures related to total budget revenues from 37.7% in 2017 to 40.8% in 2020 .

In 2020, a peak of personnel and social assistance expenditures was reached, which was equivalent to 94.3% relative to tax revenues (including social security contributions), respectively 23.9% of GDP. This situation is not sustainable, given that it is located at the level of permanent expenditure categories, and requires corrective actions.

In 2020, public debt increased to 47.3% of GDP. According to the Fiscal Council's assessments on the macroeconomic scenario from the Convergence Program, public debt will continue to increase up to 54.1% in 2023, the trajectory reversing in 2024 when it is forecasted to decrease to 53% of GDP. In a scenario of decreasing the budget deficit by only 1 pp per year, compared to 1.6 pp in the baseline scenario, the share of public debt in GDP would continue to increase in the 2021-2024 period.

Public debt, measured according to the ESA 2010 methodology, increased by about 125.7 billion lei (+33.6%) in 2020 compared to the previous year amid the COVID-19 pandemic and Government programs undertaken to mitigate the economic downturn, while its share in GDP increased significantly by 12 pp from 35.3% to 47.3%. According to FC's assessments, in the baseline scenario represented by the official data of the NCSP and MF[3], the public debt will continue to increase up to 54.1% in 2023, the trajectory reversing in 2024 when it is forecasted to decrease to 53% of GDP. Under the conditions of a less optimistic scenario, namely decreasing the budget deficit as a share of GDP by only 1 pp per year, compared to 1.6 pp in the baseline scenario of the MF, public debt would remain on an upward trajectory, reaching a significantly higher level of about 58% of GDP in 2024. This development would occur in the context of a budget deficit that does not stabilize public debt (as a share of GDP) during the 2021-2024 period[4]. Both the baseline scenario and the alternative scenarios involve significant risks.

The acute moment of the crisis caused by the COVID-19 pandemic has been overcome in most economies, the latest forecasts for 2021 indicating a comeback of real GDP in the global economy and in the EU27. The EC and the IMF,

The economic shock caused by the pandemic is one of the most significant in recent history, having, in the case of Romania, the particularity of a relatively rapid return of real GDP to pre-pandemic levels. The most acute moment of the crisis has been overcome in most economies - both developed and emerging - also through fiscal and monetary policies that have boosted economic activity. The most recent forecasts for 2021 indicate a comeback of real GDP

[3] For the real economic growth rate: 5% (2021), 4.8% (2022), 5% (2023), respectively 4.9% (2024); for the GDP deflator: 3.2% (2021), 3% (2022), 2.9% (2023), respectively 2.8% (2024); for interest expenses on public debt (share of GDP): 1.5% (2021), 1.5% (2022), 1.5% (2023), respectively 1.4% (2024); for the budget deficit (share of GDP): 8% (2021), 6.2% (2022), 4.4% (2023), respectively 2.9% (2024).

[4] An average budget deficit of about 4% of GDP would lead to the stabilization of the public debt trajectory as a share of GDP during the 2021-2024 period.

respectively, anticipate for Romania an economic growth of 5.1% and 7%, respectively, in 2021. The NBR forecasts an increase in CPI inflation up to 4.1% by the end of the year.

in the global economy (+6%) and in the EU27 (+4.2%), with the resumption of economic growth being anticipated in the case of the vast majority of countries for the second quarter of the current year.

The EC anticipates for Romania an economic growth of 5.1% in 2021 (below the IMF estimate of +7%), its driving factors being private consumption and gross fixed capital formation. On the other hand, the latest NBR projections place the annual CPI inflation rate at 4.1% at the end of 2021. The increase in inflation is due to temporary elements, outside the scope of monetary policy, mainly related to the prices of fuels and energy goods along with disruptions in international supply chains.

According to the latest available data, the nominal GDP on which the draft budget for 2021 was built appears to be underestimated, which could lead to higher fiscal/budgetary revenues.

The latest data published by the NIS suggests a credible range for economic growth substantially higher than the 4.3% value on which the draft budget for 2021 was built. Given a cautious projection of the GDP deflator, nominal GDP growth for 2021 appears to be underestimated, which could lead to higher fiscal/budgetary revenues, assuming a more alert dynamics of the economy and its reflection in the collection of taxes at normal levels from a historical perspective.

The draft budget for 2021 and the FS for 2021-2023 signal a change in the approach of fiscal-budgetary policy compared to previous years, projecting a gradual correction of deficits (cash, ESA, structural) in the medium term, as well as a different philosophy of constructing the public budget from the perspective of the sustainability of public finances. However, it should be noted that the significant reduction of the cash deficit, planned for 2021, is mainly supported by exceptional elements and to a lesser extent by structural adjustment measures.

2021 represents an important challenge for Romania because it must trigger a broad process of fiscal-budgetary consolidation that aims to gradually reduce the deficit over the coming years. The position of public finances is complicated by the high level of the structural deficit (7.5% of potential GDP in 2020, according to the EC estimate), so that most of the budget deficit is structural in nature and will continue to manifest itself in the future. The draft budget for 2021 and the FS for 2021-2023 signal a change in approach to fiscal policy compared to previous years, projecting a gradual correction of deficits (cash, ESA, structural) in the medium term, as well as a different philosophy of constructing the public budget from the perspective of the sustainability of public finances. In its Opinion on these documents, the FC considered as feasible the achievement of the budget deficit target for 2021, both according to the cash (7.16% of GDP) and European (8.23% of GDP) methodologies. It should be noted that the significant reduction of the cash deficit, planned for 2021 (about -2.5 pp of GDP compared to the previous year), is mainly supported by two exceptional elements: the amounts expected to be collected in 2021 from the budget obligations related to the previous year that were deferred from payment by economic agents and the fact that, at the time of elaborating the budget draft, the Government expected to lease the 5G frequency bands in 2021. However, these elements are not structural adjustment measures, so the ESA 2010 budget balance is projected to improve significantly less than the cash one.

The medium-term adjustment is mainly explained by a significant reduction in the share of budgetary expenditures in GDP, while the share of tax revenues remains relatively constant. In this regard, the Fiscal Council pointed out that, although the fiscal-budgetary consolidation process must envisage a restructuring of budgetary expenditures, it is absolutely necessary to increase fiscal revenues.

The medium-term adjustment projected by the FS for 2021-2023 is mainly explained by a significant reduction in the share of budgetary expenditures in GDP, while the share of tax revenues remains relatively constant. In this regard, the FC pointed out that, although the fiscal-budgetary consolidation process must envisage a restructuring of budgetary expenditures, it is absolutely necessary to increase fiscal revenues, an adjustment made only on the expenditure side being very difficult and unlikely to materialize at the levels estimated by the MF. In this regard, an increase in budget revenues as a share of GDP could come from: improving collection efficiency, broadening the tax base, narrowing down exceptions that negatively deviate taxes paid by some taxpayers from standard rates, firmly combating tax evasion and unfair tax competition, as well as optimizing tax rates.

The decision of the most developed countries on the implementation of a global minimum corporate income tax, adopted at the G7 meeting held in the UK in June 2021, is auspicious for combating tax evasion and tax optimization.

The Fiscal Council appreciates, based on the budget execution in the first 4 months of the year, that the budget deficit target for 2021 is feasible, being possible to register more favorable developments than those considered when elaborating the budget draft. Under these conditions, the Fiscal Council recommends that the potential revenue surplus be used to reduce the budget deficit in 2021, thus easing the fiscal-budgetary consolidation efforts in the coming years.

The FC appreciates, based on the budget execution in the first 4 months of the year, that the budget deficit target for 2021 is feasible, being possible to register more favorable developments than those considered when elaborating the budget draft. This is attributable to a better execution, compared to the initial projections of budget revenues, having as main sources the faster than expected economic recovery and the conservative assessment of budget revenues by the MF which, in the draft budget, estimated a limited recovery of the amounts deferred from payment by economic agents in 2020. On the other hand, the budget expenditures related to the execution in the first 4 months of the year reveal possibly insufficient allocations at the level of personnel expenditures, social assistance expenditures, as well as those with goods and services. This situation raises questions about the ability to ensure a strict control of budget expenditures for the current year. Given that the revenues in addition to those projected in the budget will probably be higher compared to the need for supplementary allocations for permanent expenditures, the FC recommends that the favorable difference be used to reduce the budget deficit in 2021, thus easing the fiscal-budgetary consolidation efforts in the coming years.

The years to come remain very complicated. Not only the process of fiscal/budgetary consolidation in Romania requires a discipline of the adjustment steps, but also the international context, despite the obvious economic recovery, remains with many uncertainties and risks. Public and private debt has risen sharply in many countries[5], there are strong inflationary pressures that can influence inflationary expectations, there are geopolitical tensions and unconventional risks such as cyber-attacks that jeopardize the basic components of a country's critical infrastructure. Financial markets are already tightening access to funding, which is reflected in the yields required on investments.

This changing context is an additional argument that strengthens the Fiscal Council's plea for increasing fiscal and budgetary revenues. Even if the necessary macroeconomic correction occurs, unfavorable developments at the international level may negatively affect Romania’s financing cost. The tightening of financing conditions is also correlated with possible outflows of funds from emerging economies.

Therefore, although the pandemic is not definitively defeated, which requires support programs in the economy and in the medical sector, since 2021 may register a lower deficit than the initial forecast, it is recommended to use these reserves to support the budgetary consolidation. Uncertainties about the economic dynamics in the coming years may affect the macroeconomic adjustment.

Consequently, the need for Romania to make the most of the European funds included in the multiannual financial framework and in the NRRP is even more acute.

The macroeconomic consolidation, it should be emphasized, does not derive from the NRRP, but from the fact that we cannot persist with large budget deficits that would invalidate any scenario of stabilizing the public debt as a share of GDP, that would destabilize the economy and force a disorderly correction with great economic and social damage. It should not be overlooked, as is often the case in the public debate, that Romania entered the EDP before the outbreak of the pandemic. In other words, it is not the NRRP that requires budgetary consolidation, but the economic reason that demands a reduction of imbalances (budgetary and external) in a credible way, in a foreseeable future. This correction takes into account the impact of the pandemic and the suspension of fiscal rules in 2021 and 2022.

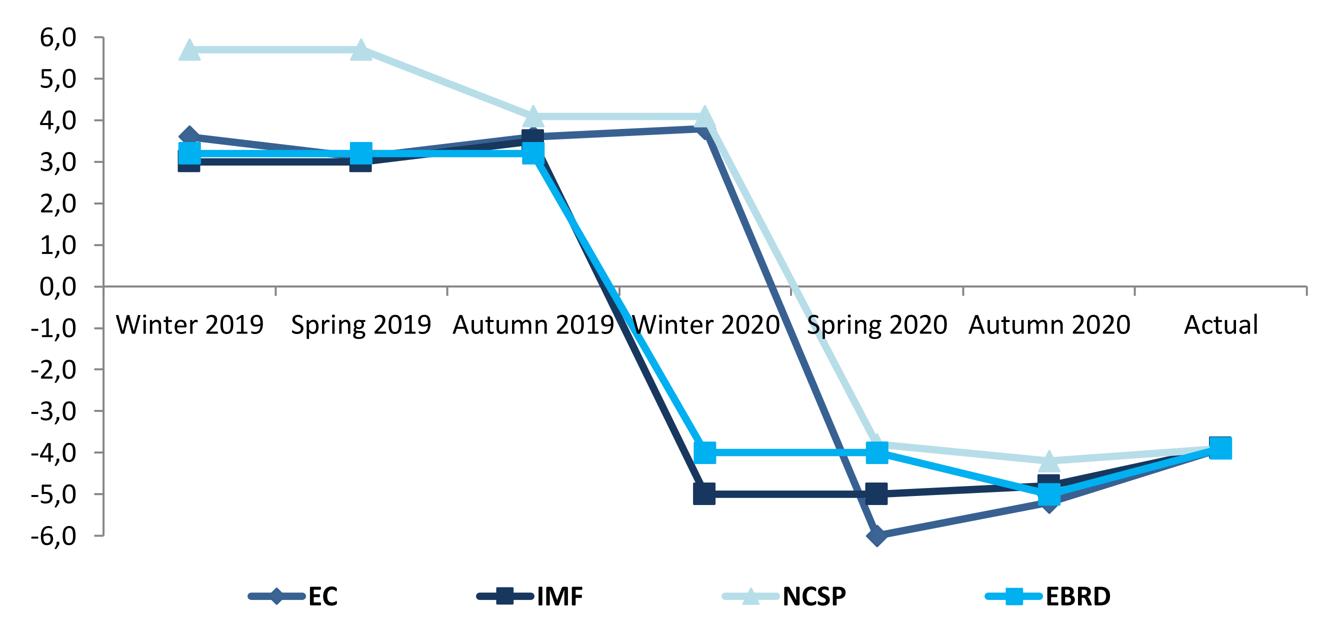
European funds and the NRRP help ease the implementation of the macroeconomic correction and increase the robustness of the Romanian economy.

[5] According to the EC, public debt at EU level increased from 79.1% of GDP in 2019 to 92.4% in 2020, and that of euro area countries from 85.8% of GDP in 2019 to 100% in 2020. According to provisional data published by Eurostat, the EU countries with the most significant dynamics of public debt as a share of GDP in 2020 compared to 2019 were Greece (+25.1 pp), Spain (+24.5 pp) and Cyprus (+24.2 pp), while at the level of private debt Belgium (+21.2 pp), Spain (+17.9 pp) and Greece (+14.7 pp) recorded the highest dynamics.

II. Macroeconomic framework in 2020

The economic activity in Romania was severely affected in 2020 by the COVID-19 pandemic, its macroeconomic impact in the world being the most severe in the last 40 year registering, according to the provisional data (2) of the National Institute of Statistics on April 8, 2021, a contraction of 3.9% in real terms compared to an advance of 4.1% in the previous year. Thus, after a period of successive increases starting with 2011, the restrictions adopted to limit spread of the coronavirus have strongly affected both supply and demand. The expenditure on final consumption of households and non-profit institutions serving households contributed to economic decline by 3.2 pp, falling for the first time since the crisis years 2009 and 2010, whereas on the supply side, the value added from industry contributed significantly to the contraction of real GDP, by 1.9 pp. The trajectory of the Romanian economy was in line with the global and the European trends, the most affected EU countries being Spain (-10.8%), Italy (-8.9%) and Greece (-8.2%). On average, the economy of the 27 EU Member States decreased by 6.1% in real terms, Romania being placed in the group of European countries with the smallest decreases. The European Commission forecasts that Romanian economy will return to the pre-crisis levels by the end of 2021[6].

Figure 1: The evolution of economic growth forecasts for 2020



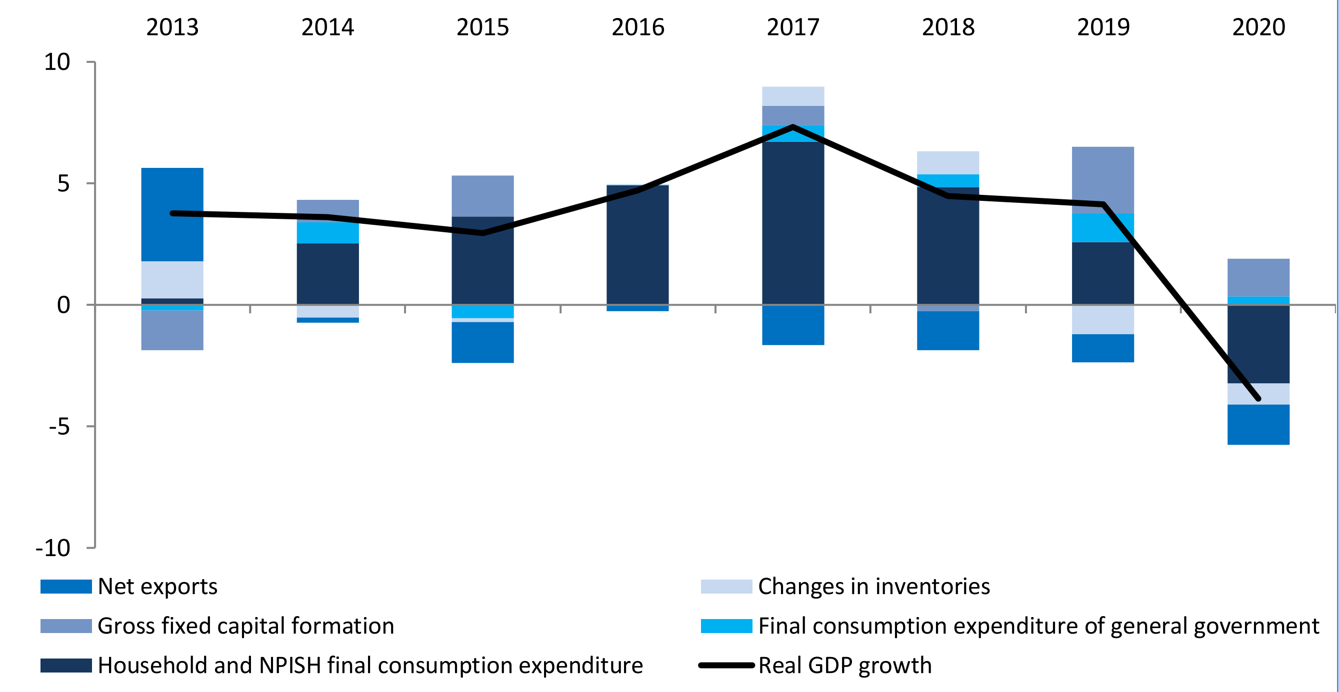
Source: EC, International Monetary Fund (IMF), National Commission for Strategy and Prognosis (NCSP), European Bank for Reconstruction and Development (EBRD)

Analyzing *Figure 1*, one can observe that the forecasts of EC, IMF and EBRD from 2019 situated the economic growth in Romania in 2020 in the range of 3-3.5%. The NCSP forecasts were slightly more

[6] According to the European Commission Spring 2021 Economic Forecast.

optimistic, over 5%. Subsequently, the projections were revised downwards, as the SARS-CoV-2 virus spread, and states began to impose restrictions to combat the pandemic, their results being felt in the results of first quarters of 2020 which showed evolutions significantly lower than expected in 2019. In the end, the GDP growth rate was close to the NCSP's autumn projections, with a large recovery of the Romanian economy in the second half of the year.

Figure 2: Contributions to real GDP growth



Source: Eurostat, Fiscal Council's calculations

On the demand side (see *Figure 2*), only gross fixed capital formation and government consumption (both individual and collective) made a positive contribution to the real GDP growth of 1.5 pp and 0.4 pp, respectively. The positive evolution of gross fixed capital formation (+6.8% in real terms) was supported by the construction sector, especially residential and engineering constructions, which was not affected by mobility restrictions. The pandemic context required the supplementation of funds allocated to the health and social areas in order to limit the spread of the SARS-CoV-2 virus, which led to an increase in government consumption (+2% in real terms compared to the same period in 2019). The other areas of activity had negative contributions, noting in this regard the expenditures for final consumption of households and non-profit institutions serving households, with a negative contribution of -3.2 pp, followed by net exports (-1.6 pp) and change in inventories (-0.9 pp). The restrictions imposed have severely affected the consumer spending of the population, the main driver of growth in most previous years, especially as a result of declining services for the population[7]. Disruptions in global supply chains and declining external demand reduced exports (-9.7% in real terms compared to the same period

[7] According to the January 2021 Monthly Bulletin published by the NBR, revenues from market services provided to the population decreased by 45% in annual terms.

of last year), imports contracting by only 5.1% given the increase in domestic investment demand. The change in inventories registered a negative contribution (-0.9 pp) given that demand could not be covered by domestic production and imports.

On the supply side, the decline in GDP was determined by almost all sectors of the national economy[8], with the largest negative contributions being made by:

- industry (-1.9 pp), with a share in GDP formation of 19.7%, amid declining industrial production (-9.2%[9]) caused mainly by very low external demand;
- wholesale and retail trade; repair of motor vehicles and motorcycles; transport and storage; hotels and restaurants (-0.9 pp) with a share in GDP formation of 17.9%;
- entertainment, cultural and recreational activities; repairs of household products and other services (-0.8 pp) with a share in GDP formation of 2.5%;
- agriculture, forestry and fisheries (-0.7 pp) with a contribution to GDP formation of 3.9% amid climatic conditions that have negatively affected agricultural production;
- net taxes on products with a contribution of -0.9 pp to the erosion of the real GDP dynamics.

One can note the positive evolutions in the construction and information and communication industries, each with a contribution to GDP growth of +0.6 pp and a share in GDP formation of 6.6% and 6.8%, respectively, as well as in the public administration and defense, social security in the public system, education, health, and social assistance (+0.1 pp) with a share in GDP formation of 15.1%.

Unlike 2019, which was characterized by inflation rates between 3.32% (January) and 4.12% (July), 2020 recorded slightly lower inflation rates, below 4% for the first three months of the year, respectively below 3% for the other nine months[10]. The inflation rate at the end of 2020 (2.06%), as well as the average annual inflation of 2.63% were below the values of 3% and 3.1%, respectively, taken into account when elaborating the 2020-2022 Fiscal Strategy. CPI inflation adjusted to eliminate the effects of changes in taxes and duties has been declining over the year 2020: after ending 2019 at 3.7%, it gradually decreased to 3% (first quarter), 2.6% (second quarter), 2.3% (third quarter) and 1.8% (fourth quarter), respectively. Growth in the economy as a whole, as measured by the GDP deflator, stood at 3.6% in 2020.

The year 2020 began with a decrease in the inflation rate, which interrupted its upward trend in the last two months of the previous year, so that at the end of March there was a decrease of about 1 pp compared to the level recorded in December 2019. At the same time, starting with February 2020, the inflation rate returned within the range of variation +/- 1 pp associated with the stationary target of 2.5%. To this evolution contributed mainly the significant reduction in fuel prices (mainly due to the decrease in the excise duty applied to them, but also as a result of the decrease in the international price

[8] According to the NIS press release of April 8, 2021.

[9] According to the February 2021 Monthly Bulletin published by the NBR.

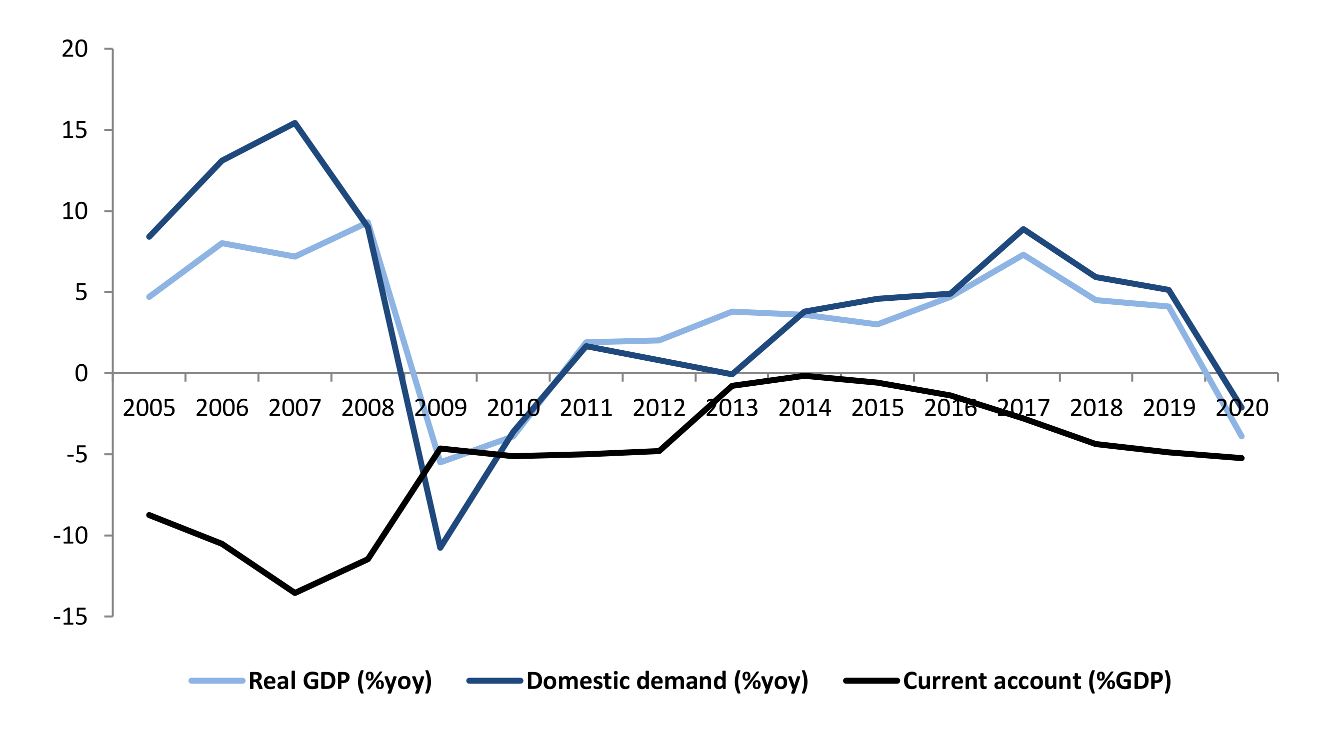
[10] According to the inflation reports from May 2020, August 2020, November 2020 and March 2021, published by the NBR.

of crude oil), as well as the manifestation of a basic effect on food products. On the other hand, the effects of the COVID-19 pandemic on supply and sales chains, respectively on the consumption of essential goods, and the March 2020 depreciation of the national currency acted in the direction of increasing the annual inflation rate. The second quarter of 2020 saw the continuation of the downward trend in inflation, which registered a level of 2.58% at the end of June, located in the immediate vicinity of the stationary target of 2.5% and representing a decrease of 0.47 pp compared to March. This inflation path was mainly determined by the significant correction in crude oil prices on international markets amid a contraction in aggregate demand and uncertainties about the future evolution of the pandemic and economic activity. The third quarter started with a slight increase in inflation to 2.8%, followed by a gradual decrease to 2.45% at the end of September 2020, a decrease of 0.13 pp compared to June. The inflation trajectory in this quarter was mainly marked by the beneficial effect of the favorable fruit and vegetable harvest (obtained at national and European level). The fourth quarter recorded the downward trend in inflation, which continued to fall in the lower half of the +/- 1 pp range associated with the stationary target of 2.5%, reaching 2.06% at the end of December. This evolution is the result of a favorable fruit and vegetable harvest, but is accentuated by the manifestation of beneficial base effects due to rising prices for some processed foods in the last quarter of 2019. Unlike the CPI inflation rate, adjusted CORE2 inflation remained relatively stable at around 3.7% during the first three quarters of 2020, declining to 3.3% at the end of December amid the favorable base effects mentioned above.

Given the evolution of inflation and the macroeconomic situation during 2020, the NBR operated a series of reductions in the monetary policy interest rate from 2.5% to 2% (in March), then to 1.75% (in June), respectively at 1.5% (in August), this level being maintained until the end of the year. As regards the minimum required reserve ratio, it was maintained at 8% in the case of national currency liabilities, while for foreign currency liabilities two successive decreases were recorded: from 8% to 6% (in February), respectively at 5% (in November).

With regard to the external position, 2020 recorded the continuation of the increasing trend of the current account deficit, reaching the level of 5.2% of GDP compared to 4.9% in 2019, amid an increase of 0.5 billion euro (+4.7%) compared to the previous year, while nominal GDP contracted by 2.2%. The deepening trajectory of the current account deficit over the last 5 years raises questions about the evolution of external imbalances and the degree of competitiveness, the European Scoreboard setting an alert threshold when the average current account deficit of the last 3 years exceeds 4% of GDP. In the case of Romania, this average reached the level of 4.8% of GDP, thus exceeding this threshold, the Romanian economy being characterized by a high level of twin deficits that raise important challenges for the country's economic stability. This is also mentioned in the European Commission's Country Report for 2020, noting that the economic growth model applied in recent years, based on tax cuts and wage increases, is unsustainable and contributes to deepening the current account deficit and budget deficit.

Figure 3: The evolution of real GDP, domestic demand and current account balance between 2005-2020



Source: NBR, Eurostat, Fiscal Council's calculations

The increase in the current account deficit was caused, mainly, by the deepening deficit of the balance of goods and services from 9.2 billion euros in 2019 to 9.7 billion euros in 2020 (the situation being determined by the evolution of the balance of goods deteriorated by 1.3 billion euros, while the balance of services registered a surplus by about 0.8 billion euros over the previous year). Favorable contributions to the evolution of the current account deficit also had the secondary income[11] balance, whose surplus increased by 0.5 billion euros, while the negative balance of the primary income[12] balance

[11] Secondary income denotes the current transfers between residents and non-residents. A transfer is an entry that corresponds to the provision of a good, service, financial asset, or other asset when there is no corresponding return of an item of economic value. Current transfers are classified by the institutional sector providing or receiving the transfer: general government or other sectors. Current transfers of the general government include current taxes on income, wealth etc., social contributions, social benefits, current international cooperation, miscellaneous current transfers and the contribution to the EU budget (calculated based on value added tax and gross national income). Current transfers of other sectors include current taxes on income, wealth etc., social contributions, social benefits, net non-life insurance premiums, non-life insurance claims, miscellaneous current transfers (personal transfers between resident and non-resident households, including workers' remittances).

[12] Primary income denotes the income received for the contribution to the production process, for the provision of financial assets and for renting natural resources, as reflected by the flows between residents and non-residents. Primary income includes the compensation of employees, investment income and other income (such as taxes on production and imports and subsidies on products and production).

deepened by 0.48 billion euros. Exports of goods and services, in nominal terms, decreased in 2020, registering a deceleration by 9.8% compared to the previous year (-8.9 billion euros), this evolution being significantly lower than the advance of 5.3% recorded in 2019 amid the coronavirus pandemic. Imports experienced similar evolution (-8.4%, representing -8.3 billion euros).

Analyzing the change in the current account balance in terms of its expression as the difference between the saving rate and the investment rate, it is noted that the saving rate increased by 0.4 pp compared to the previous year, while the investment rate increased by about 0.8 pp, explaining the increase in the current account deficit by 0.3 pp of GDP (from 4.9% to 5.2%). Comparing these results with 2007, when the largest current account deficit in the analyzed period (13.6% of GDP) was registered, the adjustment to the current level was made after 2009 mainly by reducing the investment rate by 6.8 pp, while the saving rate advanced by only 1.5 pp.

The direct investments of non-residents in Romania registered a level of 2.03 billion euros in 2020, a significant decrease (-60.7%) compared to 2019 when about 5.2 billion euros were recorded. Thus, there is a reversal of the moderately upward trajectory recorded in the last three years, whose annual average of 5.1 billion euros is well below that of 2007-2008 (about 8.4 billion euros). With respect to net foreign direct investment[13], they registered a decrease by 59.8% compared to the previous year, reaching the level of 2.2 billion euros. However, even in the context of the deterioration of the current account deficit, its coverage by non-debt-generating flows (represented by the balance of equity participations related to foreign direct investments, including reinvested profit and that of European funds in the nature of capital transfers) was maintained at the level of the previous year (about 70%).

In 2020, Romania's gross external debt increased by 14.7% compared to the previous year, to a level of about 126 billion euros at the end of December, its share in GDP increasing by 8.5 pp compared to the month December of the previous year, up to 57.7%. It should be noted that, prior to 2020, the share of external debt in GDP gradually decreased compared to the period 2010-2012, when the indicator was around 75%. On the other hand, the trend of accelerating the growth rate of external debt, which began in 2020, is expected to continue in the coming years.

Of the total external debt at the end of 2020, 73.7% was represented by long-term debt, this category registering a significant increase, respectively of 18.5 billion euros (24.9%) compared to the previous year. On the other hand, short-term external debt decreased by 2.4 billion euros (-6.7%), reaching the level of 33.1 billion euros, and its share in total external debt decreased by 6 pp from 32.3% in 2019 to 26.3% in 2020. Thus, one can note reversal in the tendency of restructuring the maturity of external debt which started in 2014 and was characterized by a reduction in the share of long-term debt (which stood at around 80% between 2013-2014) in favor of short-term external debt, the year 2020 recording a share of long-term external debt above 70%, given that in the previous two years this indicator was below 70%.

[13] Net foreign direct investments represent the total investments of non-residents in the domestic economy from which the residents' investments abroad are deducted.

The evolution of long-term debt in 2020 was mainly determined by the increase of the private external debt balance (0.8 billion euros) and the decrease of non-residents' deposits (-0.3 billion euros). On the other hand, the direct external public debt expanded by about 18.1 billion euros under the impact of the increase in financial loans by 3.6 billion euros and bond issues made by the MF in foreign markets, which registered an advance of 14.5 billion euros compared to the same period last year.

The dynamics of non-governmental loans continued on an upward path, registering in December 2020 an advance of 3.4% in real terms compared to the same period of the previous year. Thus, domestic currency denominated loans increased by 6.28 in real terms, while foreign currency denominated loans continued to lose ground, decreasing by 2.52% in euro equivalent. Given the pandemic context, among the factors[14] that contributed to the dynamics of lending activity can be mentioned in particular government programs aimed at mitigating the effects of the COVID-19 pandemic ("IMM Invest România" and "Noua Casă"), to which is added the trend reduction of interest rates and moratorium on the suspension of payment obligations to credit institutions[15]. Thus, the dynamization of private sector credit was due to loans denominated in lei contracted by non-financial companies through the “IMM Invest România” program and the decreasing trend of interest rates, in association with the increase in investment loans. In the case of loans granted to households, its dynamics have moderated, but remain high. The downward trend is mainly attributed to the declining tendency in consumer lending, other purposes and business development, including the contribution of the restriction of financing attracted in the form of credit lines. Also, a negative influence in this respect was the slowdown in house loans growth, which later had a recovery in the context of the acceleration of wage growth and the improvement of the labor market situation, with an increased contribution of the "Noua Casă" program.

The rate of non-performing loans continued the downward trend in previous years, reaching 3.83% in December 2020, compared to 4.09% in December 2019 amid moratoriums on the suspension of payment obligations to credit institutions. In the same vein, from a macroprudential standpoint, a comfortable liquidity can be found at the level of the banking system, the loan/deposit ratio for the non-governmental sector being situated below the 100% threshold (67.1% in December 2020, compared to 72.77% in December 2019).

The positive evolution of the lending activity in 2020 is due both to the dynamics of loans granted to the household loans (+2.65% in real terms) and to the dynamics of loans granted to non-financial companies (+3.15% in real terms). In the case of household loans, the advance is due exclusively to the loans granted in lei (+6.91% in real terms), while loans granted in foreign currency suffered a decrease of 10.74% in euro equivalent. Regarding the segment of non-financial companies, the positive change was also determined by the increase in credit flows in lei (+5.61% in real terms), while foreign currency loans contracted slightly (-0.18% in euro equivalent).

[14] According to the March 2021 inflation report published by the NBR.

[15] The possibility granted to some natural and legal persons, through GEO no. 37/2020, to postpone the payment of installments due on loans for a maximum period of nine months, starting from April 2020 and until December 31, 2020.

In 2020, against the backdrop of government support measures adopted, the labor market was less affected by the Pandemic shock, the average number of employees decreasing slightly (-1.4% compared to the previous year) to 5.1 million people[16], and the ILO unemployment rate rose by 1.1 pp to 5%.

In 2020, the gross average monthly wage across the entire economy amounted to 5,164 lei[17] (+6.4% compared to 2019). Thus, the net average wage was 3,188 lei, up by 6.8% over the previous year, and the real wage increased by only 4% due to the average annual inflation of 2.6%.

Given the obligation of the Fiscal Council to include in its annual report an *ex post* evaluation of the macroeconomic and budgetary forecasts included in the Fiscal Strategy that is the subject of the report (according to art. 61 of the FRL), *Table 1* exhibits the main macroeconomic forecasts of 2020-2022 Fiscal Strategy compared to the values actually achieved in 2020, according to the latest available data.

Table 1: Main macroeconomic indicators in 2020 (Fiscal Strategy forecast versus actual)

	Fiscal Strategy 2020-2022	Actual 2020
	- % change, year on year -	
GDP		
GDP (million lei)	1,129,218.1	1,055,548.8
Real GDP	4.1	-3.9
GDP deflator	4.2	3.8
GDP Components		
Final consumption	4.5	-4.0
Private consumption expenditure	4.9	-5.2
Government consumption expenditure	3.2	2.0
Gross fixed capital formation	6.8	6.8
Exports (volume)	4.5	-9.7
Imports (volume)	5.8	-5.1
Inflation		
December 2020	3.0	2.1
Annual average	3.1	2.6
Labor market		
ILO unemployment rate (end of period)	3.8	5.0
Average number of employees	1.9	-1.4
Net average wage	9.9	6.8

Source: NCSP, Eurostat, MF

[16] According to the NCSP's Spring Forecast from April 2021.

[17] According to the NCSP's Spring Forecast from April 2021.

III. Fiscal policy in 2020

III.1. Main features of the fiscal-budgetary policy in 2020

After in 2019 the budget deficit recorded a significant increase up to 4.6% of GDP in national standards, respectively 4.4% of GDP according to the ESA 2010 methodology, the year 2020 brought additional challenges for the Romania's fiscal policy in the context of efforts to combat the effects of the COVID-19 pandemic. The main features of the fiscal/budgetary policy are summarized below, and will be detailed later in this report:

- Even given the budgetary slippage registered in 2019, the approved budget for 2020 maintained the expansionary stance of fiscal policy. Thus, in the 2020 budget were included the increase of the pension point by 40% from September 1, 2020 (decision with major impact on the medium term) and the continuation of salary increases in the public sector, to which were added several fiscal easing measures, approved after the adoption of the budget, like the reduction of excise duties on energy products, the elimination of over-taxation for part-time employees and the abrogation of the additional taxation in the energy and the banking sectors, established by GEO no. 114/2018. In this context, the FC estimated for 2020 a budget deficit of 4.6-4.8% of GDP and warned that additional measures on budget revenues and expenditures are needed to control the deficit;

- The manifestation of the COVID-19 pandemic effects starting with March 2020 led to the adoption of the first budget rectification in April, in response to the severe deterioration of the macroeconomic framework, the Government estimating an increase of the budget deficit up to 6.7% of GDP. The accelerated growth of the budget deficit has led to a large increase in the need for funding, and the high structural deficit has limited the Government's room for maneuver in combating the effects of the pandemic.

- The next two budgetary amendments revised upwards the projections for the budget deficit forecasted by the Government to 8.6% of GDP and, respectively, to 9.1% of GDP, owing mainly to the additional deterioration of the macroeconomic framework, and also to the facility to defer the payment of obligations due by the economic agents (subsequently extended up to 12 months by submitting an request for the outstanding tax obligations until 31 March 2021), to the accelerated VAT refunds in order to inject liquidity in the economy and to some one-off type of measures aiming at combating the effects of the COVID pandemic. At the same time, the second amendment revised the planned increase in the pension point from +40% to +14%, which led to a significant reduction in the budget expenditures for 2020 and on the medium term;

- The 2020 budget execution, according to the cash methodology, recorded a deficit of 9.7% of GDP, by 0.6 pp above the projection from the third revision, given lower than estimate fiscal revenues as a result of the facility to defer the payment of budgetary obligations due by the economic agents, and to the under-execution of current expenditures, partially counterbalanced by higher than planned capital expenditures;

- The last years highlighted two important vulnerabilities of the fiscal/budgetary policy in Romania: a) the very low level of tax revenues, including social security contributions (27.1% of GDP), compared to the EU countries; b) the increasing rigidification in the structure of budget expenditures with an unfavorable impact on the structural deficit. Thus, in 2020, a peak was reached for personnel and social assistance expenditures, representing 94.3% of tax revenues (including social security contributions) and 23.9% of GDP, respectively. This situation is not sustainable as it is located at the level of permanent expenditures;

- Although fiscal rules were suspended in the EU in 2020 with an extension of the derogation in 2021, given the high level of headline deficit in Romania a correction targeting its substantial diminishing on medium term is needed to anchor the creditor's expectations towards a sustainable trajectory envisioned for the fiscal policy. The announcement of a credible multi-annual fiscal consolidation plan can provide the necessary respite for a gradual correction aiming at impacting the economic recovery as little as possible;

- The fiscal consolidation process needs to consider the restructuring of budgetary expenditures, but it is absolutely necessary to increase fiscal revenues in order to strengthen the robustness of the public budget given current acute needs, including in the field of public health and public education, and future pressures from climate change and other unconventional threats;

- It is difficult to imagine achieving budgetary consolidation during the 2021-2024 period in the absence of a significant increase in budget revenues. This could come from: improving collection efficiency, broadening the tax base, narrowing exceptions and loopholes that negatively deviate taxes paid by some taxpayers from standard rates, firmly combating tax evasion and unfair tax competition and optimizing tax rates;

- Romania is facing a historic opportunity, with allocations of 30.3 billion euros under the cohesion policy related to the EU multiannual financial framework for the 2021-2027 period, supplemented by 29.2 billion euros (14.3 billion euros in grants and 14.9 billion euros in the form of loans) through the Recovery and Resilience Mechanism (RRM). Romania's chance consists in absorbing these funds as much as possible, leading, on the side of macroeconomic stabilization, to the strengthening contribution of the investment factor to the increase the potential and real GDP and to the mitigation of the contractionary impact of the macroeconomic correction, and on the real economy side to the implementation of structural reforms, directly and indirectly supporting the process of fiscal consolidation in a period of constrained budgetary expenditures for this purpose.

III.2. The assessment of objectives, targets and budgetary indicators

According to article 61, para. (2) of the Fiscal Responsibility Law no 69/2010 republished (FRL), the Fiscal Council's Annual Report must contain: "*an analysis of the fiscal policy implemented during the previous year compared to the objectives that were set out in the Fiscal Strategy and the annual budget*" and will include:

> *a) An ex-post evaluation of the macroeconomic and budgetary forecasts set out in the Fiscal Strategy and the annual budget to which the Annual Report corresponds, including the reporting, where applicable, of any persistent deviations in the same direction of macroeconomic forecasts compared to actual data, which were recorded over a period of at least 4 consecutive years;*
>
> *b) An assessment of objectives, targets and indicators set out in the Fiscal Strategy and annual budget to which the Annual Report corresponds;*
>
> *c) An assessment of the Government's compliance with the principles and rules of this law during the preceding budget year;*
>
> *d) Recommendations and opinions of the Fiscal Council aimed at improving the conduct of fiscal policy during the current year, according to the principles and rules of this law.*

In order to characterize the fiscal-budgetary framework for 2020, given the extraordinary circumstances for this year, are analyzed: the draft budget for 2020 - in the context of the prevailing fiscal rules at the moment of its elaboration, the execution and the budgetary revisions made in the situation of declaring the manifestation of extraordinary circumstances and suspending the fiscal rules in European Union starting with March 2020. Another important subject further analyzed refers to the launching of the excessive deficit procedure against Romania.

The draft budget for 2020

According to article 26, para. (1) of the FRL, until July 31st of each year, the Ministry of Finance (MF) is required to submit to the Government the Fiscal Strategy for the next 3 years accompanied by the draft law approving the ceilings specified in the fiscal framework. The Fiscal Strategy (FS) for the period 2020-2022 was elaborated and approved in December 2019, just few days before drafting the 2020 budget proposal[18], which implied that both documents set out an identical fiscal framework for 2020. Under these circumstances, the requirement for the Fiscal Council (FC) to assess in its Annual Report the objectives, targets and indicators established through the Fiscal Strategy and the annual budget is reduced to an *ex-post* analysis of the projections set out in the draft budget, the *ex-ante* assessment of the compliance with the rules regarding the limits defined for the budgetary indicators stipulated by the Law of ceilings being irrelevant in this situation, similar with the previous years. Even if the FRL stipulates at art. 33, lit. c) the possibility of revising the fiscal-budgetary framework as defined in the FS in the case

[18] The FS was received by the FC on December 10, 2019, and the (initial) 2020 budget proposal on December 16, 2019.

of changing the Government, considering the repeated non-observance of the legal calendar of elaboration and approval of the FS over the last years, the Fiscal Council notice that the perpetuation of this situation undermines the role of guidance that a medium-term fiscal and budgetary strategy must have for the budget, the strategy being used only for short-term objectives.

Following the promotion of an expansionary fiscal policy since 2016, with systematic deviations from national fiscal-budgetary rules, that made them mostly inoperable, the end of 2019 marked the deepening of the structural deficit at the highest level in the EU and also, the exceeding of the 3% of GDP deficit threshold in ESA standards. Thus, the FS for the period 2020-2022[19] had as a starting point a cash headline deficit of 4.43% of GDP (compared to the target of 2.76% of GDP for 2019[20]). The structural adjustment for 2020 was planned, according to the FS, at a level of 0.32 pp (respectively from 3.71% to 3.39% of potential GDP), considerably lower than in the EU Council recommendation issued in the context of the Significant Deviation Procedure from the MTO (SDP), namely 1% of potential GDP in 2020.

The General Consolidated Budget for 2020 was backed by a macroeconomic scenario that predicted a GDP real growth of 4.1%, with a projected headline deficit of 3.59% of GDP according to the national methodology (3.58% of GDP in ESA standards). In its opinion regarding the *2020 State Budget Law*, the FC appreciated that, by the way of drafting the 2020 budget and the associated medium-term budgetary framework, was maintained the expansionary stance of the fiscal-budgetary policy, even in the situation of the imminent risk of entering the Excessive Deficit Procedure (EDP), as the headline deficit reduction aimed for 2020 was, at that moment, based only on temporary elements. The FC mentioned in its Opinions[21] a series of problematic aspects regarding the construction of the 2020 budget and the associated medium-term framework, among which we mention:

- cash deficit reduction of 0.84 pp of GDP[22] compared to the estimated level for 2019, respectively, in ESA terms by only 0.23 pp was based on one-off elements - car tax refunds made in 2019 and rent in 2020 of 5G frequency bands for the next 10 years by mobile operators (cumulative 4.9 billion lei);
- the level of structural adjustment of 0.32 pp of GDP proposed for 2020 was significantly lower than in the EU Council recommendation issued in November 2019 in the context of the SDP (1%

[19] In the initial form of the FS received by the FC on December 10, 2019, the forecasted level of the headline deficit for 2019 was 4.3% of GDP (see the FC Opinion prepared on December 12, 2019, http://www.fiscalcouncil.ro/FC's%20opinion%20on%20the%20FS%20for%202020-2022.pdf).

[20] Corresponding in the FS 2020-2022 to an ESA deficit of 3.82% of GDP in 2019. The latest data published by Eurostat (May 2021) indicate an ESA deficit of 4.4% of GDP for 2019.

[21] Respectively, the preliminary Opinion issued in December 18, 2019 (see, http://www.fiscalcouncil.ro/Preliminary%20opinion%20of%20the%20Fiscal%20Council%20on%20the%20State%20Budget%20Law%20and%20the%20Social%20Security%20budget%20Law%20for%202020.pdf) and the final one, issued in January 22, 2020, based on a modified data set received on December 16, 2019 (see, http://www.fiscalcouncil.ro/FC%E2%80%99s%20Opinion%20on%20the%20budget%20for%202020.pdf)

[22] Based on exceptional elements - reimbursements on account of the car tax made in 2019 and the rental in 2020 of 5G frequency bands for the next 10 years by mobile operators (amounting to a total of 4.9 billion lei).

of potential GDP in 2020). At the time of drafting the 2020 budget, the data indicated a structural deficit of 3.5%[23] of potential GDP, by 0.8 pp of GDP over the previous year (2.7% of GDP);

- the level of the budget deficit estimated by the FC[24], was above the MF target by 1-1.2 pp of GDP, backed by a negative revenue gap due to an oversized starting point (the 2019 revenues), a macroeconomic framework considered as optimistic, and not taking into account by the MF of certain initiatives[25] that were in the final stage of the legislative process and could impact negatively the budget revenues as well as the underestimation of budget expenditures (goods and services and social assistance);
- not enough measures have been identified to offset the budget slippage, which seemed to deepen on the medium term, leading to the accumulation of public debt and increased vulnerability of the public finances, the fiscal space being practically exhausted;
- accommodating large-scale pressures on social assistance expenditures[26] through a discretionary reduction of capital expenditures and maintaining a lower than the nominal GDP growth rate for personnel as well for goods and services expenditures;
- the balance of risks related to the budget balance for 2020 was tilted on the negative side;
- the medium-term fiscal-budgetary outlook, considering the medium-term policy conduct according to the FS 2020-2022, suggested increasing levels of the budget deficit, thus implying the need to adopt large-scale corrective measures to restore the fiscal-budgetary situation on a sustainable path.

Triggering the excessive deficit procedure against Romania

Since June 2017, Romania has been subject to the Significant Deviation Procedure from the MTO (SDP) - a component of the preventive arm of the Stability and Growth Pact (SGP). Although placed twice consecutively in the SDP, the Romanian authorities ignored all EC recommendations from 2017-2019 on reducing the structural deficit. The last notification from the EC on the deviation from the MTO, in November 2019, stated that, in addition, a foreseeable exceeding of the 3% of GDP threshold of the budget deficit would occur. The Fiscal Council has repeatedly warned in the period 2016-2019, on the risk of repeatedly targeting a budget deficit in the vicinity of the 3% of GDP ceiling, that was likely to create the conditions for exceeding the threshold provided by the European treaties, in the conditions of the downward phase of the economic cycle, expected to start, most likely, in 2020.

[23] The latest AMECO data (May 2021) indicate for 2019 a structural deficit of 5% of potential GDP, by 1.8 pp higher compared to the previous year

[24] Based on the available data at the time of drafting the budget.

[25] These measures were approved after drafting the initial budget, respectively: the reduction of excise duties on energy products, the elimination of over-taxation of part-time employees and the abrogation of the additional taxation of the energy and banking sector established by GEO no. 114/2018. Cumulatively, these measures have reduced budget revenues by about 0.5 pp of GDP.

[26] Determined by the expected increase in pensions by 40% from 1 September 2020.

The results of the budget execution for 2019, with a deficit in terms of ESA 2010 of 3.82% of GDP[27], as estimated at that time, determined, in February 2020, the EC to analyze according to Article 126 (3) the Romania's budgetary situation. The EC Report[28] noted that Romania did not comply with the deficit criterion provided in the Treaty, qualifying the opening of the excessive deficit procedure (EDP). The Economic and Financial Committee agreed with this assessment in its opinion of 24 February 2020, and in March the **EC notified Romania of the launch of the EDP** - the component of the corrective arm of the SGP.

The *EC Recommendation* of 4 March 2020[29] envisaged the correction of the actual budget deficit (ESA 2010), according to an adjustment calendar[30] to put an end to the excessive deficit situation by 2022 at the latest. The EC also recommended supporting fiscal consolidation through structural reforms, in line with the recommendations addressed to Romania in the context of the European Semester and in the framework of the *Macroeconomic Imbalance Procedure*. The deadline established by the notification for Romania to take effective measures, in accordance with art. 3 para. (4a) of Regulation (EC) no. 1467/97, and to report in detail on the consolidation strategy envisaged for achieving the targets was set for September 15, 2020.

Despite the fact that in the context of declaring the pandemic caused by SARS-COV-2, the fiscal rules were suspended at European level to allow the automatic stabilizers to operate and for taking measures to combat the economic effects of the pandemic, the **EC sent a letter to the MF on April 6th, 2020, confirming the launch of the EDP by virtue of the fact that the breaches of European fiscal rules - transposed by the FRL at national level - preceded the pandemic and, therefore, were not caused by it**. However, the reporting deadline was maintained under the mention that the EC assessment of the effective actions taken in response to the Recommendation will account for the economic and fiscal impact of the COVID-19 pandemic, as well as for the implications of triggering the SGP derogation clause.

Given the global economic and budgetary impact of the pandemic, as well as the uncertain horizon of the post-COVID recovery, it became obvious that the budget deficit targets, set for Romania under the EDP, could not have been achieved. Thus, the EC Report of September 2020[31] analyzed the measures taken by the Romanian authorities in the context of the pandemic’s evolution, concluding that if in the short term the government's efforts focused on mitigating the effects of the pandemic, in the medium

[27] The latest Eurostat update estimates the deficit at 4.4% of GDP (May 2021).

[28] 21.02.2020 https://ec.europa.eu/info/sites/default/files/economy-finance/commission_report_on_romania_126-3.pdf

[29] https://ec.europa.eu/info/files/126-7-recommendation-council-recommendation-end-excessive-deficit-situation_en

[30] It set the following targets for the ESA headline deficit: 3.6 % of GDP in 2020, 3.4% of GDP in 2021 and 2.8% of GDP in 2022, corresponding to nominal growth rates for the net primary expenditure of 8.2% in 2020, 5.5% in 2021 and 2022, and annual structural adjustments of 0.5% of GDP in 2020, 0.8% of GDP in 2021, and 0.8% of GDP in 2022.

[31] https://ec.europa.eu/info/sites/default/files/economy-finance/raport_edp_2020_final_en.pdf

term they should be aimed at effectively supporting the economy, by placing on an adjusting budget deficit path.

On 18 November 2020, the EC published the *Communiqué on the fiscal situation in Romania*[32], which, analyzing the circumstances for the upward budget deficit in 2020, concluded that it was only partially explained by the deteriorating economic outlook and by the introduction of emergency measures to combat the pandemic, being in fact determined by structural elements existing before the outbreak of the Pandemic. Given the exceptional uncertainty created by the COVID-19 pandemic, the EC had not taken any decision on EDP-related measures, but had stressed that the fiscal outlook remained very unfavorable, requiring substantial new structural actions, both on the revenue and expenditure side, to put the deficit on a downward trajectory, thus avoiding the sharp rise in public debt as a percentage of GDP. On 2 June, the EC re-examined Romania's budgetary situation[33], including the fiscal risks, based on the 2020 budget execution data, on the 2021 budget and the EC's spring forecast, and reiterated that the significant deterioration of the 2020 budget deficit was partly determined by the fiscal measures taken in the context of the COVID-19 pandemic and by the economic downturn, being mainly driven by the expansionist measures previously taken. The deadline for closing the EDP was set for 2024, while the fiscal adjustment should have been supported by the European funds allocated to Romania, the reforms to be taken in the pension sector, tax administration, public personnel wages and by the budget consolidation measures. In this regard, the Government of Romania had the obligation to send a plan of measures by October 15, 2021.

Even Romania benefited in 2020 (with an extension in the period 2021-2022[34]) from the "general derogation clause" from the provisions of the SGP, nevertheless the adjustment of the deficit to a sustainable level must remain a priority objective of the fiscal-budgetary policy in this period.

The three budget amendments during 2020

Starting with March 2020, in the circumstances of declaring the pandemic caused by the SARS-CoV-2, the temporary derogation from the Stability and Growth Pact was activated at European level, the budgetary rules being temporarily suspended. In this context, are presented below the evolution of the main budgetary aggregates during the year and the assessment of the compliance with the fiscal rules, exclusively through the modification of the ceilings according to the budget revision laws**.**

Table 2 presents the limits specified in the initial fiscal-budgetary framework (established by Law no. 238/2019) and, respectively, by the three budgetary amendments made during the year. The figures in italics represent the values of the indicators recalculated with updated data for the nominal GDP (1,055.5 billion lei, from 1,129.2 billion lei in the initial budget). It is worth to note that for all indicators significant increases were made during the year in line with the negative effects generated by the evolution of the Pandemic on the budget revenues and expenditures.

[32] https://ec.europa.eu/info/files/communication-fiscal-situation-romania_en

[33] https://data.consilium.europa.eu/doc/document/ST-9433-2021-ADD-1/en/pdf

[34] EC Communiqué of March 3, 2021, https://ec.europa.eu/commission/presscorner/detail/en/ip_21_884

Table 2: Nominal ceilings for GCB balance, total and personnel expenditure												
	Law no. 238/2019			GEO no. 50/2020			GEO no. 135/2020			GEO no. 201/2020		
	GCB balance	Total expenditure*	of which: Personnel expenditure	GCB balance	Total expenditure*	of which: Personnel expenditure	GCB balance	Total expenditure*	of which: Personnel expenditure	GCB balance	Total expenditure*	of which: Personnel expenditure
billion lei	**-40.6**	**371.6**	**109.8**	**-73.4**	**381.3**	**109.7**	**-91.0**	**391.3**	**111.8**	**-96.1**	**394.3**	**111.11**
% of GDP budget draft	**-3.6%**	**32.9%**	**9.7%**	**-6.8%**	**35.2%**	**10.1%**	**-8.6%**	**37.0%**	**10.6%**	**-9.1%**	**37.5%**	**10.6%**
% of GDP budget execution	-3.9%	35.2%	10.4%	-7.0%	36.1%	10.4%	-8.6%	37.1%	10.6%	-9.1%	37.4%	10.5%

** Excluding financial assistance from the EU and other donors*

Source: MF, Eurostat

The first 2020 budget revision (approved by GEO no. 50/2020, further amended by Law no. 115/2020) was elaborated in the conditions of the Government announcement regarding the manifestation of extraordinary circumstances allowing, according to art. 8 of the FRL, the temporary deviation from the requirements of the fiscal rules established by the FRL. The FC validated the manifestation of extraordinary circumstances, stating that, after their termination, there is a legal obligation to adopt fiscal-budgetary policy measures leading to an improvement of the structural balance of the general consolidated budget at least equal to the requirements of the SGP.

To be mentioned that the FC valued the macroeconomic scenario assumed by the Government, with a decline of the real GDP by 1.9%, as very optimistic and appreciated as prudent and necessary to consider two more macroeconomic scenarios for the contraction of the real GDP: a realistic one, with a GDP decline in the interval 4%-6%, and a pessimistic one, in the interval 8%-9%.

The budget revision recorded a downward adjustment of the total estimated revenues of GCB by 19.05 billion lei, while the total budget expenditures increased by 12.9 billion lei. Thus, the projected budget deficit increased by 31.95 billion lei and, respectively, by 3.1 pp of GDP compared to the initial target.

<u>The downward revision in the revenue</u> was made for almost all categories of budget revenues from the domestic economy, being largely attributable to the deterioration of the macroeconomic framework, while a favorable impact was generated by the additional amounts received from the EU to counteract the negative effects associated with the COVID-19 pandemic.

By revenue categories, the initial budget estimates, considering values net of swap[35], were significantly reduced:

[35] In the amount of 850 million lei, similar to the initial budget. Swap represents a chain compensation scheme for outstanding obligations to GCB; an operation that settle the outstanding budgetary obligations with an equivalent impact on revenue and expenditure.

- *Fiscal revenues*, by -13.1 billion lei, of which: *profit tax* receipts (-2.3 billion lei, with the amendment that, by changing the way of declaring and paying the profit tax[36], the estimate for 2020 included some receipts that would normally have been made in the first quarter of 2021); those from *personal income tax* (-1.55 billion lei); *VAT* receipts (-5.6 billion lei, considered by the FC in line with the updated macroeconomic framework); *excise duties* (-2.69 billion lei);
- *Social contributions*, by -8.4 billion lei. FC appreciated the new value for this budgetary aggregate as optimistic, indicating a revenue gap of about 1.1 billion lei;
- *Non-fiscal revenues*, by -1.44 billion lei, MF evaluating the reduction of dividends distributed by state companies as a result of decreased profitability.

Other amounts received from the EU for the operational programs financed under the convergence objective were increased by 3.92 billion lei, the additional amounts were received for partially financing the measures adopted in the context of the fight against the COVID-19 pandemic.

The upward revision in total expenditure was due to the supplementary amounts allocated to support the fight against the pandemic's effects on public health and economic activity, the main increases being addressed for *social assistance* expenditures, mostly for technical unemployment measures and for the *reserve funds*, with the necessary amounts to combat the effects of the pandemic. The following categories of expenses have been increased:

- *Personnel expenses*, by 0.6 billion lei, for the payment of the medical personnel working in the first-line fight against the COVID-19 pandemic, the bonuses granted to them were financed by European funds;
- *Reserve funds*, by 3 billion lei, which subsequently were to be distributed by budgetary categories according to actual needs;
- *Goods and services*, by 0.5 billion lei, FC considering the new level as considerable undersized, even not taking into account the additional needs generated by the fight against the COVID-19 pandemic;
- *Other expenses*, by 1.4 billion lei, for the amounts designed for parents who stood at home with their children, according to the provisions of Law no. 19/2020;
- *Social assistance*, by 6.8 billion lei, of which: 1.8 billion lei for supporting the liberal professions and other categories that do not fall under the technical unemployment category, according to GEO no. 32/2020; 4 billion lei as additional amounts for the technical unemployment payments; 1 billion lei for increasing the funds needed for medical leave compensation;
- *Capital expenditures*, by 1 billion lei, for supplementing the amounts related to the National Local Development Program.

[36] Carried out at the budget revision - thus, voluntarily, taxpayers could choose to pay the tax on quarterly profit in advance, receiving a bonus between 5% and 10% of the amount of the payment obligation. Thus, the receipts according to the cash methodology related to 2020 are favorably influenced by the appeal to this facility, and those according to ESA decrease with the bonus paid.

FC revealed in its Opinion a likely overestimation of budget revenues by at least 0.3% of GDP (mainly for the *personal income tax*, *other income taxes*, *profit and capital gains*, *social contributions*) and the underestimation of budget expenditures by at least 0.3-0.45% of GDP (*goods and services* by 0.2-0.3% of GDP and *social assistance* - payments for technical unemployment by 0.1-0.15% of GDP), assessing a budget deficit for 2020 in the range of 7.3-7.45% of GDP, under the macroeconomic framework assumed by the Government (built on a real GDP contraction of 1.9%, considered by the FC as optimistic). For the macroeconomic scenario considered as realistic by FC (contraction of real GDP between 4 and 6%), the budget deficit estimate was in the range of 8.1-8.9% of GDP.

The second budget revision[37] (approved by GEO no. 135/2020 and GEO no. 136/2020), increased both the total GCB revenues and expenditures by 0.92 billion lei, respectively, by 19.42 billion lei, the budget deficit deepening by another 18.5 billion lei compared to the previous estimate, respectively to 8.6% of GDP, by 1.9 pp above the formerly forecasted level, against the background of the further deterioration of the macroeconomic framework, of some additional weaknesses of the budget construction, and implementation of new discretionary measures on the budgetary expenditure side. Excluding the increase of 1.1 billion lei for the swap schemes compared to the first revision, the budget revenues decreased by 0.18 billion lei, while the budget expenditures increased by 18.3 billion lei.

The macroeconomic forecast that substantiated the budget was modified in the sense predicted by the FC in its Opinion on the first revision, respectively, a real GDP contraction of 3.8%, close to the lower limit of the range 4-6% anticipated by the FC.

As for the GCB total revenue' structure, the budgetary revenues from the domestic economy were significantly diminished (-8.6 billion lei), being apparently offset by the increase of the amounts received from the EU /other donors on account of payments made and pre-financings related to the financial framework. 2014-2020 (+8.47 billion lei).

The amendments were made mostly in the downward direction compared to previous estimates for the budget revenues (excluding the swap scheme), as follows:

- *Fiscal revenues* were reduced by 6.8 billion lei, of which: *profit tax* (-0.54 billion lei), *personal income tax* (-0.3 billion lei, in line with current execution and the new forecast regarding the average number of employees in the economy and average gross wages), *other taxes on income, profit and capital gains* (-0.5 billion lei); *VAT* (-5.4 billion lei, in line with the updated macroeconomic framework, and accelerating VAT refunds in order to inject liquidity into the economy and eliminating the over-excise duty on fuels), *excise duties* (+0.16 billion lei, amid a favorable impact of higher excise duties on tobacco products than anticipated);

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[37] The revised budget proposal was sent to the FC on August, 13, for which a Preliminary Opinion was issued on August, 14 (http://www.fiscalcouncil.ro/Traducere%20corectata%20opinie%20preliminara%20R2.pdf). As there were differences between the form published in the Official Gazette and the one initially sent, at the request of FC, MF completed and updated the dataset, and FC issued an updated Opinion on August, 31 (http://www.fiscalcouncil.ro/FC%20opinion%20second%20budget%20revision%202020.pdf).

- *Social contributions*: -1.3 billion lei, in line with the FC's remark regarding an overvaluation of about 1.1 billion lei noted in its Opinion on the first budget revision and the revaluation of the macroeconomic indicators;
- *Non-fiscal revenues*: -0.53 billion lei;
- *Amounts received from the EU/ other donors on account of payments made and pre-financing related to the financial framework 2014-2020*: +8.47 billion lei, of which European funds whose recipient is the state[38] with only 1.35 billion lei, the rest being directed to the private sector (agriculture (+2 billion lei) and for pre-financing projects of the non-governmental sector in case of temporary unavailability of European funds, based on Article 10 of GEO No. 40/2015 (+5.1 billion lei)).

It should be noted that fiscal revenues and social security contributions, according to the *GEO's Note substantiating the state budget revision for 2020*, *the amendment of normative acts and passing some budgetary measures*, included amounts of 7 billion lei[39] from the recovery by NAFA from the economic agents of the fiscal obligations postponed according to the provisions of GEO no. 29/2020 until the end of 2020 (0.9 billion lei for *profit tax* and *income tax on micro-enterprises*, 0.4 billion lei for *personal income tax*, 2.9 billion lei for *VAT*, 0.2 billion lei for *excise duties* and 2.6 billion lei for *social contributions*). FC expressed reservations regarding the expected recovery degree of the amounts deferred for payment by economic agents, in a context characterized by a high uncertainty.

<u>Budget expenditures</u> (excluding swaps) were increased by 18.3 billion lei, with the following amendments compared to previous estimates:

- *Personnel expenses:* +1.17 billion lei for public health units, representing risk incentive, bonuses for special risk conditions, overtime, the bonuses granted being financed by European funds;
- *Goods and services*: +3.1 billion lei. Considering the growth rate of the first 7 months and the context of pandemic fight, FC noted the under-sizing of this aggregate by about 0.3 – 0.5% of GDP;
- *Reserve funds*: +2.16 billion lei, to be distributed later by budget categories according to actual needs;
- *Interest:* +1.72 billion lei, due to the increase in financing needs, borrowing costs and the depreciation of the national currency;
- *Subsidies*: +0.7 billion lei;
- *Other transfers*: +1.02 billion lei, of which +0.5 billion lei to supplement Romania's contribution to the EU budget;

[38] From the perspective of the ESA 2010 methodology, only the structural funds whose final beneficiary is the state are relevant, the amounts directed toward agriculture and the pre-financings granted to the non-governmental sector not being included in the public administration sector.

[39] The MF estimated that this facility would lead to late collection compared to the initial planning of an amount of about 10 billion lei, to which it applied a collection rate of about 70%, a hypothesis considered reasonable by FC. Subsequently, the deadline provided by GEO no. 29/2020 (October 25, 2020) was extended until March 31, 2021.

- *Other expenses*: -0.9 billion lei related to the allowances granted to parents for the supervision of children during the period of temporary closure of educational units.
- *Social assistance*: -1.06 billion lei. Regarding its components, the *insurance budget* was reduced by 6.8 billion lei (due to the revaluation of the pension point increase starting September 1, 2020, from 40% in the initial budget to 14%), and were supplemented: the *unemployment budget* (+3 billion lei for financing measures to support employees and employers by settling a part of the salary), the *state budget* (+1.55 billion lei for the payment of social assistance rights[40] and the implementation of the approved measures to combat the effects of Pandemic) and the *Unique National Health Insurance Fund* (+0.8 billion lei needed for medical leave payment);
- *Capital expenditures*: +3.34 billion lei, of which 1.1 billion lei for supplementing the amounts related to NLDP;
- *Projects financed from non-reimbursable external funds related to the financial framework 2014-2020*: +8.55 billion lei, of which 7.1 billion lei for increasing the funds allocated to payments for *agriculture* and *pre-financing projects of the non-governmental sector in case of temporary unavailability of European funds* and 1.5 billion lei for *projects from European funds whose final beneficiary is the state*.

The FC pointed out in its opinion that, given the further deterioration in the finance position of about 0.6-0.8 pp of GDP by 2020, it would subsequently deepen the budget deficit compared to the first revision (to 8.1-8.9% of GDP[41]). Following the analysis of the measures taken for this budget revision which increased the permanent expenditures, FC highlighted that the main factors that led to the large budget slippage are of permanent nature and difficult to correct, and reiterated the importance of taking into account the extreme complicated budgetary situation, as any further increase in permanent expenditure subsequently would require equivalent corrective measures on the GCB throughout the budgetary consolidation process.

The **third budget amendment** (approved by GEO no. 201/2020), ensued in the second half of November, was based on a downward revision of the macroeconomic scenario, with a GDP contraction of 4.2%. Compared to the parameters approved by the second budget amendment, the total budget revenues were decreased by 4.2 billion lei (against the unfavorable and large-scale impact on the budget revenues of the facility for postponing the payment of budget obligations by economic agents[42]), total budget expenditures were increased by 0.8 billion lei, and the budget deficit augmented by 5 billion lei (0.5 pp of GDP), to 9.1% of GDP.

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[40] Mainly to cover the increase of the state allowance for children by 20% from August 1, 2020, the monthly allowance for raising children, the rights granted to persons with disabilities.

[41] Given a GDP contraction of 4-6%. Admitting the scenario of -3.8% GDP contraction, the deficit would have been 8% of GDP.

[42] In October 2020, the modification of this facility was approved by GEO no. 181/2020, which extended the possibility of staggering the outstanding tax obligations for 12 months by submitting an application by the end of the year, involving the payment of an interest of about 3.65% per year.

Revisions in the projection of GCB total revenues (net of swap[43]) were operated as follows:

- *Amounts received from the EU/ other donors on account of payments made and pre-financing related to the financial framework 2014-2020*: -2.2 billion lei, namely: 3 billion lei less for the *amounts transiting the consolidated general budget for pre-financing projects of the non-governmental sector in case of temporary unavailability of European funds*, *based on art. 10 of GEO no. 40/2015*, 1.1 billion lei more for the *European funds for agriculture*, while the *amounts from structural and cohesion funds* were diminished by about 0.3 billion lei;
- *Fiscal revenues*: -1.3 billion lei, of which: *profit tax*, -0.8 billion lei (lower amounts than NAFA anticipated to recover from the deferred payments); *personal income tax*: +0.27 billion lei; *property taxes and fees*: -0.3 billion lei; *VAT*: +0.4 billion lei; *excise duties*: -0.6 billion lei; *taxes on the use of goods, authorization to use goods or on carrying out activities*: -0.04 billion lei, while the estimate of 2.5 billion lei from the sale of 5G licenses by ANCOM was maintained;
- *Social contributions*: +0.3 billion lei, in line with the current budget execution, but also including the amounts recovered from the budgetary obligations deferred to payment according to NAFA estimate (about 1.9 billion lei), about FC has already expressed its reservations, appreciating as probable an important revenue gap for this category;
- *Non-fiscal revenues*: -0.87 billion lei, in line with the up-to-date budget execution.

Given the substantial change in the provisions of the deferred payment scheme of the remaining budget obligations of economic operators compared to the existing version of the August budget revision and the fact that the organization of the tender for renting 5G licenses seemed unlikely to be completed by the end of the year, FC assessed as probable the materialization of a total revenue gap in 2020 (from fiscal revenues, social contributions and other revenues) of approximately 6.5-7.5 billion lei (0.65%-0.75% of GDP) .

The increase in budget expenditures (net of swap) by 0.8 billion lei was the result of supplementing *social assistance* (+2.5 billion lei), *other transfers* (+2.1 billion lei[44]) and *goods and services* (+1 billion lei,) partially offset by the reduction in *capital spending* (-2.6 billion lei), *expenditures related to projects financed from non-reimbursable external funds* (-1.4 billion lei) and *reserve fund* (-1 billion lei[45]).

It should be mentioned that out of the increase in social assistance expenditures, two thirds (1.8 billion lei) were allocated to the *state insurance budget*, as a result of the additional need revealed by the budget execution for the first 9 months. FC requested the investigation of the causes that determined this unexpected evolution. Also, FC warned that additionally 1.4 billion lei were needed if the reversal of the decision to pay a few days in advance of the pensions distributed through the Romanian Post was

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[43] Maintained at the level planned in the second budget revision.

[44] Of which 1.5 billion lei are the amounts from the auctioning of greenhouse gas emission certificates assigned to Romania at EU level (recorded also on expenditure and revenue sides) and 0.6 billion lei for supplementing Romania's contribution to the EU budget

[45] In fact, an additional 1.2 billion lei, the amounts previously existing in the reserve fund being already spent, and found at that time in other categories of budget expenditures.

reversed.

Public investment expenditures were reduced by 2.4 billion lei (the decrease in *capital expenditures* by 2.6 billion lei[46] was marginally offset by the advance of *expenditures related to projects financed from structural funds* by 0.4 billion lei).

FC expressed reservations only for the estimate of *goods and services*, assessing a possible level of the budget deficit for 2020 according to the cash methodology around 9.8% of GDP[47], by 0.7 pp above the MF estimate, as a result of the identification of a probable revenue gap (recoverable in 2021 in cash execution), which would not influence the 2020 execution from the perspective of ESA 2010 methodology.

The budget execution

The results of the budget execution (including the swap scheme) in 2020 were strongly affected by the impact of the COVID-19 pandemic, the budget deficit in cash methodology reaching 9.66% of GDP, respectively, 101.9 billion lei, by 61.4 billion lei more than initial expectations (40.5 billion lei), respectively, by 5.8% of GDP above the initial budget (-3.84% of GDP). According to the ESA methodology, the budget deficit deepened to 97.6 billion lei, respectively, to 9.2% of GDP, significantly above the level projected in the initial budget (3.6% of GDP).

The difference between the nominal levels of the budget deficit according to the two methodologies can be explained by elements that act in both directions, respectively some that affect only the budget deficit according to the national methodology, and others only the one according to the European methodology. Thus, the main elements that explain the gap of -4.3 billion lei between the deficit according to ESA 2010 and the one according to the national methodology were represented by:

- taxes deferred to payment in 2020 and which will be collected in the coming years (-12.2 billion lei);
- property income treated as super-dividends (+1.74 billion lei)[48];
- payment of advances for the purchase of military equipment to be recognized in ESA 2010 standards only upon delivery (gap: +2.44 billion lei);
- amounts actually paid regarding the refund of the pollution tax (+3.44 billion lei);
- payment of amounts in the account of Law 85/2016 already registered in the execution of ESA in 2016 (court decisions amounting to 2.8 billion lei, payments made in the amount of 1.55 billion lei, resulting in a gap of +1.26 billion lei);
- differences in the treatment of interest expenses (-1.4 billion lei);

[46] The reduction at the state budget (by 1.6 billion lei each to MND and institutions/ activities financed entirely and/ or partially from own revenues) and the supplementation of the amounts related to NLDP by 1 billion lei.
[47] For an economic decline according to the FC forecast, the cash budget deficit would have stood at 9.9% of GDP.
[48] Respectively, from reserves previously accumulated by state-owned companies and from the NBR; the decision to oblige the distribution of additional dividends from reserves accumulated in previous years does not affect the budget deficit according to the European methodology

- differences between the receipts from social contributions and VAT according to ESA and the cash ones (-0.2 billion lei related to January 2020);
- registration as capital transfers of loans and guarantees[49] (+1.67 billion lei);
- positive contribution of consolidated state-owned companies in the public administration sector (-0.93 billion lei).

The execution of 2020 (including the swap scheme) revealed that the total revenues of GCB were significantly below the initial expectations (by 37.6 billion lei), while the total expenditures exceeded by 23.7 billion lei the initial estimates. The substantial non-realization of revenues compared to the initial budget is mainly attributable to the significant worsening of the macroeconomic framework compared to the initial projections, and to the facility granted for payment deferral of the obligations of economic agents to the GCB, while the expenditures increased due to measures taken aiming to offset the social and economic effects of the pandemic, as well as to address shortcomings in the initial budget programming or discretionary measures that increased the permanent expenditures.

Table 3: The evolution of the main budgetary aggregates during 2020 (billion lei)

	Initial budget	First revision	Second revision	Third revision	Budget execution
Total revenues, of which:	**359.3**	**340.2**	**340.1**	**335.8**	**321.3**
Tax revenues	176.2	163.1	157.4	156.0	150.7
Social security contributions	124.0	115.7	113.3	113.6	111.7
EU funds	29.3	33.2	41.7	39.5	33.6
Total expenditures, of which:	**399.8**	**412.7**	**431.1**	**431.9**	**423.3**
Current expenditures, of which:	372.6	384.5	400.1	403.5	391.9
Projects from EU funds	33.0	32.7	41.3	39.9	34.9
Capital expenditures	27.3	28.2	31.6	29.0	33.2
Budget balance	**-40.55**	**-72.50**	**-91.00**	**-96.06**	**-101.92**

Source: MF

Note: Amounts without the compensation schemes impact

Table 3 shows the evolution of the main budgetary aggregates during 2020 in cash standards, excluding swap compensation schemes.

Total budget revenues, net of swap compensation schemes (1.2 billion lei), amounted to 38 billion lei, below the initial estimate, amid the large non-realization of budget revenues from the domestic economy: *fiscal revenues* (-25.5 billion lei), *social contributions* (-12.3 billion lei, due to the weaker than initial estimate evolution of the labor market indicators and the facility to defer the payment of economic agents' obligations to GCB) and *non-fiscal revenues* (-4.1 billion lei, amid declining in the profitability of state-owned companies and, conversely, in the dividends paid) which were marginally offset by the positive evolution of the *amounts received from the EU* (+4.2 billion lei, of which: 1.2 billion

[49] Respectively, from: classification of the loan to Unifarm as unlikely to be repaid, guarantees granted to TAROM and Blue Air considered as due and provision related to the guarantees granted to the SMEs Invest program.

lei *additional amounts received from the EU to combat the COVID-19 pandemic*, 1.3 billion lei *structural funds* and 1.7 billion lei funds for *agriculture*).

Execution below expectations for the *fiscal revenues* was located at: *VAT* (-11.2 billion lei, mainly due to accelerated repayments made in 2020 and the facility on staggering the obligations of economic agents to GCB), *profit tax* (-3.8 billion, as an effect of the economic downturn and the facility on payment rescheduling), *excise duties* (-3 billion lei, following the elimination of over-excise on fuels, not included in the initial budget), *taxes on the use of goods, the authorization of the use of goods and conducting activities* (-2.9 billion lei, as a result of the postponement of the tender for the rental of 5G frequency bands by mobile operators), *personal income tax* (-2.1 billion lei) and *other taxes and duties on property* (-1.2 billion lei).

The budget expenditures were well above the initially estimated value (+23.4 billion lei). Thus, the main categories with significant increases were: *social assistance* (+7.33 billion lei, due to insufficient initial budgeting, but also to measures decided during the year), *capital expenditures* (+5.96 billion lei), *goods and services* (+5.58 billion lei, due to the initial sub-budgeting and additional amounts necessary to fight the Pandemic), *other transfers* (+1.97 billion lei), *expenses related to projects financed from non-reimbursable external funds post-accession 2014-2020* (+1.9 billion lei) and *other expenses* (+1.63 billion lei). Reductions compared to the initial level were recorded for *payments made in previous years and recovered in the current year* (-1.81 billion lei).

Table 4 shows the development of budget revenues and expenditures from the perspective of national methodology (cash), expressed as a share of GDP. The benchmarks for 2020 are the previous year and 2009, which marked the peak of the recession period generated by the economic and financial crisis triggered in 2008.

Compared to the previous year, in the context of the manifestation of the effects of the pandemic caused by SARS-COV-2 starting with March, in 2020 there was a further deterioration in the budget deficit, by about 5 pp of GDP, while budget revenues registered a slight increase of 0.2 pp of GDP, and budget expenditures, increased significantly, by 5.2 pp of GDP.

The GCB revenues that had the most unfavorable evolution were: *fiscal revenues* (-0.48 pp of GDP) and *non-fiscal revenues* (-0.22 pp of GDP), partially offset at the aggregate level by the increase in the share of *amounts received from the EU* (+ 0.8 pp) and *social security contributions* (+0.09 pp).

For *fiscal revenues*, significant decreases were recorded for *VAT revenues* (-0.42 pp), *profit tax* (-0.19 pp), *other taxes on goods and services* (-0.07 pp) and *excise duties* (-0.06 pp), partially offset by positive developments for *taxes on the use of goods, the authorization of the use of goods or the carrying out of activities* (+0.22 pp) and *personal income tax* (+0.11 pp).

It should be noted that the impact on the revenue side as an effect of the measures taken to mitigate the effects of the Pandemic, was estimated by the MF at about 2% of GDP (Convergence Program 2021-2024).

Table 4: The evolution of budgetary revenues and expenditures (cash methodology, % of GDP)									
	2009	2015	2018	2019	Initial budget 2020	Budget execution 2020	Initial budget 2020/ 2019	Execution 2020/ 2019	Execution 2020/ 2009
Total revenues	**29.6**	**32.8**	**31.0**	**30.3**	**34.0**	**30.4**	**3.8**	**0.17**	**0.8**
Tax revenues (without SSC)	16.4	19.4	15.0	14.8	16.7	14.3	1.9	-0.5	-2.1
Personal income tax	3.5	3.7	2.4	2.2	2.5	2.3	-12.3	0.1	-1.2
Corporate income tax	2.0	1.9	1.6	1.7	1.8	1.5	0.2	-0.2	-0.5
Property tax	0.6	0.8	0.6	0.6	0.7	0.6	0.1	0.0	-0.1
VAT	6.5	8.0	6.2	6.2	6.8	5.7	0.6	-0.4	-0.7
Excise duties	2.9	3.7	3.0	3.0	3.2	2.9	0.2	-0.1	0.0
Social security contributions (SSC)	9.0	8.1	10.3	10.5	11.7	10.6	1.3	0.1	1.6
Non-tax revenues	3.1	2.7	2.8	2.6	2.7	2.3	0.2	-0.2	-0.8
Donations	0.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-0.6
Amounts received from the EU for payments made	0.4	2.4	2.85	2.38	2.78	3.18	0.4	0.80	2.8
Total expenditures	**36.6**	**34.2**	**33.9**	**34.9**	**37.9**	**40.1**	**3.0**	**5.24**	**3.5**
Personnel expenditures	8.8	7.3	9.0	9.7	10.3	10.4	0.7	0.7	1.6
Goods and services	5.3	5.7	4.7	5.0	4.8	5.4	-0.2	0.3	0.0
Interest	1.1	1.3	1.4	1.1	1.3	1.4	0.2	0.2	0.2
Subsidies	1.4	0.9	0.7	0.7	0.7	0.8	0.0	0.1	-0.6
Projects funded by post-accession non-reimbursable external funds	0.5	3.4	2.6	2.6	3.1	3.3	0.5	0.7	2.8
Social assistance	12.0	10.7	10.6	10.8	12.4	13.1	1.6	2.3	1.1
Capital expenditures	4.1	2.6	2.5	2.9	2.6	3.1	-0.3	0.3	-1.0
Budget balance	**-6.95**	**-1.45**	**-2.87**	**-4.59**	**-3.84**	**-9.66**	**0.7**	**-5.07**	**-2.7**

Source: MF, Fiscal Council's calculations

Note: Amounts without the compensation schemes impact

On the budget expenditure side, compared to the previous year, there were significant increases for the following aggregates: *social assistance* (+2.28 pp of GDP, mainly due to the financing of measures to support employees and employers by settling a part from the salary, and the increase in the pension point), *personnel expenses* (+0.75 pp of GDP, against the background of granting incentives and salary increases to the personnel in the first line of the fight against the pandemic); *projects financed from post-accession non-reimbursable external funds* (+0.69 pp of GDP), *goods and services* (+0.32 pp of GDP), *capital expenditures* (+0.29 pp of GDP), *interest* (+0.23 pp of GDP, due to the increase in financing needs, borrowing costs and the depreciation of the national currency) and *subsidies* (+0.1 pp of GDP).

Compared to 2009, 2020 recorded a cash budget deficit higher by 2.7 pp of GDP, as the budget revenues increased by 0.8 pp of GDP, and total expenditures of GCB by 3.5 pp of GDP.

Table 5 shows the evolution of budget revenues and expenditures in ESA 2010 standards, expressed as a percentage of GDP. The analysis of 2020 is made compared to the developments of the previous year and, respectively, 2009.

Table 5: The evolution of budgetary revenues and expenditures (ESA 2010, % of GDP)

	2009	2015	2016	2017	2019	2020	Changes 2020/2019	Changes 2020/2009
Total revenues	**30.3**	**35.5**	**31.9**	**30.8**	**31.8**	**33.1**	**1.3**	**2.8**
Tax revenues (excluding SSC) out of which:	16.2	19.9	17.8	16.4	15.4	15.1	-0.3	-1.1
Indirect taxes, out of which:	10.2	13.3	11.3	10.3	10.6	10.4	-0.2	0.2
VAT	6.3	8.1	6.4	6.2	6.2	6.1	-0.1	-0.2
Excise and custom duties	3.9	5.2	4.9	4.1	4.4	4.3	-0.1	0.4
Direct taxes, out of which:	5.9	6.6	6.4	6.1	4.8	4.7	-0.1	-1.2
Personal income tax	3.3	3.7	3.6	3.6	2.3	...	...	...
Corporate income tax	2.3	2.3	2.2	2.0	2.1	...	...	...
Social security contributions	9.7	8.1	8.8	9.4	11.3	12.0	0.7	2.3
Other current revenues	1.4	2.1	1.6	1.6	1.1	2.1	1.0	0.7
Total expenditures	**39.4**	**36.1**	**34.5**	**33.5**	**36.2**	**42.4**	**6.2**	**3.0**
Intermediate consumption	6.0	5.9	5.6	5.2	5.6	5.9	0.3	-0.1
Compensation of employees	10.3	7.8	9.0	9.8	11.3	12.1	0.8	1.8
Interest	1.4	1.6	1.5	1.3	1.2	1.4	0.2	0.0
Social assistance	12.7	11.5	11.5	11.6	11.9	13.5	1.6	0.8
Subsidies	1.1	0.4	0.3	0.4	0.4	1.0	0.6	-0.1
Other current expenditure	1.7	2.4	1.4	1.7	1.5	2.2	0.7	0.5
Gross fixed capital formation	5.8	5.2	3.6	2.6	3.5	4.6	1.1	-1.2
Budget balance	**-9.1**	**-0.6**	**-2.6**	**-2.6**	**-4.4**	**-9.2**	**-4.8**	**-0.1**

Source: Eurostat

The fiscal consolidation process that was initiated in 2010, aiming to correct the major imbalances in the public finance position, was characterized by a fast pace, Romania succeeding in a relatively short period of time, to reduce the budget deficit according to ESA 2010 from 9.1% of GDP in 2009 to 0.6% of GDP in 2015. In 2016-2019, the loosening fiscal policy led to the reversal of this process, with a significant increase in the budget deficit compared to 2015, amid the massive decline in revenues (by 3.7 pp in 2019). In this way, the results of the fiscal consolidation process were partially canceled in an abrupt manner, the year 2019 marking the exceeding of the threshold of 3% of GDP, and Romania being placed in the EDP from March 2020. The impact of the fiscal measures taken in the context of the Pandemic massively amplified the budgetary imbalance compared to 2019, amid the increase of total GCB expenditures by 6.2 pp of GDP and of the revenues by only 1.3 pp of GDP, in 2020 the deficit reached 9.2% of GDP. It should be noted that in 2020 was exceeded by 0.1 pp of GDP the previous highest deficit reached in 2009 (9.1% of GDP) in the context of the global financial crisis.

Compared to the previous year, in 2020, *fiscal revenues* were lower by 0.3 pp of GDP, due to reductions in *indirect taxes* (-0.2 pp of GDP), and *direct taxes* (-0.1 pp of GDP), being offset by a good evolution of *social contributions* (+0.7 pp of GDP) and *other current revenues* (European funds, +1 pp of GDP). Compared to 2009, in 2020 *fiscal revenues* were lower by 1.1 pp of GDP, mainly due to *direct taxes* which decreased by 1.2 pp of GDP, as a result of the reduction in the personal income tax rate from 16% to 10% from 2018, while the increase from *social contributions* (+2.3 pp of GDP, amid the transfer of social contributions from employer to employee in 2018) and *other current revenues* (+0.7 pp of GDP), determined the increase of total revenues by 2.8 pp of GDP in 2020 compared to 2009.

In 2020, budget expenditures were by 3 pp of GDP above the 2009 level, on the background of significant increases in: *remuneration of employees* (+1.8 pp of GDP) and *social assistance* (+0.8 pp of GDP). On the other hand, decreased: *gross fixed capital formation* (-1.2 pp of GDP) and *intermediate consumption* (-0.1 pp of GDP). Compared to the previous year, the main categories that contributed to the increase in the budget expenditures by 6.2 pp of GDP were: *social assistance* (+1.6% of GDP), *gross fixed capital formation* (+1.1% of GDP) and *remuneration of employees* (+0.8 of GDP).

While the fiscal adjustment in the period 2009-2015 was mainly completed through *investment, personnel* and *social assistance* spending, in the period 2016-2020 the decrease in the last two categories was strongly reversed, especially the *remuneration of employees* that was by 4.3 pp of GDP higher in 2020 compared with 2015 (supported by high wage dynamics and the change in fiscal treatment of social contributions starting 2018), as well as *social assistance* (+2 pp of GDP), both being permanent spending categories.

The FC notes the major difference between registering high budget deficits due to the manifestation of structural elements, based on tax cuts and increased permanent expenditures legislated in recent years, as in the case of Romania and recording similar deficits in size due to the implementation of the economic support programs to counteract to the economic and social effects of the SARS-COV-2 pandemic, as is the case in many EU countries. Thus, the latter had enough room to maneuver to stimulate the economy and, in addition, have the advantage that these measures being temporary (one-off type) will not affect budget execution when the stimulus is withdrawn, as no structural measures are needed to return to a sustainable trajectory of the fiscal-budgetary policy. In addition, the recent fiscal-budgetary measures adopted during 2020 could lead to a further deterioration of the public finance position, which complicates the budgetary consolidation process in the coming years. FC notes the persistence of some risks regarding the amplification of the deterioration in the structural fiscal position, on the account of permanent expenditures increases (personnel, social assistance), that are likely to arose and supplementary complicate the situation of the public budget.

In the case of Romania, there is an additional constraint, related to the relatively large size of public debt relative to the size of domestic financial markets, which indicates a limited capacity to absorb an additional stock of public debt.

The FC emphasizes that, in the context of high funding needs in the coming years, given the aversion of financial markets to risk and to high levels of the budget deficit for a long time, even if fiscal rules in the EU remain suspended in 2021-2022, a correction that would lead to lower levels of the budget deficit on the medium term and that would anchor creditors' expectations towards a sustainable trajectory of fiscal-budgetary policy is mandatory. The announcement of a credible multi-annual fiscal consolidation plan and a maximum use of European funds made available to Romania, could be the preconditions for a gradual adjustment, which would minimize the associated economic and social costs while fueling the economic recovery.

III.3. The structural budget balance in Romania

By signing and ratifying in 2012, the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG) which stipulated a rule-based fiscal framework, for Romania the target for the structural deficit was set at a maximum of 1% of GDP[50]. The provisions of TSCG and of the Directive no. 85/2011 were incorporated into domestic law by amending the FRL in December 2013, so, beginning with 2015, the medium-term budgetary planning has been constrained by the new rule for the structural budget deficit[51]. However, while in 2015 the structural deficit stood below the 1% of GDP target, in theory, the consolidation process initiated in 2010 has been completed. But this constrained did not function anymore, **as starting with 2016 there has been a deliberate and sizeable deviation from the 1% structural deficit limit's rule. In the period 2017-2019, Romania was placed twice in the Significant Deviation Procedure from the MTO (SDP) - the preventive arm of the SGP, and from March 2020 being the only EU country placed in the EDP - the corrective arm of the SGP**.

However, it should also be considered that defining the target in terms of structural deficit implies a corresponding deficit target that is adjusted according to the position of the economy within the economic cycle. Therefore, once the output gap becomes positive, complying with the 1% of GDP target is equivalent to recording budget deficits that are actually lower than this level (because the cyclical component[52] of the budget balance will be positive). Despite the fact that structural budget balance reflects the fiscal stance of an economy more accurate, it also presents some disadvantages, the most important one being related to the uncertainties associated with its estimation. Thus, the structural balance is dependent on the output gap which, in turn, is computed based on potential GDP, an unobservable variable that is often subject to more or less significant revisions depending on adjustments concerning the statistical data and the estimation methodology. Compared to the previous FC's Annual Report, the output gap was revised significantly by the EC from 0.99% in 2018, 0.47% in 2019

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[50] The TSCG requires the contracting parties to ensure convergence towards the country-specific MTO (according to the SGP), with a structural deficit limit of 0.5% and 1% of GDP, respectively, for Member States with a public debt significantly below 60% of GDP (Romania's case). Achieving the MTO should ensure a safety margin for meeting the 3% of GDP ceiling for the ESA budget deficit and sufficient fiscal space for some discretionary measures.

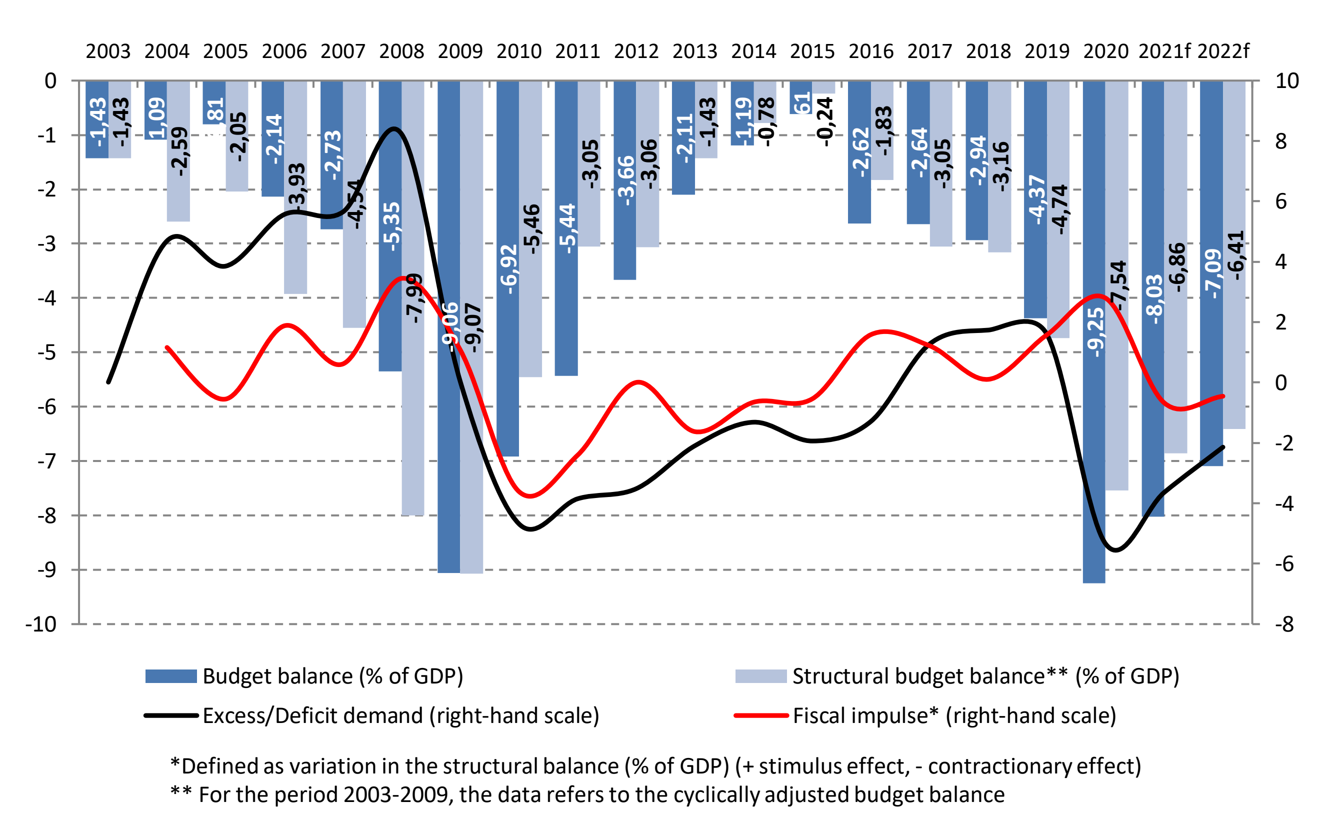
[51] It is calculated by subtracting from the actual budget balance the cyclical component of the budget deficit and the one-off and temporary measures. For details, see http://www.fiscalcouncil.ro/annualreport2012.pdf, pg. 45-57.

[52] The cyclical component of the budget balance = output gap * ε, where ε represents the semi-elasticity of the budget deficit to the economic activity changes.

and -8% in 2020 (AMECO data base, May 2020) to 1.74% in 2018, 1.59% in 2019 and -5.34% in 2020, (AMECO data base, May 2021).

The evolution of the structural deficit, the fiscal impulse and the excess of demand presented in *Figure 4* illustrates how Romania practiced mainly a pro-cyclical fiscal-budgetary policy in the period 2003-2020[53]. The discretionary policy of intense but unnecessary and counterproductive stimulation of the economy in the period of pre-crisis expansion (2006-2008) and of decelerating in the period when it operated below potential (2010-2015), by maintaining the pro-cyclical character contributed to amplifying the fluctuations of the economic cycle, the automatic, beneficial and stabilizing action of the cyclical deficit (automatic stabilizers) being thus canceled.

Figure 4: Structural deficit, fiscal impulse and excess demand



Source: AMECO, Fiscal Council`s calculations

Over the period 2009-2015, the structural budget deficit declined sharply, from 9.1% of GDP in 2009 to 0.2%, and at a fast pace, the average rate of adjustment being around 1.5 pp per year. As the starting level was very high compared to financing constraints, it required the rapid adoption of decisive measures in 2010 and 2011, when the fiscal adjustment of 3 pp annually was made predominantly on the expenditure side. This process has been reversed in a steep manner since 2016 as a result of the new Fiscal Code, which implied a broad loosening of the fiscal policy, while simultaneously regulating

[53] Except for 2005, 2016 and 2020.

significant increases in permanent spending (wages and pension benefits [54]). Continuing the expansionary fiscal stance despite a positive output gap since 2017, and deliberating circumventing the rules established by TSCG and FRL, while abandoning the structural deficit target, contributed to the rapid weakening of public finances position and since the 3% limit for the headline deficit was significantly surpassed in 2019, Romania was placed in the EDP starting with 2020, even in the context of the escape-clause activation.

Romania entered in the extremely difficult context generated by the pandemic with a structural deficit of over 4% of potential GDP, the highest in the EU, which had greatly limited the room for maneuver in combating the effects generated by pandemic, and ended 2020 with a structural deficit of 7.54% of potential GDP[55], by 2.8 pp above the previous year's value, in the circumstances of an adverse cyclical evolution[56]. In 2020, the fiscal-budgetary policy was anti-cyclical, having a strong stimulating character (fiscal impulse of 2.8 pp), against the background of the support measures and the additional necessary financing for the health sector[57], as well as the expenditure growth (increases in the pension point in 2019-2020 and child allowances) and the reductions in taxes and duties decided before the outbreak of the Pandemic (elimination of over-excise duty and tax on bank assets).

The budget law for 2021 took into account a gradual reduction of the budget deficit according to the ESA 2010 methodology starting with 2021 to below the 3% of GDP threshold by 2024. In structural terms, at the end of 2024 the deficit adjustment represents 4.6 pp of potential GDP compared to 2020, persisting a deviation of 2.6 pp from the medium-term objective. In the Convergence Program 2021-2024, the adjustment trajectory as projected in the budget law is maintained, backed by an average economic growth projected at 4.9% for this period, the consolidation being supported on the revenue side by increasing absorption rate of European funds (multiannual financial framework and the Recovery and Resilience Mechanism) and on the expenditure side, by limiting personnel and social assistance[58] spending.

Of particular note is the persistence of high uncertainties regarding macroeconomic and budgetary forecasts, generated by possible new developments of the pandemic and by the implications of the associated measures, with a major impact on current forecasts.

The FC considers as of particularly importance in order to avoid the risk of major macroeconomic and fiscal imbalances, that the adjustment process has to start in 2021, supported by a credible multi-annual fiscal consolidation plan that takes into account both the restructuring of expenditure, through a gradual

[54] Starting with 2017, ad-hoc increases of the pension point were legislated (+65% between 2017-2020).
[55] According to the AMECO database. It should be noted that the level of the structural deficit is identical in the EC assessment with that of the cyclically-adjusted deficit.
[56] According to the EC, from a demand excess of 1.6% of potential GDP in 2019 to a demand deficit of 5.3% in 2020.
[57] The impact of the support package on the ESA2010 budget deficit is estimated by the EC at 1.6% of GDP (same assessment as FC).
[58] By GEO no. 8/2021 postponing the entry into force of Law no. 127/2019 until September 1, 2023.

approach, to affect as little as possible the recovery of the economy, as well as the increase of budgetary resources through the broadest possible use of the significant volume of European funds allocated to Romania, which would support the macroeconomic correction effort in the coming years. In this regard, the FC reiterates that sound economic and fiscal governance, budgetary consolidation, is an important precondition for ensuring an environment conducive to attracting EU funds, including those allocated through the Recovery and Resilience Mechanism.

III.4. Budgetary revenues

GCB's revenues, net of the impact of the compensation schemes of the outstanding obligations towards the budget of swap type (in the amount of 1.2 billion lei), increased in 2020 by only 0.3% (corresponding to an absolute change of almost 1 billion lei) compared to the previous year, in the context of the manifestation of the effects of the COVID-19 pandemic starting with March 2020. Thus, the budgetary revenues registered the value of 321.3 billion lei, representing about 30.4% of GDP, a level that records a marginal increase compared to 30.3% of GDP in 2019. This development was mainly due to the increase in the share of *amounts received from the EU* (+0.8 pp) and *social security contributions* (+0.1 pp) which was largely offset by the decrease in the share of *tax revenues* (-0.5 pp) and *non-tax revenues* (-0.2 pp). It should be borne in mind that the *cash* outflow of tax revenues and social security contributions for 2020 was adversely affected by the granting of the facility to defer the payment of obligations of economic operators to GCB with the possibility of staggering the outstanding tax obligations for 12 months. by submitting an application by March 31, 2021. According to the latest estimates, the MF estimates the amount of these obligations at 12.2 billion lei.

At the level of *tax revenues*, the largest decreases were recorded in the case of *VAT revenues* (-0.4 pp, and against the background of accelerated VAT refunds made by the state in 2020, estimated at 2.2 billion lei), from the *corporate income tax (CIT)* (-0.2 pp), *other taxes on goods and services* (-0.1 pp) and *excise duties* (-0.1 pp), these being partially offset by the favorable evolution of revenues *on the use of goods, authorization of the use of goods and conducting activities* (+0.2 pp, as a result of a base effect, because the execution of 2019 was affected by the impact of refunds on account of car tax) and the *tax on income and salaries* (+0.1 pp, supported by the positive dynamics of the average gross earnings, this factor having a favorable impact on the receipts from *social security contributions*). Regarding *non-tax revenues* (-0.2 pp), their decrease reflects the unfavorable macroeconomic developments caused by the pandemic, which led to the reduction of the profitability of state-owned companies and, implicitly, to the decrease of dividends distributed by them. Last but not least, the evolution of *the amounts received from the EU* reflects, in addition to those intended to combat the COVID-19 pandemic, the impact of funds for agriculture [59] and pre-financing to the non-governmental sector, although they do not represent actual government revenue. Thus, the amounts related to the financial framework 2014-2020

[59] Amounts granted through the European Agricultural Guarantee Fund (EAGF), the European Agricultural Fund for Rural Development (EAFRD) and the European Fisheries and Maritime Fund (EMFF).

increased by about 7.4 billion lei compared to 2019 (the increase being 5.5 billion lei if the impact of funds for agriculture is eliminated), while the effective absorption of structural funds, calculated on the basis of EC reimbursements, advanced by almost 13.8 billion lei[60].

Compared to the initial budget projection, the impact of the COVID-19 pandemic becomes much more visible, the budgetary revenues from the execution of 2020 recording a large reduction by almost 38 billion lei. This unfavorable evolution was due to significant shortfalls recorded by almost all categories of budget revenues: *tax revenues* (-25.5 billion lei), *social security contributions* (-12.3 billion lei) and *non-tax revenues* (-4.1 billion). lei) which were marginally counterbalanced by the positive evolution of the *amounts received from the EU* (+4.2 billion lei). It should be noted that the non-achievement of the revenue targets proposed by the draft budget is largely due to the significant worsening of the macroeconomic framework compared to the initial projections, under the impact of the pandemic effects, plus the deferral of GCB payment obligations by economic agents.

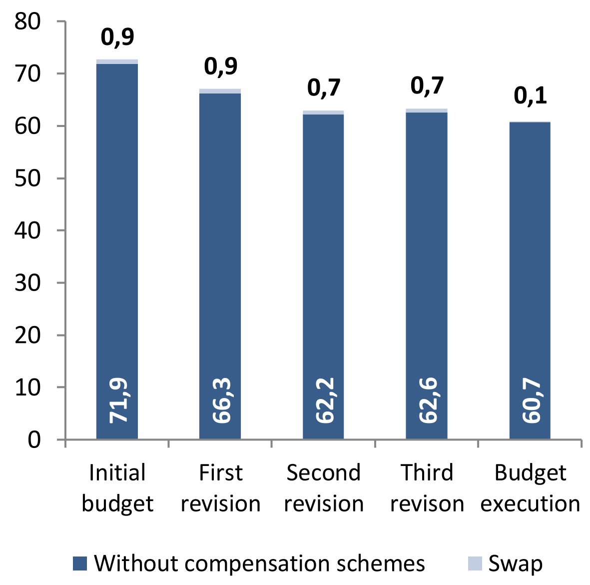
In the case of *tax revenues*, the execution below the initial projection is mainly due to *VAT receipts* (-11.2 billion lei, amid accelerated reimbursements made in 2020 and the reduction of excise duty on energy products), from *corporate income tax* (-3.8 billion lei, taking into account the higher sensitivity of this budget aggregate to large economic decreases), from *excise duties* (-3 billion lei, against the background of the elimination of excise duty on fuels, a measure that had not been included in the initial budget), from the *tax on the use of goods, the authorization of the use of goods and conducting activities* (-2.9 billion lei, amid the postponement of the tender for renting 5G frequency bands by mobile operators), from the *tax on income and salaries* (-2.1 billion lei) and from *other taxes and property taxes* (-1.2 billion lei). As mentioned above, the non-realization of the scheduled receipts from social security contributions is due to the weaker evolution of the labor market compared to the initial estimates, as well as the ease of deferring the payment of obligations of economic agents to GCB, while the deficit registered at the level of *non-tax revenues* reflects the impact of the pandemic on the profitability of state-owned companies and the dividends paid by them. The only GCB aggregate that exceeded the target proposed by the initial budget is *the amounts received from the EU*, their evolution being determined by the additional amounts received from the EU to combat the COVID-19 pandemic (+1.2 billion lei compared of the initial budget), but also of the upward revision, both of the structural funds (+1.3 billion lei) and of the funds destined for agriculture (+1.7 billion lei).

[60] According to the absorption stage on 31 December 2019, respectively on 31 December 2020, published by the Ministry of Investments and European Projects (MIEP).

III.4.1. VAT and excise duties

VAT receipts in cash standards, net of the impact of swap compensation schemes, registered in 2020 a level of 60.7 billion lei, being 11.2 billion lei below the level provided in the initial draft budget . The attached graph shows the evolution of receipts and compensation schemes scheduled in the draft budget and on the occasion of budget revisions, compared to the values actually recorded in the budgetary execution. Thus, the first two budget revisions operated large-scale negative revision of this budgetary aggregate (-5.6 billion lei, respectively -4.1 billion lei) as a result of the worsening macroeconomic framework under the effects of the COVID-19 pandemic, but also on the background of reducing the excise duty on energy products, respectively of accelerating the VAT refunds in order to inject liquidity into the economy.

Figure 5: VAT revenues in 2020 (billion lei)



Source: MF

The third budget revision operated a positive revision of 0.4 billion lei, taking into account the amounts estimated to be recovered from the budgetary obligations deferred to payment (valued by NAFA at about 2.9 billion lei). At that time, FC expressed its reservations regarding the recovery of these amounts, appreciating as probable the registration of an important revenue gap at the level of VAT receipts. The final execution of 2020 confirmed the FC reserves, the level of VAT revenues being lower by 1.9 billion lei compared to the estimates from the third rectification.

Regarding the compensation scheme, it was initially forecast at 0.85 billion lei, it was decreased to 0.67 billion lei at the second rectification, but the actual execution recorded a much lower level of it, of 0.12 billion lei.

It should be mentioned that the significant non-fulfillment (-11.2 billion lei) of the scheduled level of VAT revenues occurs in the context of the manifestation of the following factors:

- At the time of drafting the budget, NCSP estimated an advance of the relevant macroeconomic basis for VAT revenues (represented by the final consumption of households, excluding the self-consumption component and NPISH[61]) of 9.44% during 2020. The latest available data indicate an effective decrease in the relevant macroeconomic base by about 3.5%, which justifies a reduction in VAT revenues by approximately 8.5 billion lei compared to the scheduled level;
- The projection from the initial budget does not incorporate the effect of reducing excise duties on energy products, estimated by FC at about 0.55 billion lei;

[61] Non-profit institutions serving households.

- During 2020, the state achieved accelerated VAT refunds in order to inject liquidity into the economy, valued at 2.2 billion lei;
- According to the latest available information, the volume of VAT obligations deferred for payment by economic agents, by submitting an application until March 31, 2021, is about 5.1 billion lei.

Cumulating the effects of all the factors mentioned above, it is found that they would have justified a reduction in VAT revenues by about 16.3 billion lei compared to the level provided in the initial budget. In this context, the non-achievement of only 11.2 billion lei of the level programmed for VAT receipts could suggest an improvement of the collection of this budget aggregate insofar as the amounts deferred to payment will be recovered at the currently estimated level.

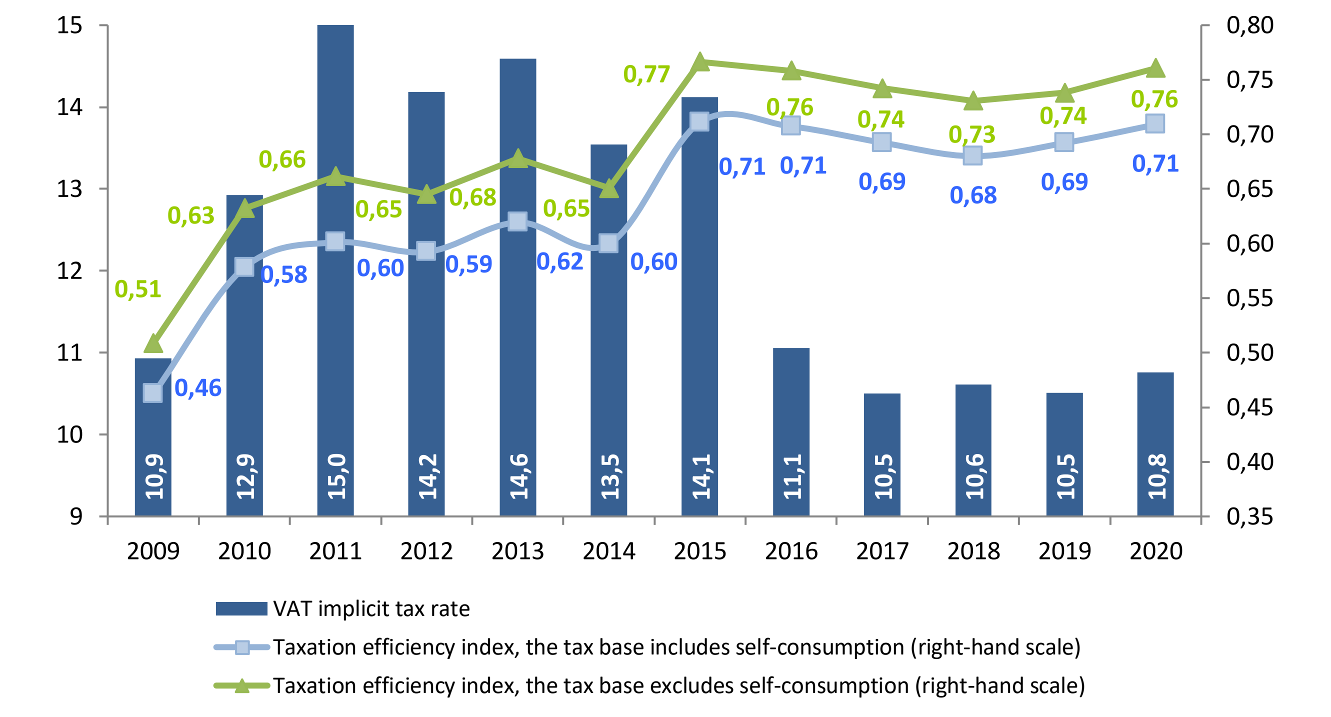
Compared to the previous year, the level of revenues corresponding to this budgetary aggregate, net of the impact of swap schemes, decreased by over 7% (-4.6 billion lei). In order to corroborate the results of the analysis performed above, one can investigate the performance of VAT revenues by making an *ex-post* projection of this budget aggregate and comparing it with the actual achievements. Thus, starting from the budget execution for 2019 of the VAT revenues, the decrease by 3.5% of the final consumption expenditures of the population (excluding the self-consumption component and NPISH) was applied and then the effects of the reduction of excise duties on energy products were deduced, of accelerated VAT refunds and of the facility to defer the payment of economic agents' obligations to GCB (the estimated amount of these effects being presented above). Under the impact of these factors, the *ex-post* projection of VAT revenues for 2020 is about 55.2 billion lei, while the actual execution recorded a level of 60.7 billion lei, confirming the existence of a favorable difference.

Next, the efficiency of VAT collection will be assessed through the ratio between the implicit tax rate[62] and the weighted average tax rate. Regarding the latter, it should be recalled that, starting with the Annual Report for 2015, the weighted average VAT rate was determined[63], which is a change in methodology compared to the reports of the Fiscal Council for the period 2010-2014, and the results obtained are not comparable to those in those editions. The weights used to determine the weighted average VAT rate are those of the Harmonized Index of Consumer Prices (HICP), which are the only sources available for international comparisons, and are only an approximation of the weighted average VAT rates across the economy. Thus, given the higher proportion of goods and services with a reduced share in the consumption basket, it is expected that the weighted average VAT rate in the whole economy will be higher than that resulting from the calculations of the Fiscal Council, the collection efficiency can be overrated to some extent.

[62] Defined as the ratio between the revenue actually collected for a given type of tax and the corresponding macroeconomic tax base.

[63] Previously, the standard VAT rate was used, starting with 2015 being introduced the average rate that takes into account the effect of reduced rates. This is determined by the share of products in the consumption basket and the related VAT rate, as well as the timing of the introduction of legislative changes on the level of the VAT rate.

Figure 6: The evolution of the implicit tax rate and of the taxation efficiency index for VAT in Romania



Source: EC, NCSP, Eurostat, Fiscal Council`s calculations

Figure 6 shows the evolution of the implicit tax rate and the efficiency index of VAT collection in Romania, using as a tax base both the final consumption of households and NPISH (right scale, in blue) and final consumption of households and NPISH, excluding self-consumption and the peasant market (scale on the right, in green). The decision to assess the efficiency of collection by excluding self-consumption and the peasant market from the tax base is given by the fact that these components have an important dimension in the case of Romania, the results obtained on collection efficiency being about 7% to 10% higher than the situation in which the results were related to the total final consumption of the population and the NPISH.

Analyzing the evolution of the collection efficiency index related to VAT, it can be seen that, after a period of relative stability between 2010 and 2014, 2015 marked a substantial improvement in collection efficiency, reaching the maximum level in the post-crisis period. Subsequently, the efficiency index suffered minor decreases, but remained close to the value recorded in 2015, amid the 5 pp decrease in the standard VAT rate (from 24% in 2015 to 19% in 2017) and the extension of the applicability of reduced rates VAT of 9% and 5%, respectively. The previously mentioned measures led to the decrease of the weighted average VAT rate from 18.4% in 2015 to 14.5% in 2018, being then registered slight decreases (up to the level of 14.2% in 2019, respectively at 14.1% in 2020) amid changes in HICP weights. Thus, it should be noted that the reduction of VAT rates from 2016-2017 (materialized by significant decreases in both legal rates and weighted average rates) did not lead to an improvement in collection efficiency and, implicitly, neither in compliance with payment. In 2020, the efficiency index of VAT collection registered a level of 0.71 (respectively 0.76 in the hypothesis of eliminating self-consumption and the peasant market), compared to 0.69 (respectively 0.74) in 2019, the results being consistent with the analysis based on the comparison between the *ex-post* projection of this budget aggregate and the actual revenues from the cash execution of 2020.

Table 6: Taxation efficiency - VAT

Country	Weighted average VAT rate (%)			Implicit tax rate* (%)			Taxation efficiency index**			Rank		
	2018	2019	2020	2018	2019	2020	2018	2019	2020	2018	2019	2020
BG	16.9	16.7	16.7	15.2	15.6	15.6	0.90	0.93	0.94	4	4	4
CZ	18.8	18.7	18.7	15.9	16.0	15.9	0.85	0.85	0.85	5	5	5
EE	18.6	18.6	18.6	17.9	18.0	18.3	0.96	0.97	0.98	3	1	2
LV	19.3	19.2	19.3	14.2	14.5	15.5	0.74	0.76	0.80	7	7	7
LT	19.2	19.1	19.0	12.6	13.0	13.3	0.66	0.68	0.70	10	10	10
HU	19.9	20.4	20.2	19.3	19.3	19.9	0.97	0.95	0.99	2	3	1
PL	17.1	17.1	17.1	13.9	13.8	14.1	0.81	0.81	0.82	6	6	6
RO	14.5	14.2	14.1	9.9	9.9	10.0	0.68	0.69	0.71	9	9	9
SI	15.9	15.9	15.9	15.8	15.3	15.5	0.99	0.96	0.98	1	2	3
SK	17.3	17.1	16.9	12.5	12.8	12.7	0.73	0.75	0.75	8	8	8

Source: EC, Eurostat, Fiscal Council's calculations

* Calculated as a ratio between "VAT revenues" (ESA code D211REC) and "Households and NPISH Final Consumption Expenditure" (ESA code P31_S14_S15). In the case of Romania, VAT revenues include additional receipts due to implementing the compensation scheme for clearing arrears (205.5 mil. lei in 2018, 96.4 mil. lei in 2019 and 123.8 mil. lei in 2020).

** Computed as a ratio between the implicit and weighted average VAT rate.

By comparison with the degree of efficiency of VAT collection at the level of 2020, related to the group of new EU Member States in Central and Eastern Europe (NMS CEE), the value of 0.71[64] registered by Romania is significantly lower than those recorded by Hungary (0.99), Estonia and Slovenia (each with an efficiency index of 0.98), Bulgaria (0.94), the Czechia (0.85), Poland (0.82) and Latvia (0.80). Thus, in 2020 Romania collected VAT revenues representing only 6.1%[65] of GDP (according to the ESA 2010 methodology), compared to 9.9% of GDP in Hungary, 9.4% of GDP in Bulgaria, 9% of GDP in Estonia, 8.7% of GDP in Latvia, 8% of GDP in Poland, 7.6% of GDP in Slovenia and 7.5% of GDP in the Czechia. At the same time, the weighted average VAT rates in these countries were 20.2% in Hungary, 19.3% in Latvia, 18.7% in the Czechia, 18.6% in Estonia, 17.1% in Poland, 16.7% in Bulgaria and 15.9% in Slovenia, while Romania recorded a weighted average share of only 14.1%. In this sense, it should be noted that starting with 2016, Romania has the lowest weighted average VAT rate compared to other NMS CEE

[64] In *Table 6*, for comparability, the same tax base is used for all countries, namely the final consumption of households and NPISH, including self-consumption of the population.

[65] Representing the lowest level of VAT revenues (expressed as a percentage of GDP) among all 10 countries analyzed.

states, following the 5 pp reduction of the standard rate from 24% to 19%. In the ranking of taxing efficiency, our country is penultimate ranked, maintaining this position over the past three years, while Hungary, Estonia and Slovenia occupied the top three positions (the order differing each year) in 2018-2020 .

The ranking of the taxation efficiency index must also be interpreted in terms of structural differences between the analyzed economies, given that the higher percentage of the Romanian population living in rural areas is reflected in a higher share of self-consumption and peasant market (non-taxable), with an impact on the value of this index, as shown in *Figure 6*. In this regard, the conclusion of a study by Aizenman and Jinjarak (2005)[66], that examined a panel of 44 countries in the period 1970-1999, was that the efficiency of VAT collection is inversely proportional to the share of agriculture in GDP and directly proportional to the degree of urbanization and the degree of openness of the economy - the three variables having an unfavorable influence in the case of Romania. At the same time, it should be noted that the current methodology for calculating the tax efficiency index, although taking into account the impact of reduced VAT rates, does not include that of other components of GDP that are subject to VAT (part of intermediate consumption and training fixed capital gains in the case of non-VAT payers who do not have the right to deduct).

Revenues collected from **excise duties**, net of the impact of swap compensation schemes, amounted to 30.7 billion lei in 2020, this level being about 3 billion lei lower than the estimates taken into account in substantiating the draft budget. Thus, the initial program for excise revenues amounted to 33.7 billion lei, taking into account a projected increase in the macroeconomic base (final consumption of the population in real terms) of 5.1%, as well as an increase of revenues estimated at 0.7 billion lei as a result of the rise in the level of excise duty on tobacco products. The first budget revision negatively revised the level initially estimated by 2.7 billion lei as a result of the reassessment of the evolution of the relevant macroeconomic base in the context of the effects of the COVID-19 pandemic, as well as against the reduction of excise duties on energy products the initial budget. The second budget amendment carried out a small positive revision (+0.1 billion lei)

Figure 7: Excise duty revenues in 2020 (billion lei)

Source: MF

[66] Aizenmann J., Jinjarak Y, "The Collection Efficiency of the Value Added Tax: Theory and International Evidence", National Bureau of Economic Research Working Paper no. 11539, August 2005.

as a result of a favorable impact of higher than the anticipated increase in excise duties on tobacco products, despite a new downward revision of the relevant macroeconomic basis. Given the budget execution at that time, the third revision decreased the estimates on excise revenues by 0.6 billion lei, to 30.5 billion lei, the actual execution for 2020 recording 30.7 billion lei, close to the level estimated at the third revision.

Compared to the previous year, the level of revenues collected from excise duties decreased by almost 0.8 billion lei (-2.4%) in the context of a 5.5% decline in the final consumption of the population (excluding the self-consumption component and NPISH) in real terms and the reduction of excise duty on energy products, partially offset by the increase in the level of excise duty on tobacco products from 1 April, 2020. Given that excise duties are presented as an aggregate in the budget construction, which does not allow the study of the modification of only one category, it is of interest to perform an analysis of the structure of excise revenues. Thus, with a share of 49.5% , excise duties on energy products continue to be the most important component of excise revenues. However, as a result of the elimination of the excise duty on fuels in 2020, their share decreased significantly compared to the previous year when it was around 55%. On the other hand, in the context of increasing the excise duty on tobacco products, this category had a share of almost 47% of total revenues, which is an important advance compared to 2019 when it had a share of about 41%. Revenues from excise duties on alcohol, distillates and alcoholic beverages remained at a share of about 4% of total revenues, while the rest of the categories continued to be below 1%.

Analyzing the changes registered compared to 2019 at the level of each product category, it is found that the revenues from excise duties on energy products decreased by 12.6% (-2.2 billion lei), far exceeding the unfavorable dynamics of the relevant macroeconomic base, on the background of the elimination of excise duty on fuels. However, the decrease in revenues related to this category is lower than the initial projections that estimated a budgetary impact of the elimination of excise duty of about -3 billion lei. Regarding the excise duties applied to tobacco products, their level registered an increase of almost 11% (+1.4 billion lei), this being higher than the income increase of 0.7 billion lei, anticipated by the MF on account of the increase this category of excise duties starting with April 1, 2020. The third category, represented by excise duties on alcohol, distillates and alcoholic beverages, remained at the level of 1.3 billion lei, both in 2019 and in 2020, however, due to the low share in total, their impact on the whole budgetary aggregate is not significant. Consequently, considering a volume of obligations related to excise duties deferred for payment by economic agents, estimated by the MF at 0.1 billion lei, it can be estimated that the excise revenues had evolved beyond expectations.

III.4.2. Direct taxes

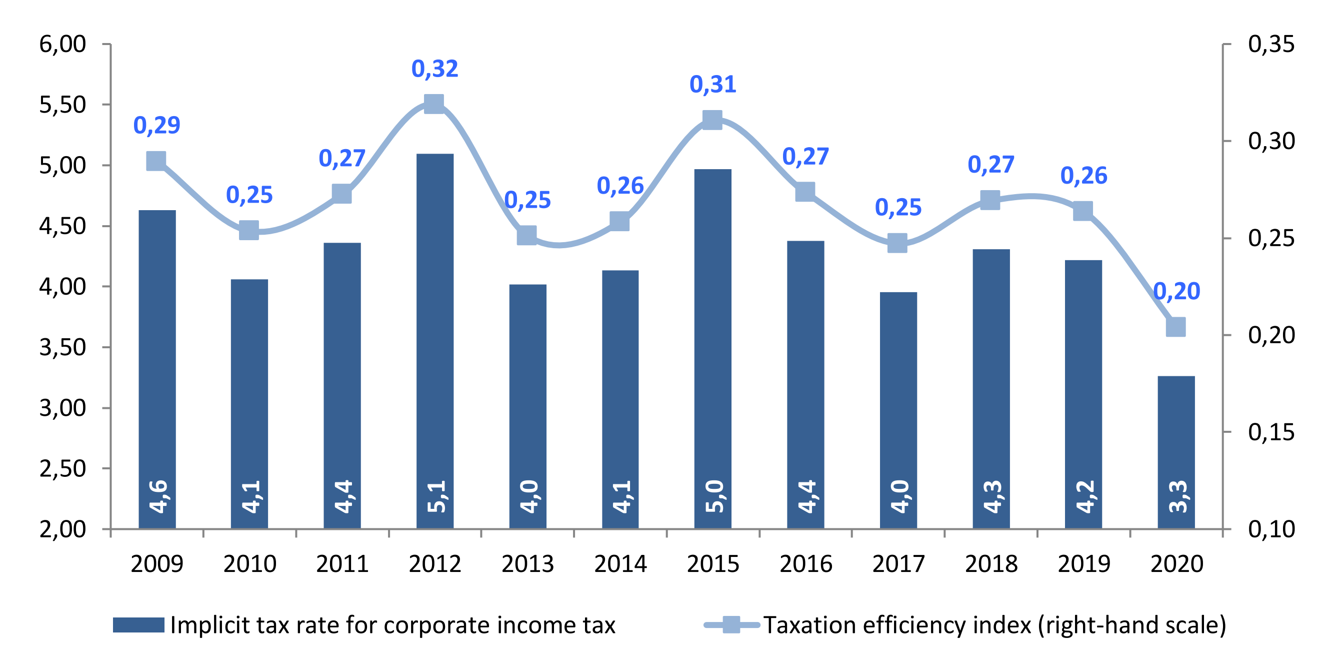
Corporate income tax revenues in cash standards, net of the impact of compensation schemes, amounted to 15.7 billion lei, representing a decrease of 2 billion lei (-11.4%) compared to 2019, but also a non-compliance with 3.8 billion lei of the estimates from the adopted budget for 2020. Thus, the initial program provided revenues from the corporate income tax amounting to 19.5 billion lei, in the context in which an increase of the relevant macroeconomic base was anticipated (nominal GDP) by 8.5%. This value was revised downwards by 2.3 billion lei during the first budget revision in the context of the revaluation of the macroeconomic framework as a result of the manifestation of the effects of the COVID-19 pandemic, but also as a result of granting a bonus for taxpayers who chose to pay the quarterly corporate income tax in advance. At the time, FC warned that the estimate was subject to major uncertainties, with corporate tax revenues having the potential to decline sharply in the face of a large economic decline, and and appreciated that the balance of risks tilts towards lower-than-expected revenues. The downward revisions operated at the second and third revisions (-0.6 billion lei, respectively -0.7 billion lei) confirmed the FC warning, being the result of the budget execution during 2020 and the granting of the deferral facility. the payment of the obligations of the economic agents towards GCB. The execution at the end of the year recorded a level of corporate income tax revenues lower by 0.2 billion lei than the estimates from the third budget revision.

Figure 8: Corporate income tax revenues in 2020 (billion lei)

Source: MF

The downward evolution of corporate tax revenues compared to the previous year (-11.4%, representing -2 billion lei) was much more pronounced than the decrease of the relevant macroeconomic base (nominal GDP, which decreased by only 0.3%). Even taking into account the volume of corporate tax liabilities deferred for payment by economic agents, valued by the MF at 0.5 billion lei, there is a potential revenue gap of about 1.5 billion lei, which could be justified by an increased sensitivity of this budgetary aggregate to the evolution of GDP in times of recession, a worsening of the degree of collection, or a combination of these two factors.

Figure 9: The evolution of the implicit tax rate and of the taxation efficiency index for corporate income tax in Romania



Source: EC, Eurostat, Fiscal Council's calculations

An analysis of the revenue structure related to this budgetary aggregate shows that the greatest impact was exerted by the evolution of the corporate income tax paid by commercial banks (-0.9 billion lei compared to the previous year, representing a decrease of 44%), while the corporate income tax paid by the economic agents from the non-financial sector (this representing the main component of the revenues from the corporate income tax by over 92% of the total receipts) decreased by 0.8 billion lei (representing a decrease of 5.2% compared to the previous year), the difference of 0.3 billion lei being caused by the increase of the swap type compensation scheme in 2020 compared to 2019. There is a great volatility of the corporate income tax revenues paid by commercial banks, which have undergone extensive changes in the last two years (44% decrease occurring after an increase of over 70% in 2019[67]) which significantly influenced the evolution of the entire budgetary aggregate. In this context, also marked by an increased uncertainty regarding the sensitivity of corporate tax revenues to the evolution of nominal GDP, it is quite difficult to assess the extent to which the decrease in corporate tax revenues is due to a reduction in collection efficiency.

[67] The volatile evolution of the profits from the profit tax paid by the commercial banks occurred on the background of the decision of June 2019 of the High Court of Cassation and Justice in the dispute between the Court of Accounts and the savings-lending banks in the housing field which determined the establishment of consistent provisions for litigation or credit risk, as well as the impact of the tax on financial assets. In the case of banks, according to the Fiscal Code, the tax base for corporate income tax paid in the current year is represented by the profit obtained in the previous year, they make advance payments based on last year's profit tax (updated with inflation), which is regularized in next year.

Table 7: Taxation efficiency – corporate income tax												
Country	Legal corporate income tax rate* (%)			Implicit tax rate** (%)			Taxation efficiency index***			Rank		
	2018	2019	2020	2018	2019	2020	2018	2019	2020	2018	2019	2020
BG	10.0	10.0	10.0	5.0	4.9	5.2	0.50	0.49	0.52	1	1	1
CZ	19.0	19.0	19.0	7.5	7.3	5.7	0.39	0.38	0.30	2	2	4
EE	20.0	20.0	20.0	5.1	4.7	4.3	0.25	0.24	0.22	8	8	7
LV	20.0	20.0	20.0	2.5	0.3	2.0	0.13	0.01	0.10	10	10	10
LT	15.0	15.0	15.0	3.4	3.6	3.7	0.22	0.24	0.25	9	9	6
HU	9.0	9.0	9.0	3.1	3.1	3.0	0.35	0.34	0.33	3	3	2
PL	19.0	19.0	19.0	5.1	5.4	5.4	0.27	0.28	0.29	7	6	5
RO	16.0	16.0	16.0	4.3	4.2	3.3	0.27	0.26	0.20	6	7	8
SI	19.0	19.0	19.0	5.2	5.4	3.5	0.27	0.29	0.19	5	5	9
SK	21.0	21.0	21.0	7.0	6.5	6.4	0.33	0.31	0.30	4	4	3

Source: EC, Eurostat, Fiscal Council's calculations

* Compared to some of the previous reports, local taxes were no longer taken into account when determining the legal corporate income tax rate.

** Computed as the ratio between "current taxes on income, wealth, etc. paid by corporations to government and rest of the world" and "gross operating surplus" (ESA code ESA B2A3G).

*** Computed as the ratio between the implicit and legal tax rate.

In the following, the evolution of the collection efficiency index will be analyzed (calculated according to the ESA 2010 methodology). However, it should be noted that the results presented are not comparable with those of the editions of the report prior to 2018 for reasons related to the availability of statistical data[68]. At the same time, in the context of the significant volume of deferred payment obligations by economic operators to GCB, the estimates of current tax revenues paid by enterprises for 2020 (according to ESA methodology) are provisional and the results obtained should be treated with caution. In this regard, subsequent revisions of the data series will provide a more accurate picture of the evolution of the efficiency of the collection of these revenue categories. As can be seen in *Figure 9*, the efficiency index of the collection of taxes paid by enterprises recorded the highest value in the post-crisis period in 2012 (amid the resumption of economic growth in 2011), followed by a significant decrease in the following two years. In 2015, there was an improvement in collection efficiency, with the index approaching the level recorded in 2012, but the increase was temporary because, amid declining revenues, the index declined over the next two years, returning to a level similar to that of 2013. In this

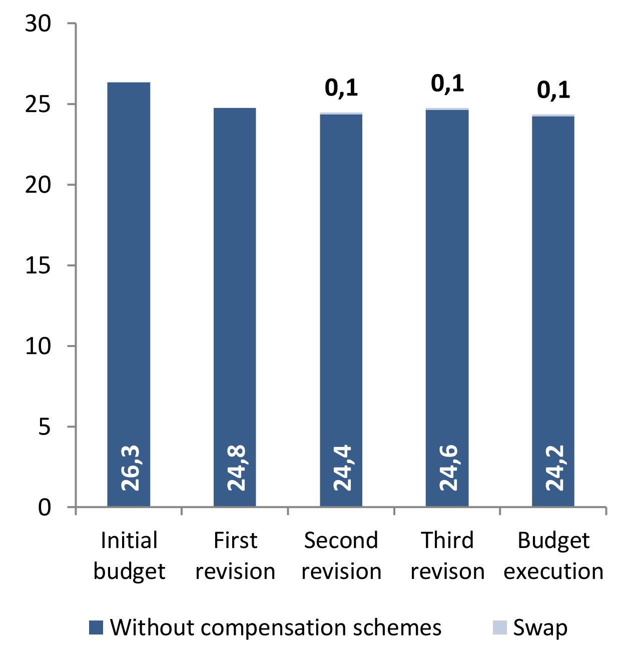
[68] In order to determine the implicit tax rate, the aggregate of "current taxes paid by enterprises on income, wealth, etc., to the government and the rest of the world '' was used, while in the editions before 2018 the aggregate of" direct taxes paid by enterprises "was used.

context, the year 2018 marked a slight revival, the efficiency index of tax collection paid by enterprises increasing from 0.25 in 2017 to 0.27. In 2019, there was a slight reduction of the index to 0.26, determined by the faster growth rate of the relevant macroeconomic base (gross operating surplus) compared to that of taxes paid by enterprises, respectively 10% compared to 7.7%. The year 2020 recorded a level of 0.20 for the collection efficiency index (which represents the minimum of the entire analyzed period), against the background of the decrease of revenues from taxes paid by enterprises (-24.6%) but, as mentioned above, the result must interpreted with caution, the data being provisional.

Compared to the other NMS CEE states, Romania has been on a downward trajectory over the last three years, dropping to the eighth position in 2020, after Poland (0.29), Lithuania (0.25) and Estonia (0.22) which occupies the next places. On the other hand, Bulgaria (0.52) remained in first place for the last 3 years, and Lithuania (0.1) remained in the last position of the ranking, both states being at a considerable distance from the other countries included in the analysis. Regarding 2020, the difficulty of estimating the data at the level of the entire sample is noted, with potential consequences on the results, several countries suffering significant reductions in the collection efficiency index (Slovenia -0.1, Czechia -0.08, Romania -0.06), while Lithuania increased by 0.09. Subsequent revisions of the data series are expected to provide a more accurate picture of the evolution of the efficiency of tax revenue collection paid by enterprises in the NMS CEE countries.

Revenues from **personal income tax** according to cash standards amounted to 24.2 billion lei, which represents a non-achievement of 2.1 billion lei of the budgeted level at the beginning of the year. Thus, the initial program provided for revenues of 26.3 billion lei due to an estimated increase in the average number of employees of 1.9%, and an advance of 9.8% of the average gross salary. This level was revised downwards by 1.5 billion lei at the first budget revision, as a result of the reassessment of the labor market evolution in the context of the COVID-19 pandemic. Even in this context, FC appreciated the projection as too optimistic, anticipating a revenue gap of about 0.6 billion lei. The second revision operated a new downward revision of 0.4 billion lei, based on the latest data available at that time on the labor market.

Figure 10: Personal income tax revenues in 2020 (billion lei)



Source: MF

The third revision revised upwards by 0.2 billion lei the projection of this budgetary aggregate on account of the amounts expected to be recovered from the obligations deferred to the payment by the economic agents. FC warned at the time about the uncertainty of recovering these amounts which could generate a revenue gap. The actual execution confirmed the FC's objections, set out on the occasion of its opinions on the first and the third rectification, respectively, accounting for a level of wage and income tax revenues of 0.4 billion lei lower than the projection from the last budget revision .

However, this value of revenues of 24.2 billion lei represents an increase of 4.8% (+1.1 billion lei) compared to the revenues achieved in 2019, the dynamics of this category of budgetary revenues being in line with the evolution of macroeconomic bases relevant during 2020. Thus, starting from the budget execution of 2019 (when the receipts from wage and income tax, net of the impact of compensation schemes, were 23.1 billion lei) and extrapolating with the evolutions of the average number of employees (-1.4%), respectively of the average gross salary (+6.4%), appears as justified a level of revenues of about 24.2 billion lei, this being the amount recorded by the actual execution of 2020. Moreover, taking into account that the actual execution does not include the obligations related to wage and income tax deferred to payment by economic agents (valued by MF at almost 0.7 billion lei), there is the possibility of materializing a surplus of revenues, conditioned by the degree of recovery of sums deferred, which could suggest an improvement in the collection of this budgetary aggregate.

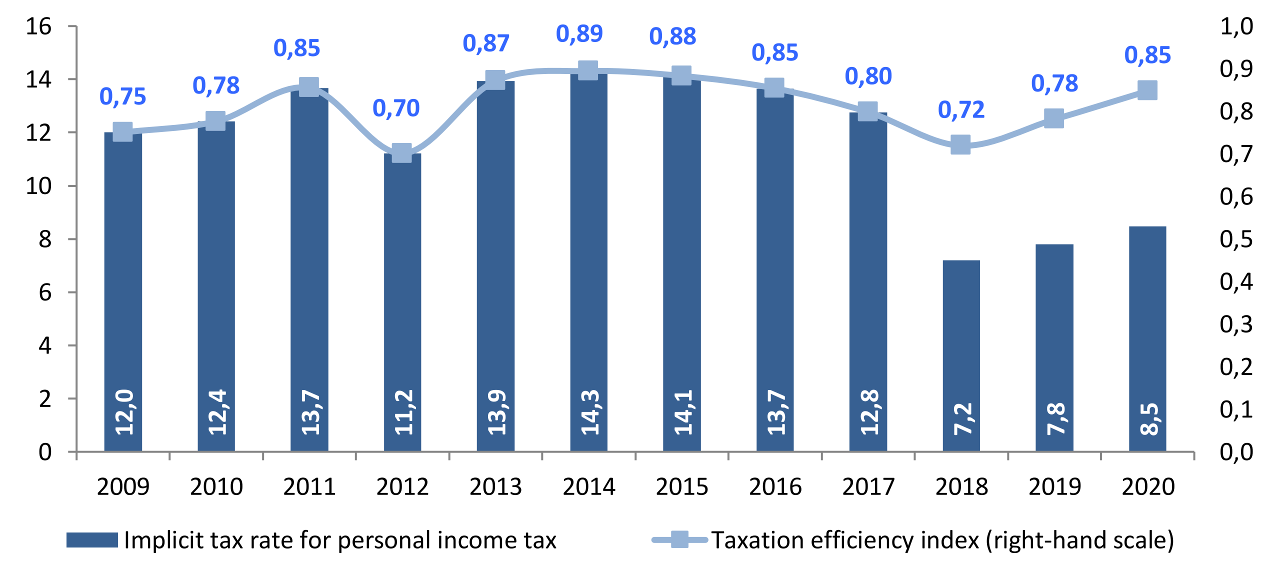
In order to investigate this development in more detail, an analysis was made of the structure of wage and income tax revenues on its main components. Thus, the payroll tax (which represents 76.5% of the revenues related to this budget aggregate) had a slower dynamics than that of the relevant macroeconomic bases, recording an increase of only 2.4% (+0.4 billion lei) compared to the previous year. This evolution would justify a potential revenue gap of 0.4 billion lei, which is, however, lower than the MF's estimates regarding the amounts deferred for payment by economic agents. The faster growth rate of the entire category (+4.8%) was reached as a result of the favorable contributions made by the other components of the wage and income tax: dividend income tax receipts (weight of 7.9% in total revenues) increased by 7.9% (+0.1 billion lei) compared to the previous year, revenues from income tax established on the basis of the single declaration form (share of 7% in total revenues) increased by 9.2% (+0.1 billion lei) compared to the previous year, and the receipts from the pension income tax (weight of 5.9% in total receipts) advanced by 40.9% (+0.4 billion lei) compared to the previous year, and against the background of the increase of the pension point by 14% from 1 September 2020. Concluding the analysis carried out at the level of the main components of the wage and income tax, it is found that the payroll tax is the only category with a slower dynamics than relevant macroeconomic bases, but its evolution is more favorable than it would have been justified by the volume of amounts deferred for payment by economic agents, according to the evaluations of the MF.

As in the case of the analysis of the efficiency of collecting corporate tax revenues, for reasons related to the availability of statistical data, the results presented in this report are not comparable with those found in previous editions of 2018[69]. According to ESA 2010 standards, current tax revenues paid by households and NPISH increased by about 4.7 billion lei (+15.7%) compared to the previous year, although revenues from wage and income tax in cash standards increased by only 1.1 billion lei (+4.8%). And in this case,

[69] In order to determine the implicit tax rate, the aggregate of “current taxes paid by households and IFSLSG on income, wealth, etc., was used. to the government and the rest of the world ”instead of the aggregate of“ direct taxes paid by households ”.

similar to corporate income tax, it should be noted that, in the context of the significant volume of deferred liabilities paid by economic agents, the estimates of current tax revenues paid by households for 2020 (according to ESA methodology) are provisional, and the results obtained must be treated with caution. Subsequent revisions of these estimates are expected to provide a more accurate picture of the evolution of the efficiency of household income tax collection. As can be seen in *Figure 11*, the efficiency index of collecting taxes paid by households reached the minimum of the period 2013-2020 in 2018 (0.72) amid the transfer of contributions from employee to employer that led to a decrease in the calculation basis of income tax, and the total effect exceeded the reduction of the legal rate from 16% to 10%, being equivalent to a reduction of the personal income tax rate to 9.33% which allows comparison with previous years. Therefore, considering an equivalent legal rate of 9.33%, the tax efficiency index would have recorded an improved value of 0.77 but, even in these conditions, a worsening of the collection could be observed in the case of taxes paid by households compared to 2017. The year 2019 marked the entry of the collection efficiency index on an increasing trend due to the more accentuated dynamics of revenues compared to the relevant macroeconomic base (gross wages at aggregate level). In 2020, the collection efficiency index registered a level of 0.85, compared to 0.78 in 2019, the meaning of this evolution being in line with the conclusions of the comparative analysis between the *ex-post* projection of this budget aggregate and the actual cash receipts, however, as mentioned above, the result must be interpreted with caution, the data being provisional.

Figure 11: The evolution of the implicit tax rate and of the taxation efficiency index for personal income tax in Romania



Source: EC, Eurostat, Fiscal Council's calculations

The evolution of the collection efficiency index over the last two years is also felt in the case of comparison with other NMS CEE countries. Thus, Romania climbed three positions compared to the 2018 ranking (from sixth place to third place), lagging behind Hungary (1.02) and Bulgaria (0.91). It should be noted that Hungary and Bulgaria have remained in the top two positions over the last three years, recording significantly higher efficiency index values than the other countries analyzed. A constant evolution is also observed at the bottom of the ranking, Slovenia (0.41) and Slovakia (0.52) occupying the last places in each of the last three years. On the whole ranking, there is an increased heterogeneity of the efficiency index, the difference between the first and last ranked being over 60 pp., several countries suffering significant reductions in the collection efficiency index (Latvia -0.08, Hungary -0.07, Lithuania -0.06), while Romania registered an increase of 0.07. Subsequent revisions of the data series are expected to provide a more accurate picture of the evolution of the efficiency of tax revenue collection paid by households in the NMS CEE countries.

Table 8: Taxation efficiency – personal income tax

Country	Legal personal income tax rate* (%)			Implicit tax rate** (%)			Taxation efficiency index***			Rank		
	2018	2019	2020	2018	2019	2020	2018	2019	2020	2018	2019	2020
BG	10.0	10.0	10.0	9.5	8.9	9.1	0.95	0.89	0.91	2	2	2
CZ	15.0	15.0	15.0	10.9	11.2	11.4	0.72	0.75	0.76	5	6	6
EE	20.0	20.0	20.0	15.7	15.3	16.2	0.78	0.76	0.81	4	5	4
LV	23.0	23.0	23.0	16.1	16.8	15.0	0.70	0.73	0.65	7	7	7
LT	15.0	20.0	20.0	11.8	16.4	15.3	0.79	0.82	0.76	3	3	5
HU	15.0	15.0	15.0	16.0	16.4	15.3	1.07	1.09	1.02	1	1	1
PL	25.0	25.0	24.5	16.3	16.1	15.2	0.65	0.64	0.62	8	8	8
RO	10.0	10.0	10.0	7.2	7.8	8.5	0.72	0.78	0.85	6	4	3
SI	33.2	33.2	32.8	14.2	13.8	13.4	0.43	0.42	0.41	10	10	10
SK	22.0	22.0	22.0	12.4	12.9	11.4	0.56	0.59	0.52	9	9	9

Source: EC, Eurostat, Fiscal Council's calculations

* For countries with progressive taxation systems (Latvia, Lithuania, Poland, Slovakia and Slovenia), the figure reported is the average tax rate.

** Computed as the ratio between "current taxes on income, wealth, etc. paid by households and NPISH to government and rest of the world " and "gross wages and salaries" (ESA code D11) which do not include social security contributions paid by employers. In the case of Czechia, the taxation base is "the compensation of employees", which includes social security contributions paid by employers, given the use of super-grossing in computing the personal income tax.

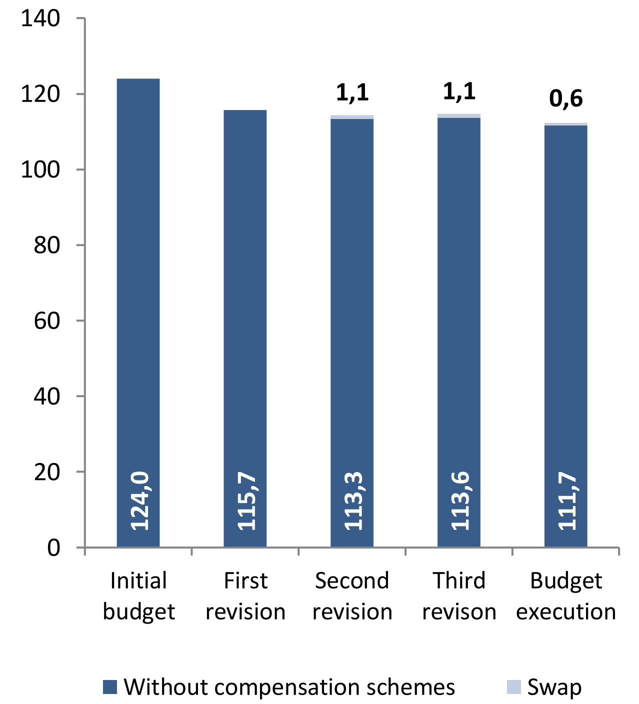
*** Computed as the ratio between the implicit and legal tax rate.

III.4.3. Social security contributions

SSC revenues in cash standards, net of the impact of compensation schemes, stood at the end of 2020 at a level of 111.7 billion lei, which is lower by approximately 12.3 billion lei (-9.9%) compared to the estimates in the draft budget given that, amid the manifestation of the effects of the COVID-19 pandemic, the average number of employees decreased by 1.4%, compared to the initial projection of +1.9%, and the average gross salary increased by only 6.4%, compared to the initial projection of +9.8%. The non-fulfillment of the programmed level of receipts for this budgetary aggregate also occurred in the context in which the effective execution does not include the obligations related to SSC postponed to payment by economic agents (valued by the MF at almost 4.7 billion lei). On the other hand, the enforceable titles paid during 2020 must also be taken into account, including Law no. 85/2016 on the payment of salary differences due to teachers in state education for the period October 2008 - May 13, 2011, as well as GEO 75/2020 on the recalculation of paid salaries for police officers in the structures of the Ministry of Internal Affairs and for active military personnel. Although the planned value of the enforceable titles for 2020 was about 2.8 billion lei, the actual payments were only 1.6 billion lei, which led to a decrease in SSC revenues compared to the scheduled level by approximately 0.4 billion lei.

Analyzing the projection of SSC revenues during 2020, it is observed that the first budget rectification recognized the existence of a deficit of revenues of about 8.4 billion lei in the conditions of the downward revision of estimates on the evolution of the wage bill in the economy, but FC appreciated at that time that there was an additional revenue gap of about 1.1 billion lei. The FC estimate was validated at the second budget rectification, which decreased the estimated level of revenues from SSC by another 2.4 billion lei, thus recognizing the slower dynamics of labor market indicators. The third rectification recorded an upward revision of 0.3 billion lei, the MF considering a partial recovery of budgetary obligations deferred to payment by economic agents. FC expressed its reservations about this estimate, anticipating a significant revenue gap in SSC revenues, and the effective execution confirmed FC's reserves, recording a level 1.9 billion lei lower than the one estimated at the third rectification.

Figure 12: Social security contributions revenues in 2020 (billion lei)



Source: MF

Compared to 2019, SSC revenues, net of the impact of compensation schemes, increased by only 0.7 billion lei (+0.6%), mainly due to the positive evolution of the average gross salary, the other factors (the average number of employees, the facility to postpone the payment of budgetary obligations and the elimination of the minimum tax threshold for part-time employment contracts) having an unfavorable impact on SSC revenues. For a more detailed analysis of the revenue performance related to this budget aggregate, an ex-post projection will be carried out, the starting point of which is the budget execution from 2019, which recorded a level, net of the impact of the compensation schemes, of about 111 billion lei. Indexing the starting point with the actual dynamics registered by the relevant macroeconomic bases (-1.4% average number of employees, respectively +6.4% average gross salary per economy), but also taking into account the negative impact of eliminating the minimum tax threshold for part-time employment contracts (estimated by FC at about 1.5 billion lei), as well as the granting of the facility to postpone the payment of economic agents' obligations to GCB (with a negative impact on SSC revenues assessed by MF at 4.7 billion lei), a level of revenues of about 110.3 billion lei appears as justified, this being lower than the one recorded in the effective budget execution of 2020 (111.7 billion lei). This favorable difference could suggest an improvement in the collection in the case of SSC revenues, provided that the amounts deferred to payment by the economic operators are recovered.

In order to more accurately reflect the dynamics of SSC during the period 2017-2020, the table below shows the adjusted series of this budgetary aggregate[70], as well as its gross series obtained by eliminating the adjustments related to swap compensation schemes and transfers to the Pillar II:

Table 9: Social security contributions (million lei)

		Budget execution 2017	Budget execution 2018	Budget execution 2019	Budget execution 2020
Adjusted series	**1**	**71,705.7**	**98,101.1**	**111,473.5**	**112,250.7**
Swap	2	632.6	490.9	464.3	552.4
Pension Pillar II	3	7,142.6	7,717.8	8,487.3	8,912.2
Gross series*	**4=1-2+3**	**78,215.8**	**105,327.9**	**119,496.5**	**120,610.5**
*out of which enforcement titles		378.6	55.0	668.0	537.9

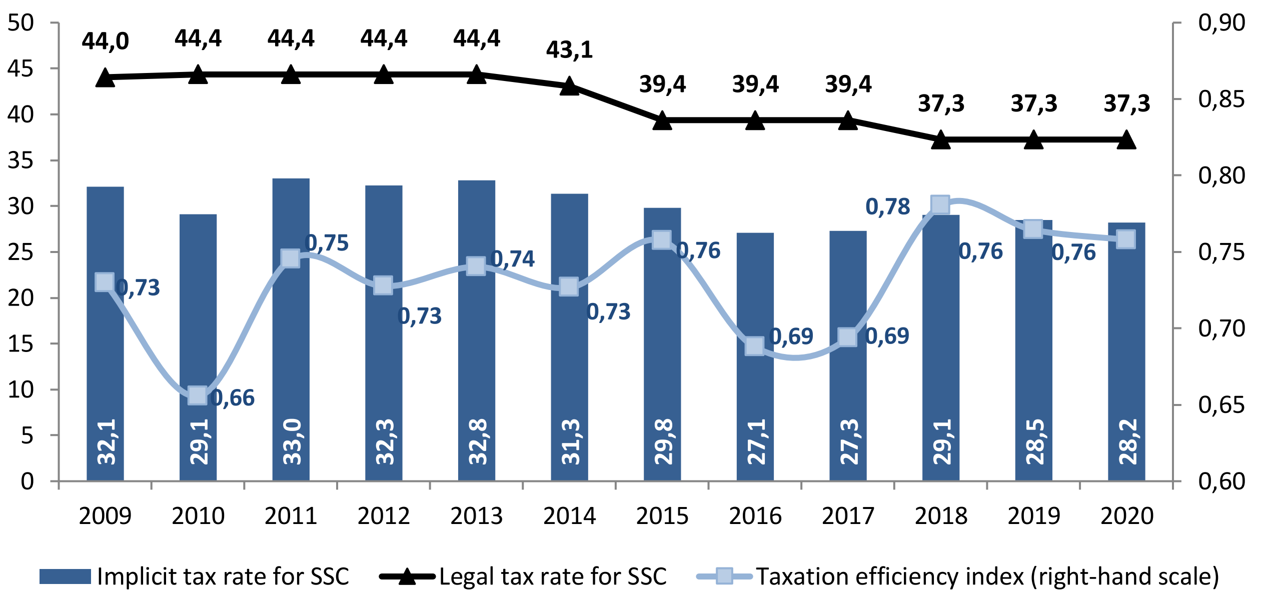
Source: Romanian Association for Privately Managed Pensions, MF, Fiscal Council's calculations

Thus, if we take into account the gross series, it is observed that in 2020 the revenues from SSC were in the amount of over 120 billion lei, exceeding the revenues from 2019 by only 0.9% (+1.1 billion lei) , the dynamics being slightly faster than the increase of SSC revenues from the budget execution (+0.7%), because the gross series also includes the transfers to Pillar II which had a more pronounced advance (+5%). Eliminating the impact of executory securities from the gross series, SSC revenues increased in 2020 compared to the previous year by almost 1.1% (+1.2 billion lei) amid declining payments related to this category.

Before analyzing the evolution of social contributions according to the ESA 2010 methodology, it should be noted that, starting with 2017, the statistical treatment of special pensions has been modified, being incorporated simultaneously in social contributions on the part of incomes and staff costs. As this treatment is likely to artificially alter the levels of the two budget aggregates, while also affecting the comparability with previous years, the amounts related to special pensions were eliminated. Thus, the social contributions were calculated as a total of the contributions borne by employers and the population. The same calculation formula was applied in the case of the other NMS CEE countries included in the analysis to allow the ranking of the efficiency of the collection of social contributions on the basis of comparable data sets.

[70]Taken from the budget execution of each year.

Figure 13: The evolution of the implicit tax rate and of the taxation efficiency index for social security contributions in Romania



Source: EC, Eurostat, Fiscal Council's calculations

* For 2014, the legal SSC tax rate was computed as the weighted average of the applicable rates: 44.35% for the first 9 months of the year and 39.35% as of October 1, 2014.

The revenues obtained from SSC in 2020, according to the ESA 2010 methodology, had a more accentuated increase than in cash standards, registering an advance of 5.5% (+6.1 billion lei) compared to the previous year. This development appears as a result of the aforementioned factors regarding the increase of the wage bill in the economy (due to the positive developments of the average gross salary, partially counterbalanced by the decrease of the average number of employees) and the negative impact of eliminating the minimum tax threshold for part-time employment. The significant difference compared to the level of cash receipts is mainly determined by the deferred payment obligations of economic agents (valued by MF at 4.7 billion lei) that do not affect the level of income from SSC, calculated according to ESA 2010 methodology. gross wages paid at the aggregate level increased at a slightly faster pace (+6.3%), the level of the implicit SSC tax rate decreased marginally compared to 2019, from 28.5% to 28.2 %, which led to maintaining the collection efficiency index at 0.76 in 2020.

Table 10: Taxation efficiency – social security contributions												
Country	Legal SSC rate* (%)			Implicit tax rate** (%)			Taxation efficiency index***			Rank		
	2018	2019	2020	2018	2019	2020	2018	2019	2020	2018	2019	2020
BG	33.0	33.0	33.0	23.1	23.8	24.1	0.70	0.72	0.73	9	9	9
CZ	48.0	48.0	48.0	45.2	45.4	46.1	0.94	0.95	0.96	4	4	5
EE	35.4	35.4	35.4	32.2	31.7	34.2	0.91	0.90	0.97	6	6	4
LV	35.1	35.1	35.1	23.2	23.5	23.5	0.66	0.67	0.67	10	10	10
LT	39.5	21.0	21.0	36.1	21.6	22.0	0.91	1.03	1.05	5	1	1
HU	38.0	38.0	36.0	33.9	33.3	30.7	0.89	0.88	0.85	7	7	7
PL	41.5	41.5	41.5	40.0	40.1	40.3	0.96	0.97	0.97	1	2	2
RO	37.3	37.3	37.3	29.1	28.5	28.2	0.78	0.76	0.76	8	8	8
SI	38.2	38.2	38.2	36.1	35.9	37.0	0.95	0.94	0.97	3	5	3
SK	48.6	48.6	48.6	46.3	46.3	46.0	0.95	0.95	0.95	2	3	6

Source: EC, Eurostat, Fiscal Council's calculation

* Aggregate data for employer and employee contributions.

** Computed as the ratio between "employers' actual social contributions" (ESA code D611REC) and "households' actual social contributions" (ESA code D613REC) relative to "gross wages and salaries" (ESA code D11). In the case of Romania, revenues include additional temporary receipts due to implementing the compensation scheme for clearing arrears (490.9 million lei in 2018, 464.3 million lei in 2019 and 552.4 million lei in 2020).

*** Computed as the ratio between the implicit and legal tax rate.

Compared to the other NMS CEE states, Romania continued to be on the 8th place in the ranking of the SSC collection efficiency index for 2020 and climbed to the fifth position in terms of the level of the aggregate legal rate (after Slovakia, Czechia, Poland and Slovenia), as a result of the decrease of the legal rate in Hungary from 38% to 36%. Among the states that charge a lower legal share of SSC than Romania, it is noteworthy that Estonia, Lithuania and Hungary have obtained higher implicit tax rates over the past three years. These results could also be explained in terms of the different taxation regime in terms of SSC for certain categories of income (income from self-employment, copyright, rent, investment income, etc.).

III.5. Budgetary expenditures

Budgetary expenditures, net of the impact of swap-type compensation schemes (amounting to 1.18 billion lei), recorded an advance of 5.3% compared to the previous year (+54.3 billion lei), reaching the end year 2020 at the value of 423.3 billion lei. In the conditions of a decrease registered at the level of nominal GDP (-0.4%), the share of budgetary expenditures in GDP advanced significantly by about 5.3 pp, respectively from 34.86% to 40.16% of GDP. Among the expenditure aggregates that registered a positive dynamic are *transfers between public administration units* (+315.1%), *expenditures related to programs with reimbursable financing* (+51.1%), *projects with financing from non-reimbursable external funds post-accession 2014-2020* (+26.4%), *social assistance* (+20.8%), *interest* (+19.4%), *subsidies* (+14.5%), *other expenses* (+10.2%), *capital expenditure* (+9.8%), *personnel expenditures* (+7.5%) and *goods and services* (+6.2%). Among the expenditure aggregates that registered a negative dynamic, there are *payments made in previous years and recovered in the current year* (-50.6%) and *projects with non-reimbursable external financing* (-19.6%). The increase of the share of total expenditures in GDP was made in the context of the substantial increase of *current expenditures* (+4.3 pp), of which *total transfers* had the most significant dynamics (+3.3 pp), due to the need to support local authorities for a better good endowment of hospitals and schools for the pandemic period, followed by the category of *personnel expenses* (+0.76 pp) and *expenditures on goods and services* (+0.3 pp). Compared to the execution of 2019, *social assistance expenditures* (+2.3 pp) have changed substantially, determined by the measures taken to support employees in the sectors affected by the COVID-19 pandemic, especially the measure of technical unemployment, by the increase of 14 % of the pension point and the increase by 20% of the allowances from September 1, 2020. At the same time, other categories of expenditures had a positive dynamic, among which, *projects financed from non-reimbursable external funds post-accession 2014-2020* (+0.7 pp) and *capital expenditures* (+0.29 pp). A marginal change compared to the previous year's execution can be found in the case of *projects with non-reimbursable external funding* (-0.01 pp) and *expenditures related to reimbursable financing programs* (+0.02 pp).

Compared to the amounts announced in the draft budget for 2020, budget expenditures were at a net higher level, by 23.4 billion lei (+5.9%), respectively by 2.22 pp from GDP, mainly due to positive contributions related to *total transfers* (+1.17 pp), *expenditure on goods and services* (+0.53 pp), *capital expenditure* (+0.57 pp) and *social assistance expenditure* (+0.7 pp). The main increases in expenditures were represented by the *total transfers* (+1.17 pp), of which *social assistance expenditures* (+0.7 pp), *other transfers* (+0.19 pp), *projects financed from external funds non-reimbursable post-accession 2014-2020* (+0.18 pp) and *other expenses* (+0.15 pp). There is a tendency to increase investment spending as well as goods and services. In terms of personnel expenditure, they had a much lower momentum compared to previous years, due to the fact that the number of employees in the budget system remained relatively constant during the year and their salaries did not increase as much.[71]. Pressures from social security and goods and services expenditures were much higher than initially anticipated

[71] Amendments to Law no. 153/2017.

due to the need to finance pandemic expenditures, but also due to the economic contraction that affected the expected level of budget revenues.

Figure 14: Quarterly revenues of the GCB in 2020 (billion lei)

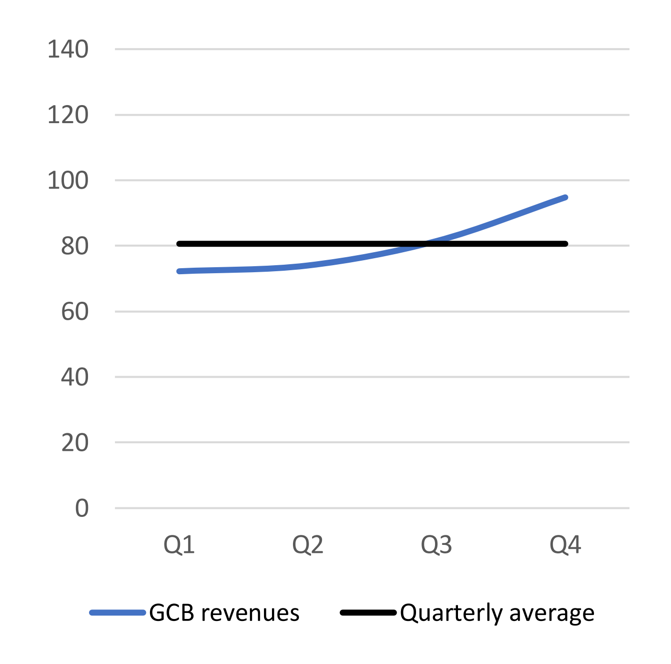
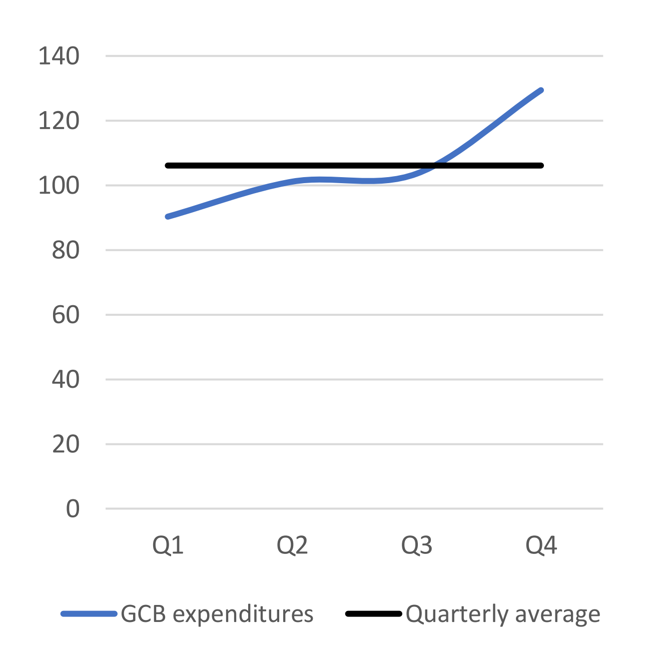


Figure 15: Quarterly expenditures of the GCB in 2020 (billion lei)



Source: MF

In 2020, the analysis of the quarterly execution of GCB expenditures[72] indicates a degree of their concentration in the last quarter, with a share of the fourth quarter in total year slightly decreasing compared to 2019 (respectively 30.5% compared to 30.8% in previous year). Thus, the total expenditures in the fourth quarter of 2020 amounted to approximately 129.4 billion lei (compared to 113.8 billion lei in the fourth quarter of 2019, respectively an increase of 13.71%), being 24.9% higher than the level from the previous quarter (compared to a 30.7% increase in expenditures made in the fourth quarter compared to the third quarter of 2019).

Analyzing the evolution of the structure of expenditures in the fourth quarter of 2020 compared to the previous quarter, we notice the acceleration of proportions of *expenditures with projects financed from non-reimbursable external funds related to the financial framework 2014-2020* (+191.9%, respectively a contribution of 46.8% of the total increase in the IV/III quarter), as well as those related to *projects financed from reimbursable external funds* (+131.6%, respectively a contribution of 0.8% to the total increase), determining a similar evolution of *capital expenditures* (for which the share of the fourth quarter in total year was 45.3%, respectively an advance over the previous quarter of about 24.1%). The other categories of budgetary expenditures had a total contribution of 28.3% to the increase of total expenditures in the fourth quarter compared to the previous quarter, respectively: *expenditures on*

[72] Including the swap-type scheme.

goods and services had a contribution of 12.3% (+22.4% compared to of the previous quarter), *personnel expenses* accounted for a contribution of 5.1% (+4.7% compared to the third quarter), those with *social assistance* contributed -0.9% (-0.7% compared with the third quarter), *other transfers* had a contribution of 11.1% (respectively an increase of 78.2% compared to the previous quarter), and *subsidies* a contribution of 3.2% (+48.2%).

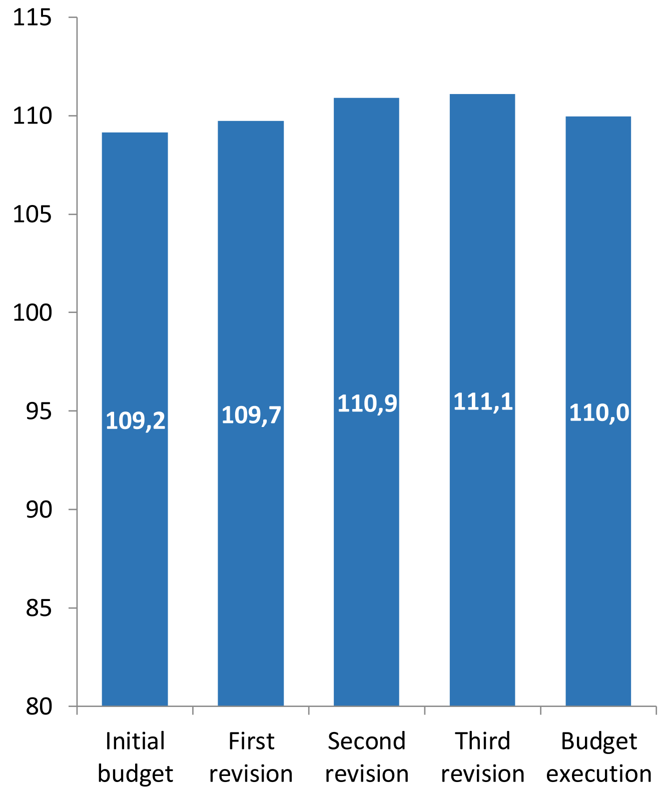
The concentration of expenditure in the last quarter of the year highlights serious shortcomings in the budgetary programming process, especially for public investment expenditure (financed by capital expenditure and European funds), even if the precautionary principle could partially justify the postponement of expenditure until the projection on budget revenues has a lower degree of uncertainty, this uncertainty being the watchword of the year 2020, marked by great challenges from a health and economic point of view. On the other hand, in 2020, the quarterly evolution of budgetary revenues indicates that they were mostly realized in the last quarter of the year, but in a lower proportion compared to the previous year (with a share in total year of 29.4% compared to 30.6% in 2019, respectively an increase compared to the previous quarter by about 16.4%, compared to 23.7% in 2019).

III.5.1. Personnel and social assistance expenditures

The execution of personnel expenditures recorded an increase of 0.8 billion lei compared to the level considered in the elaboration of the draft budget for 2020. Initially estimated at a level of 109.2 billion lei, the final value of these expenditures was of 110 billion lei, respectively 10.44% of GDP.

The evolution forecasted during the year 2020 for the personnel expenses registered an exceeding compared to the ceilings defined by Law no. 239/2019 *on the approval of some indicators specified in the budgetary fiscal framework for 2020*. Thus, on the occasion of the first budgetary revision, the level provided for this expenditure aggregate was increased by about 0.58 billion lei (+0.53%), in while nominal GDP was revised downwards by 47.1 billion lei (-4.2%) compared to the estimates used in the initial budget construction. At the second budget revision, personnel expenses increased by 1.17 billion lei (+1.07%) compared to the previous budget iteration and by 1.75 billion lei (+1.6%) compared to the draft budget. At the same time, the level of nominal GDP was 71.23 billion lei (-6.31%) below the one estimated at the time of establishing the initial budget. On the occasion of the third budget revision, personnel expenses increased by 0.195 billion lei (+0.18%) compared to the second budget revision and by 1.95 billion lei (+1.78%) compared to of the initial draft budget.

Figure 16: Personnel expenditures in 2020 (billion lei)



Source: MF

On the occasion of the first budget revision, the Fiscal Council stated that the additional amounts allocated to staff costs were directed to front-line medical staff in the fight against the COVID-19 pandemic and that the bonuses granted to these employees will be financed from European funds.

Compared to 2019, personnel expenses increased by 7.6 billion lei, respectively by 7.5%. Unlike in 2019 when the increase in staff costs was supported by higher amounts paid on account of court decisions on the payment of salary differences for some categories of public servants compared to 2018, in 2020, the impact of paying these amounts was no longer such a significant one, but still higher than in 2018. Thus, we note that for 2020, the enforceable titles paid (1,096 million lei) were lower than those paid in the previous year (1,949.8 million lei). However, there are also newly issued enforceable titles in the amount of 2,822.6 million lei, which will negatively affect the cash execution in the following years.

Table 11: Enforceable titles issued/paid on the account of the court decisions regarding the payment of salary differences for some categories of government employees, million lei												
		2011	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**Total**
Enforceable titles issued, including Law no.85/2016	Central administration. (State budget)	3,239.5	531.7	8.5	3.8	82.3	1,599.4	67.4	996.9	1,461.6	2,812.3	10,803.3
	Local administration	3,059.6	580.7	867.6	1,614.4	1,064.1	2,094.3	20.3	0.0	0.0	10.3	9,300.8
	Social security budget	115.6	14.5	28.6	5.5	12.2	7.6	1.2	0.0	0.9	0.0	185.9
	Total	**6,414.7**	**1,126.8**	**904.7**	**1,623.6**	**1,158.5**	**3,701.2**	**88.9**	**996.9**	**1,462.5**	**2,822.6**	**17,477.9**
Enforceable titles paid, including Law no.85/2016	Central administration. (State budget)	-	162.0	311.3	1,531.7	1,234.6	363.1	476.2	80.8	999.7	1,551.5	5,159.4
	Local administration	-	153.0	306.0	2,447.2	2,806.1	544.6	705.0	79.2	947.7	17.5	7,988.8
	Social security budget	5.8	24.2	72.6	59.3	0.0	0.6	0.6	4.2	2.4	-	169.7
	Total	**5.8**	**339.2**	**689.8**	**4,038.2**	**4,040.7**	**908.4**	**1,181.8**	**164.2**	**1,949.8**	**1,096.0**	**13,317.9**

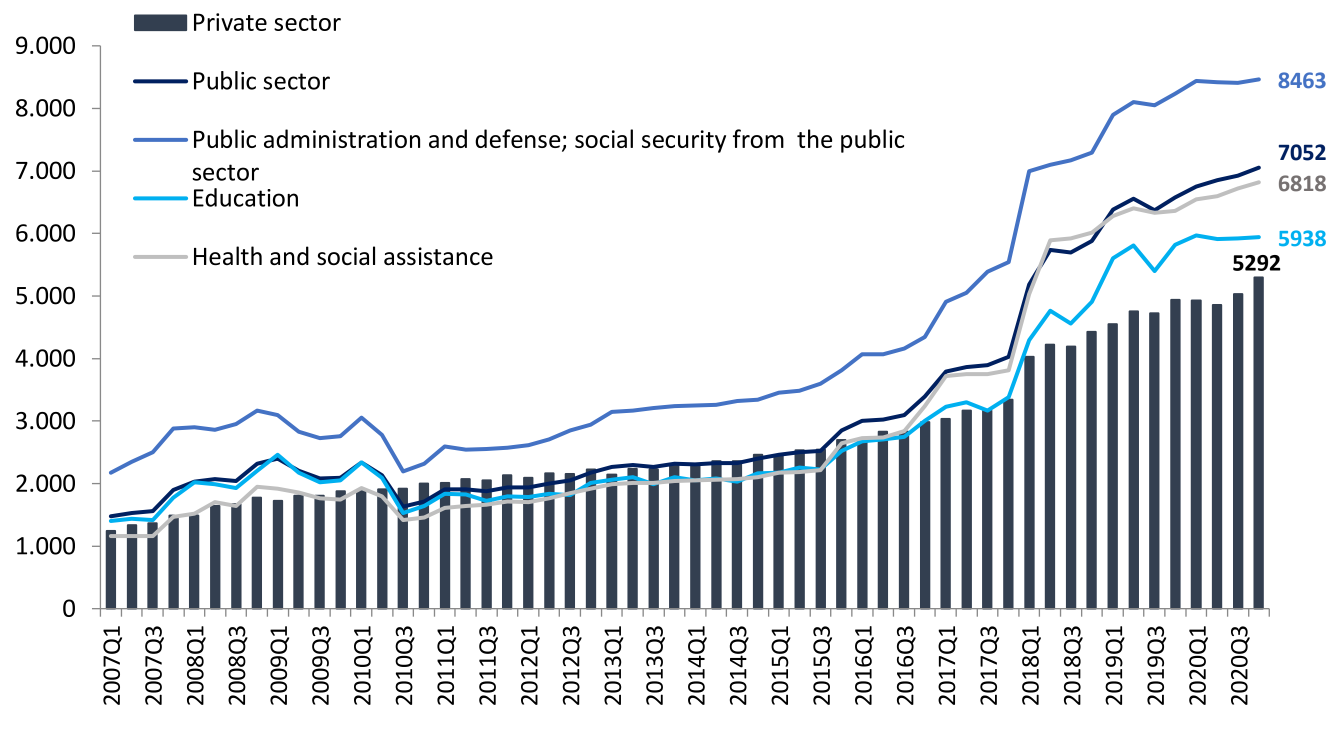
Source: MF

The draft budget for 2020 included a series of increases in state personnel expenditures that were determined by the entry into force, starting with July 1, 2017, of Law no. 153/2017 on the remuneration of staff paid from public funds, based on which for some categories of budget staff were granted or allowed salary increases. A negative impact on this budgetary aggregate also had the increase of the minimum gross basic salary per country from 2,080 lei/month to 2,230 lei/month starting with January 1, 2020, according to the Draft Budget for 2020.

The average gross salary in the public system reached 6,895 lei/month in 2020, by 6.53% higher than in 2019, exceeding by 37.11% the one in the private sector which stood at 5,029 lei/month (increasing by 6.12% compared to the previous year). Considering quarterly averages, the average gross monthly salary in the public sector for the fourth quarter of 2020 registered a level of 7,052 lei, 7.26% more than in the same period of 2019, while the salary in the private system was 5,292 lei, increasing by 7.29% compared to the fourth quarter of 2019.

Taking into account the fields of activity of the public sector, the three most important ones had the following evolution of the average gross salary in the fourth quarter of 2020 compared to the fourth quarter of 2019: in public administration and defense was 2.85%, in education the increase was 1.97%, and in health there was the highest increase, of 7.15%. The latter dynamic is mainly attributable to the increase in bonuses for frontline medical staff in the fight against the COVID-19 pandemic.

Figure 17: Average gross earnings in the private and public sectors between 2007-2020 (lei/month)

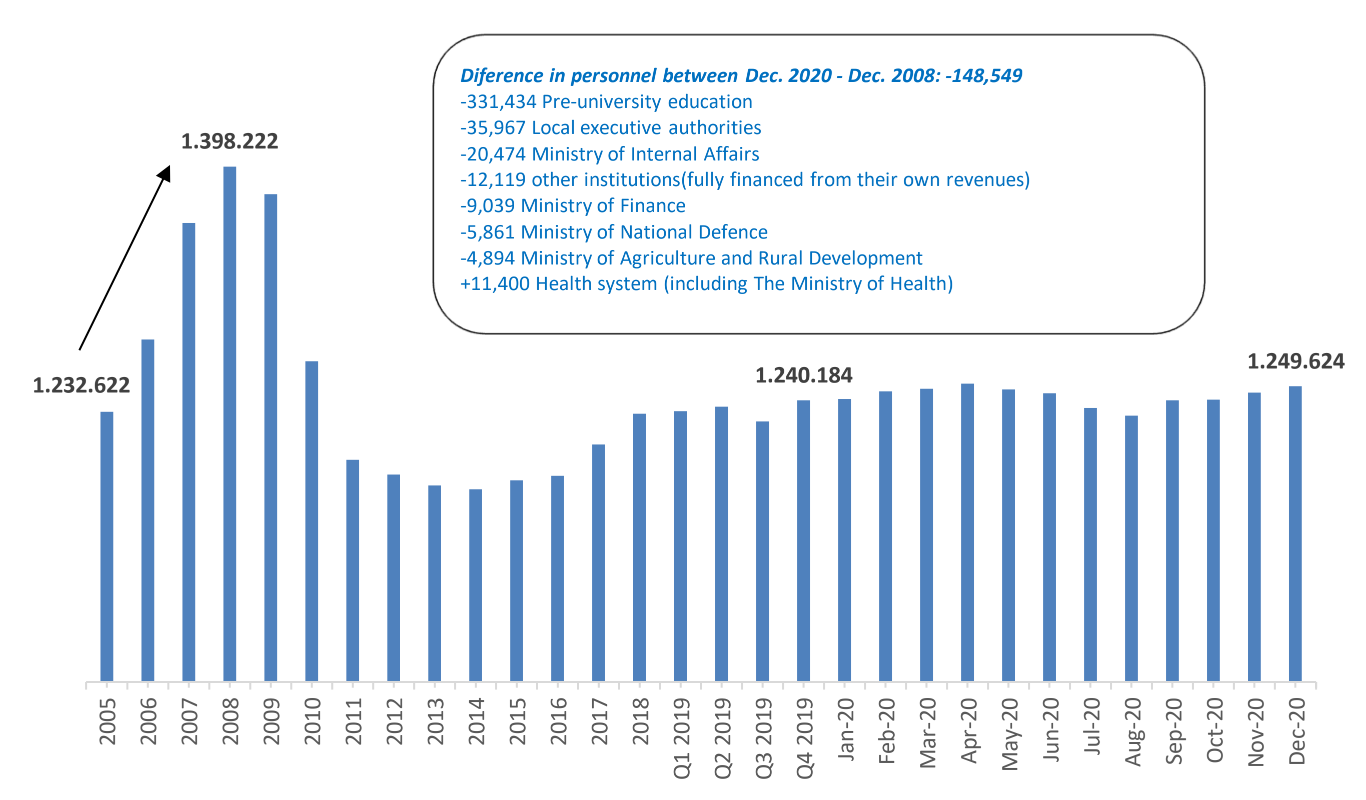


Source: NIS, Fiscal Council's computation

Following the increase of 165,600 people in the period 2005-2008, the total number of employees in the government sector decreased by 148,549 people between December 2008 and December 2020, to a level of 1.25 million (*Figure 18*). Practically, most of the staff reduction took place in the period 2009-2011, when the number of employees in the budget sector decreased by about 180 thousand, while in the period 2012-2014 the decrease was about 9,540 positions . The adjustment registered in the period 2009-2020 occurred mainly at the level of local executive authorities (-35,967 posts), the Ministry of Internal Affairs (-20,474 posts), other institutions financed entirely from own revenues (-12,119 posts), the Ministry of Finance -9,039 positions occupied), the Ministry of National Defense (-5,861 positions occupied), the Ministry of Agriculture and Regional Development (-4,894 positions occupied). On the other hand, during the same period, there were increases in the Ministry of Justice (+3,057 posts), the Ministry of Investment and European Projects (+1,342 posts), the Ministry of Labor and Social Justice (+995 posts) and the Public Ministry (+969 positions occupied).

At the same time, it should be mentioned that in 2020, the growth rate of the number of employees was lower than that recorded the previous year, respectively 0.6% (+7,515 people) compared to 0.9% (+11,095 people). Staff increases were recorded especially in the health system, including the Ministry of Health (+8,861 positions occupied), the Ministry of Education (+2,671 positions occupied), the General Secretariat of the Government (+1,382 positions occupied), the Ministry of National Defense (+1,101 posts) and local executive authorities (+1,006 posts). On the other hand, there were staff reductions at the level of the Ministry of Internal Affairs (-6,151 positions occupied) and the Ministry of Finance (-521 positions occupied).

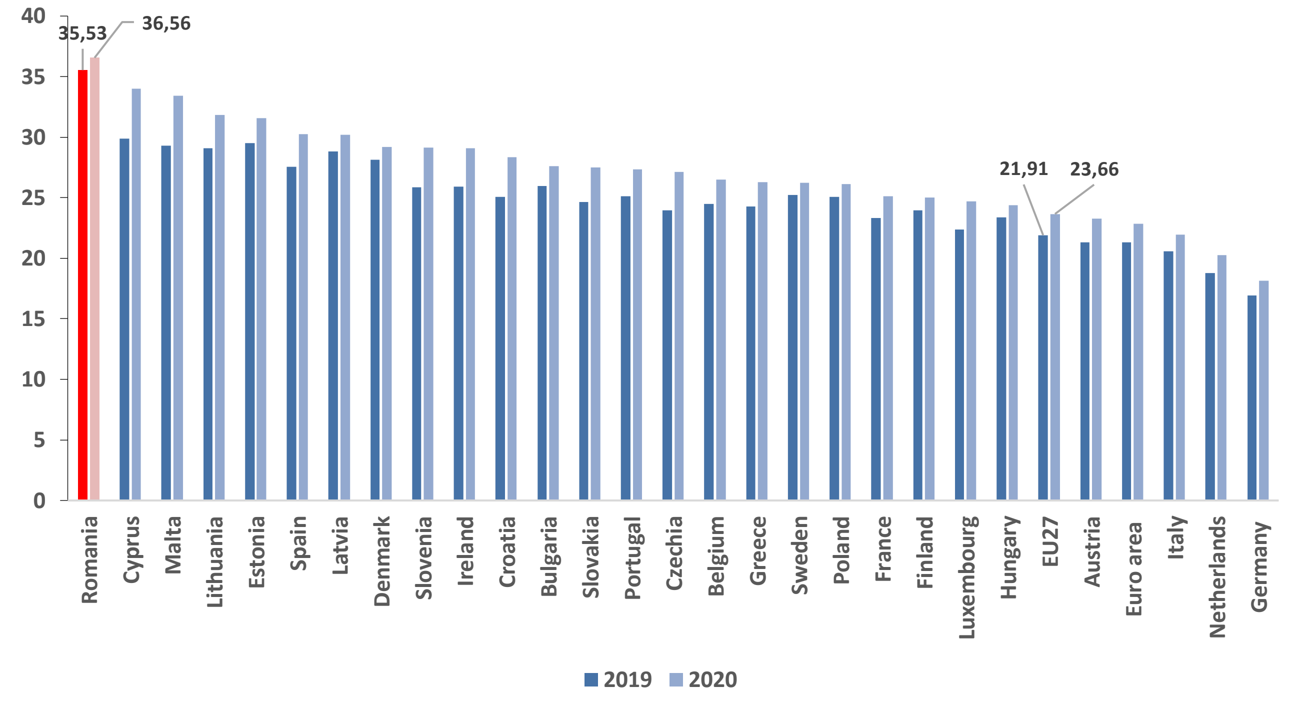
Figure 18: The evolution of public sector employment between 2005-2020



Source: MF

The adjustment for the period 2009-2012 is mainly the result of the application of the rule of "1 new employee for 7 departures" given that most of the exits from the system were made through voluntary or retirement departures. The abandonment of this rule starting with 2013 was meant to diminish the adverse selection and to allow the operation of some changes in the structure of the employed personnel. Thus, the reduction operated in the period 2009-2012 was achieved only to a small extent based on qualitative criteria, such as the reduction of staff where a surplus of employees is identified at the same time as new employment in deficient areas based on cost standards, rigorously defined and by establishing an optimal level of operation. The Fiscal Council considers this approach to be appropriate and recommends that new hires be made in the identified deficient areas, even by transferring posts from areas with surplus staff to those with deficits, taking into account at the same time the strict inclusion in the previously approved salary envelope.

Figure 19: Personnel expenditures as a share of total budget revenues in EU27 countries



Source: Eurostat

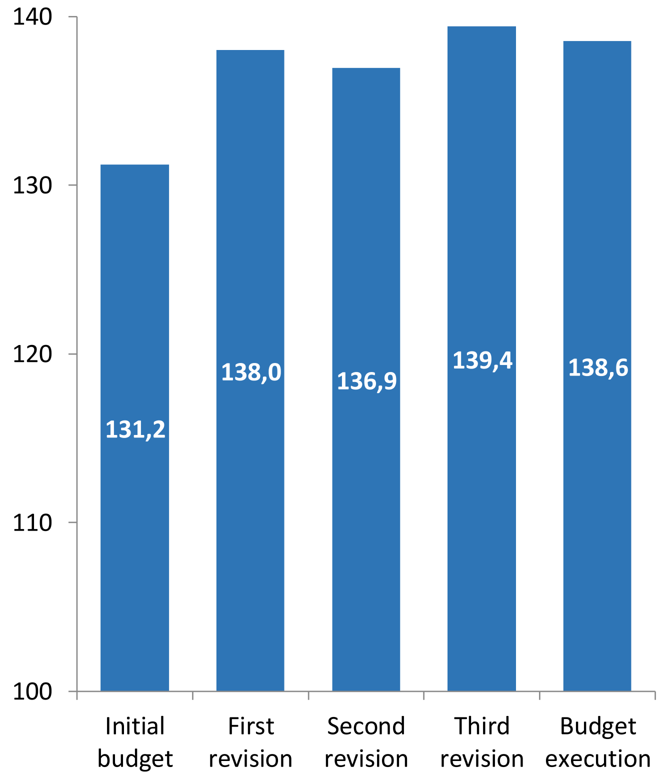
Note: Taking into account the change in the treatment of special pensions by Eurostat, personnel expenditures and total budget revenues have been adjusted in the case of Romania in order to avoid double counting.

Regarding the share of expenditures with salaries in the budget sector in total revenues collected, according to ESA 2010 standards, Romania was in 2020 on the first position in the ranking of the 27 EU countries, as in the previous year. If until 2009 Romania was placed in the first half of the ranking in terms of the share of expenditures with salaries in total revenues (on the eighth position in 2008 and the tenth in 2009), in 2011 as a result of the fiscal consolidation measures initiated in mid-2010, Romania dropped to the 19th position out of 27. In 2013, Romania reached the 17th position in this ranking, against the background of salary recoveries and salary increases of some categories of public servants, in 2015 occupying the 20th place out of 27, on the basis for a slight increase in budget revenues and the maintenance of wage expenditures as a percentage of GDP. Starting with 2016, however, the situation changes and Romania climbs steeply to 10th place, reaching second place in 2017, and in 2018 occupying the first position. In 2020, there **is a trend of slowing down the growth of staff costs**.

Social assistance expenditures were higher in 2020 than in the draft budget, being revised upwards during the three budget revisions mainly due to the evolution of the Pandemic and the need for state support for employees in the sectors affected by the it. Although estimated in the budget proposal for 2020 at a level of 131.2 billion lei, the actual execution of social assistance expenditures, net of the impact of compensation schemes was 138.6 billion lei, by 4.7% (the equivalent of about 5.2 billion lei) more than in the initial program.

Starting with 2009, the deficit of the social insurance budget, considering also the special/service pensions, deepened significantly, reaching the maximum level of 21.3 billion lei in 2020. In 2018 it decreased significantly, reaching 11.6 billion lei, mainly as a result of the adoption of fiscal measures regarding the resettlement of the income tax structure from salaries, pensions, self-employed activities and copyrights by transferring contributions from employer to employee.

Figure 20: Social assistance expenditures in 2020 (billion lei)

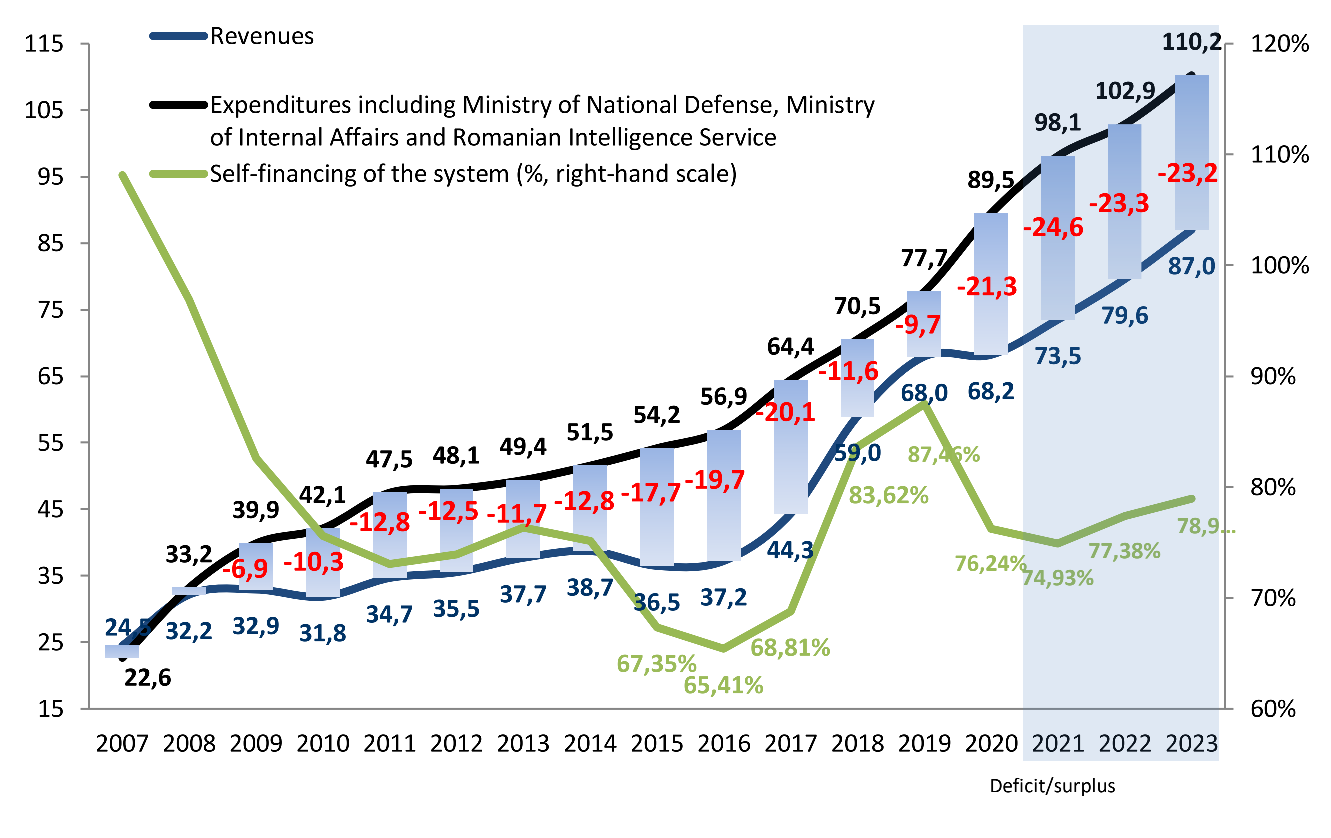


Source: MF

Thus, although the total contribution rates apparently decreased from 39.25% to 37.25%, the transfer of contributions from employer to employee led to a significant increase in gross salary, practically leading to an increase in the level of taxation through insurance contributions by about 13.9%. In addition to the increase in labor taxation through SSC, the reduction of the deficit in 2018 is also explained by the reduction of the share of contributions to the Second Pillar of pensions (from 5.1% in 2017 to 3.75% in 2018). In 2019, the deficit of the social insurance budget continued to decrease, reaching the value of 9.7 billion lei, as a result of the increase in the number of employees in the economy. In 2020, the deficit in the social insurance budget deepened both due to the increase in pensions and the unfavorable evolution of incomes, as a result of the recession generated by the Pandemic, but also to the measure of postponing the payment of taxes due by economic agents.

Estimates for the coming years, according to data from the fiscal strategy for the period 2021-2023, show that the deficit of the social insurance budget will remain on an upward trend in 2021, registering a significant increase to the level of 24.6 billion lei, followed by a moderate decrease to 23.3 billion lei in 2022 and 23.2 billion lei in 2023. In the Opinion on the draft budget for 2021, the Fiscal Council drew attention to the fact that risks remain regarding to this expenditure aggregate, despite the freezing of the pension point and special pensions, given that the slight increase in the average pension (regardless of the increase in the pension point) observed in previous years will continue in 2021 (in the case of pensions state, the trend is also explained by the calculation formula which is favorable to those who retire in the current year).

Figure 21: The evolution of revenues and expenditures from the social security budget (billion lei)



Source: MF, cash standard data

Note: In addition to the expenditures of the social security budget, military pensions were also included for the 2016-2022 period. According to Law no. 223/2015, since January 1, 2016 the necessary funds for paying military pensions and other social security rights due to military pensioners are provided from the state budget, through the budgets of the following institutions: Ministry of National Defense, Ministry of Internal Affairs and Romanian Intelligence Service.

From the perspective of expressing the deficit as a percentage of GDP, the achievements indicate a decrease from 2.29% in 2011 to 1.92% in 2014, followed by a further increase in 2015 to 2.48%, and a significant decrease in 2018, when it reached 1.21% of GDP and in 2019, when it reached -0.92%. The downward trend of the deficit as a share in GDP was reversed in 2020, its level reaching 2.01% of GDP based on the economic contraction caused by the COVID-19 pandemic, but also by the significant increase of the social assistance expenditure aggregate, of 15.15%, while revenues remained relatively constant compared to 2019. Projections for the following years indicate an increase in 2021, followed by successive decreases in 2022 and 2023[73] (2.15%, 1.89% and 1.74%).

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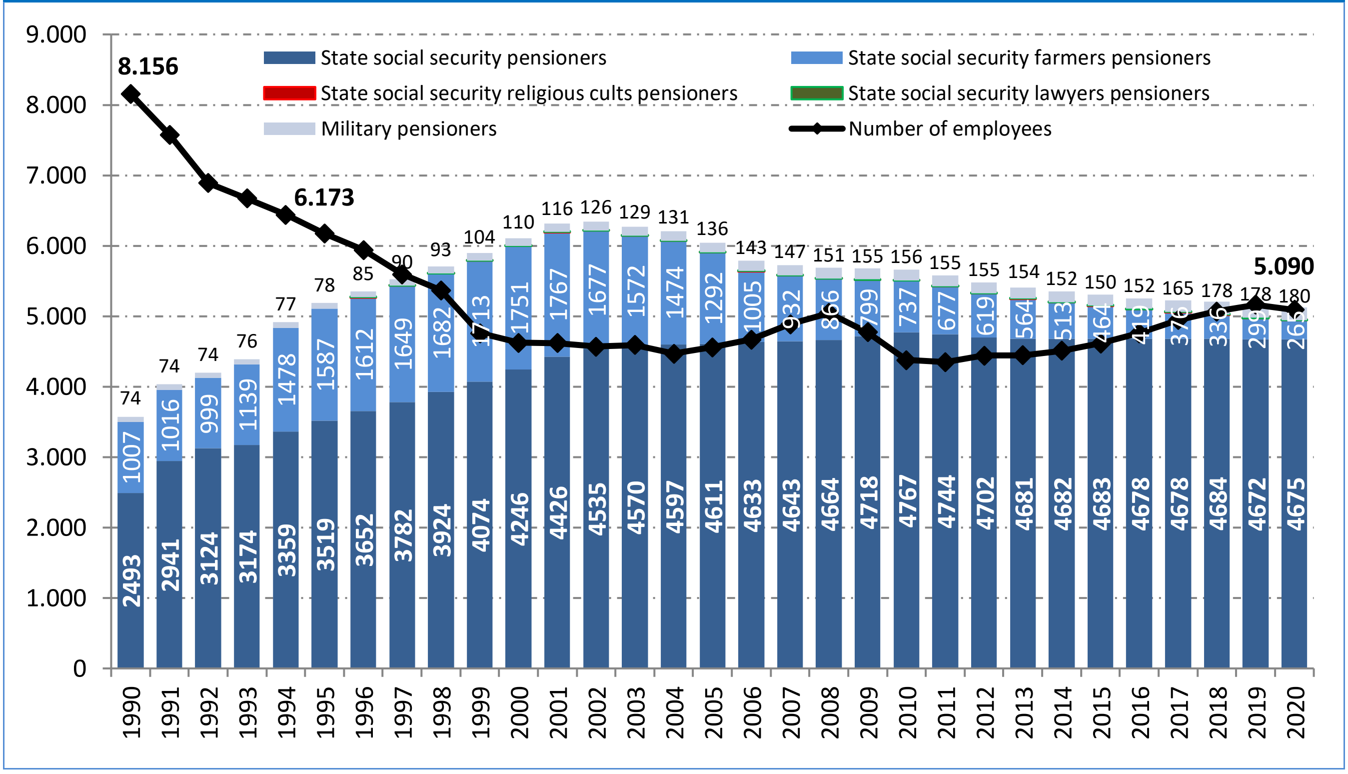
[73] According to the growth hypotheses presented by the Ministry of Finance in the Fiscal Strategy for the period 2021-2023.

The deficit of the state social insurance budget took place due to the excessive increase of social insurance budget expenditures from 2007-2009 (+75.8%) and in the context of a favorable dynamics of receipts from contributions in the period preceding the financial crisis, as a result of the economic boom, but also anticipating the maintenance of this trend in the future. However, a significant part of the increase in contribution income proved to be cyclical, with subsequent developments refuting the optimistic forecasts that underpinned the substantial increase in the pension point. The self-financing of the system decreased sharply from 2006 (from 111.8%) to 2011 (73.02%), reaching the historical minimum in 2016 (65.4%) and remained close to 2017 (68.84%). In 2018, the self-financing capacity registered a slight recovery reaching 83.6%, and the growth continued in 2019 when the value of 87.5% was registered. For 2020, there was a reduction in the degree of self-financing of the system, its value being 76.24%. Estimates show the continuation of the downward trend in 2021, being projected a level of 74.93%, but the premises for 2022 and 2023 are more optimistic, this indicator recording the value of 77.38% in 2022 and 78.93% in 2023.

Figure 22: The evolution of the number of pensioners versus the number of employees (thousand persons)



Source: NIS, except for the 2020 number of employees provided by the NCSP 2021 Winter Forecast

The decision to increase permanent expenses such as those related to pensions should take into account the trend of income from contributions, as well as forecasts on the employee-pensioner ratio, especially in the context of the accentuation of the demographic aging phenomenon, on January 1, 2018 the people of age 65 years and over numerically exceeding the young population of 0-14 years (3,596 thousand compared to 3,042 thousand people) according to NIS data. At the same time, the need to find an indexation rule to ensure the long-term sustainability of the social security budget instead of the discretionary approach of the past has become apparent.

The ratio between the number of taxpayers and the number of beneficiaries has decreased very sharply in the last 30 years, from 2.28 employees to a pensioner in 1990 to only 0.99 employees to a pensioner in 2020, the number of social security pensioners state with an upward trend, while the number of employees had a downward trend, especially until 1999-2002. However, recently the ratio has improved from 0.77 employees to a pensioner in 2010, to 0.84 employees to a pensioner at the end of 2014, standing in 2016 at 0.91, slightly exceeding the level of 0.89 in 2008. The European Commission's projections[74] show that the ratio between the population over 65 and the population aged 15-64 will increase from 28.98% in 2019 to over 50% in 2050.

The year 2020 marked important developments in social assistance expenditures, from the perspective of the change, on the occasion of the second budgetary revision, in pension point value, from an increase of 40% to 14%, and the increase in child allowances by 20% from 1 August 2020. As the FC mentioned in the Opinion on the second rectification of the general consolidated budget for 2020, raising pensions is a valid goal, but on the incompatibility of such an increase with the desire to ensure fiscal and budgetary discipline, to create macroeconomic premises for accession to the euro area, being likely to lead to significant deterioration of public finances and having a destabilizing effect on the domestic economy. Compared to the previous version of the law, this decision involved lower expenditures both in 2020, by approximately 6.8 billion lei and by 20.3 billion lei in 2021, thus limiting the even stronger deterioration of budget deficit. With regard to the decision to increase the pension point, the FC considers that such measures cannot disregard the general situation of GCB, whose primary and structural deficit remains at very high levels, which clearly requires a correction process, so that decisions to increase permanent expenses will inevitably lead later to the adoption of additional corrective measures of an equivalent size.

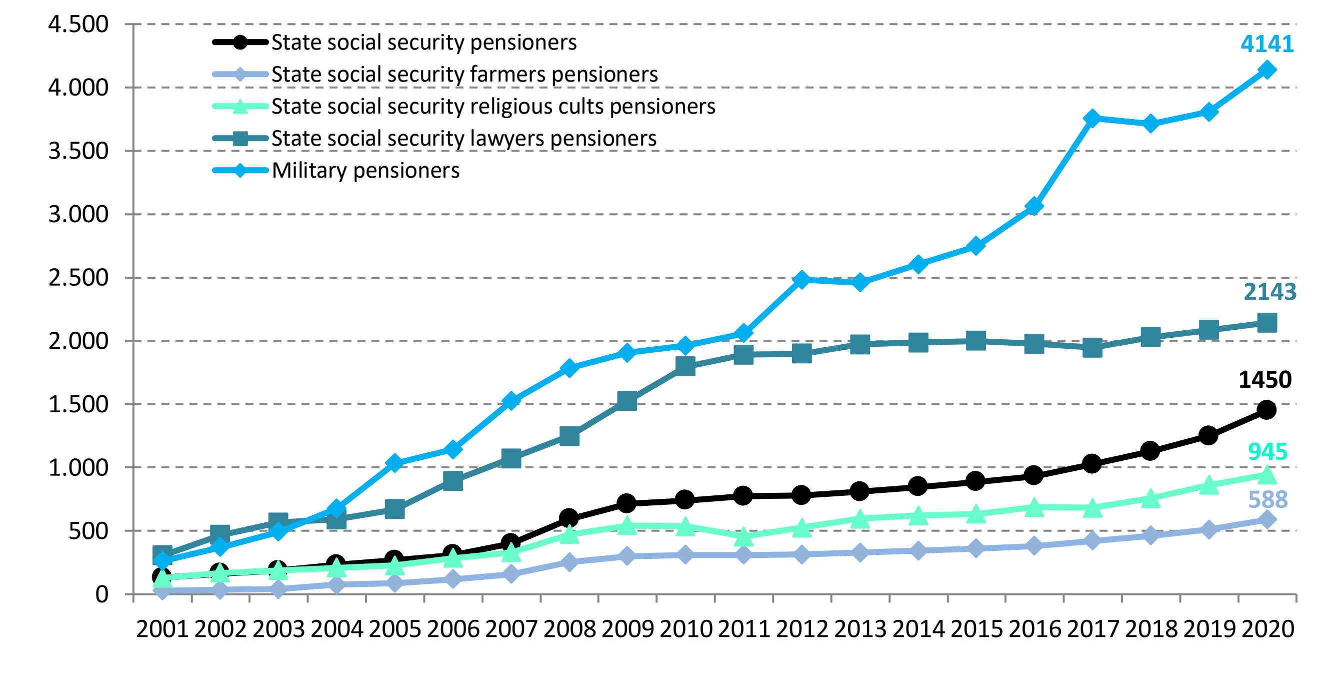
The FC considers that a rules-based approach to pension indexation would bring multiple benefits in terms of the stability of the pension system and anchoring participants' expectations, fiscal sustainability and budgetary programming.

According to NIS reports, in 2020, the average monthly pension was 1,500 lei, increasing by 16% compared to the previous year, given the indexation of the pension point by 14%, respectively by 165 lei starting with September 1. The pensions paid from the social insurance budget stood at an average level of 1,450 lei, and those corresponding to agricultural pensioners were on average 588 lei. At the same time, the pensions granted to the military reached an average monthly level equal to 4,141.4 lei, increasing by 333.6 lei (8.8%) compared to the level of 2020. It should be noted that the average monthly pension corresponding to the beneficiaries from the system of defense, public order and national

[74] According to *Ageing Europe — looking at the lives of older people in the EU* report (https://ec.europa.eu/eurostat/documents/portlet_file_entry/3217494/KS-02-20-655-EN-N.pdf/9b09606c-d4e8-4c33-63d2-3b20d5c19c91).

security increased by about 111% between 2010 and 2020, while those of pension beneficiaries from the state social insurance budget increased by 96.2% over the same period.

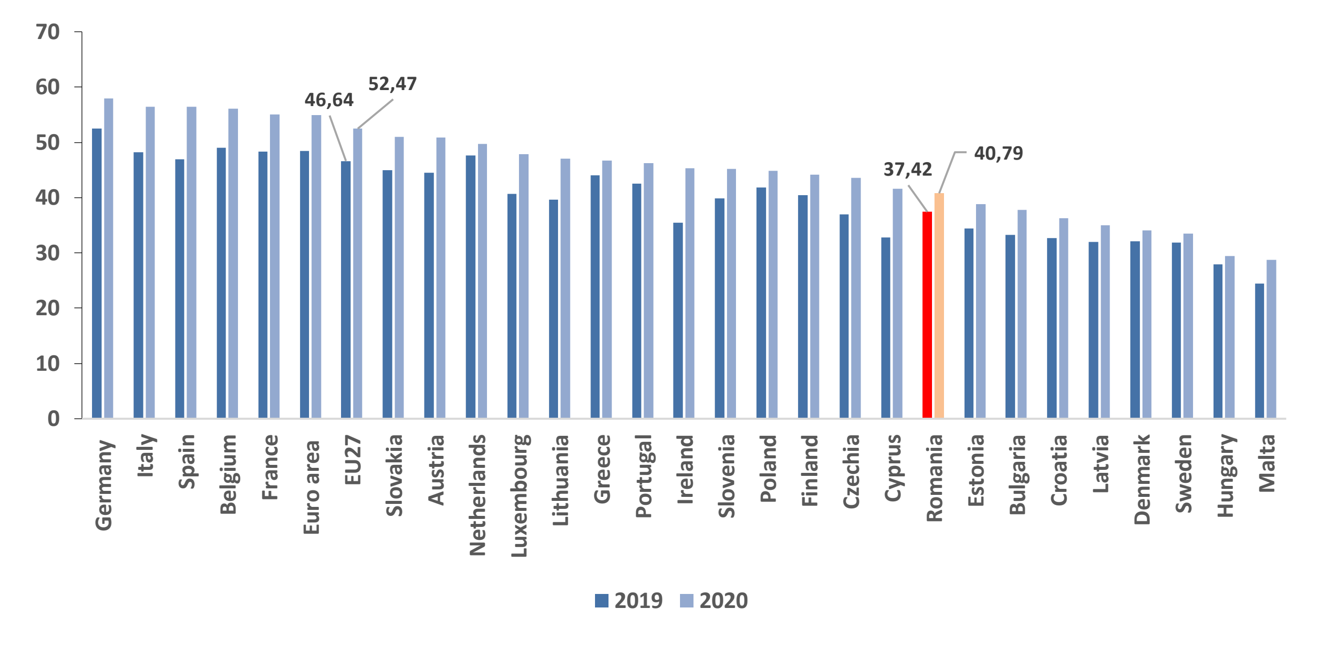
Figure 23: The evolution of the average pension (lei) between 2001-2020



Source: NIS

In 2020, Romania was 3 positions lower in the ranking of EU member states by the share of social assistance expenditures in total revenues, respectively on the 21st position, in 2019 occupying the 18th position. In 2020, the share of social assistance expenditures in total budget revenues increased by 3.6 pp compared to the previous year. This increase was also determined by the faster growth rate of this category of expenditures compared to that of budget revenues in GDP, but also by the fact that the Government intervened to support citizens working in industries affected by the pandemic COVID-19 . At the same time, the fact that Romania downgraded 3 positions in this ranking can also be attributed to the fact that other EU countries had the necessary fiscal space before the Pandemic to funding a wider range of measures to support the population working in sectors affected by the restrictions imposed to prevent the spread of the SARS-COV-2 virus, while in Romania it was greatly diminished even before the outbreak of the Pandemic.

Figure 24: Social assistance expenditures as a share of total budget revenues in EU27 countries



Source: Eurostat

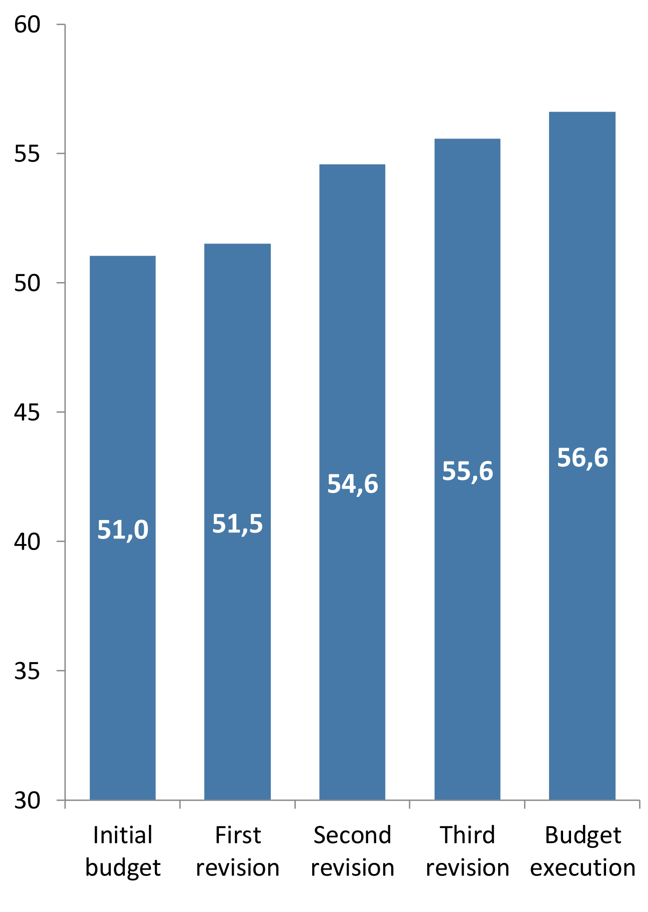
Note: Taking into account the change in the treatment of special pensions by Eurostat, total budget revenues have been adjusted in the case of Romania in order to avoid double counting (similar to Figure 19).

III.5.2. Goods and services expenditures

The execution of **goods and services** expenditure recorded a much higher level, both compared to that envisaged in the draft budget (+4.2 billion lei), and to the values projected on the occasion of the three budget revisions made during the year mainly as a result of measures taken by the authorities to combat the effects of the pandemic. Initially projected at 51.0 billion lei, the final execution of this aggregate reached a level of 56.6 billion lei, being by 5.1 billion lei higher than the value estimated in the first budget revision, by 2 billion lei higher than the value proposed in the second budget revision and by 1 billion higher than the value proposed on the occasion of the third revision.

Expressed as a share in GDP, expenditures on goods and services increased by 0.33 pp compared to 2019, reaching the level of 5.37% of GDP. Compared to the execution of 2019 (53.3 billion lei), this category of expenditures (net of the impact of swap compensation schemes) was projected, in the initial version of the budget, at a lower level by about 2.2 billion lei.

Figure 25: Goods and services expenditures in 2020 (billion lei)



Source: MF

During 2020, the budget allocation was increased on the occasion of each of the three budget revisions made. At the first budget revision, operated in April 2020, the amount of the aggregate of expenditures on goods and services was revised upwards by 0.5 billion lei, respectively by 2.5% below the nominal level of this aggregate in 2019. In the first two months of 2020, the dynamics of this aggregate was about 14% compared to the same period of 2019, without taking into account the impact of additional needs related to this category generated by the fight against the COVID-19 pandemic, this fact showing a sub-budgeting with 0.2-0.4% of GDP before the outbreak of the Pandemic.

On the occasion of the second budget revision, expenditure on goods and services was revised upwards. Even in these conditions, the Fiscal Council considered it probable that in the context of the pandemic, this aggregate would be under-dimensioned by about 0.3-0.5% of GDP. At the same time, the amount taken into account on the occasion of this budget revision of about 54.6 billion lei, increasing by 3.1 billion lei compared to the target proposed at the first budget revision and by 3.4% above the nominal level in 2019, although in the first seven months of 2020, the growth of this aggregate was about 15%

higher than in the same period of 2019, mainly due to the endowment of the health system with those necessary to fight the COVID-19 pandemic.

On the occasion of the third budget revision, an additional allocation of 1 billion lei was registered, the new tire being at a level of 55.6 billion lei, respectively by about 5.3% above the nominal level in 2019. And on the occasion of the third budget revision, the FC drew attention to the fact that this aggregate is under-dimensioned by about 0.15-0.25% of GDP, taking into account that in the first 9 months of 2020 , this category registered a growth rate of about 12.7% compared to the same period in 2019.

From the note accompanying the execution of the general consolidated budget for 2020[75], the main explanation for the fact that this aggregate was increased during each budget adjustment that took place during 2020 is the need to support the medical system in the fight against the COVID-19 pandemic, especially at the level of local administrations through subordinate hospitals, that needed funds to purchase medicines, medical supplies, reagents and other products needed to fight the pandemic. Also, an increase is reflected in the budget of the National Unique Health Insurance Fund of 3.7% compared to the previous year determined by higher returns for the payment of medicines subject to cost-volume contracts and for the settlement of outpatient medical services .

The cumulative increases made in the context of the budgetary corrections of the allocations related to this expenditure aggregate, as well as the final execution, confirmed the observations of the Fiscal Council on the need for additional allocations compared to the amounts advanced at that time.

In previous years, the aggregate of expenditure on goods and services proved difficult to control. Thus, in the periods 2011-2013 and 2017-2020, the level of expenditure on goods and services (net of the impact of compensation schemes) recorded in the budget executions was higher than the initial budget or even revised upwards on the occasion of budget revisions, while the period 2014-2016 was characterized by a different situation, the final execution registering a lower level of expenditures compared to the last budget iteration.

The Fiscal Council notes a chronic lack of transparency regarding the projection of this expenditure aggregate, the assumptions underlying the trajectory of this expenditure chapter or the motivation for large-scale revisions during the year are not explained in the documents accompanying successive iterations of the budget. These explanations are all the more necessary as changes are often substantial with the potential to influence the achievement of the budget deficit target or compliance with fiscal rules. The Fiscal Council calls for budgetary programming to include all the expenditure envisaged under this budget chapter in the draft budget together with an appropriate breakdown of the allocation of funds, as well as for comprehensive explanations on budgetary adjustments in relation to sources. potential increases in this category of expenditure. Increased transparency could be a good starting

[75] Note of the implementation of the consolidated general budget - December 2020 (https://mfinante.gov.ro/documents/35673/377101/nota_bgc31dec2020.pdf)

point for streamlining spending on goods and services, but this needs to be accompanied by a broad reform of the public procurement system in general.

III.5.3. Public investment expenditures

Investment expenditures include, according to the budget classification, capital expenditures (non-financial assets), projects financed from non-reimbursable external funds after accession, expenditures related to reimbursable financing programs, capital transfers and other investments of an investment nature. In this chapter, the structural analysis of this budget aggregate follows the above definition.

Compared to the previous year, in 2020, state investment expenditures, considering all budget chapters included in this category, including the amounts related to the *swap* compensation scheme, increased by 9.4 billion lei, from 43.7 billion lei to 53.1 billion lei (in *cash* standards), respectively, by 21.5% in nominal terms, and in real terms by 17.3%[76], the share of investment expenditures in GDP increasing by 0.9 pp. from 4.13% of GDP in 2018 to 5.03% of GDP) amid an investment recovery in 2020 (which also includes an increase in the absorption of European funds), but also a nominal GDP reduction of 0.25% (compared to an increase of over 11% in 2019 compared to 2018).

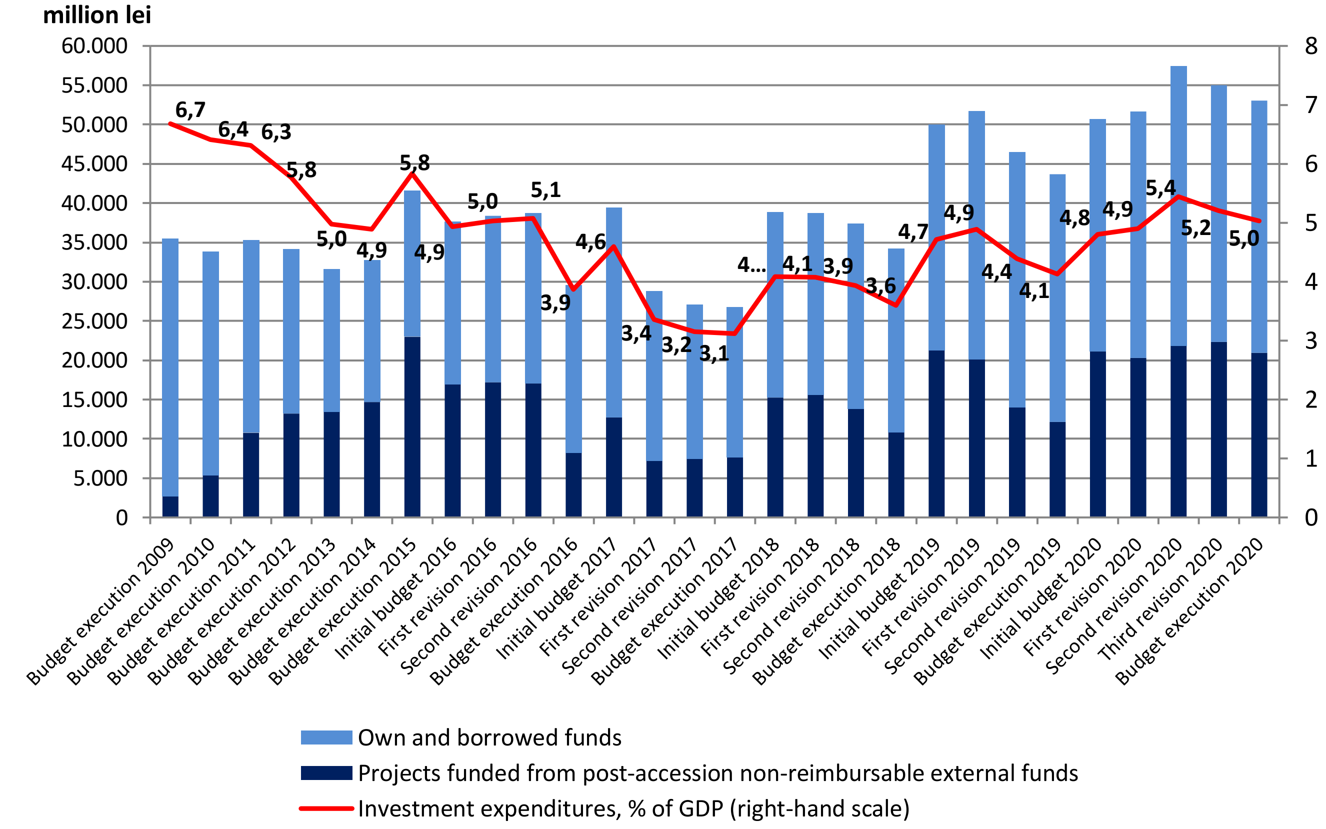
The analysis of this budgetary aggregate from the perspective of the comparison between the actual achievements against the values planned in the initial budget or on the occasion of budgetary corrections for the period 2015-2019 constantly reveals considerable deviations, in the sense that the results of executions are without exception lower than the initial budgets. the rectified ones (*Figure 26*). The year 2020 is differentiated by a net result higher in execution compared to the estimate from the initial budget (+2.4 billion lei, respectively +0.23 pp of GDP), but below the estimate from the second budget correction (-4.3 billion, respectively, -0.41 pp of GDP), or the third rectification (-1.9 billion lei), amid the failure to make estimates on financing from non-reimbursable external sources. It should be noted that, in the context of extremely high uncertainties in the context of the Pandemic and the closure of some economic sectors in the first part of the year, the positive evolution of this budget aggregate contributed decisively to mitigating the economic downturn in 2020 Q4 the highest economic growth compared to the third quarter of the EU (4.8%).

Compared to 2019, for which the execution reported to the initial program for *European funds intended to finance investment expenditures* was 57.1%, in 2020 the degree of realization of the program reached 99.2% (respectively, a non-achievement of -186 million lei), this year being the last year in which projects related to the financial year 2014-2020 were submitted. Compared to 2015, which represented a maximum investment due to the very high absorption of European funds in the previous financial year (2007-2013), the ratio between internal and external sources of financing for public investments is almost double (139% in 2020 compared to 74% in 2015), but still well below the level recorded in the previous year (235% in 2018). The share of investment as a percentage of GDP (with the amendment

[76] The GDP deflator (values of investment expenditures in cash standards) was used as the price index.

that in 2020 real GDP decreased by 3.9%), practically approached the level recorded in 2013-2014, still below the average of 2009-2015 (5.8% of GDP). In the event of a much better absorption in 2021 of European funds in the financial year 2014-2020, those of the next financial year 2021-2027 and, in particular, the availability of additional sources of funding by facilitating the recovery and resilience mechanism in the next period, it is possible that the upward investment trend of the last period will be significantly accentuated in the next 3-4 years.

Figure 26: The evolution of public investment expenditures between 2009-2020 (million lei and % of GDP)



Source: MF

When drawing up the budget for 2020, the return on an upward trajectory of the aggregate investment expenditure was taken into account, after the result registered in 2019 (4.12% of GDP), based on a possible recovery in attracting European funds and continuing compliance with the commitment assumed by Romania within NATO[77]. In the initial budget construction, investment expenditures were slightly forecast over the 2019 program (at 50.68 billion lei compared to 49.95 billion lei)[78] and with a

[77] Allocation of 2% of GDP for the endowment of the army, for strengthening Romania's strategic partner profile at NATO, EU and USA level according to the Government Program 2017-2020, as well as for streamlining the endowment of the Romanian Army in accordance with the measures in the Memorandum approved by Council Decision Supreme Court of National Defense no. 174/24.11.2016

[78] Respectively, by +0.75 billion lei, but significantly over the execution of 2019 (+7 billion lei).

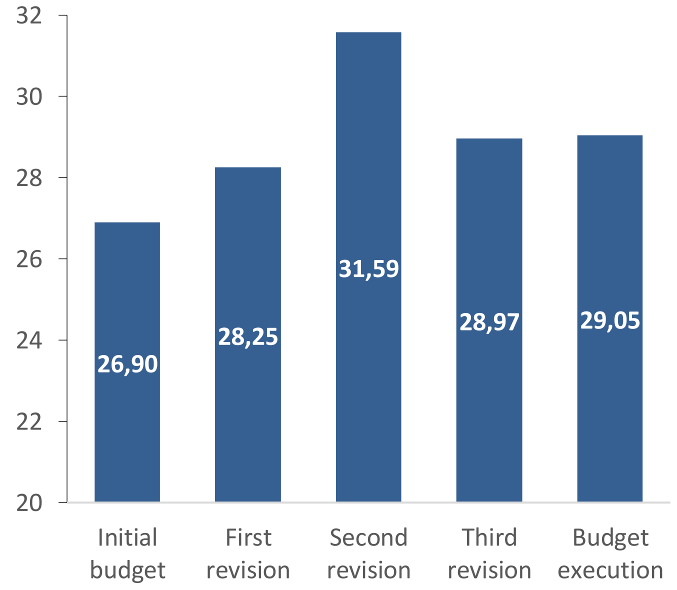
financing structure from similar internal and external sources. Compared to the previous year's execution, characterized by a major non-realization localized at the level of expenditures related to projects financed from EU funds (-43%, respectively -9.1 billion lei), which, even if it was partially mitigated by supplementing domestic sources of financing, led to a non-realization of -6.3 billion lei for the investment expenditures related to the program, in 2020 the program was exceeded by 2.4 billion lei, amid the supplementation of internal sources of financing, while the non-realization at the level of sources from external financing being minor (-0.2 billion lei).

The quarterly evolution of investment expenditures indicates a concentration in the last quarter (almost half of the total year), which, given the extremely high degree of uncertainty regarding budget revenues in the context of the Pandemic, is partially justified, but given the similar developments in previous years, calls into question the efficiency of the budgetary programming process both in terms of how investment projects are managed and in terms of establishing criteria for making investments in accordance with their importance and usefulness. The amounts allocated in the last quarter were 2.4 times higher than the average of the previous three quarters, this budget aggregate, systematically, showing an extremely high volatility of the quarterly distribution of scheduled expenditures compared to the actual ones. From the perspective of the evolution of the share of quarterly investment expenditures in total execution, it fluctuated between 11% in the first quarter, 19.3% in the second quarter and 25.7% in the third quarter, reaching 43.9% in the last quarter of the year 2020, being approximately in line with the quarterly evolution of the flows related to the projects financed from non-reimbursable external funds.

In 2020, *capital expenditures* for investments[79], were projected through the initial budget at a level higher by 5.5 billion lei than in the initial program of the previous year, respectively by 3.2 billion lei below the amounts actually achieved in 2019, relying on a better absorption of European funds, a correct approach from the perspective of the Fiscal Council.

The final execution recorded a level by about 2.2 billion lei higher than the program established by the initial budget of 2020 (+8%), respectively by over 1 billion lei below the value recorded in 2019 (-3.4%).

Figure 27: Capital expenditures in 2020 (billion lei)



Source: MF

[79] These are the main component of GCB's capital expenditures (which also include capital transfers and inventories).

The projects with financing from non-reimbursable external funds (NREF) for public investments were estimated by the initial budget of 2020 at a level close to the program for the previous year (21.1 billion lei), respectively by over 8.3 billion lei higher than the execution of 2019. Compared to the estimates from the initial budget and from the three budget revisions operated during the year, the final execution recorded about 21 billion lei, very close to the initial estimate (a non-achievement of -164 mil. lei), relatively large deviations being registered in relation to the scheduled level through the second rectification (-0.9 billion lei), respectively, the third budget rectification (-1.9 billion lei). At the level of the total amounts related to the financial framework 2014-2020, the increase compared to 2019 was of about 7.4 billion lei, excluding the impact of the funds destined for agriculture of +5.5 billion lei.

Expenditures related to reimbursable financing programs, which have an extremely low share in total investment expenditures, were above the level recorded in the previous year (by 325 million lei, respectively +75.3%), and above the estimate from the projection initial budget (by 187 million lei, respectively, by 32.8% over the program).

Box 1: Changing the scope of budget revenues and expenditures for projects funded by non-reimbursable funds during 2016-2020

Starting with 2016, the aggregate of *projects with financing from non-reimbursable external funds* (NREF) *post-accession* (most of which was for investment) also includes funds for agriculture, which in previous years were not included in NREF, considering that these funds does not transit the state budget, being intended for the private sector. Since 2017, in addition to funds for agriculture have been included, according to art. 10 of GEO no. 40/2015, and transitional amounts representing funds intended for pre-financing of non-governmental sector projects in case of temporary unavailability of European funds (TUEF). Thus, in 2020 out of the total of 41.6 billion lei related to payments related to projects financed from NREF 2014-2020, 16.1 billion lei) were allocated to payments for agriculture (respectively EAGF and EMFF related to the financial year 2014-2020) and 1 billion lei for TUEF. Out of the difference of 24.5 billion lei representing structural and cohesion funds whose final beneficiary is the state, 20.95 billion lei (85.5% of the latter) were allocated to investment expenditures. It should be noted that, in 2015, the maximum year for attracting NREF related to the financial year 2007-2013, the projects financed from NREF post-accession amounted to 24.6 billion lei (of these, 0.5 billion lei NREF related to the financial year 2014-2020), of which 23 billion lei were allocated for investment expenditures (94% of the total post-accession NREF). We mention that, from the perspective of the ESA 2010 methodology, only the structural funds whose final beneficiary is the state are relevant, the amounts destined for agriculture and the pre-financings granted to the non-governmental sector not being included in the public administration sector. Moreover, the transit of GCB by the amounts representing funds intended for agriculture and pre-financing of non-governmental sector projects in case of temporary unavailability of European funds makes it practically impossible, at aggregate level, the comparability of budget execution data for 2016-2020 with European funds flows from financial year 2007-2013.

An analysis of the efficiency of investment spending over the last few years reveals from this perspective an unsatisfactory result for our country, especially in relation to the evolution of other EU Member States. In the 2020 Country Report prepared by the EC[80], it is reiterated that despite a relatively high level of public spending on investment, Romania stands out with insufficient infrastructure, with a negative impact on the connection to the main transport corridors[81], on the mobility of the work, but also on the decisions of private external investors to invest, thus accentuating regional disparities. Given that Romania has had, in the last decade, one of the highest rates of public investment, the infrastructure is insufficient both in terms of quantity and quality, which indicates a poor efficiency of public capital expenditure. Moreover, the EC notes that insufficient investment in transport, energy and environmental infrastructure affects the potential of the economy to move closer to EU levels. Among the factors that contributed to this situation, highlighted in the Report, are: the low degree of absorption of European funds; reduced administrative capacity; lack of legislative predictability and persistence of inefficiency in the preparation, prioritization and implementation of investment projects with economic impact.

Figure 28: Projects funded from post-accession non-reimbursable external funds in 2020 (billion lei)

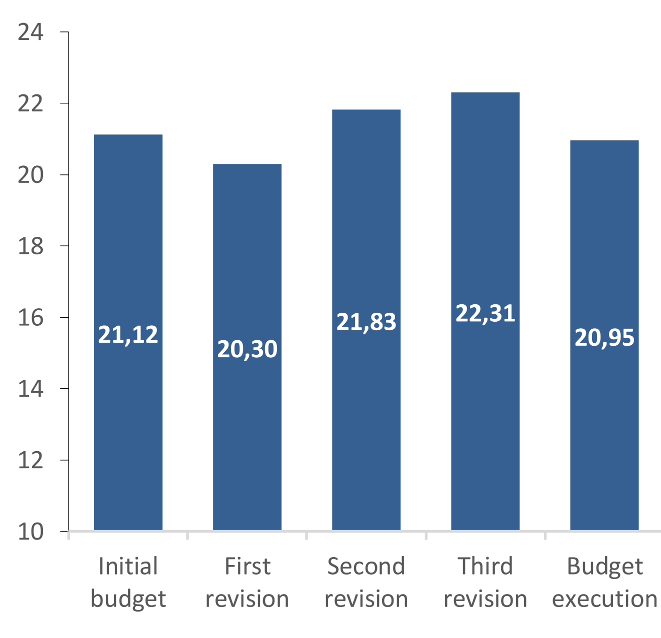
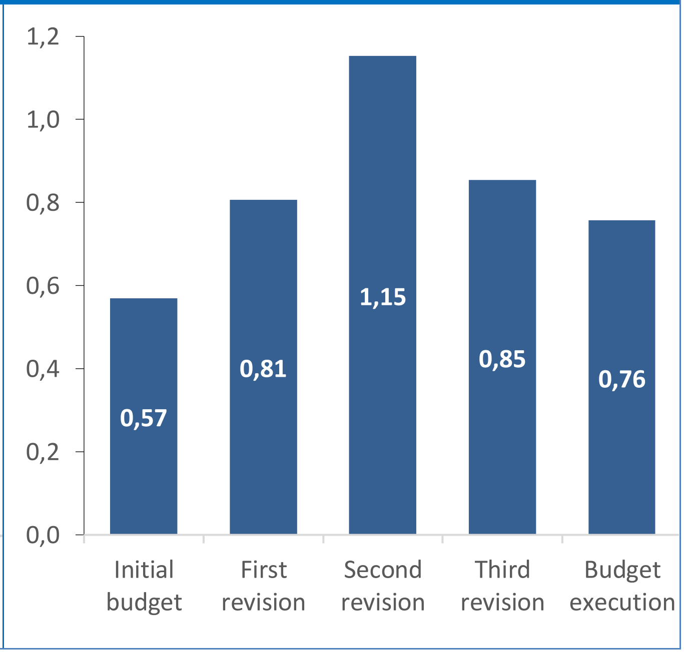


Figure 29: Expenditures funded from reimbursable funds in 2020 (billion lei)



Source: MF

The quality of infrastructure in Romania is among the lowest in Europe, especially in critical sectors such as road, rail and energy infrastructure due to the extremely modest performance of most state-owned enterprises and the lack of progress in restructuring those who record losses. It should be noted that,

[80] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52020SC0522&from=EN

[81] Romania is on the last place in the EU regarding the density of highways, but on a leading place regarding the risk of road accidents.

although in 2019 the rate of new investments in state-owned companies[82] increased significantly compared to the previous year (to 5.8%[83] from 1.3% in 2018), it remains at a level much lower than the average recorded in the pre-crisis period (about 12%). Empirical evidence from the literature suggests that there is a correlation between the inefficiency of public spending and the overestimation of effective share capital, with poor results of state-owned enterprises - the main providers of infrastructure in these areas - being considered of particular concern[84]. Moreover, the poor condition of the infrastructure is directly responsible for the low efficiency[85] with which Romania can deliver its goods and connect producers with consumers, compared to its main trading partners in the EU.

This fact is supported by the statistical data published by Eurostat, if we consider the position of Romania in the first half of the ranking in terms of the share of public investment in GDP as an average over the last 10 years for EU Member States[86] (8th place - after Estonia, Hungary, Latvia, Sweden, Poland, the Czechia and Finland), respectively, in third place in terms of the average share of public investment in total budget revenue over the same period (ahead of Estonia and Latvia), while the quality of infrastructure (especially that of road transport) will place us in 2019[87] in the last position within the EU28, which proves the weak capacity to adequately spend funds for public investments.

The year 2020 marked an investment recovery, the share of public investments in GDP and budget revenues being above the average of the last 10 years, respectively, 4.6% compared to an average of 4.13% of GDP (but below the value recorded in 2015, by 5.2% of GDP). Compared to a 10-year average of the share of investments in budget revenues of 12.4%, in 2020 they represented 13.9% (compared to 14.6% in 2015), which, in the context of continuing this trend, by making maximum use of European funds, it is likely to contribute to reducing the gap between the quality of infrastructure in Romania and that of most EU countries, in the perspective of the coming years.

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[82] http://www.consiliulfiscal.ro/Analiza%20SOE%202019%20RO.pdf

[83] Excluding the influence of the revaluation of the assets of the R.A.-A.P.P.S. the growth rate is only 3.2%.

[84] http://ec.europa.eu/economy_finance/publications/country_focus/2015/pdf/cf_vol12_issue1_en.pdf

[85] Measured by the performance index for logistics services (IPL), which, according to the 2018 Report prepared by the World Bank (https://lpi.worldbank.org/) is well below that of Germany, Italy and France. Compared to the previous report (since 2016), Romania has increased in the IPL ranking for infrastructure with 7 positions, being on the 51st place, far from Germany (1st place), France (13) and Italy (19). The six components of the IPL include: (i) the efficiency of the customs clearance process (speed, simplicity and predictability of formalities) by border control agencies, including customs; (ii) quality of trade and transport infrastructure (ports, railways, roads, information technology); (iii) ease of organizing shipments at competitive prices; (iv) competence and quality of logistics services (transport operators, customs brokers); (v) ability to track shipments; (vi) the frequency with which the shipments reach the consignee during the scheduled or scheduled delivery.

[86] Excluding Great Britain.

[87] According to the Global Competitiveness Report for 2019. In 2020, the Global Competitiveness Report no longer offers rankings by country, as in the previous years, establishing only new directions to support policy makers in the unique context and priorities redefined by the Pandemic.

Regarding the efficiency reserves regarding the way of spending public funds allocated to investments, they are high, and the Government initiated in the period 2013 - March 2014 a reform process regarding the management of public investments[88]. In this regard, a technical assistance contract was signed with WB on *"Improving the management of public investments"*, in order to improve the process of preparation, selection and strategic prioritization of public investment projects, which was completed in December 2015, during 2016 being implemented the recommendations for improving the selection process of public investments and strengthening the role of the Public Investment Evaluation Unit in the related legislation (GEO no. 88/2013[89], GD no. 225/2014). From 2017, the provisions of *Decision no. 907/2016* on the stages of elaboration and the framework content of the technical-economic documentation related to the objectives / investment projects financed from public funds, in order to eliminate the deficiencies signaled in the development of the investment process, to optimize financing and achieve investment objectives and increase efficiency public funds. *By Decision no. 363/2018 for amending and supplementing the Methodological Norms on prioritizing public investment projects*, new clarifications were made to the procedure for prioritizing new investments, but efforts are needed to prioritize public investment projects and their preparation.

Romania's General Transport Master Plan adopted in 2016, which was an important step towards improving strategic investments in road and rail transport infrastructure, is progressing very slowly so far.

The NIS communiqué from March 2021 highlights that, in 2020, despite an unprecedented level of uncertainty, there was a dynamic of productive investment of 5.6% compared to the previous year, supported by a low level of real costs. financing, the implementation of the SME Invest program, but also of a high development potential in the domestic economy. Given the latter aspect, the possibility of attracting public investment by public ones, the Fiscal Council advocates accelerating efforts to implement real reform measures in the field of public investment to take full advantage of the exceptional opportunity to access European funds over 60[90] billion euro. These directions of action include: streamlining the public procurement process, resuming corporate governance reform in state-owned companies, strategic investment planning, directing them to key policy areas, and strengthening the prioritization of business projects. public investment, consulting the private environment in adopting

[88]In accordance with the requirements of the new legal framework, before approving the budget, the MF is obliged to present to the Government the list of prioritized public investment projects to be financed by the state budget, selected according to opportunity, economic and social justification, sustainability. financial, the remaining period until completion, the commitments assumed by Romania with the international financial institutions.

[89] Amended in 2015 in order to align the process of prioritizing significant projects with the budget calendar.

[90] Of these, 29.2 billion euro through the Recovery and Resilience Mechanism, 30.3 billion euro through the Multiannual Financial Framework 2021-2027. From this volume of resources, Romania's contribution to the EU budget must be deducted (including the additional contribution related to the European recovery and resilience plan).

measures to impact on it and creating a legal institutional framework for assessing the impact of regulations in the field.

The Fiscal Council advocates the firm application of the legal framework on public investment management and considers that extremely limited progress has been made on reform in this area, and decisive steps are needed to increase transparency in the process of prioritizing public investment and streamlining the allocation process. and spending public money. A good prioritization of investments, their orientation towards the increase of investments in research, development and innovation, in the physical infrastructure and especially in the digital one, can contribute to the reduction of regional disparities and to the improvement of productivity and long-term growth of the Romanian economy. In this sense, the National Recovery and Resilience Plan (NRRP), developed in accordance with Romania's key investment priorities, is a useful tool for consolidating public investment.

III.5.4. The contingency reserve fund and intervention fund at Government's disposal

According to the Public Finances Law no. 500/2002, article 30 para. (2), the contingency reserve fund at the Government's disposal is allocated to main authorizing officers from state government and local governments, based on Government decisions, for the financing of "urgent or unforeseen expenditures" incurred during the budgetary exercise. The legal framework provided by the Law no. 500/2002 specifies only in general terms the allowed allocations from the contingency reserve fund (for "unforeseen and urgent" situations respectively), without explicitly specifying the categories of expenses that can be undertaken from this fund or the allocations amount, thus providing space for discretionary and non-transparent allocations. In this regard, the Fiscal Council maintains its request for a legislative clarification of the way of using amounts from this fund and the allowed destinations, while increasing transparency and public control over the reserve fund.

Even if the year 2020 was marked by extraordinary circumstances that induced unprecedented uncertainties in recent history, triggered by the pandemic caused by the SARS-CoV-2 virus, and the magnitude of the economic and social impact associated with it, we draw attention, like in previous years, to the unending practice to enact government decisions during the year for the use of money from the contingency reserve fund beyond the framework enforced by the Public Finances Law no. 500/2002, respectively for spending that cannot be classified as urgent or unforeseen expenditures. Thus, excluding those expenses generated by the socio-economic effects induced by the pandemic with the new coronavirus, the use of a significant part of the budgetary reserve fund at the disposal of the Government which was approved during 2020 by derogation from the provisions of art. 30 para. (2) of Law no. 500/2002 was intended for expenses that cannot be considered as unforeseen and should have been taken into account when substantiating the state budget, such as:

- financing the National Local Development Program (NLDP) stages I and II;
- various investment expenses (mostly proposed for METROREX S.A.);
- payment of current and capital expenditures for some administrative-territorial units;
- ensuring the continuity of the public service of thermal energy supply;

- financing the costs of supporting the child protection system and the payment of the rights of the personal assistants of the severely disabled and the monthly allowances of the severely disabled;
- organizing and conducting the census of the population and housing in Romania in 2021;
- organization of the general agricultural census in Romania - round 2020 and so on.

The utility of a contingency reserve fund lies in the flexibility given to the Government regarding the annual budget execution, particularly for covering urgent or unforeseen expenditures. The opportunity of including a contingency reserve fund into the general budget is confirmed by the literature on budget programming, which also highlights the necessity of finding a balance regarding the dimension of such a fund. Thus, a level too low of the contingency reserve fund might be insufficient to cover unforeseen expenditures, while an oversized fund might grant too much power for the authorities to make excessive outlays, without the Parliament's approval.

The Court of Accounts, in its Public Report on 2019 published in March, 1st, 2021, identified the following issues regarding the allocations from the budgetary reserve fund (BRF):

- regarding the formation and use of the contingency reserve fund it was found the continuation of the practice of allocating the budgetary reserve fund to the Government's disposal by derogations from the provisions of art. 30 of the Law no. 500/2002 (these accounted for 73.5% of the total amount allocated in 2019), as well as the violation of art. 54, para (10) of the Law no. 500/2002 by constituting the BRF from the amounts deriving from the renunciations of the main budgetary authorizing officers;
- the significant portion of allocations made by derogation from the Public Finances Law indicates the ignorance of the BRF' principle of functioning, that of being a real reserve resource, used exclusively in difficult times, only in the last instance and under the condition that all other ways of financing were exhausted;
- the role of the MF regarding the management, monitoring and implementation of the funds at the Government disposal is limited only to the activity of confirming the existence of the "availability" of funds to be allocated and of modifying the budgets of the main credit officers, after the Government' approval.

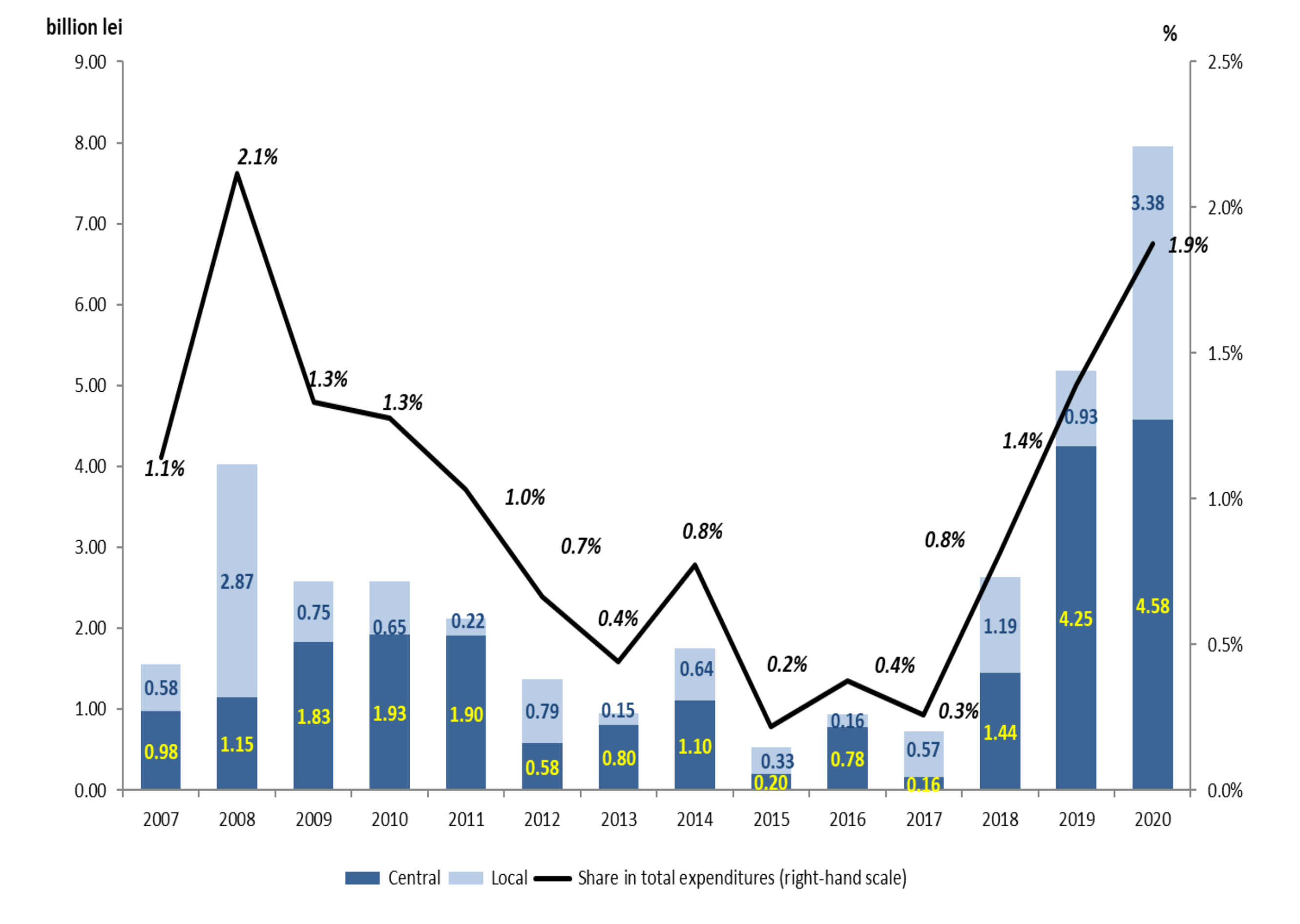
The recommendation of the Court of Accounts refers to the need that MF has to exercise its attributes of approving the government decisions, in the direction of reducing/eliminating the practice of derogations from the rules of the BRF resource allocation, pursuing the provision of these funds during the budget year only for expenses for which the urgent or unforeseen nature is justified, and for which immediate financing is required as the existing funds of the authorizing officers' budgets are insufficient in relation to their purpose, for reasons beyond their control.

This report studies the use of the **contingency reserve fund** at Government's disposal during 2020, based on the Government decisions published in Romania's Official Gazette by which are allocated amounts to main authorizing officers and to specific destinations.

In 2020, the allocations from the contingency reserve fund amounted to 7,960.75 million lei (1.9% of total expenditures, respectively 0.8% of GDP), out of which about 4,578.22 million lei to the central administration and 3,382.53 million lei to the local one. Compared to the previous year, the allocations from the reserve fund increased by 2,784 million lei (+53.8%), and in the structure, transfers to the central administration increased by 332.9 million lei (+7.8%), while the amounts to local authorities increased significantly, by 2,451.1 million lei (by 3.6 times).

In 2020 was recorded the second highest level of use of the reserve fund as share of total budget expenditures, respectively, 1.9%, by only 0.2 pp below the maximum of the period 2007-2019 reached in 2008 (2.1%), and double compared to the average of the period 2007-2019 (*see Figure 31*). It is noted the accelerated upward trend of the trajectory of this indicator starting with 2018 (in 3 years the share increased by 1.6 pp compared to 2017), after in the period 2009-2015 was recorded a reduction by 1.9 pp compared to the 2008 level.

Figure 30: Total contingency reserve fund allocations (billion lei)



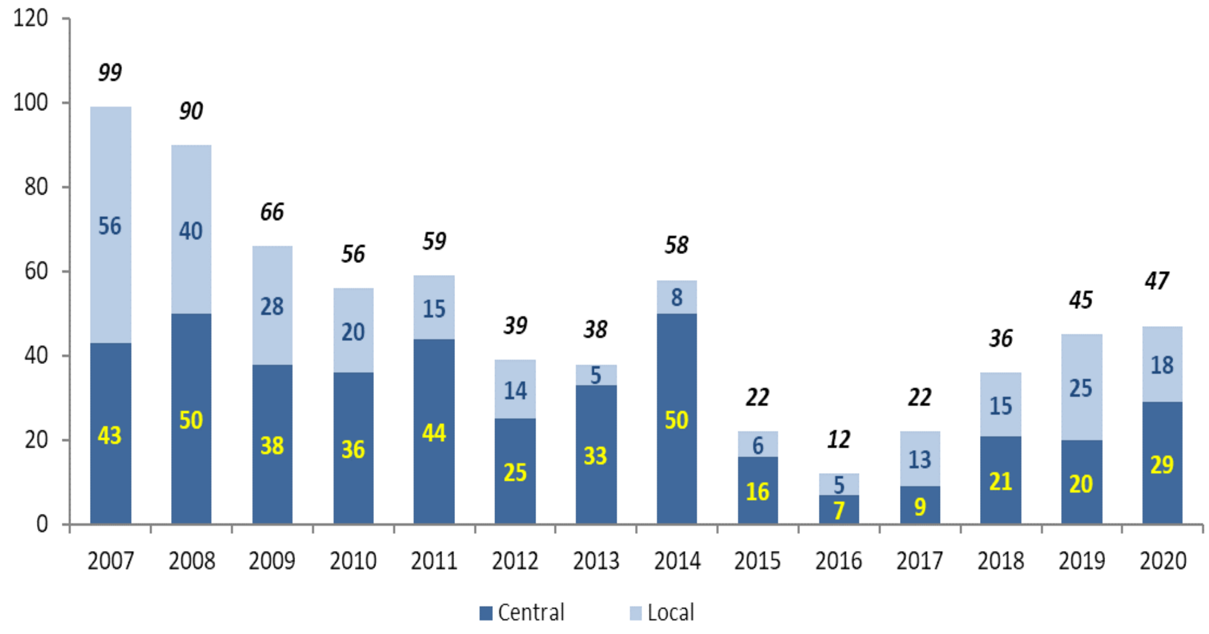
Source: Fiscal Council's calculations based on Government decisions regarding the contingency reserve fund allocations

In 2020, a number of 47 Government decisions were adopted in order to allocate amounts from the reserve fund, compared to 45 decisions in 2019, this level being lower than the average registered in

2007-2009 and similar to that in 2010-2015 (see *Figure 31*), given the manifestation of exceptional circumstances caused by the pandemic.

Also, it is notable that the tendency of the preceding years to decide most spending from the contingency reserve fund in the last months of the year was maintained, 18 out of the 47 decisions being approved in December, respectively in the amount of 3,158.1[91] million lei, representing almost 40% of the allocations of the whole year. This practice makes it extremely difficult to track the amounts spent from the reserve fund and constitutes an additional argument for the discretionary nature of the formation and utilization of this fund.

Figure 31: Number of Government decisions regarding contingency reserve fund allocations



Source: Fiscal Council's calculations based on Government decisions regarding the contingency reserve fund allocations

Comparing the amounts allocated from the reserve fund in the last two years (see *Figure 32*), it is observed that, in 2020, the main beneficiary is represented by the central authority which received 4,578.2 million lei (by 332.9 million lei more than in 2019), respectively, with a share of 57.5% of the total), while the local authorities benefited from 3,382.5 million lei (3.6 times more compared to the previous year), respectively, 42.5% of the total allocations. In 2019, the reserve funds were directed in

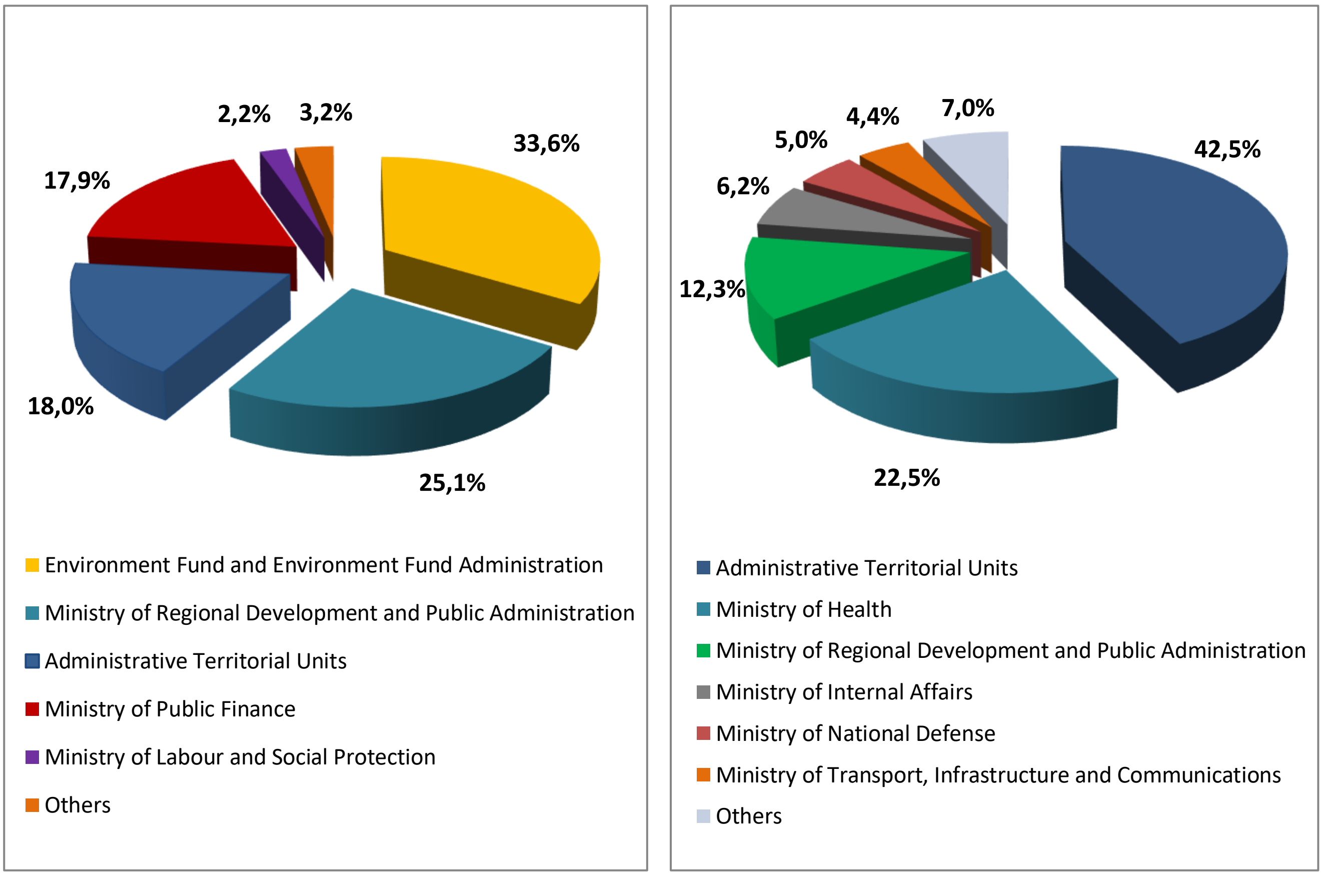
[91] Out of these amounts, at local level 1620.1 million lei, of which 92% for the payment of the rights of personal assistants of severely disabled persons and monthly allowances of severely disabled persons, financing of operating expenses until the end of the year and those necessary for the activity of social assistance and child protection, and at the central level, 1193.9 million lei, of which 96% expenses for Metrorex S.A., organization of the agricultural census, supplementation of NLDP, etc.

proportion of 82% to the central authority (4,245.3 million lei), and the administrative-territorial units received 931.4 million lei, respectively 18% of the amounts allocated from the reserve fund.

From the perspective of the allocations from the reserve fund at the disposal of the Government, directed to the central authority in 2020, the main beneficiaries were: Ministry of Health with 22.5%[92] of the total allocations at central and local level, used for combating the effects of the pandemic, the Ministry of Regional Development, Public Administration with 12.3%[93] of the total and the Ministry of Internal Affairs with 6.2%[94] of the total amounts allocated from the reserve fund.

Figure 32: The beneficiaries of the contingency reserve fund (% of total allocations)

2019 **2020**



[92] Respectively, in the amount of 1,789.9 million lei, representing 39.1% of the amounts allocated to the central authority.

[93] Respectively, in the amount of 980 million lei, representing 21.4% of the amounts allocated to the central authority, intended to finance the National Local Development Program stages I and II.

[94] Respectively, 497.7 million lei (6.2% of the amounts allocated to the central authority), representing expenses generated by the organization and development of the census of the population and housing in Romania in 2021 and by the organization of the general agricultural census in Romania.

Source: Fiscal Council's calculations based on Government decisions regarding the contingency reserve fund allocations

The local authorities received in 2020 about 42.5% of the total allocations from the reserve fund, respectively, 3,382.5 million lei, by 3.6 times higher compared to 2019. A significant share of these allocations was intended to finance current and capital expenditures (41%), social assistance, protection of children and people with disabilities (27%), to ensure the continuity of the public heat supply service (4%) and to investments. To combat the effects of the pandemic, about 1.1% were allocated from the reserve fund, representing expenses for social services personnel in preventive isolation at work, respectively to compensate for the losses of some regional airports.

The Fiscal Council notes for 2020 that, except for the allocations related to this year's exceptional situation to combat the effects generated by the pandemic caused by the SARS-CoV-2 virus, the deterioration continued as evidenced in the analysis for 2019 of the framework of the use of the reserve fund from the perspective of the magnitude of the allocations and the way of using the amounts from the reserve fund by derogation from the provisions of the Public Finance Law no. 500/2002.

Similar to previous years, regarding the manner of using the amounts from the contingency reserve fund the Fiscal Council notes the lack of transparency in terms of their utilization, the nonexistence of explicit identification criteria of the expenditure that can be made from the contingency reserve fund, the absence of a Parliamentary or of other institution's control of the money utilization. Thus, having in view the upward trend of the amounts spent from this fund which are not intended for urgent or unforeseen situations, the Fiscal Council strongly recommend amending the legislation that regulates the contingency reserve fund use in order to establish clear criteria and procedures for the exclusively use of the reserve fund for destinations related to the unforeseen and urgent expenditures that cannot be predicted in the budgetary allocation process.

Considering the international best practices in this field and the Court of Accounts conclusions, the Fiscal Council reiterates its recommendation on the explicit identification of expenditure that can be made from the contingency reserve fund and a higher transparency, including through reporting on a regular basis to the Parliament about the use of this fund, including the amounts actually spent. Thus, detailing the contingency reserve fund allocations, presenting the conditions and the criteria of allocations and a breakdown between main authorizing officers are required. The Fiscal Council also mentions limiting the amounts that can be assigned and used from this fund as a share of total budgetary expenses, a level of 1% being apparently adequate for urgent expenses, given the previous developments.

According to the article 30, paragraph (4) of the Public Finance Law no. 500/2002, **the intervention reserve fund** at Government's disposal is allocated, based on government decisions, to main authorizing officers of the state budget and local budgets, to finance urgent expenditures designed to eliminate the effects of natural disasters and to support the individuals affected. If the possible destinations of the allocations from the contingency reserve fund can be interpreted differently, in the case of the intervention fund, the allocations' destinations are clearly indicated in the law, the existence of such a fund being fully justified. During a year, this fund may be increased by allocations from the contingency reserve fund, depending on the needs regarding the amounts that are necessary for the removal of the effects of natural disasters. In 2020, the allocations from the intervention fund amounted to 828.1 million lei (by 452.9 million lei, respectively, 2.2 times higher compared to the previous year), the destinations being in accordance with the provisions of the Law of public finances no. 500/2002.

III.6. The public debt

Interest expenses in cash standard increased in 2020 by almost 2.4 billion lei compared to the previous year and, against the background of a decrease of about 0.3% of nominal GDP, their share in GDP rose from 1.1% to 1.4%. This evolution occurs in the context of an accelerated growth of the public debt stock in recent years (+5.5% in 2017, +9.9% in 2018, +13% in 2019, and +33.6% in 2020). The evolution in 2020 occurred as a results of the increasing financing needs of Romania as a result of the shock induced by the COVID-19 pandemic.

Public debt, measured according to the ESA 2010 methodology, increased by about 125.7 billion lei (+33.6%) in 2020 compared to the previous year amid the COVID-19 pandemic and government programs undertaken to mitigate the economic downturn, and its share in GDP registered a hike by 12 pp from 35.3% to 47.3%. On the other hand, from the perspective of the national methodology, the public debt increased by about 141.3 billion lei (+31.5%), and its share in GDP advanced by 14.3 pp, from 42.4% in 2019 to 56.7% in 2020.

The average interest paid on public debt debt had a decreasing evolution in 2020, similar to that manifested during the last decade, decreasing from 3.7% in 2019 to almost 3.3% in 2020. The downward trend was manifested in the context of low interest rates on international markets in terms of quantitative easing programs undertaken by central banks. According to the ESA 2010 methodology, interest expenses registered a significant advance (+3 billion lei, representing +24.4%) compared to the previous year.

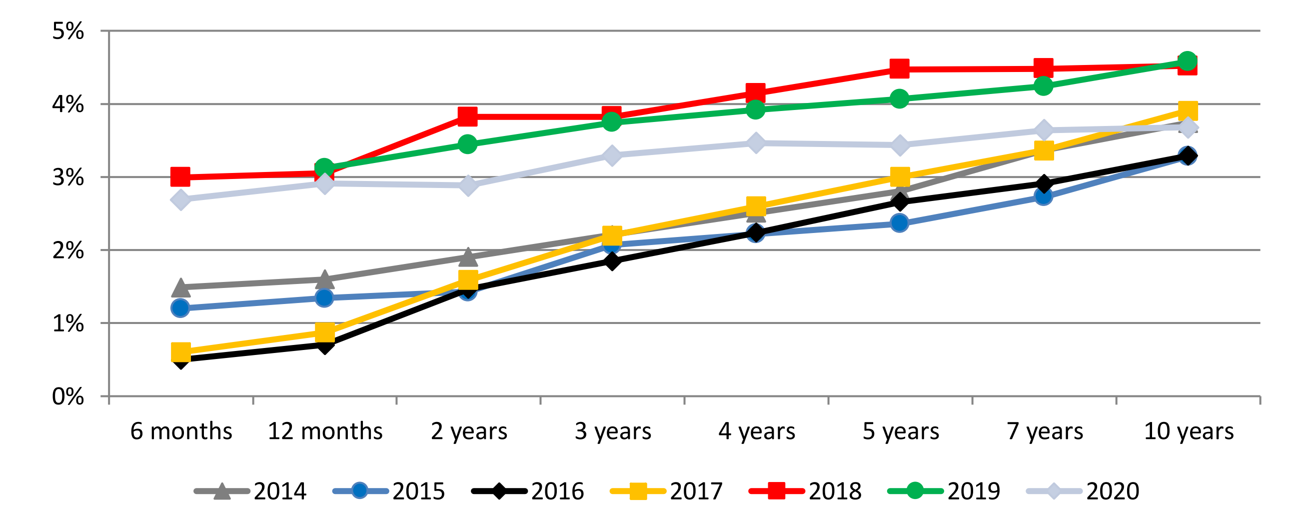
The cost of attracting new resources in national currency registered a positive development between 2014-2016, due to the inclusion, beginning with July 2014[95], of the bonds issued by the Romanian government in the calculation of the GBI-EM Global Diversified index series by JP Morgan, the extension of the average maturity of public debt, the relaxed monetary policy conducted by the central bank, the achievement of a BBB- rating from Standard & Poor's in May 201485, but also due to a liquidity surplus in the financial markets. However, starting with 2017, there was a reversal of this trend manifested by an increase in the cost of attracting new loans in national currency, the upward trajectory accentuating considerably during 2018 amid the sharp rise in inflation. The year 2019 marked a slight reduction (between 0.1 and 0.4 pp) in the cost of attracting new resources in national currency for most of the considered maturities, a trend manifested in 2020 for all maturities, especially starting with the end of

[95] Some investors have restrictions on investing in debt securities issued by countries that are not classified in the investment grade category.

March when a stabilization trend followed, with reductions averaging 0.5 pp: between 0.2 pp for a 1-year maturity and 0.9 pp for a 10-year maturity (see *Figure 33*). This trend was positively influenced by the liquidity in the market, by the intervention measures adopted by the National Bank of Romania, by successive decreases of the monetary policy interest rate from 2.5% to 2% (in March), then to 1.75% (in June), respectively at 1.5% (in August), this level being maintained until the end of the year, as well as carrying out repo operations[96] and purchase of government securities in lei on the secondary market[97].

A decreasing evolution was also observed in the case of the cost of attracting new resources in foreign currency from foreign markets[98], especially in the case of those with a maturity of more than 10 years, the yields of government securities having values of about 0.66% for the 5-year maturity (compared to 0.39% in the previous year) and 2.63% for the 30-year maturity (compared to 3.35% in the previous year).

Figure 33: The yield curve for government securities issued in domestic currency between 2014-2020



Source: NBR

Regarding the structure of public debt[99], in 2020 the gradual expansion of central government debt continued (97.1% of the total, compared to 96.3% in the previous year) to the detriment of local public debt (2.9% of the total, compared to 3.7% in the previous year). Government bonds maintained their position as the main instrument of government public debt, accumulating 40.5% of the total (compared

[96] Repo operations are a category of money market operations available at the disposal of the NBR for liquidity injection, in which the NBR buys from credit institutions eligible assets for trading, with a commitment to repurchase those assets at a later date and at a set price on the date of the transaction.

[97] According to the Government Public Debt Management Strategy 2021-2023.

[98] During 2020, Romania attracted financing from foreign markets through several issues of Eurobonds, made in January, May, July and December, with a total value of 11.7 billion euro and maturities of 5, 9, 10, 12, 20 and 30 years, respectively.

[99] According to the national methodology, the data being available on the MF website.

to 42.3% in 2019), followed by Eurobonds with 31% (compared to 30.4% in 2019), government loans (14.5% compared to 12% in 2019), bonds for the population through the Tezaur Program (1.8% compared to 1.2% in 2019) and treasury certificates in lei and euro (1% compared to 0.4% the previous year), while loans from the general account of the State Treasury suffered a contraction (11.3% compared to 13.7% in 2019). The structure by currencies reveals a reduction in the share of loans in national currency from 56.7% in 2019 to 53.7% in 2020, while the share of loans contracted in US dollars rose from 6.7% in 2019 to 7% in 2020, respectively those contracted in euro from 36.1% in 2019 to 39% in 2020, our country thus benefiting from the climate dominated by low interest rates in the context of extensive programs to support national economies in the most developed countries.

Regarding the maturity structure of government securities in national currency issued on the domestic market in 2020, the trend of attracting longer-term resources, initiated in recent years, seems to have reversed, registering an advance only at the level of bonds with a maturity of more than 10 years. Thus, treasury certificates with maturities of up to 1 year accounted for 9.7% of the value of new loans contracted in 2020, a sharp increase compared to the share of 3.1% recorded in 2019. At the same time, one can note that the share of financing for longer periods has advanced significantly compared to the period 2009-2012 (the share of treasury certificates with a maturity of up to 1 year being 65% in 2009). Bonds with a maturity between 1 and 5 years accounted for 53.6% of the value of new loans contracted in 2020 (compared to the value of 55.7% recorded in 2019), those with a maturity between 5 and 10 years had a share of 26.3% in 2020 (decreasing compared to the level of 33.6% recorded in 2019), and those with a maturity over 10 years had a share of 10.3% in 2020 (representing an advance of 2.6 pp compared to of the value of 7.7% registered in 2019). As a result of a significant attraction of resources in the shorter terms, as well as the NBR's intervention on the secondary market, the average residual maturity of government securities in national currency newly issued on the domestic market decreased compared to the previous year, from 5.6 years at 5.1 years, but being above the level of 4.6 years recorded in 2018.

In order to forecast the evolution of public debt in the coming years, its dynamic as a share of GDP can be expressed by the following formula[100], derived from the budget identity:

$$\frac{d_t}{y_t} = (1 + \lambda_t) \times \frac{d_{t-1}}{y_{t-1}} + \frac{pb_t}{y_t} + sfa_t$$

where d_t denotes the stock of public debt at time t, y_t denotes the nominal GDP at time t, pb_t denotes the primary deficit at time t, sfa_t denotes the stock-flow adjustment at time t, and

$$1 + \lambda_t = \frac{1 + i_t}{(1 + \pi_t) * (1 + \gamma_t)}$$

[100] Cafiso, G., (2012), „A guide to public debt equations", available online: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1975710. A relatively similar model is presented by Escolano, J., (2010), „A Practical Guide to Public Debt Dynamics, Fiscal Sustainability, and Cyclical Adjustment of Budgetary Aggregates", IMF Technical report, available online: https://www.imf.org/external/pubs/ft/tnm/2010/tnm1002.pdf.

where y_t - real GDP growth rate during time t, i_t – interest rate at time t, and π_t – inflation rate at time t.
Essentially, the relationship shows that the share of public debt in GDP at time t depends on the share from the previous period multiplied by the difference between the real interest rate and economic growth, to which is added the GCB primary deficit expressed as a percentage of GDP. Given an economic growth rate higher than the real interest rate on public debt, the share of public debt expressed as a percentage of GDP will have a downward trend that can compensate for the increase caused by a primary deficit. Therefore, it is possible to reduce public debt as a percentage of GDP even if the GCB deficit has a primary surplus below the level of interest expenditure, only if the economic growth rate is higher than the real interest rate on public debt. Thus, the λ_t coefficient can be interpreted as the real interest rate adjusted with economic growth.

The year 2020 recorded a substantial increase (+12 pp) in the share of public debt as a percentage of GDP. Using the dynamics equation presented above, one can identify the factors that contributed to this evolution. Thus, it can be appreciated that all factors acted in the sense of increasing the share of public debt in GDP: primary deficit (+7.8 pp), stock-flow adjustment (+2.7 pp), real economic growth (+1.4 pp) and the real interest rate (+0.1 pp). It can be seen, therefore, that the most important contribution was made by the primary deficit, in the context of a budget balance of -9.2% manifested by the slowdown in activities in various sectors of the economy as a result of the health crisis[101]. As concerning the stock-flow adjustment, an important contribution of this indicator can be observed to the increase of public debt relative to GDP, highlighting the fact that the public debt increases in a higher proportion than the deficit. This development was influenced by contracting loans for the pre-financing of the resource needs of the year 2021 and for the consolidation of the foreign exchange reserve at the disposal of the State Treasury, as well as by the revenues registered according to the ESA 2010 methodology which were not actually collected, in the amount of 12.2 billion lei. Also, considering the fact that a significant part of Romania's public debt stock is denominated in foreign currency, especially in euro, the nominal depreciation of the leu against the euro, by 1.9% compared to the same period last year, led to an increase in stock-flow adjustment.

Contrary to previous years, the negative economic growth recorded in 2020 (-3.9%) overlapped with a real positive interest rate (0.2%), which led to a positive value of the coefficient λ_t and, implicitly, to an impact unfavorable on the dynamics of public debt expressed as a percentage of GDP. **For the public debt to stabilize or fall on a downward trend, a primary surplus is needed.**

Analyzing the level of public debt at the end of 2020, it should be noted that it exceeded the alert threshold of 45% of GDP, set by the FRL, the MF being required to submit a report justifying the increase in public debt and proposals to maintain it at a sustainable level. This justification is not a problem in the conditions of the Pandemic, but the warning signal is relevant given the large structural budget deficit. The level of debt is very sensitive to the future evolution of the differential between the real growth rate and the cost of financing, represented by the real interest rate. Although this differential was favorable

[101] The same tendency is forecast for 2021 according to the EC's 2021 Spring Forecast.

in recent years before the outbreak of the Pandemic, which allowed a relatively stable level of public debt as a share of GDP to be maintained before 2020, even amid budget deficits, the impact of severe economic shocks may lead to an accelerated increase in public debt as a result of the reversal of the ratio between economic growth and the real interest rate. Even in the absence of major shocks, there is still a vulnerability due to the increase in the share of public debt denominated in foreign currency and the possible depreciation of the leu against the euro. The fragility of Romania's position is underlined by the EC Report on the sustainability of public debt[102] (2020 edition), which places the risk related to short-term, medium and long-term sovereign debt at the "high" level, highlighting an unfavorable evolution compared to the 2019 edition. The EC estimated that Romania's public debt will stand at 49.7% of GDP, exceeding the 50% threshold in 2022, rising to 52.7% as a share of GDP. It is true that that EC report envisaged a 40% increase in the pension point in 2020. The risks related to the evolution of public debt are all the more evident in the context in which a series of measures were applied in 2020 to combat the pandemic caused by the SARS-CoV-2 virus and are expected to continue in 2021, but to a lesser extent. Thus, the EC's 2021 Spring Forecast on the main factors influencing Romania's public debt dynamics (*Table 12*) foreshadows a recovery of the economy in 2021 and 2022 with economic growth at 5.1% and 4.9%, respectively, but the dynamics of the budget deficit is expected to be slower, with reductions of up to 8% in 2021 and 7.1% in 2022. These improvements in the budget balance are due to the reconsideration of measures to increase pensions and wages in the budget sector and other expenses, as well as to the reduction of government support measures.

Table 12: EC forecasts of the main indicators that impact the dynamics of the national public debt Spring 2021 versus Autumn 2020

Forecast	Real GDP growth rate (%)		Budget deficit (% of GDP)		GDP deflator (%)	
	2021	2022	2021	2022	2021	2022
Autumn 2020	3.3	3.8	-11.25	-12.5	2.9	2.9
Spring 2021	5.1	4.9	-8.0	-7.1	3.2	2.7

Source: EC

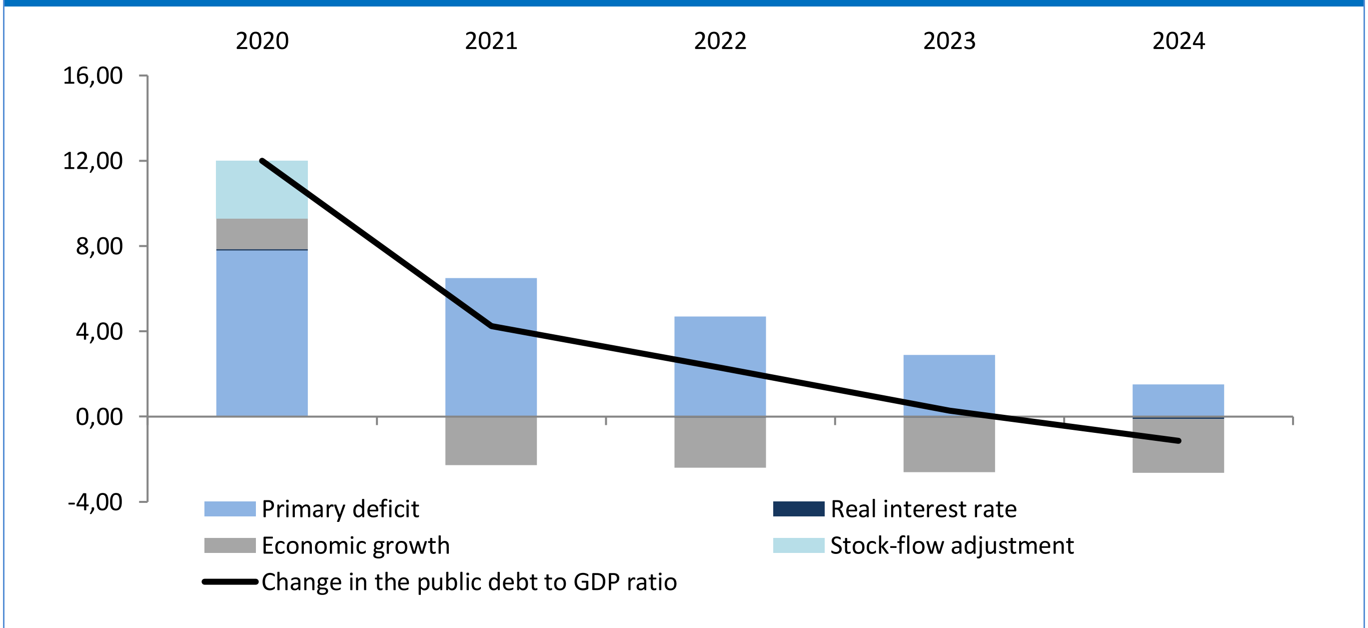
It is therefore projected a gradual improvement of the macroeconomic framework over the next two years as the vaccination process progresses and the suspension of social distancing measures, with economic activity returning to pre-COVID-19 by the end of 2021. Even in the absence of updated estimates of interest rate developments, the differential between economic growth and the cost of financing is expected to positively influence the evolution of public debt as a share of GDP, the favorable effect being diminished by the reduction of the GDP deflator which will increase the real cost of financing of public debt. To this is added the impact of the budget deficit, even if it is projected to decline over the next two years amid fiscal consolidation efforts and the sustained rate of GDP growth.

[102] https://ec.europa.eu/info/sites/default/files/economy-finance/ip143_en.pdf

Based on the 2021 Spring Forecast of NCSP for the period 2021-2024, as well as from the MF estimates made within the Convergence Program 2021-2024, an assessment was made of the evolution of public debt in GDP over the next 4 years, considering that the stock-flow adjustment will be equal to 0 on the forecast horizon. The results show a gradual increase in public debt in the period 2021-2023, increasing in 2021 to 51.5%, in 2022 to 53.8%, and in 2023 to 54.1%, and then entering a downward trajectory in 2024, to a level of 53% of GDP. It is worth mentioning that the 2021-2024 Convergence Program envisages a significant improvement in the budget deficit in 2024, to 2.9% of GDP.

From the perspective of the contribution of the determining factors (see *Figure 34*), the increasing trajectory of the public debt is propelled by the impact of the budget deficit (and, implicitly, of the primary deficit) which will be in negative territory during the 4 years forecast, the other factors contributing to the sense of decreasing the share of public debt in GDP. However, it must be borne in mind that the projection of public debt depends to a large extent on the forecasts used for the real interest rate and the real GDP growth rate. A higher-than-projected real interest rate entails higher debt financing costs and may lead to further debt-to-GDP increases. Also, a lower growth rate may lead to an increase in the share of public debt compared to initial estimates. Against this backdrop, it is appropriate to conduct a sensitivity analysis to assess the impact of changes in key variables on the evolution of public debt.

Figure 34: Contributions to changes in the public debt to GDP ratio for the 2020-2024 period



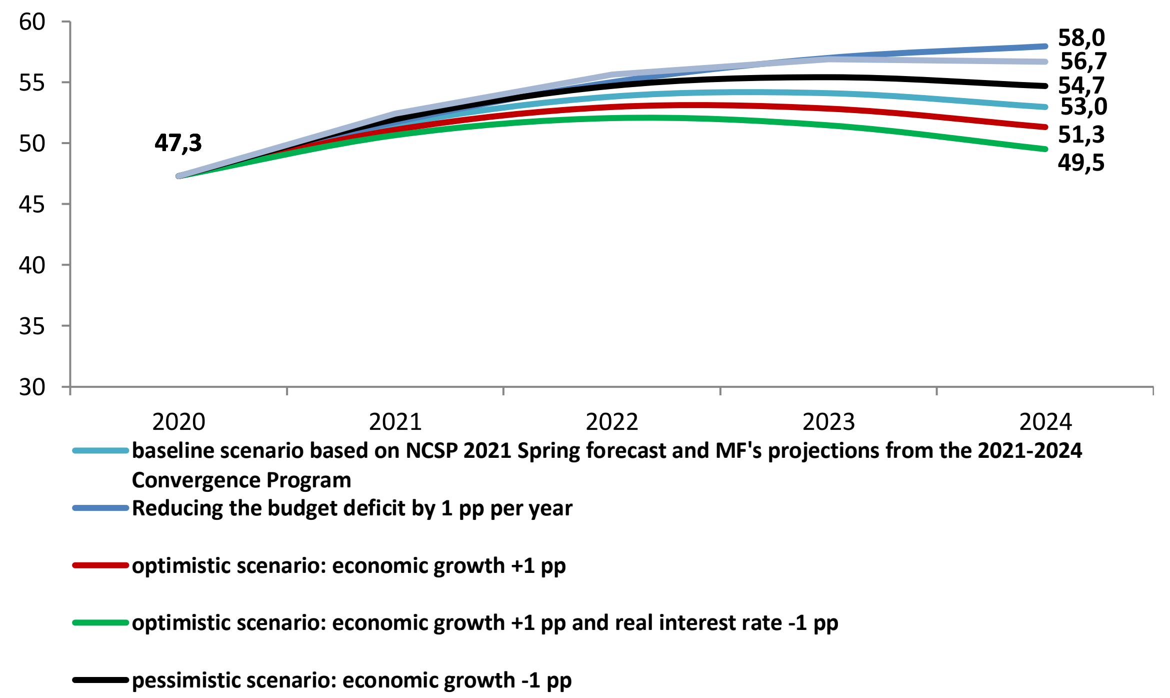
Source: EC, MF, Fiscal Council's calculations

Starting from the projections of CNSP and MF within the Convergence Program 2021-2024, several possible scenarios for the evolution of public debt were defined (see *Figure 35*):

- A scenario in which we assume a less optimistic reduction of the budget deficit (according to the European methodology) compared to the one forecasted in the Convergence Program 2021-2024, of 1 pp per year (compared to 1.6 pp in the baseline scenario), being thus close to the EC estimates for this indicator for 2021 and 2022. Such a scenario leads to a budget deficit of 5.2% of GDP in 2024. The reduction of public debt depends to a large extent on the reduction of the budget deficit (and, implicitly, of the primary one) even in conditions of high economic growth. Hence, compared to the baseline scenario which predicts a share of public debt in GDP of 53% in 2024, in the conditions of a less pronounced decrease in deficits (correction step of 1 pp per year) the share of public debt would be on a growth trajectory in the period 2021-2014, reaching the level of about 58% of GDP in 2024;

- Two optimistic scenarios, the first one being characterized by a real GDP growth rate that is 2 pp higher than the baseline forecast, and the second one adding a 1 pp decrease in real interest rates. Despite the optimistic assumptions underlying them, the two scenarios continue to anticipate a trajectory of public debt growth (due to high projected deficits for the period 2021-2024), reaching a level of 51.3% of GDP at the end of the forecast horizon in the case of the first scenario, respectively of 49.5% of GDP in the case of the second scenario;
- Two pessimistic scenarios, the first one being characterized by a real GDP growth rate 2 pp lower than the baseline forecast, and the second one adding a 1 pp increase in real interest rates. As a result of the more pronounced upward trajectory of public debt, at the end of the forecast horizon a level of 54.7% of GDP is reached in the case of the first scenario, respectively of 56.7% of GDP in the case of the second scenario.

Figure 35: Scenarios for the evolution of public debt (% of GDP)



Source: NCSP, MF, Fiscal Council's assessments

The results of the sensitivity analysis show that, regardless of the scenario considered, Romania's public debt is projected to increase during the period 2021-2024, exceeding the level of 50% of GDP

even in the case of the most optimistic assumptions, while the most pessimistic scenarios anticipate the level of public debt at over 55% of GDP. The reporting of these values is relevant even if the Pandemic changes the context of judging the situation and correcting the budget imbalance[103].

An additional constraint is related to the size of the public debt compared to the depth of the domestic financial sector and the most likely limited capacity to absorb an additional stock of public debt at the current level of financial intermediation. Thus, at the end of 2020, the exposure to the government sector relative to the assets of local banks (these being the main holder of public debt in the domestic market) remained close to 26%, the level of this indicator being among the highest in the EU. Maintaining this situation is likely to lead to an increased dependence on non-resident investors, which is associated with an enhanced vulnerability to interest rate and exchange rate shocks, changes in risk appetite in global financial markets, and a possible change of sovereign rating.

[103] It should be noted that the FRL was amended at the end of 2013, one of the changes being the introduction of thresholds for public debt that trigger actions by the Government. Thus, if public debt exceeds 45% of GDP, the MF draws up a report to justify the debt increase and presents proposals for maintaining this indicator at a sustainable level. If public debt exceeds 50% of GDP, the Government has to freeze public sector wages and possibly take additional debt reduction measures. If the indicator rises above 55%, social assistance expenditures from the public system are also automatically frozen. All these new provisions aim to prevent the public debt from exceeding the 60% of GDP threshold stipulated in the Maastricht Treaty.

IV. The absorption of EU funds

In the 2014-2020 financial framework, according to the data provided by the Ministry of Investments and European Projects (MIEP)[104], Romania has been allocated European structural and investment funds (ESIF) of about 30.9 billion euro. A key objective funded through ESIF is the EU cohesion policy which aims to eliminate economic and social disparities between regions, to support the convergence of Member States and to increase competitiveness and employment. The Structural and Cohesion Funds[105] are financial instruments designed to achieve the objectives of the EU cohesion policy and, through them, Romania was allocated about 22.6 billion euro directed towards six operational programs (OP): Regional OP, Infrastructure OP, Competitiveness OP, Human Capital OP, Administrative Capacity OP and Technical Assistance OP. It should be noted that seven operational programs had been initially defined (the above mentioned and the SME Initiative OP), but in October 2018 the SME initiative was integrated into the Regional OP, while its allocation was increased by 150 million euro[106]. In addition to the funds related to the EU cohesion policy, 19.5 billion euro were allocated for the Common Agricultural Policy[107], 168.4 million euro for the Operational Program for Fisheries and Maritime Affairs (OPFMA) and 441 million euro for the Operational Program for Assistance to Disadvantaged People (OPADP), additional funds being granted for Cross-border Cooperation and through the Connecting Europe Facility (CEF) instrument. Given the diversity of programs, instruments and funding sources, **this chapter analyzes the absorption of European funds in Romania, considering exclusively the Structural and Cohesion Funds**.

Compared to the 2007-2013 financial framework, the 2014-2020 programming period introduced a new legislative framework and a homogenous set of rules in order to establish a clear link with the Europe 2020 strategy for stimulating smart, sustainable and inclusive growth in the EU, for an improved coordination, ensuring consistency and simplifying access to ESIF[108]. The total budget for the 2014-2020 cohesion policy is set at approximately 355 billion euro out of which almost 190 billion euro (about 53%) is allocated to the group of new EU Member States from Central and Eastern Europe: Bulgaria, Czechia, Croatia, Estonia, Latvia, Lithuania, Poland, Romania, Slovakia, Slovenia and Hungary[109]. As stated in the beginning of this chapter, Romania benefits from an allocation of about 22.6 billion euro from the structural and cohesion funds, higher in comparison to the 2007-2013 budget which amounted to 18.8 billion euro. *Table 13* presents a comparison between the allotment of funds for each operational program during the two programming periods. It may be noted that, except for the Competitiveness OP,

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[104] According to the absorption report for ESIF funded programs from March 28, 2021.

[105] The Cohesion Fund (CF), the European Regional Development Fund (ERDF) and the European Social Fund (ESF).

[106] https://ec.europa.eu/romania/news/20181017_modificare_program_operational_regional_utilizare_fonduri_ue_romania_ro

[107] Representing the amount of funding provided through the National Rural Development Program (NRDP) and the European Agricultural Guarantee Fund (EAGF).

[108] ESIF 2014-2020: official texts and comments.

[109] A detailed presentation of the funds allocated to each country, together with their respective absorption rates, can be found in *Table 16*.

all the other operational programs benefited from increases in the allocated funds, the most important ones being encountered in the case of programs that recorded high absorption rates over the 2007-2013 financial framework.

Table 13: Comparison between the allocations for the 2007-2013 and 2014-2020 programming periods (billion euro)

Total allocations 2014-2020		Total allocations 2007-2013	
Regional	6.9	**Regional**	4.0
Infrastructure	8.6	**Environment**	4.4
		Transport	4.3
Competitiveness	1.8	**Competitiveness**	2.5
Human Capital	4.4	**Human Resources**	3.2
Administrative Capacity	0.6	**Administrative Capacity**	0.2
Technical Assistance	0.3	**Technical Assistance**	0.2
Total	**22.6**	**Total**	**18.8**

Source: EC, MIEP

Considering the obligation of Member States to contribute towards achieving the objectives of the Europe 2020 strategy, each country draws up a National Reform Program (NRP) that transposes the EU's overall objectives into national ones, taking into account its specific economic circumstances, which is transmitted together with the Stability or Convergence Program, both programs being integrated into the national budgetary plans for the next three years. Thus, NRP contains the policies and measures proposed for promoting sustainable and inclusive growth, high levels of employment and the achievement of the objectives set in the Europe 2020 strategy.

In the NPR developed in April 2020, the reforms and development priorities were defined taking into account the aspects highlighted in the *2020 Annual Sustainable Growth Strategy*, in the *2020 Country Report for Romania* and in the *2019 Country Specific Recommendations*. In addition, the shock caused by the COVID-19 pandemic requires a number of exceptional measures to mitigate the negative economic and social effects. In this context, a comprehensive assessment of the post-COVID-19 situation will be needed, and these elements will be taken into account in the course of the European Semester for 2020-2021. Analyzing the progress made towards achieving the national targets for the Europe 2020 Strategy, the document appreciates that good results have been achieved in the areas of employment, reduction of greenhouse gas emissions, promotion of energy from renewable sources, energy efficiency and tertiary education. On the other hand, the results obtained in terms of investments in research and development, respectively early school leaving are significantly lower than the targets assumed.

The 2020 NRP has established a series of policies to respond to economic challenges in the fiscal-budgetary sphere (with an emphasis on efficient management of public investment, streamlining budget expenditures, improving the collection of taxes and duties and improving customs activity), in the sphere of business environment (with emphasis on creating a favorable environment for public and private investments, development of transport infrastructure, development of sectors with potential for economic growth, granting state aid to support investments, improving the performance of public enterprises) and strengthening administrative capacity and other government measures (with a focus on, *inter alia*, implementing sustainable development goals, increasing the absorption capacity of European funds, continuing the decentralization process, strategic planning and prioritizing government policies, strengthening a culture of transparency and participatory governance, improving the management of human resources in public administration, territorial development, etc.).

In order to achieve the national objectives of the Europe 2020 Strategy, the NRP 2020 outlined a number of key directions of action, in addition to short-term measures taken in the context of the COVID-19 pandemic for the relevant areas, including: maintaining jobs in economic sectors confronted with difficulties as a result of the effects of the COVID-19 pandemic, mobilizing segments of the population to enter the labor market, increasing the number of jobs and diversifying local economies in rural areas, combating undeclared work, minimum wage (employment target); stimulating private investment in research, development, innovation, strengthening the European dimension of national research, development, innovation policies and programs, ensuring a high quality scientific basis (the objective of research, development and innovation); building a low-greenhouse gas economy, mitigating the effects of climate change, reducing greenhouse gas emissions from the energy and transport sectors (medium-term objective and climate change); promoting renewable energy sources through the Environment Fund and green certificates, encouraging the production of energy from less exploited renewable resources (the objective of renewable energy sources); increasing energy efficiency, modernizing centralized heating systems (energy efficiency objective); modernization of the school curriculum, increasing the quality of pre-university education, strengthening vocational and technical education, strengthening the social package in education, improving the educational infrastructure, implementing the National Strategy on reducing early school leaving (objective of early school leaving); development and integration of the information system in education and research, development of institutional capacity, increase of the quality of higher education and correlation with the labor market, promotion of entrepreneurial education, increase of the quality of higher education and correlation with the labor market (tertiary education objective); socio-economic development of local communities, reform of the health system, completion of the reform of the minimum income for inclusion (objective of social inclusion and combating poverty). It should be noted that many priorities and directions of development under the NRP 2020 are funded in whole or in part from European funds, so that the degree of absorption of these funds stands out as a relevant indicator of the ability to meet the proposed objectives.

Analyzing the data available in March 2021 (see *Table 14*), one can observe an improvement in the absorption rate of European funds compared to the results recorded by the Fiscal Council in February 2020[110]. Thus, compared to the situation at that time, the absorption rate (including pre-financing[111])

[110] See the 2019 Annual Report of the Fiscal Council.

[111] According to GEO no. 64/2009, pre-financing is the amount transferred from structural instruments to beneficiaries through direct payment or indirect payment at the initial stage to support the start of the projects

increased by almost 14 pp from 29.9% to 43.7% of the total funds allocated for the 2014-2020 programming period. At the level of operational programs it is found that unlike Competitiveness OP (28.1% compared to 29.9% in February 2020) and Technical Assistance OP (63.9% compared to 60.0% in February 2020), the absorption rate for all other OPs increased by more than 10 pp: Regional OP (41.9% compared to 29.5%), Large Infrastructure OP (45.6% compared to 29.9%), Human Capital OP (48% compared to 29.2%) and Administrative Capacity OP (41.9% compared to 27.9%). Thus, with the exception of the Competitiveness OP (in which there is a much lower level of the indicator) and the Technical Assistance OP (in which there is a much higher level of the indicator) one can note a trend of uniformity among absorption rates of the six operational programs.

Table 14: Structural funds absorption by operational program for the 2014-2020 programming period (million euro)

	Total allocations 2014-2020 (cumulative)	Payments March 2021			Absorption rate March 2021	Absorption rate excluding pre-financing March 2021
		Total, out of which:	Pre-financing	EU refunds		
Regional	6,860.0	2,875.7	591.1	2,284.6	41.9%	33.3%
Infrastructure	8,638.5	3,942.4	830.9	3,111.5	45.6%	36.0%
Competitiveness	1,829.8	515.0	120.6	394.4	28.1%	21.6%
Human Capital	4,362.1	2,095.7	339.2	1,756.5	48.0%	40.3%
Administrative Capacity	563.6	235.9	51.1	184.8	41.9%	32.8%
Technical Assistance	332.8	212.6	19.6	193.0	63.9%	58.0%
Total	**22,586.7**	**9,877.3**	**1,952.5**	**7,924.8**	**43.7%**	**35.1%**

Source: EC, Fiscal Council's calculations

According to the situation reported by MIEP, until February 28, 8.865 billion euros were requested to the EC for the following operational programs: Regional OP (2.392 billion euros), Large Infrastructure OP (3.722 billion euros), Competitiveness OP (0.427 billion euros), Human Capita OP (1.926 billion euros), Administrative Capacity OP (0.195 billion euros) and Technical Assistance OP (0.203 billion euros). Following the submission of payment applications, the EC made reimbursements of about 7.9 billion euros in March 2021, their distribution by operational programs being also presented in *Table 14*. Hence, it can be seen that the effective absorption rates (calculated by eliminating pre-financing) are lower on average by about 8 pp compared to the situation of including pre-financing.

Table 15 presents an analysis of the situation in Romania compared to the other new EU Member States from Central and Eastern Europe based on data available in March 2021. The vast majority of these

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and/or during their implementation under the terms of the contract/decision/order for financing concluded between a beneficiary and the Managing Authority/the responsible intermediary body, in order to ensure the proper execution of the projects financed under the operational programs.

states (including Romania) received higher structural and cohesion funds allocations for the period 2014-2020 compared to the previous financial year, the exceptions being the Czechia (21.5 billion euros compared to 26.5 billion), Latvia (4.4 billion euros compared to 4.5 billion euros), Slovenia (3.1 billion euros compared to 4.1 billion euros) and Hungary (21.5 billion euros compared to 24.9 billion euros). On the other hand, when comparing the allocations received per inhabitants[112], Romania stands on the penultimate place with approximately 1,132 euro/inhabitant, ahead only of Bulgaria (1,024 euro/inhabitant). On the opposite side, seven out of the eleven states analyzed have allocations of over 2,000 euros/inhabitant, the highest values being recorded by Estonia (2,659 euro/inhabitant) and Slovakia (2,505 euro/inhabitant).

Table 15: Absorption of structural funds for the 2014-2020 programming period – comparison with other EU Member States

	Total allocations 2014-2020 billion euro	Payments March 2021 billion euro	Absorption rate March 2021 %	Total allocations 2014-2020 /inhabitant euro	Total payments/ inhabitant March 2021 euro
Bulgaria	7.4	3.8	51.2	1,024.2	524.7
Czechia	21.5	12.0	55.9	2,047.9	1,145.7
Croatia	8.5	3.5	41.9	1,990.3	833.6
Estonia	3.5	2.2	63.1	2,659.3	1,678.8
Latvia	4.4	2.5	55.6	2,207.5	1,228.1
Lithuania	6.7	4.1	61.6	2,279.4	1,403.7
Poland	76.9	47.7	62.1	2,022.3	1,255.7
Romania	**22.6**	**9.9**	**43.7**	**1,132.3**	**495.2**
Slovakia	13.6	6.2	46.1	2,504.8	1,153.9
Slovenia	3.1	1.8	60.1	1,488.5	894.5
Hungary	21.5	13.3	61.6	2,181.2	1,344.0

Source: EC, Eurostat, Fiscal Council's calculation

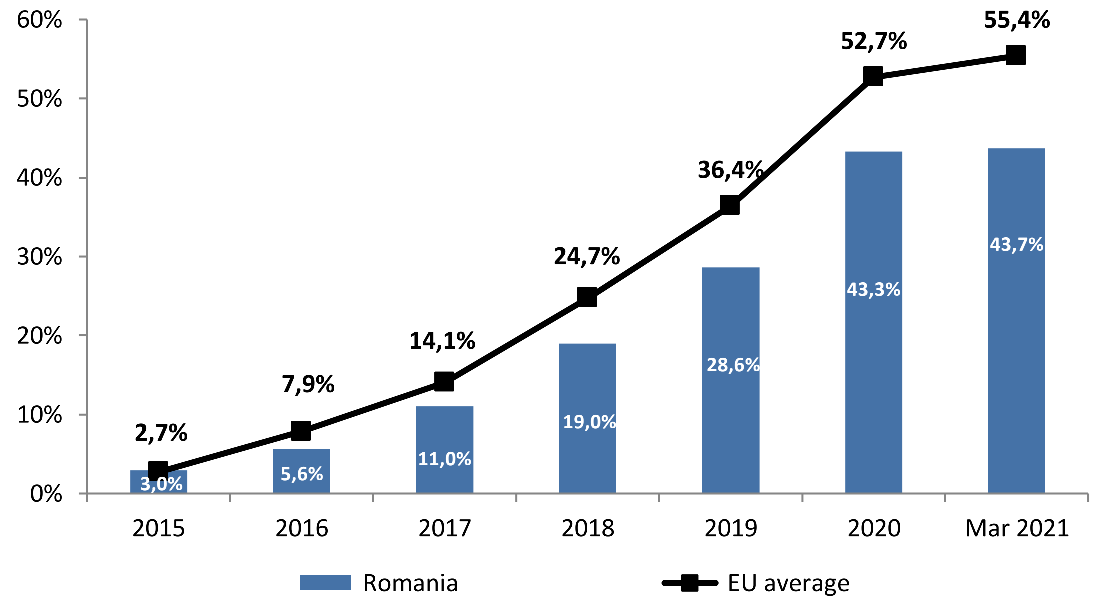
Note: The absorption rate is calculated on the basis of interim payments and pre-financing.

From the perspective of the absorption rates of structural and cohesion funds recorded in March 2021, Romania and Croatia continue to occupy the last positions in the ranking, our country remaining on the penultimate place (with an absorption rate of 43.7%) while preserving a slight lead over Croatia (with an absorption rate of 41.9%). With the exception of Slovakia (46.1%), all other states included in the analysis reached absorption rates of over 50%, with the highest values being recorded for Estonia (63.1%), Poland (62.1%) and Lithuania and Hungary (both with an absorption rate of 61.6%). Thus, although Romania registered an advance of almost 14 pp compared to February 2020, the growth rate is lower than most of the new Member States from Central and Eastern Europe, and the gap with them is maintained and even widens compared to developments in previous years. In this sense, it should be noted that the

[112] Population on January 1, 2014 (the start of the 2014-2020 multi-annual financial framework), according to the data provided by Eurostat.

average absorption rate of the states included in the analysis (excluding Romania and Croatia which ranks last) is 59.1%, highlighting an unfavorable gap of 15.4 pp in the case of our country.

Figure 36: Evolution of EU funds absorption rate: Romania versus EU average, 2015 – March 2021 (2014-2020 financial framework)



Source: EC, Fiscal Council's calculations

The unfavorable gap relative to the other EU Member States can also be observed by analyzing the evolution of the absorption rates of the structural and cohesion funds in Romania compared to the EU[113] average (see *Figure 36*). The 2014-2020 programming started with difficulty both in Romania and at EU level, dur to the late completion of the related legislative framework. Consequently, the first years of the period recorded low absorption rates, Romania being close to the European average. However, since 2016 there has been an unfavorable gap towards the EU average, which has continued to increase every year, so that in March 2021 it had reached almost 11,7 pp. Given that the funds allocated for the 2014-2020 programming period can be spent by the end of 2023, the unfavorable evolution of the absorption rate, both relative to the EU average and to the new Member States in the region, raises serious questions about the possibility of repeating the difficulties in absorbing European funds, manifested during the previous financial framework.

In the Country Report published at the beginning of 2020[114], the EC considers that Romania is one of the main beneficiaries of cohesion policy, many programs being dedicated to financing the structural transformations of the Romanian economy and mobilizing private investment, but points out that the

[113] For 2020 and March 2021 without the United Kingdom.

[114] For 2021, the country reports for the European Semester will be replaced by the evaluation of the national resilience and recovery plans by the European Commission, part of the Recovery and Resilience Mechanism.

level of absorption of allocated funds is well below the European average (a fact confirmed by the analysis carried out in this chapter).

The absorption of European funds is an objective of national importance and a solution for stimulating the economy, generating a series of positive effects for society such as: reducing disparities between regions, poverty and social exclusion, improving the quality and relevance of education, developing a sustainable transport network and investments in infrastructure, improving water and waste management systems, promoting the competitiveness of companies, as well as their research and innovation capacities, etc. Moreover, in the context of the large-scale budget slippage recorded in 2020, when the GCB deficit has substantially exceeded the 3% of GDP threshold, influenced by exceptional spending to combat the effects of the COVID-19 pandemic, the importance of absorbing European funds becomes even more pronounced in order to reduce the strain on the public budget. Given that the available data indicates an unfavorable evolution of absorption rates, with the gap towards the EU average and the Member States in the region widening from one year to the next, increasing the absorption rate of European funds appears to be a pressing need. In this regard, given the limited progress made in implementing the EC recommendations, efforts to improve the absorption of European funds should focus on: strategic investment planning in key areas, increasing the administrative capacity to manage projects, prioritizing large-scale projects and accelerating their implementation, improving the efficiency of the public procurement system and ensuring the predictability of the legislative framework.

The National Recovery and Resilience Plan (NRRP)

As stated in the 2021-2023 FS, Romania is facing an extraordinary opportunity, besides allocations of 30.3 billion euros under cohesion policy related to the multiannual financial framework of the EU for the period 2021-2027, adding additionally 29.2 billion euros through the Recovery and Resilience Mechanism (RRM)[115] facility, 14.248 billion euros being in the form of grants and 14.935 billion euros in the form of loans. RRM, which was approved at European level on 12 February 2021, provides Member States with grants of up to 312.5 billion euros and loans of up to 360 billion euros in support of reforms and investments. This mechanism is the central element of the European Union's Next Generation EU Recovery Instrument, the plan to enable the EU to overcome the negative consequences of the shock caused by the COVID-19 pandemic. It is important to note that 70% of the amount of grants must be contracted by the end of 2022, and the difference of 30% by 31 December 2023. **Unlike the Cohesion Policy, the projects within the NRRP cannot be extended after the end of the period nor can they be phased out, thus being urgently necessary to complete them by 2026.**

The access to the MRR facility is done through the National Recovery and Resilience Plan (NRRP), Romania's strategic document that substantiates the reform priorities and investment areas at national level in a single integrated document, to be analyzed and approved on the basis of a complex evaluation

[115] Initially, the amount allocated to Romania through RRM was 30.5 billion euros - 13.8 billion euros structured in the form of grants and 16.6 billion euros in the form of loans. This is due to the recalculation of GDP decline in 2020 compared to the European average.

grids. The key principles underpinning the development of the NRRP are the priorities set for Member States in the 2020 European Semester (Country-Specific Recommendations). In the case of Romania, the main recommendations refer to the application of a fiscal consolidation strategy to correct the excessive deficit, for the success of which it is important that it is supported by comprehensive structural reforms, as well as to the promotion of mature investment projects, both public and private, focused on the green and digital transition. Thus, the investments and reforms foreseen in the NRRP must contribute to the effective approach of the country-specific recommendations and to the strengthening of the potential for economic growth, job creation and economic and social resilience. In addition, investments and reforms must also contribute to meeting the 37% climate change target, including biodiversity, and achieving the 20% digitalization target.

Through the current NRRP, Romania can benefit from 29.2 billion euros, both from grants and loans, for reforms that would produce structural changes. A key aspect of the NRRP analytical and evaluation framework is the alignment of national objectives with the priorities of the European Union, namely a coherent package of public investment and reforms with six pillars: **(i) Green transition - 15.89 billion euros** (Component 1: Water and sewerage system management - 1.88 billion euros; Component 2: We afforest Romania and protect biodiversity - 1.37 billion euros; Component 3: Management waste - 1.2 billion euros; Component 4: Sustainable transport - 7.62 billion euros; Component 5: Renewal Wave Fund - 2.2 billion euros; Component 6: Energy - 1.62 billion euros), **(ii) Digital transformation - 1.89 billion euros** (Component 7: Government cloud and digital public systems - 1.89 billion euros), **(iii) Smart, sustainable and inclusive growth - 2.842 billion euros** (Component 8: Tax reforms and pension reform - 0.482 billion euros; Component 9: Support for the private sector, research, development and innovation - 2.36 billion euros), **(iv) Social and territorial cohesion - 2.3 billion euros** (Component 10: Local Green and Digital Transition Fund - 2.1 billion euros; Component 11: Tourism and culture - 0.2 billion euros), **(v) Health and institutional resilience - 2.772 billion euros** (Component 12: Health - 2.45 billion euros; Component 13: Social reforms - 0.167 billion euros; Component 14: Public sector reform, increasing the efficiency of justice and strengthening the capacity of partners social security - 0.155 billion euros) and **(vi) Policies for the next generation, children and youth, such as education and skills - 3.6 billion euros** (Educated Romania - 3.6 billion euros).

Thus, the largest initial negotiating budgets are allocated to Sustainable Transport - Green Transition (7.62 billion euros), Educated Romania - Policies for the next generation, children and youth, such as education and skills (3.6 billion euros) and Health - Health and institutional resilience (2.45 billion euros). On the opposite side, the areas with the lowest allocations are Public Sector Reform, Increasing the Efficiency of Justice and Strengthening the Capacity of the Social Partners - Health and Institutional Resilience (0.155 billion euros), Social Reform - Health and Institutional Resilience (0.167 billion euros) and Tourism and Culture - Cohesion social and territorial development (0.2 billion euros).

V. The sustainability of public finances

V.1. Arrears of the general consolidated budget

The development of the stock of arrears of GCB[116] to the private sector indicates that in present these are no longer a major problem as a result of improving financial discipline during recent years both at central and local levels. At the end of 2020, a year characterized by the exceptional situation generated by the evolution of the COVID-19 pandemic, the level of arrears registered 204.7 million lei, higher by 68.3 million lei than in December 2019, respectively an increase by 18.6%.

In what concerns the outstanding payments with a delay of less than 90 days, that do not belong to the category of arrears according to the Public Finance Law no. 500/2002, they increased significantly, reaching a level of 1,745.6 million lei at the end of 2020, by 1,005.3 million lei more than the value recorded at the end of the previous year (808.6 million lei). Although this leap was caused by the difficult economic environment generated a pandemic, this trend is worrying in the context of extending the economic and social effects in 2021 (and possibly 2022), these outstanding payments having the potential to turn into arrears the next years. Compared to 2019, the increase in 2020 was located at the level of local budgets (+514.4 million lei, respectively, from 692.8 million lei to 1,207.2 million lei) and at the social insurance budget (+450.2 million lei). Reductions in the outstanding payments with a delay of less than 90 days were registered for the state budget (-27.6 million lei, respectively a decrease of 27.4%).

The total outstanding payments of the GCB (*0-360 days)* to private sector companies reached a level of 2,026.2 million lei at the end of 2020, higher by 1,100 million lei compared to December 2019 (926.6 million lei). This significant increase was mostly attained at the level of *outstanding payments with a delay of less than 90 days*, which at the aggregate level reached 1,800 million lei (+1,006.7 million lei compared to the end of the previous year). In the structure, the increase was mainly located at the level of local budgets (+515.3 million lei) and of the social security budget (+450.2 million lei). The *GCB arrears to private sector companies* increased by 96.2 million lei, respectively by 70%, being located at the level of local budgets (+95.3 million lei). In the context of the prolongation of the economic and social effects generated by the Pandemic in the following period, with a significant negative impact on the economy, it is foreseeable that this trend of accelerated growth of the GCB total outstanding payments will continue.

The following table shows the quarterly evolution of the stock of the *GCB outstanding payments (arrears and overdue payments with a delay of less than 90 days)* in total and in structure: state budget, local budgets and social security budget, compared to the end of the previous year. While the increase in *arrears* compared to the previous year is relatively minor, in contrast, we notice a significant

[116] According to the Public Finance Law no. 500/2002 with subsequent amendments and additions, arrears are defined as overdue payments with a delay of more than 90 days, calculated from their due date.

deterioration in the stock of *overdue payments with a delay of less than 90 days*, which led to a doubling of GC'Bs total stock of outstanding payments compared to the end of the previous year.

Table 16: Quarterly evolution of GCB overdue payments (0-360 days) in 2020 (million lei)

	Q4 2019	Q1 2020	Q2 2020	Q3 2020	Q4 2020
State budget	**126.1**	**57.4**	**87.8**	**95.5**	**71.1**
Under 90 days	100.6	30.7	36.2	37.3	73.0
Over 90 days	6.2	8.9	9.4	9.9	7.7
Over 120 days	7.2	12.9	12.7	12.7	12.3
Over 360 days	12.2	14.2	13.1	12.2	12.2
Local budgets	**803.7**	**812.1**	**1,104.1**	**1,017.0**	**1,413.8**
Under 90 days	692.8	666.3	886.7	805.6	1,207.2
Over 90 days	38.7	59.0	105.2	65.1	68.7
Over 120 days	34.4	47.9	72.0	109.3	102.9
Over 360 days	37.8	38.8	40.2	37.0	35.1
Social security budget	**15.2**	**19.8**	**3.4**	**5.0**	**465.4**
Under 90 days	15.2	19.8	3.4	5.0	465.4
Between 90 and 360 days	0.0	0.0	0.0	0.0	0.0
Total overdue payments	**945.0**	**889.3**	**1,195.3**	**1,117.5**	**1,950.3**
Under 90 days	**808.6**	**716.8**	**926.3**	**847.9**	**1,745.6**
Over 90 days	44.9	67.9	114.6	75.0	76.4
Over 120 days	41.5	60.8	84.7	122.0	115.2
Over 360 days	50.0	53.0	53.3	49.2	47.3
Total arrears (90-360 days)	**136.4**	**172.5**	**269.0**	**269.6**	**204.7**

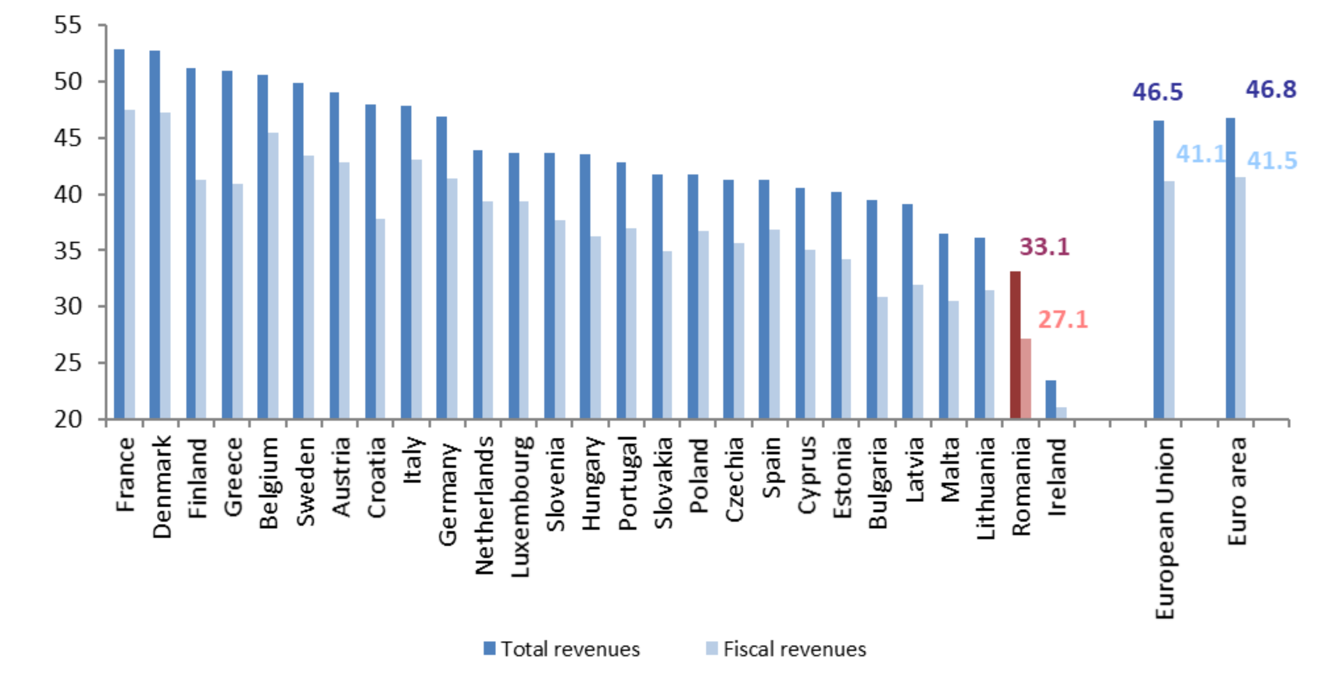
Source: MF

Overall, there is a considerable reduction in the *GCB outstanding payments (90-360 days)* in the last 8 years (from 3.8 billion lei in 2012 to 0.2 billion lei in 2020), which is explained, mainly, by the implementation of the EU Directive no. 7/2011 on combating late payments in commercial transactions (Law no. 72/2013) and of other legislative measures taken in recent years which aimed to reduce the stock of arrears (GEO no. 29/2011 for regulating the facility of payment rescheduling, GEO no. 3/2013 which restricts the local authorities' possibility of contracting new loans in order to reduce their arrears, GEO no. 12/2013 which introduced a mechanism for the settlement of reciprocal payment obligations). However, the steep increase in the *outstanding payments with a delay of less than 90 days*, which led to more than doubling the stock of the *GCB total outstanding payments* (0-360 days) compared to the end of the previous year, is worrying given the prospect of imminent growth of the stock of arrears under a difficult economic background and a deteriorating fiscal situation amid the persistent effects generated by the pandemic.

V.2. Tax collection in Romania – international comparisons

Romania registered in 2020, according to the ESA 2010[117] methodology, a level of the share in GDP of budgetary revenues (fiscal and non-fiscal revenues) of 33.0%, with 13.1 pp below the European average (46.5% of GDP), among the lowest in relation to EU Member States, followed only by Ireland. The level of fiscal revenues (taxes and social contributions) reached a level of 27.1% of GDP, also on the penultimate place, with a gap of 14 pp compared to the EU average (41.1% of GDP). Analyzing the evolution of these indicators compared to the previous year, the gap between the EU27 average decreased in the case of budget revenues[118] by 0.9 pp of GDP (from a gap of 14.3 pp of GDP in 2019), and in the case of fiscal revenues remained at 14 pp of GDP.

Figure 37: Total budget revenues and fiscal revenues in 2020 (% of GDP, ESA 2010)



Source: Eurostat; Fiscal revenues include social security contributions

The share of *tax revenues* (including social contributions) in GDP for Romania is significantly lower than that recorded in 2020 by countries with similar economies, such as Hungary (36.3%), Slovenia (37.7%), Poland (36.7%) and the Czechia (36.1%). Compared to Bulgaria, the share of budgetary revenues in GDP is lower by 6.4 pp, respectively, that of fiscal revenues by 3.7 pp. To this unfavorable evolution contributed the effect of major changes brought by the new Fiscal Code, by fiscal relaxation of which resulted in a reduction in both the share of budgetary revenues in GDP by 2.4 pp in 2020 compared to

[117] The ESA methodology includes revenues that would have been collected in 2020 in the absence of facilities provided to combat the effects of the Pandemic. For details see subchapter 3.1.

[118] Mainly due to the increase in revenues from European funds, including those granted to support measures taken by the government in the difficult context of the health crisis caused by the pandemic.

2015 (at EU27 level their share in GDP increased by 0.3 pp) and in that of fiscal revenues by 0.9 pp of GDP (while for the EU as a whole their share increased by 0.6 pp of GDP).

The structure of tax revenues has changed slightly compared to 2019[119]. Thus, the share of *indirect taxes* in tax revenues decreased by 1.3 pp (as a combined effect of the reduction of excise duty and accelerated VAT refunds made by the state), but remains at a net level higher than the European average (38.4% compared to 32.4%). The share of *revenues from social contributions* in tax revenues reached a level of 44.3%, 2 pp above the value of the previous year (amid a positive dynamics of average gross earnings), being 8.5 pp above the EU27 average (of 35.8%), Romania being from this perspective, on the fourth place in the EU27, after Slovenia, Slovakia and the Czechia. Regarding *direct taxes*, their share in tax revenues decreased by 0.7 pp compared to 2019, to a level of 17.3%, by 14.5 pp below the EU27 average[120].

Indirect taxes continue to be an important component of tax revenues in Romania, in fact, a specific feature of developing countries, their share in total tax revenues being significantly above the EU average (+6 pp). By reducing the standard VAT rate from 24% in 2015 to 19% in 2017 simultaneously with the extension of reduced VAT rates[121], there was a significant decrease in the gap between Romania and the EU average compared to 2010-2015. Thus, the fiscal consolidation initiated in 2010, which aimed to increase indirect taxes, contributed to increasing their share in total tax revenues (from 43.9% in 2010 to 47.3% in 2015), while at EU level this indicator varied between 33.6% and 33.9% in the same period. During the last 5 years, in the case of Romania, there is a tendency to reverse the increase in the importance of indirect taxes at a fast pace (from 42.6% in 2016 to 38.4% in 2020), but they still occupy an important place in budgetary revenues.

The structure of *budgetary revenues* in Romania is mainly oriented towards *indirect taxes* and *revenues from social contributions* (together they represent 82.7% of fiscal revenues), while at European level there is a tendency to balance the share of direct, indirect taxes and revenues from social contributions, and some Member States that benefit from high values of budgetary revenues in GDP, have relatively high shares of direct taxes in total budgetary revenues (Denmark, Sweden, the Netherlands).

It should be noted that the position at the bottom of the ranking from the perspective of collecting budget revenues as a share of GDP in the last 5 years is also the result of an insufficiently modernized fiscal administration apparatus, the reforms started in this sense being carried out in a slow rhythm, even with major syncope, as is the case of the Tax Administration Modernization Project[122], initiated in

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[119] Starting with 2018, the share of indirect taxes in tax revenues was overtaken by that of revenues from social contributions, due to the change in the social contributions regime and the increase in payments from legal entities for people with disabilities.

[120] The reduction of the personal income tax from 16% to 10% in 2018 contributed to this result.

[121]The reduction of the weighted average VAT rate was about 7 pp in 2018 compared to 2013 (when the legal VAT rate on bread and bakery products was reduced from 24% to 9%).

[122] The objective of the program was to redesign and increase the capacity of the IT system, in order to manage a centralized database containing information on all taxpayers in the country. FC has written extensively about this program in its previous reports.

2013 by signing the Loan Agreement between Romania and the World Bank (of 70 million euros), a program similar to the one completed in Bulgaria in the period 2002-2008 with very good results. If in the case of Romania, after many delays and postponements in the implementation of the centralized IT system - the main component of the program - in 2019 it was decided to abandon this project, in the case of Bulgaria, the success of this program and further initiation of a new set of reforms led, in the conditions of a lower flat tax than in Romania (10%) and much lower social contribution rates[123], to constantly growing budget revenues, from 35.7% in 2006 to 38.4% of GDP in 2020 (for Romania they decreased from 33.1% in 2006 to 31.7% of GDP).

However, it can be appreciated that in recent years there has been a simplification and relative efficiency of the administrative tax collection apparatus, which has considerably reduced the number of financial administrations at central level, although efficiency efforts are still needed at local level. The extensive and complex process of simplifying the tax system and reducing bureaucracy has taken place gradually, with recognition of progress being highlighted by PricewaterhouseCoopers' annual *Paying taxes reports* and the *World Bank's Doing Business reports*. Thus, the latest report available *Paying taxes* 2020[124] (with the reference year 2018), Romania ranks, from the perspective of ease of payment of taxes by a medium-sized company, on position 32 out of 189 countries analyzed, a better position compared to the previous year (position 49/190 countries).

An encouraging element regarding the resumption of NAFA reform is the start in 2019 of the program "Strengthening the capacity of the National Agency for Fiscal Administration to support modernization initiatives", with an initial duration of 2 years, the general objective of the project being to strengthen NAFA's capacity by introducing business-oriented electronic public services, mainly through the implementation of SAF-T (international standard for electronic data exchange between companies and tax authorities on information relevant to tax audits) and the orientation towards digitization of the institution.

From the perspective of the digital economy and society index (DESI, *see Box 2*), according to the EC Report in 2020[125], Romania ranks 26th out of the 28 EU member states (ahead of Greece and Bulgaria). Thus, in the structure of the 5 major sub-indices in the composition of DESI, Romania is ranked last in: internet use, digital public services, on the penultimate place on the integration of digital technology (before Bulgaria) and human capital (before Italy) and on the place 11 in terms of connectivity (see *Figure 38*).

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[123] In 2009-2015, on average a legal share of only 30.5% compared to 43.4% in Romania, and in 2016-2020, of 32.4% compared to 42.6% (recalculated, considering from 2018 the impact of the transfer contributions exclusively to the employee on the legal rate).

[124] Made with data updated to July 1, 2019, refers to the fiscal year 2018, including reforms made between May 2018 and May 2019 (see: http://consiliulfiscal.ro/RA%20CF%202019.pdf, pg. 115-117). For 2021 this report has not been updated.

[125] https://ec.europa.eu/digital-single-market/en/scoreboard/romania. The data is for 2019, the United Kingdom being included in the analysis.

Box 2: Digital Economy and Society Index (DESI)

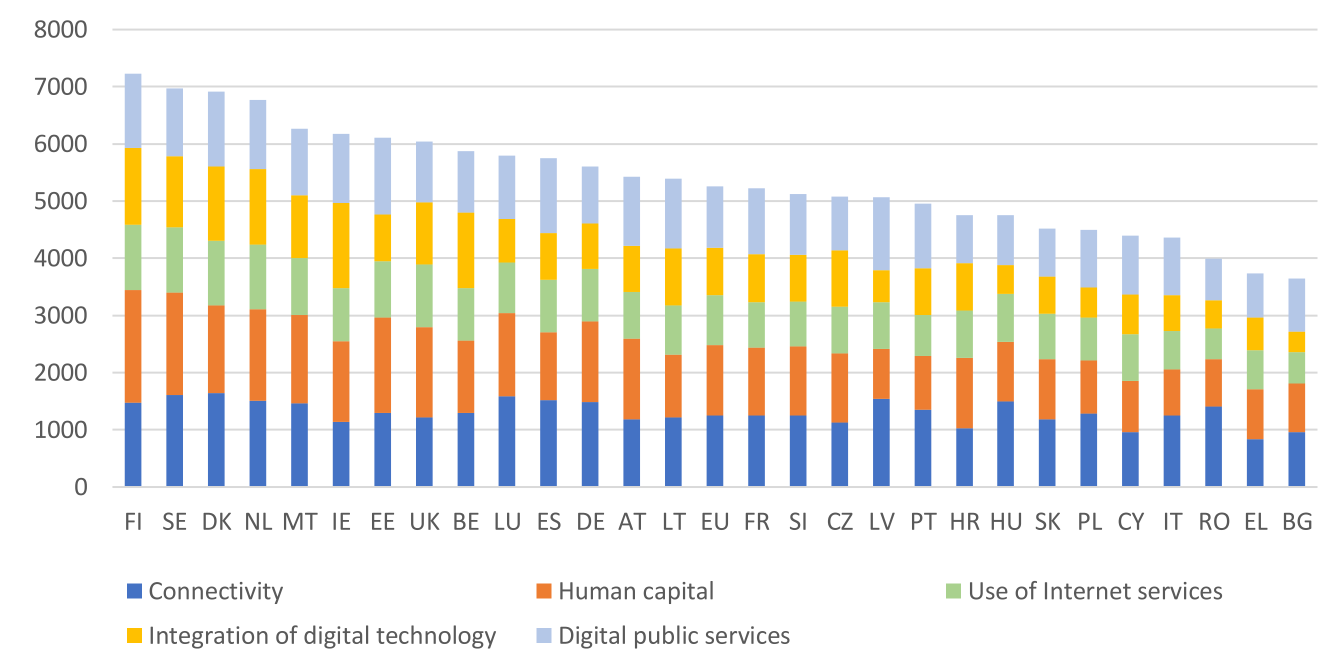
The DESI report monitors the EU's overall digital performance, tracking Member States' progress towards a digital economy and society, being the analytical tool for the evolution of digital competitiveness in the European Semester. The DESI composite index has 5 major axes: *connectivity, human capital, use of internet services, digital public services, integration of digital technology*, each with several sub-components.

The DESI report includes a detailed analysis of national digital policies, providing an overview of progress in the digitalization of the economy, while identifying sectors that need investment and priority measures, given that good e-government performance is a key element in implementing sustainable development. The areas covered by the Report are: connectivity, digital skills, use of internet services, adoption of digital technology by enterprises, digital public services, investment in research - development - innovation dedicated to information and communication technology and use of funds available for research and innovation in the program Horizon 2020 by Member States. Statistics from the last 6 years have shown that the performance of countries that have set ambitious targets in line with the *EU Digital Single Market Strategy* and made targeted investments has improved significantly in a relatively short period of time. In order to improve the methodology taking into account the latest technological developments, in the 2020 edition of the Report, the DESI index was recalculated for previous years for all countries.

Regarding *digital public services* (sub-index of DESI), Romania has the lowest performance among the Member States, ranking last, despite the high share of users of *e-government services* (8th place, with 82% among internet users, compared to the EU average of 67%), due to the high use of very high speed broadband and the wide availability of very high capacity fixed networks, especially in urban areas. The report highlights for our country that the lack of interoperability of IT systems in public administration is a chronic problem, and low scores on services provided entirely online, Romania ranking last, indicates a systemic problem in terms of quality and usability of the services offered.

Romania registered in 2019 the lowest level of use of internet services in the EU28. Regarding the human capital from the perspective of at least elementary competencies in terms of digital knowledge and software, Romania ranks 27th out of 28, similar to the previous year.

Figure 38: DESI composite index for 2019



Source: *EC 2020 - https://digital-agenda-data.eu/*

Regarding *the integration of digital technology by enterprises* [126] Romania ranks the penultimate place (8% of enterprises use communication platforms, well below the EU average of 25%). In recent years there has been a slight improvement in the share of SMEs making online sales, from 8% in 2017 to 11% in 2019, but well below the EU average of 18%.

The report notes that Romania's poor performance in terms of efficiency in providing digital public services is the result of a still poor legislative framework in this area, the non-standard technological infrastructure in public institutions, but also the lack of concern for developing digital skills in the administrative apparatus. The main barriers identified are: lack of coordination between public institutions; migration of public sector IT specialists to the private sector/other countries and a general lack of digital skills.

It should be noted that during 2020, given the extremely important role of digitalization in managing the COVID-19 pandemic and supporting economic recovery, a number of measures were taken that are not reflected in the official statistics reported in DESI 2020 (which includes data for 2019).

Thus, we mention that, in 2020, NAFA implemented some measures meant to facilitate the digital interaction with economic agents, such as: payment of tax obligations directly with the bank card for persons registered in the Virtual Private Space (VPS), extension of enrollment in VPS to individuals who do not hold a digital certificate. Moreover, in March 2021 NAFA presented the *Digital Strategy* 2021-2024[127], which is a reform package consisting of a set of coherent actions on the digitization strategy,

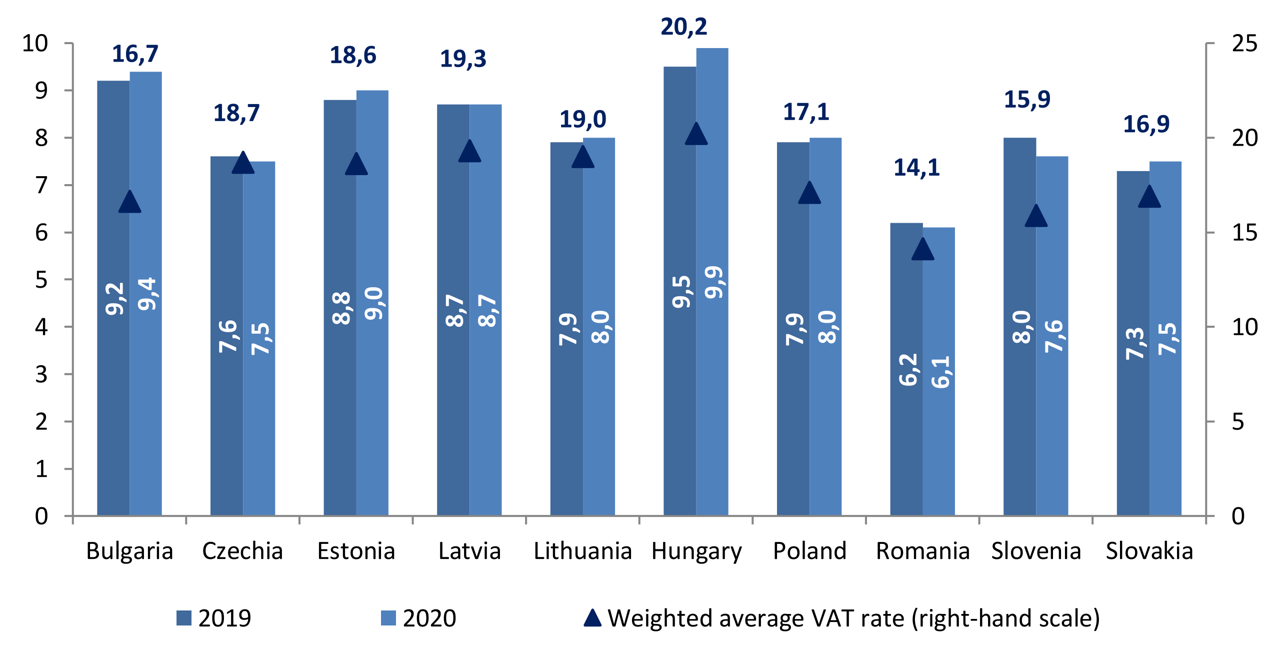
[126] Romania does not have a national strategy for digital transformation in the field, but it supports the newly established enterprises through *the Start-up Nation* program..

[127] https://static.anaf.ro/static/10/Anaf/Informatii_R/Strategia_ANAF_2021-2024_130421.pdf

communication strategy and steps for the rapid implementation of ongoing projects (SAF-T, Traffic Control, NOES, *One Stop Shop*, etc.), as well as those to be implemented (SPHERE, APIC). Given the possibility of attracting significant amounts through European funds made available to Romania, this package has the potential to materialize successfully by 2024, if all these components of the program are completed on time, according to plan and conditional on good cooperation among the main shareholders of the project. The objectives of the NAFA Strategy - improving the services offered, integrated digital solutions, preventing and combating tax evasion, but also efficiency and institutional transparency can be achieved by prioritizing the implementation of standardized electronic reporting measures that have the potential to lead to a much better placement of Romania in the perspective of digital public services, in addition to improving collection, combating evasion and fraud and supporting fair taxpayers.

Compared to similar economies, Romania has a relatively modest degree of **collection of VAT revenues** relative to GDP (see *Figure 39)*, under the conditions of registering the lowest level of the weighted average VAT rate. Thus, in 2020 from the perspective of VAT revenues relative to GDP and the level of the weighted average VAT rate (determined on the basis of the weights of the HICP and characterized by the limitations described in subchapter III.4.1), Romania ranked last among the new EU member states.

Figure 39: VAT revenues in 2020 compared with the previous year (% of GDP)



Source: EC, Eurostat

At a weighted average share of 14.1%, Romania collected a percentage of 6.1%[128] of GDP VAT revenues, at a distance of -1.4 pp from GDP of Slovakia, which collected VAT revenues representing 7.5% of GDP

[128] The level of this indicator decreased by 0,1 pp compared to 2019 (6,2% of GDP), as a result of accelerated VAT refunds and the elimination of over-excise on fuels.

at a level of the weighted average share (16.9%). It is worth noting the very good performance of Bulgaria, with a structure of the economy relatively similar to that of Romania and a weighted VAT rate of 16.7%, which recorded the second best performance among the new EU Member States (9.4% of GDP), surpassed only by Hungary with 9.9% of GDP (but at an average VAT rate of 20.2%), outperforming countries with a much higher average VAT rate, such as Latvia (19.3%), Lithuania (19.0%), Estonia (18.6%), or Poland (17.1%). The low VAT revenues compared to the CEE states are the result of an extremely high level of VAT collection deficit[129] (*VAT gap*). Thus, according to the latest evaluations (September 2020) on this indicator[130], for 2018, a level of the VAT collection deficit of 30.7 billion lei was estimated for Romania, respectively, a share of 33.8% of the theoretical revenues to be collected, the highest value in the EU and CEE. In comparison, Estonia recorded a collection deficit compared to the theoretical revenues to be collected from VAT of only 5.2%, Hungary 8.4% (from 14% in 2017), Poland 9.9% (from 14.3% in 2017), Bulgaria by 10.8% (from 12.2% in 2017), the Czechia by 12% and Slovakia by 20%. It is worth noting the positive evolution of Bulgaria and Poland, which in the period 2015-2017 implemented consistent reform programs. Thus, compared to 2015, at the end of 2018 Bulgaria reduced this indicator by 11.4 pp, and Poland by 14.8 pp, while for Romania the reduction was marginal, of 1 pp, maintaining far to the highest level in the EU.

From the perspective of income received from **social security contributions** (SSC) paid by employees and employers (expressed as a share in GDP), compared to the level of the legal rate of social contributions, for the same set of countries as above, Romania stands out by a relative degree reduced collection (see *Figure 40*). Thus, the revenues collected in 2020, increased slightly compared to the previous year (+0.7 pp of GDP), registering a level of 12% of GDP, but at an equivalent legal rate of 44.7%[131] (level corresponding to the legal rate of 37.25% adjusted with the tax base to make it possible to compare with other countries). Given that this tax rate is the third largest of the rates of the countries analyzed (after Slovakia and the Czechia), the revenues collected are higher only in Hungary (11.3% of GDP at a legal rate of 36%), Lithuania (revenues of 10.8% of GDP in the context of a legal rate of only 21%), Latvia (with 10.5% of GDP, at a legal rate of 35.1%) and Bulgaria (9.3% of GDP, but at a legal rate of 33%). Slovenia (revenues of 17.4% of GDP) and Estonia (13.1% of GDP) outperformed Romania, given that legal rates of social contributions are significantly lower. Compared to Poland, which collected 14.7% of GDP from social contributions, the legal share in Romania is 3.6 pp higher, while compared to the Czechia, which is the leader of this ranking with SSC revenues of 16.1% of GDP, the equivalent legal rate in Romania is 3.3 pp lower.

A more detailed analysis of the indicators on the efficiency of taxation is presented in the sub-chapters III.4.1. VAT and excise duties, respectively, III.4.3. Social security contributions.

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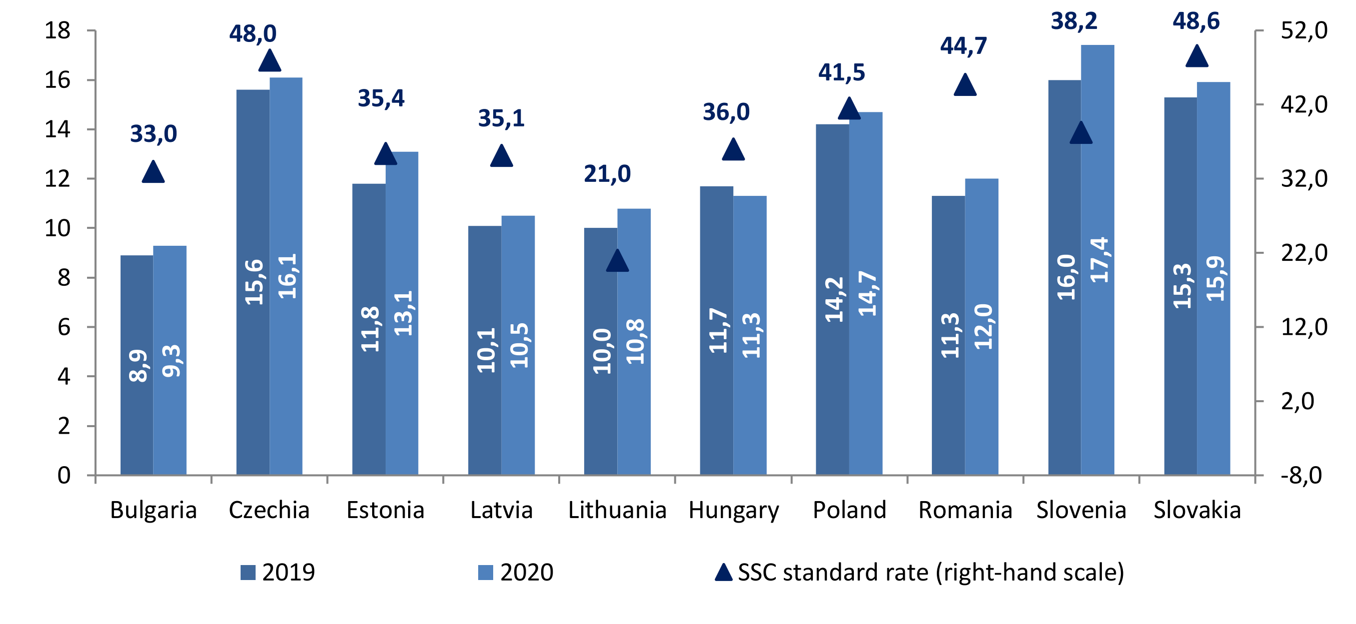
[129] Defined as the difference between the revenues actually collected by the tax administration and those theoretically estimated to be collected (amounts due by economic agents, in full compliance conditions).

[130] *Study and Reports on the VAT Gap in the EU-28 Member States: 2020 Final Report* https://ec.europa.eu/taxation_customs/sites/taxation/files/vat-gap-full-report-2020_en.pdf

[131] This level was calculated to correct the legal rate with the increase of gross salaries due to the transfer of social contributions from the employer to the employee starting with 2018.

Figure 40: Social security contributions revenues in 2020 (% of GDP)



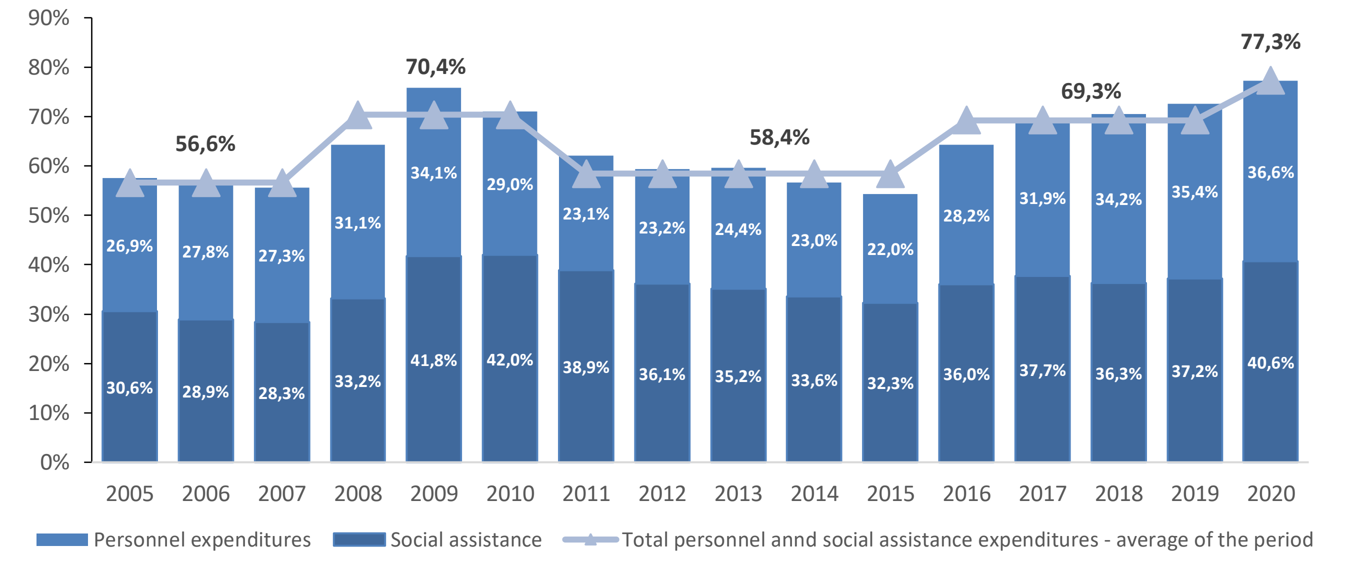
Source: EC, Eurostat

In conclusion, following a relative improvement in the efficiency and simplification of the administrative apparatus for collecting taxes, both from the perspective of the decrease in the number of financial administrations (although with the increase in the number of employees), and in terms of the ease with which taxes are paid, the reform initiated in Romania in this field seems to stagnate, with extremely unfavorable results from the perspective of budget revenues related to the need for post-pandemic economic recovery and the obligation to reduce the budget deficit, following the placement of our country in EDP in 2020. Sustained efforts are needed to increase investment in tax infrastructure and, in particular, digital technology, as it has been shown that the digitization of financial reporting processes has the potential to streamline the work of tax authorities with an effect on increasing the collection rate and access to available resources. Romania's recovery through the Recovery and Resilience Mechanism represents the opportunity through which they can be effectively achieved in the coming years.

V.3. Public expenditures - structure and sustainability

The structure of budgetary expenditures in Romania is characterized by the preponderance of expenditures on wages and social assistance (pensions, social benefits, etc.). Although their relative importance decreased significantly in the period 2011-2015 as a result of the fiscal consolidation process, the year 2015 representing the minimum of the analyzed period, starting from 2016 the reversal of this evolution was recorded (*Figure 41*), the share of expenditures with wages and social assistance in budgetary revenues recorded a major jump of 9 pp in that year compared to the previous year. In 2019, the upward trend continued, but at a slower pace, the share of these expenditures in total revenues reaching 72.6% from 70.5% in 2018. The level recorded in 2020, of 77.3%, represented the maximum of the analyzed period.

Figure 41: The evolution of social assistance and personnel expenditures as a share of total budget revenues (ESA 2010, %)



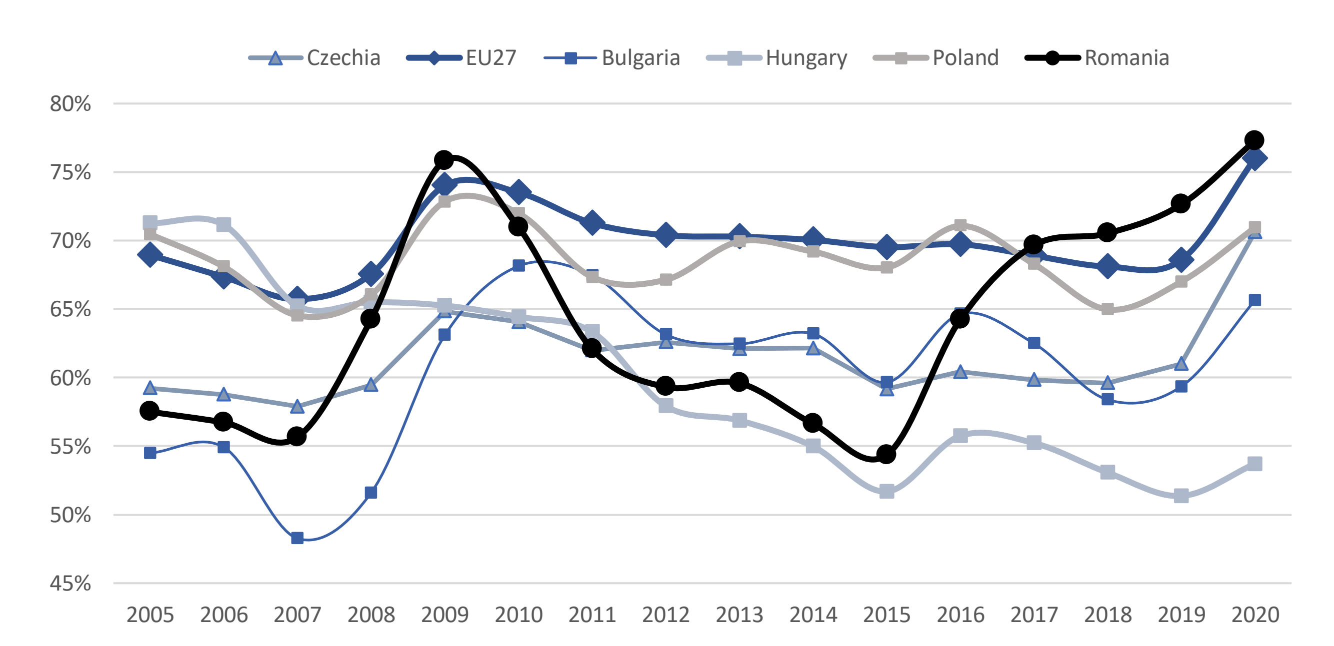
Source: Eurostat

Note: Taking into account the change in the treatment of special pensions by Eurostat, personnel expenditures and total budget revenues have been adjusted in the case of Romania in order to avoid double counting.

This development can be attributed to the nominal increase of these categories of expenditures compared to the previous year, respectively by 7% in the case of personnel expenditures (against the background of the increase in wages) and 13% in the case of social assistance expenditures, which outperformed the increase of budget revenues by 4%. It is noted that the share of wage expenditures in total budgetary revenues in 2020 (36.6%) is clearly higher than the average for the period 2008-2010 (31.4%), while the share of social assistance expenditures (40.6%), is above the average for the period 2008-2010 (39%), registering a higher difference than the average for the years 2011-2015 (35.2%), the expansionary fiscal policy of recent years thus canceling the effect of adjustments to wage expenditures and social assistance from 2011-2015. Compared to the previous year, the share of social assistance expenditures in total budgetary revenues increased by 3.4 pp, while the share of wage expenditures increased by 1.3 pp, this development being mainly due to support measures in the field of social assistance to combat the Pandemic, but also to increase the pension point by 14% in 2020.

Starting with 2018, the change in the tax regime of earnings by transferring contributions from employer to employee led to a significant increase in gross salary, which was equivalent to increasing the contribution to the social insurance system. These measures, together with the reduction of the quota transferred to Pillar II, have contributed to a substantial improvement in the system's self-financing capacity over the last two years. On the other hand, the share of this category of expenditure in total revenues still remains very high compared to other EU Member States. Also, from the point of view of ensuring the medium and long-term sustainability of public finances, it is important that any increases in wage expenditures in the public sector in the coming years to be made only in line with the evolution of economic activity and, in particular, with productivity gains, given that in the period 2016-2019 there is a slight upward trend in state personnel expenditures, with rates significantly higher than the nominal GDP advance and, especially, compared to the growth rate of total budgetary revenues from this period.

Figure 42: The share of personnel and social assistance expenditures (including pensions) in total budget revenues in EU27 and CEE between 2005-2020



Source: Eurostat

Note: Taking into account the change in the treatment of special pensions by Eurostat, personnel expenditures and total budget revenues have been adjusted in the case of Romania in order to avoid double counting.

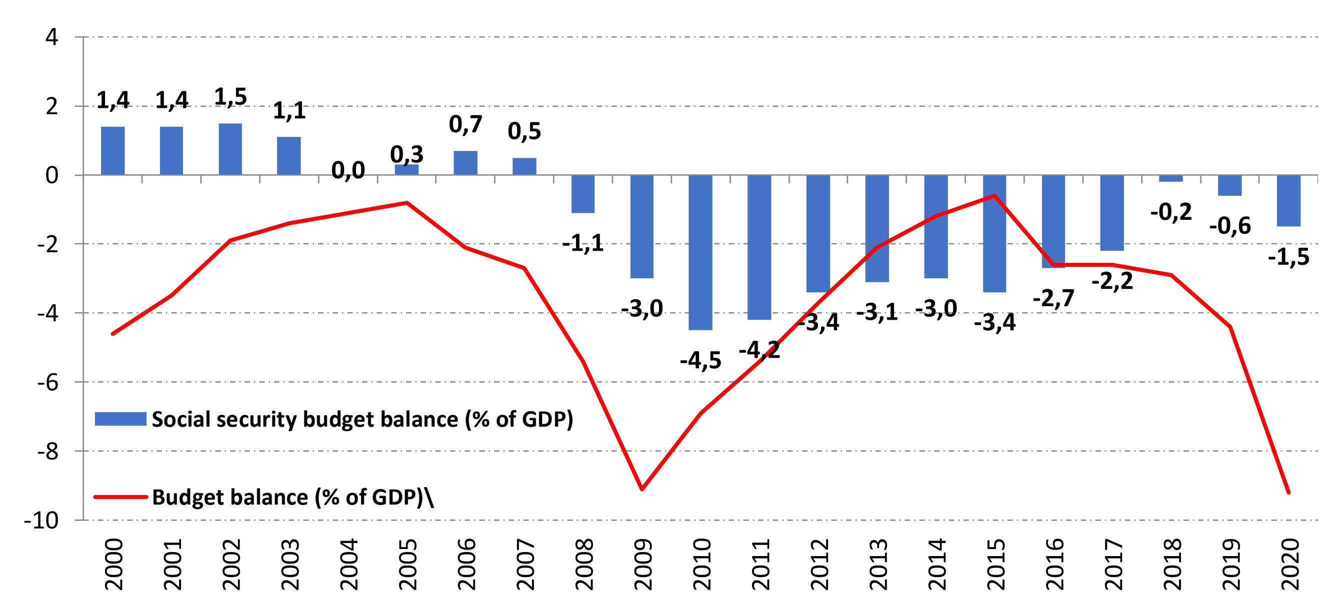
After a relatively stable evolution in relation to budgetary revenues before 2007, expenditure on salaries and pensions advanced at a brisk pace in the period 2008-2009[132], with a maximum of 75.8% in 2009, Romania registering in that year the largest share of expenditures on salaries and social assistance in total budget revenues in CEE countries, even exceeding the EU27 average. Following the implementation of the fiscal consolidation program, their share decreased significantly in the period 2013-2015, falling to a lower level than the CEE countries, with the exception of Hungary. However, since 2016, Romania has reversed this trend, and against the background of aggressive increases in salaries in the budgetary sector, and of pensions in 2018 and 2019, the highest values in the region of salary expenditures and social assistance related to budgetary revenues (70.5% in 2018 and 72.6% in 2019) were recorded again. In 2020, the share of these expenditures in budgetary revenues reached 77.3%, being 6.3 pp over the

[132] Respectively, an average of their share in total budgetary revenues of 70%.

next ranked country, Poland and 23.3 pp over the last ranked country, Hungary. At the same time, this indicator is 1.3 pp above the EU27 average, which reached 76% in 2020. The evolution of the share of wage expenditures and social assistance in total income for CEE countries and the EU27 average in the period 2005-2020 is presented in *Figure 42*.

Regarding the evolution of social security budgets (pensions, unemployment and health) it is observed that, if in the period 2000-2007, they were characterized by a relatively balanced or even surplus balance, after 2008 they went into deficit, and even came to represent an important component of the total deficit, respectively between 65% and 85% in the period 2010-2017. In 2019, the deficit of social security systems accounted for 14% of the total budget deficit, after in 2018, it decreased considerably as a result of fiscal measures to resettle the taxation materialized in increasing taxation through insurance contributions (reaching 7% total budget deficit). In 2020, it increased by 2 pp compared to 2019, representing 16% of the total budget deficit. Practically, in the period 2013-2016, Romania would have had a budgetary position characterized by budgetary surplus if the social security budget had been in balance.

Figure 43: Social security budget balance (pensions, unemployment and health) and total budget balance (ESA 2010, % of GDP)



Source: Eurostat

Note: Data according to ESA 2010 - the differences from the figures in the reports for the years 2010-2015 are due to the transition from ESA 95 to ESA 2010 methodology.

According to the Global Competitiveness Report 2019 edition, the last for which these data are available[133], Romania ranks 55th out of 141 countries with a score for the quality of transport

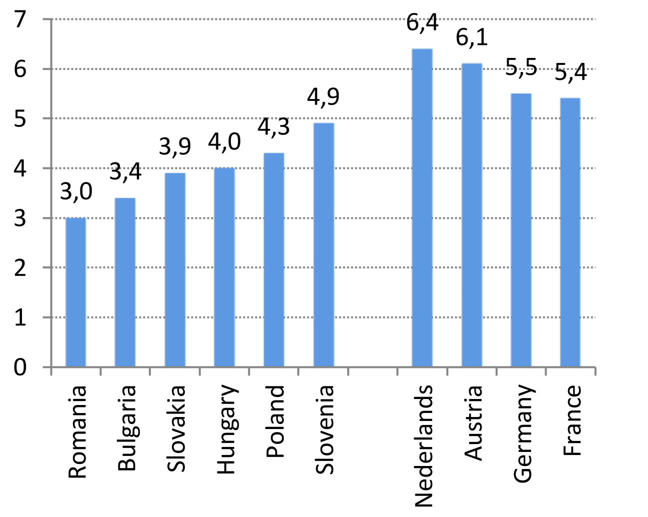
[133] The 2020 edition of the Global Competitiveness Report focused on analyzing the resilience of economies, as well as their ability to recover from the Pandemic.

infrastructure of 71.7%[134], while the quality of the roads represents the weakest component, which positions us only on the 119/141 place, with a score equal to 3 (out of a maximum of 7).

The score on the Infrastructure pillar represents, however, only a part of the global competitiveness index (GCI 4.0), for which Romania registers a score of 64%, climbing a position to 51st place, but out of a number of 141 countries compared to 140 in 2018. The top is led by Singapore (with a score of 84.8%), followed by the United States (with a score of 83.7%) and Hong Kong (with a score of 83.1%).

The efficiency reserves on the budget expenditure side are still very high. For example, Romania ranked 5th in terms of allocation for investment expenditures in 2009-2019 as a percentage of GDP among all EU countries and second in their share of budget revenues in the last 11 years. Despite all these budgetary efforts, the results were very modest, Romania having at the level of 2019 the weakest transport infrastructure in the EU (*Figure 44*), after occupying the third position in 2018, being followed only by Bulgaria and Malta[135].

Figure 44: Quality of transport infrastructure



Source: World Economic Forum, The Global Competitiveness Report 2019

Compared to the previous year, investment expenditures increased in 2020 by about 1.1 pp, reaching the level of 4.6% of GDP [136]. Thus, it is the third year of the analyzed period in which this aggregate of expenditures increased as a percentage of GDP compared to the previous year, but this value is still significantly lower than in 2009, being 20.7% lower, respectively 1,2 pp of GDP. Reported to 2015[137], public investment expenditures as a percentage of GDP are at a level 11.5% lower, respectively by 0.6 pp. From the perspective of allocations with this destination as a percentage of GDP, Romania ranked 8th in the EU in 2020 (up 6 positions compared to

[134]Starting with 2018, the score is calculated as a percentage compared to a maximum of 100%. Also, as an element of novelty compared to 2017 was the introduction of new sub-indicators, the aggregate score being defined on a much wider area of indices.

[135] According to the Global Competitiveness Report, 2019 edition. In the 2018 edition, a series of new sub-indicators for this pillar were introduced, which placed Romania in a much more favorable position compared to the 2017 evaluation (for example, a sub-indicator was introduced). indicator on electrification at which we have 100%, being on the first place in the analyzed countries).

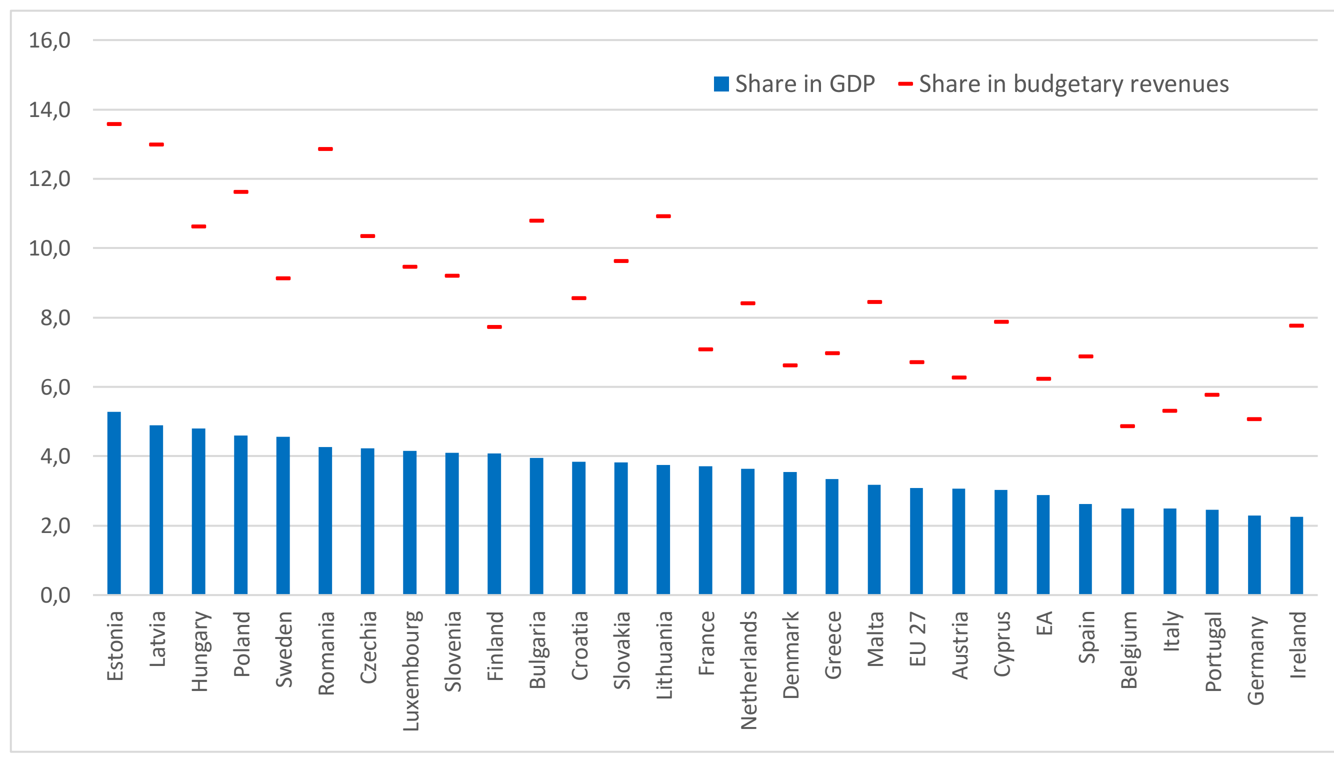
[136] However, the contractionary effect of the Pandemic on the GDP must be taken into account.

[137] 2015 was the first year after 2008 that public investment expenditures increased as a percentage of GDP compared to the previous year, given that this year was the deadline for attracting European funds for the financial year 2007-2013.

2019) and in the middle of the ranking among CEE countries, ahead of Bulgaria and Poland, but behind Hungary and Czechia.

Compared to budget revenues, public investment expenditures were higher by 2.9 pp compared to the previous year, but lower by 0.75 pp compared to 2015, remaining well below the pre-crisis level. It is worth noting the constant improvement of the allocations for this budgetary aggregate in the last three years, and in the context of the approval and entry into force of the National Recovery and Resilience Plan, the prospects can be considered optimistic from this point of view.

Figure 45: The share of investment expenditures in GDP and in total budget revenues (2009-2020 average)



Source: Eurostat

VI. 2021 – Macroeconomic and fiscal perspectives

VI.1. Macroeconomic framework

The Romanian economy was, in 2020 - from the second quarter - in an economic contraction caused by the COVID-19 pandemic, induced both by the internal effects of the health crisis and by the economic evolution of Romania's main external partners. The economic shock caused by the Pandemic is one of the most significant in recent history, and it has, in addition, the particularity of a very rapid effect on economic indicators, but also a relatively rapid return of real GDP in our country to pre-pandemic level. The most acute moment of the current crisis has been overcome in most economies - both developed and emerging - by fiscal and monetary policies that have boosted economic activity, deeply affected by the combined shock of supply and demand caused by the Pandemic triggered by the SARS-CoV-2 virus. In addition, supply and demand shocks have been accompanied by a deterioration in the confidence of both consumers and firms in the economic outlook combined with a transmission of shocks and, in some cases, an amplification of them through financing channel. The combined effects of these shocks cause an unprecedented level of uncertainty about the economic outlook, albeit witnessing a slight attenuation recently, which accentuates current and future challenges in both fiscal and monetary policy and structural reform policies - post-pandemic economies may reflect a deep structural resettlement, which would have partially taken place anyway, but extended over a longer period of time.

At the world economy level, the latest IMF[138] forecast estimates that the GDP will recover in 2021, with an aggregate 6% growth in real terms, all against the backdrop of both a strong base effect and of the effect of the policies adopted. The distribution of economic recovery shows deep disparities between different countries and regions in terms of the speed of economic recovery. The economic recovery shows that some countries have reached the level of pre-COVID GDP since 2020 (China), some are expected to reach this level this year (the US, and among the EU countries in this situation is Romania), and other countries are projected to recover the GDP gap only in 2022 or 2023. The speed of recovery depends decisively on the magnitude of the negative economic shock caused by the Pandemic, as well as on the policies and economic structure of the countries concerned. The developed economies are expected, according to the IMF, to show a lower real GDP growth of only 5.1% (faster compared to the last WEO Update forecast in January 2021), located mainly in the US (+ 6.4%) and to a lesser extent in the euro area - with a projected increase in real GDP in 2021 of only 4.4% (and relatively similar for the European Union). In emerging economies, the recovery is projected to be faster, with GDP growth of 6.7% in 2021, especially in emerging and developing countries in Asia, with an aggregate projected GDP growth rate of 8.6%. For 2022, the IMF forecasts a general slowdown in real GDP growth, to 4.4%

[138] World Economic Outlook – April 2021, https://www.imf.org/en/Publications/WEO/Issues/2021/03/23/world-economic-outlook-april-2021.

globally, 3.8% in the euro area and 3.9% for the EU economy, simultaneously with a recovery in economic growth in emerging and developing economies in Europe at 3.9%.

The EC[139] Spring Forecast estimates for 2021 a real GDP growth of 4.2% at the EU27[140] level (from a contraction of 6.1% in 2020) and 4.3% at the level of the euro area (from a contraction of 6.6% in the previous year), and for 2022 the growth rate of real GDP is forecast to remain at 4.4% for the EU27 and 4.4% for the euro area, respectively. Compared to the 2021 Winter Forecast, for this year the economic growth projection has been revised by +0.4 pp for the EU27 and +0.6 pp for the euro area. The economic scenario and the assumptions underlying it are similar to those of other similar institutions, in terms of: (i) the significant advance of the vaccination program, (ii) the gradual lifting of restrictions, but with the maintenance of some of them, (iii) carry on macroeconomic policies to support economies - and an advance on the Next Generation EU (NGEU) program; and (iv) favorable developments in the external environment. The risks that the forecast foresees are determined by (i) a different evolution than assumed for vaccination and the Pandemic, (ii) different inclinations of households towards saving and consumption, (iii) a different staging of the withdrawal and/or restriction of macroeconomic measures to support savings, (iv) a different impact of problems at the level of companies, including on the dynamics of the labor market and (v) a higher rate of economic recovery in the US that would boost the return in Europe, but worsen financial conditions in international capital markets - with an impact especially in emerging markets. Overall, the risks are assessed as balanced against the evolution of the baseline scenario.

Regarding the growth forecasts for the EU27 Member States, for 2021 the EC estimates faster growth rates for countries such as Spain (5.9%), France (5.7%), Romania (5.1%), Croatia and Hungary (both with 5.0%). The lowest GDP dynamics are expected to be recorded in countries such as the Netherlands (2.3%), Finland (2.7%), Estonia (2.8%), Lithuania and Denmark (both with 2.9%). For the United Kingdom, a GDP growth rate of 5.0% is expected, in the immediate vicinity of the countries at the top of the ranking in this respect. The resumption of economic growth is expected for the vast majority of countries for the second quarter of this year, with the exception of countries such as Ireland, France, Lithuania and Slovakia - where real GDP is already on an upward trajectory since early 2021. The global GDP is projected to grow in real terms, in the EC projection, by 5.6% in 2021, following a relatively slower growth of 4.3% in 2022. At the same time, the projection shows that the degree of dispersion of GDP per capita in European countries could increase, in the context of both starting points and uneven developments, which would increase the gap between countries and regions within the projection horizon.

From the perspective of the evolution of inflation at the EU27 level, expressed by the Harmonized Index of Consumer Prices (HICP), for 2021 is estimated, in line with the usual macroeconomic relations, that it will be relatively higher and close to 2% (1.9% and 1.7% in the EU27 and the euro area, respectively), but there are exceptions to this trend. It is noteworthy that emerging countries within the euro area, but

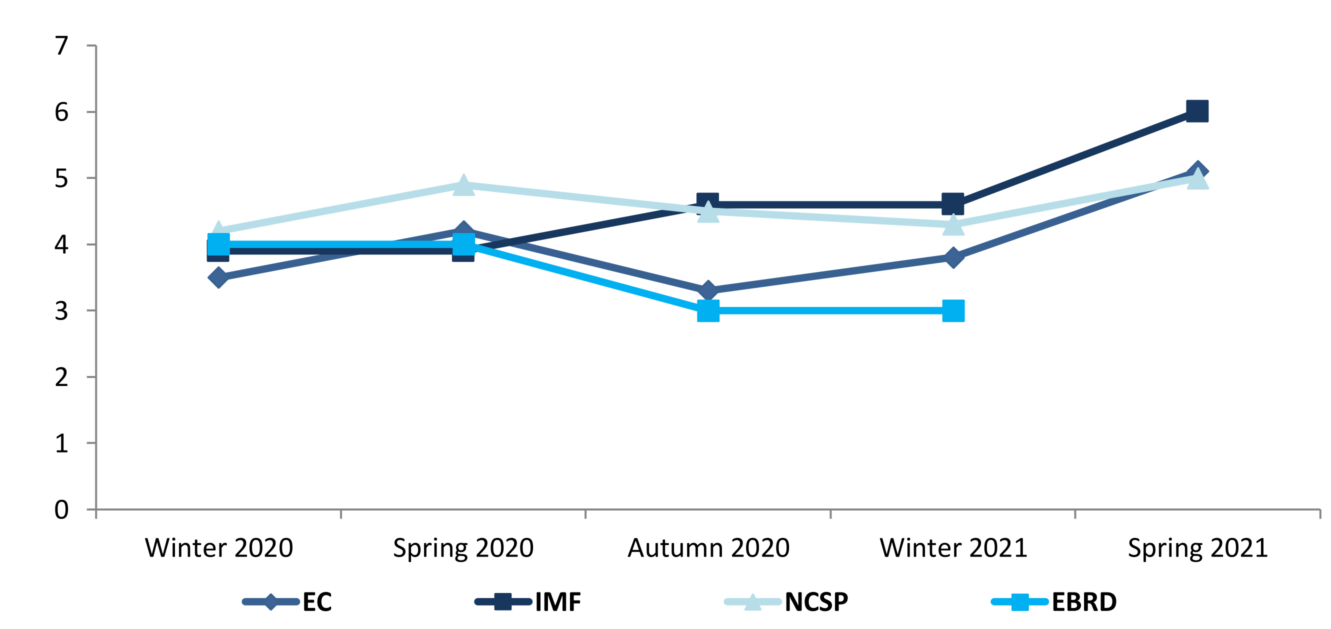
[139] European Economic Forecast, Spring 2021, https://ec.europa.eu/info/business-economy-euro/economic-performance-and-forecasts/economic-forecasts/spring-2021-economic-forecast_en.

[140] Excluding the United Kingdom.

especially those outside the euro area, have higher HICP levels than other states - differences from both different monetary and exchange rate policies (for non-euro area countries) and from the inflationary effects of the economic convergence process (such as the Balassa-Samuelson effect, administered price alignments, changes in the structure of the consumer basket, etc.). From the perspective of HICP inflation, the biggest difference between EU27 countries is, in 2021, between the anticipated inflation in Hungary (4%), Poland (3.5%) and Romania (2.9%) and that projected for Greece (-0.2%), Ireland and Portugal (both with 0.9%).

From the perspective of the economic growth rate for Romania, the EC anticipates an advance of 5.1% in 2021 - below the IMF anticipation of +7% - followed by a marginal attenuation at +4.9% next year (+4.8% in IMF projection). The determining factors of the upward trajectory of GDP in the next two years are private consumption and gross fixed capital formation (both to increase by about 6% in 2021 and by 5.9% and 7.4% in 2022, respectively). Net exports are expected to have a negative contribution to economic growth, the dynamics of exports of goods and services (+9.8% and +8.7% in 2021 and 2022) will be ahead of imports (+11.4% and +10.2%, respectively). However, the influence of other factors, including European funds - such as those allocated to Romania under the NGEU - determines a compression of the current account deficit as a share of GDP in the two forecast years, from a deficit of 5% in 2020 to 4.9% and 4.6% in 2021 and 2022. Economic developments depend on the evolution of the vaccination campaign and, implicitly, of the Pandemic as well as on the particularities of the economic structure, on the external influences determined by the degree of integration in European and world value added and production chains, and on the measures adopted by the authorities in the context of manifestation of twin imbalances (current and fiscal account) - the support measures will be gradually withdrawn in order to reach the assumed budget deficit target of 3% by 2024.

Figure 46: 2021 economic growth forecasts for Romania



Source: EC, IMF, NCSP, EBRD

For 2021, the initial forecasts of the EC, the IMF and the EBRD pointed an economic growth close to Romania's potential. Subsequently, as more favorable statistical data emerged, the forecasts were revised upwards. In this respect, during 2021 there is a process of aligning the projections of economic growth to a level of 5% and even above it, the latest developments - such as the signal data published by the NIS on May 18 this year - being able to indicate even a faster economic dynamic, recovering losses in terms of real GDP (caused by the Pandemic) and returning to pre-crisis levels in the same timeframe.

According to the Inflation Report, published by the NBR in May this year, the annual CPI[141] inflation rate will reach 4.1% by the end of 2021 and then fall within the target range (2.5% +/- 1 pp) since Q1 2022, and will reach a value of 3.0% at the end of 2022. The acceleration of the CPI in 2021 is due to temporary elements outside the prices that monetary policy may influence (adjusted CORE2), mainly due to prices for fuels and energy goods (electricity and natural gas). The deceleration in 2022 is due to a significant base effect, determined mainly by the dissipation of the influence of price increases on energy goods. The upward trend of inflation in the medium term is determined by the gradual increase of inflationary pressures from output gap, those associated with inflation expectations, as well as those from inflation of imported goods. The adjusted CORE2 inflation projection shows a relatively stable level at the beginning of the projection period - at 2.8% at the end of 2021 -, following a slight increase to the level of 3.1% towards the end of it.

The latest statistical data published by the National Institute of Statistics (NIS), respectively for the first quarter of 2021, indicate a quarter-on-quarter increase (seasonally adjusted data) of 2.8%, attenuating from 5.5% and 4.6% in Q3 and Q4 2020. This increase marks the return of real GDP to approximately the Q1 2020 level. Although the "signal" data published by the NIS do not include its structure - from the perspective of the three methods of determining GDP (formation, use, income) - the dynamics of other variables may suggest that part of it is dominated by consumption (the deficit on goods and services of the current account of the balance of payments, cumulated on January-March 2021, in euro, increased by about 20%, the average real net salary increased in March, year by year, by 4.5%, turnover in retail trade without trade in motor vehicles and motorcycles increasing, in January-March, cumulatively, in 2021, compared to the same period of the previous year by 0.8%, and wholesale trade in the same conditions by 3.6%), as well as a good dynamics of the industry (where both the industrial production and the new orders, cumulated for the first 3 months, compared to the same period of the previous year, increased by about 3.3% and 7%, respectively, the turnover from industry increasing, under similar conditions, by 6.9%).

Detailed data on GDP (in terms of its structure), for Q4 2020, show that at the level of 2020 the main factors that led to an economic contraction of only -3.9% are represented, on the part of GDP formation, by the positive evolution of agriculture, the construction sector and the information and communications sector, but influenced by unfavorable developments in trade, industry and product taxes. On the use of GDP side, there is a positive contribution of the statistical discrepancy (which in fact

[141] Calculated according to the national methodology. It is different from the HICP inflation rate, calculated according to the European methodology.

reflects elements being distributed) and that of gross fixed capital formation, which could not offset the negative contribution of total consumption and net exports.

In its opinion on the draft budget for 2021 and the 2021-2023 Fiscal Strategy, the Fiscal Council considered that, for 2021, "the risks to the evolution of real GDP are balanced, however, for the rest of the macroeconomic forecast horizon (2022-2024), these risks tend towards a less favorable scenario in terms of the dynamics of macroeconomic variables. The economic trajectory assumed in FS requires, according to FS, the elaboration of alternative scenarios and the detailing of back-up measures, as well as the clarification of the ambiguities arising from the assumed economic growth relationship - based on domestic demand - and the dynamics of the external balance, as well as on the determinants of the assumed economic acceleration". New statistics released in the meantime show that, for 2021, the Government's economic forecast of +4.3% in the initial draft budget and 5.0% in the NCSP's Spring Forecast, published on April 26 this year, it could be a minimum threshold, and a credible range for this variable could be considerably higher. This fact can be corroborated with a prudent projection of the GDP deflator - initially it was anticipated at 2.8%, and in the revised forecast of NCSP from April 2021 the deflator was to reach 3.1% for this year.

Under these conditions, nominal GDP growth for 2021 appears to be underestimated, even in the Government's updated (upward) projection from April this year, which could lead, in the conditions of a more alert dynamics of the economy, and of its reflection in taxes and duties at historically normal levels, to the registration of higher fiscal/budgetary revenues. With the revision of the data for 2021, and in terms of the economic trajectory proposed by NCSP in the updated projection in April this year in the period 2022-2024, the Fiscal Council considers that this is plausible, maintaining the observations and clarifications considered necessary regarding its determinants (by clarifying including the coordinates assumed regarding the attraction of NRRP funds) and, implicitly, the correlations of internal savings - external balance.

VI.2. Fiscal framework

After the year 2020 marked the reach of a budget deficit of 9.7% of GDP (according to the cash methodology) and 9.2% of GDP (according to the ESA 2010 methodology), respectively, and as a result of the effects produced by the COVID-19 pandemic, the year 2021 is an important challenge for Romania because it represents the start of a broad process of fiscal consolidation that aims to gradually reduce the deficit over the coming years, given that the effects of the Pandemic are still felt nationally and globally.

The position of public finances is complicated by the high level of the structural deficit (7.5% of potential GDP in 2020, according to the EC estimate, being high even before the COVID-19 pandemic) so that, although the previous year's budget execution includes and some one-off elements, most of the budget deficit recorded in 2020 is structural in nature and will continue in the future.

An important factor that determined the ascending evolution of the structural deficit is represented by the strong increase of personnel expenses and those with social assistance during the last years, in 2020 reaching the level of 94.3% compared to fiscal revenues (including insurance contributions), respectively 23.6% of GDP. At the same time, the fragility of the public finances position at the end of 2020 is highlighted by the low level of tax revenues, including social security contributions (about 25% of GDP), and budget revenues (30.6% of GDP), these values being the lowest in the EU except for the particular situation of Ireland.

As of 2020, Romania is covered by the EDP, but the special circumstances of the COVID-19 pandemic have led to the activation of the general derogation clause of the SGP by the EC, by which the fiscal rules of the European budgetary framework were temporarily suspended in 2020, with extension in the years 2021-2022. On 2 June 2021, the EC re-examined Romania's budgetary situation, including fiscal risks, and reiterated that the significant deterioration of the 2020 budget deficit was partly due to fiscal measures taken in the context of the COVID-19 pandemic and economic downturn, being driven by the expansionist measures taken previously. The deadline for closing the EDP is set in 2024, the fiscal adjustment will be supported by European funds allocated to Romania, reforms to be taken in the pension sector, tax administration and budget staffing and budget consolidation measures. In this sense, the Romanian Government must send a plan of measures by October 15, 2021.

In this context, the draft budget for 2021 had in mind a budget deficit target of 7.16% of GDP, according to the cash methodology, representing a decrease of about 2.5 pp of GDP compared to the level recorded in the previous year. The corresponding level of the budget deficit target for 2021, according to the ESA 2010 methodology, was 8.23% of GDP, which represents a reduction of about 1 pp of GDP compared to the level recorded in 2020.

In the Opinion on the draft budget and on the 2021-2023 FS, FC appreciated that these documents signal a change in approach to fiscal policy compared to previous years, being projected a gradual correction of deficits (cash, ESA, structural) for the period 2021-2024, as well as another philosophy of building the public budget from the perspective of sustainability of public finances, avoiding major internal and external imbalances. At the same time, FC noted in its Opinion the following relevant aspects regarding the budget construction for 2021 and the medium-term estimates (2022-2024):

- Although fiscal rules were suspended in the EU in 2020, with an extension of the derogation in 2021, a macroeconomic correction is needed in Romania to control deficits in the coming years. In this context, the gradual reduction of the budget deficit corresponds to a rational attitude, which allows the recovery of the economy to be strengthened;

- According to NCSP projections, real GDP is expected to grow significantly over the entire period 2021-2024. There is a dynamic of macroeconomic variables - relevant to the fiscal projection - favorable to fiscal consolidation, especially in the period 2022-2024, but there is an asymmetry between the emphasis on spending and the dynamics of budget revenues. Hence the need for alternative scenarios as well as for back-up measures to help macroeconomic correction in the event of more unfavorable developments;

- The reduction of the cash deficit in 2021 compared to the previous year is significantly supported by the amounts expected to be collected in 2021 from the budgetary obligations related to 2020 deferred to payment by economic agents. This justifies a significant reduction in the cash deficit in 2021 compared to 2020 - but does not represent a structural adjustment measure - while the budget balance according to ESA 2010 improves significantly less than according to the cash methodology. Thus, the relatively small step of reducing the budget deficit in 2021, according to the European methodology, must be increased starting with 2022, given that the gap compared to the 3% threshold is large;

- FC considered as feasible the achievement of the budget deficit target in 2021, both according to the cash and European methodology. At the same time, in the opinion of the FC, the possible materialization of additional revenues must be used to reduce the budget deficit, facilitating the consolidation effort in the coming years;

- The fiscal consolidation process needs to consider a restructuring of budget expenditures, but it is absolutely necessary to increase fiscal revenues in order to strengthen the robustness of the public budget. From this perspective, it should be noted that, according to FS, budget revenues are projected to remain at 31% of GDP in the period 2021-2023;

- The reduction of the budget deficit according to the national methodology in the period 2022-2024 by 4.4 pp of GDP (from 7.2% to 2.9%) is forecast by the MF to be achieved almost exclusively through budget expenditures. In the FC's view, an adjustment made only on the expenditure side is very difficult and it is unlikely that reducing the budget deficit in this way will suffice;

- It is unlikely that budget consolidation will be achieved in the period 2021-2024 in the absence of a significant increase in budget revenues. This could come from: improving collection efficiency, broadening the tax base, narrowing down exceptions that negatively deviate taxes paid by some taxpayers from standard rates, firmly combating tax evasion and unfair tax competition and optimizing tax rates;

- Romania is facing an exceptional opportunity, to the allocations of 30.3 billion euros within the cohesion policy related to the multiannual financial framework of the EU for the period 2021-2027, adding 29.2 billion euros (14.3 billion euros grants and 14.9 billion euros in the form of loans) through the RRM facility. Attracting these funds as much as possible can lead, on the side of macroeconomic stabilization, to increasing the contribution of the investment factor to the increase of potential and real GDP and to mitigating the contractionary impact of macroeconomic correction, and on the side of the real economy to the implementation of structural reforms, directly and indirectly supporting the process of fiscal consolidation in a period of constraints on budgetary expenditure for this purpose.

The most recent estimates of the MF, found in the 2021-2024 Convergence Program, indicate a favorable reassessment of the budget deficit for 2021, according to the European methodology, at the level of 8% of GDP (compared to 8.23% in the initially proposed budget), this value being in line with the latest EC projections from the 2021 Spring Forecast. However, for 2022 the MF estimates (ESA deficit of 6.2% of GDP) are more optimistic by almost 1 pp compared to the EC projections which place the ESA deficit at 7.1% of GDP. Similarly, both the MF and the EC estimates indicate a structural adjustment step of 0.6 pp of potential GDP in 2021, but for 2022 they differ significantly: the MF forecasts a broad structural adjustment of 1.4 pp of potential GDP, compared to the EC which anticipates an adjustment of only 0.5 pp of potential GDP. The adjustment of the budget deficit in the medium term is explained, according to the MF, mainly by the significant reduction of the share of budget expenditures in GDP, while the share of tax revenues is to remain relatively constant. In this regard, the FC drew attention in its Opinion on the draft budget for 2021 and the 2021-2023 FS that, although the process of fiscal consolidation must consider a restructuring of budget expenditures, it is absolutely necessary to increase fiscal revenues, an adjustment made only on the expenditure side being very difficult and unlikely to materialize at the levels estimated by the MF.

Regarding Romania's public debt, it reached the level of 47.3% of GDP at the end of 2020 (according to the European methodology) and is forecast, according to the baseline scenario of the MF, to continue the upward trend during the years 2021-2022, but at a slower pace, amid high primary deficits partially offset by economic growth. According to FC evaluations, in the baseline scenario represented by the official data of NCSP and MF, the public debt will continue to increase to the level of 54.1% in 2023, the trajectory reversing in 2024 when it is forecast to decrease to 53% of GDP. In the context of a less optimistic scenario, of a decrease in the budget deficit as a share in GDP, of only 1 pp per year, compared to 1.6 pp in the baseline scenario of the MF, the share of debt would be on a growth trajectory, reaching a significantly higher level of about 58% in 2024. Both the baseline scenario and the alternative scenarios involve significant risks.

Given that the primary deficit is the determining factor for the increase of public debt, its return to a sustainable trajectory depends decisively on the success of the fiscal consolidation process in the coming years. At the same time, given that interest rates in the domestic market have fallen recently, and those at European level have been low over the last decade, there are prerequisites for obtaining reasonable costs of financing public debt. However, it is worth noting a possible weakening of accommodation conditions in the international financial markets due to inflationary pressures and changes in the size of the special programs of the FED and the ECB. Last but not least, a firm commitment to a credible fiscal consolidation plan is a key premise for maintaining the country's rating and investor confidence in international markets.

FC appreciates, based on the budget execution in the first 4 months of the year, that the budget deficit target for 2021 is feasible, being possible even more favorable developments than those considered in the construction of the draft budget. This is due to the more favorable development compared to the initial projections of budget revenues, having as main sources the faster economic recovery than expected and the conservative assessment of budget revenues by the MF which, in the draft budget, took into account a limited recovery of amounts deferred to payment in 2020 by economic agents, but recent developments are favorable to budget revenues. On the other hand, the budgetary expenditures related to the execution in the first 4 months of 2021 reveal probably insufficient allocations at the level of personnel expenditures, social assistance expenditures, as well as those with goods and services - elements of a permanent nature. The latter development raises questions about the ability to ensure strict control of budget expenditures for the current year. Given that the budget revenues in addition to those projected in the budget will probably be higher compared to the need for additional allocations for permanent expenditure, the FC resumes the recommendation in its Opinion on the draft budget that these possible more favorable developments materialize in a lower budget deficit for 2021, thus facilitating the fiscal consolidation effort in the coming years.

The years to come remain very complicated. Not only the process of fiscal/budgetary consolidation in Romania requires a discipline of adjustment steps, but also the international context, despite the obvious economic recovery (for 2021 the IMF forecasts a real GDP growth of 6% worldwide, respectively 6.4% in the US, and the EC anticipates economic growth of 4.2% in the EU and 4.3% in the euro area, respectively), remains with many uncertainties and risks. Public and private debt has risen sharply in many countries (according to the EC, public debt at EU level has risen from 79.1% of GDP in 2019 to 92.4% of GDP in 2020, and that of euro area countries since 85.8% of GDP in 2019 to 100% in 2020), there are strong inflationary pressures (according to the EC Spring Forecast, HICP inflation is projected to increase in 2021 by 1.2 pp at EU level, respectively by 1.4 pp at the level of the euro area) which can influence inflationary expectations, there are geopolitical tensions and unconventional risks such as cyber-attacks that jeopardize the basic components of a country's critical infrastructure. Financial markets are already tightening the conditions for access to finance, which is reflected in the returns required on investments.

This changing context is an additional argument that strengthens the FC's plea for increasing fiscal and budgetary revenues. Even if the necessary macroeconomic correction occurs, unfavorable developments at the international level may negatively affect Romania’s cost of financing. The tightening of financing conditions is also correlated with possible outflows of funds from emerging economies.

Therefore, although the Pandemic is not definitively defeated, which requires government support programs in the economy and in the health sector, as we can end 2021 with a lower deficit than forecast, it is appropriate to use these reserves to support budget consolidation. Uncertainties about economic dynamics in the coming years will affect macroeconomic adjustment.

Consequently, the need for Romania to make the most of the European funds included in the multiannual financial framework and in the NRRP is even more acute.

The macroeconomic consolidation, it should be emphasized, does not derive from the NRRP, but from the fact that it cannot persist with large budget deficits that would invalidate any scenario of stabilizing public debt as a share of GDP, which would destabilize the economy and force a disorderly correction, with great economic and social damage. It should not be overlooked, as is often the case in public debate, that Romania came under the auspices of the EDP before the outbreak of the Pandemic. In other words, it is not NRRP that demands budgetary consolidation, but economic reason, which demands a reduction of imbalances (budgetary and external) in a credible way, in a foreseeable future. This correction takes into account the impact of the Pandemic and the suspension of fiscal rules in 2021 and 2022. European funds and NRRP help to make the macroeconomic correction easier and to increase the robustness of the Romanian economy.

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Appendix – Glossary of terms

Adjustment program – a detailed economic program, usually supported by IMF resources, that is based on an analysis of the economic problems of the member country and specifies the policies implemented or that will be implemented by the country in the monetary, fiscal, balance of payments and structural areas to set the basis for economic stabilization and sustainable economic growth.

Aggregate demand – total expenditures of internal and external users for acquiring final goods and services produced in an economy. It is computed as the sum between internal demand and exports of goods and services.

Aggregate supply – represents all goods and services offered on the domestic market by all domestic and foreign operators. In other words, the aggregate supply is the total domestic production of economic goods plus foreign countries offer (imports).

Annual spending ceiling – the maximum amount, set by law, that can be allocated to a certain category of government spending in one year.

Arrears of the general government – money loans or debt that have become overdue for more than 90 days following the breach of a contract between economic entities and the state as result of contractual terms' violations.

Automatic disengagement – part of the budget commitment that is automatically disengaged by the European Commission if it remains unused or if no request for payment is received by the end of the third year after the budgetary commitment. The difference between the two values (the one allocated and the one forwarded to the Commission for reimbursement) is lost through the automatic disengagement procedure.

Automatic stabilizers – features of the tax and transfer systems that tend to offset fluctuations in economic activity. Examples are unemployment compensation and progressive taxation rates.

Balance of payments – accounting record describing the transactions concluded between a country and its external partners in a specified period of time.

Base point – unit of measure for the interest rate, equivalent to 0.01%.

Budget balance – indicator computed as the difference between overall budget revenues and expenditures.

Budget revision – operation through which the budget is amended during a budgetary year.

Budgetary policy – financial policy of the state regarding public expenditures; public resource allocation policy.

Buffer – a reserve established by the Ministry of Finance in the Treasury in order to cover in advance the financing needs and which serves to protect against the event of adverse conditions in financial markets.

Capital account – flows of capital transfers and acquisitions /sales of non-financial and intangible assets.

Cash methodology – involves recording revenues when they are actually received and recording expenditures at the time of payment.

Clawback tax – charge imposed on the pharmaceutical industry that requires all manufacturers of medicinal products to help the funding of the public health system with part of the profits made from sales of subsidized drugs in excess of their allocated quota from the National Unique Fund for Health Insurance.

Cohesion Fund (CF) – financial instrument supporting investments in transport infrastructure and environment.

Conditionalities – economic policies that members intend to follow as a condition for the use of IMF resources. These are often expressed as performance criteria (for example, monetary and budgetary targets) or benchmarks, and are intended to ensure that the use of IMF credit is temporary and consistent with the adjustment program designed to correct a member's external payments imbalance.

Contagion – the transmission of shocks to several economic sectors, internally and abroad.

Contingency reserve fund – amount of money available to the Government, which is allocated to main authorizing officers from state government and local governments, based on the Government's decisions to finance urgent or unforeseen expenditures incurred during the year.

Contribution – compulsory imputation of a share from the revenues of employees or firms, with or without the possibility of obtaining a public service in exchange.

Countercyclical fiscal policy – is a fiscal policy behavior which has the role of stabilizing the economic cycle and helps to reduce cyclical fluctuations and inflationary pressures from excess demand.

Country risk premium – additional return required by an investor to compensate for the increased risk posed by a certain investment in a country. This is reflected in CDS quotations which measure the cost of insuring against default risk.

Current account deficit – occurs when total imports of goods, services and transfers of a country are greater than exports of goods, services and transfers of that country; in this case, that country becomes a net debtor to the rest of the world.

Cyclical adjustment of budgetary revenues – elimination of the budgetary revenue's component dependent on the demand excess/deficit (economic expansion/contraction), eliminating trend deviations; the level of cyclically adjusted budgetary revenues is the level that would have been collected if the GDP reached its potential growth.

Cyclical component of budget balance – modification of the budget balance due to cyclical developments in the economy.

Cyclically adjusted budget balance (CABB) – the general government balance net of the cyclical component. CABB is a measure of the fundamental trend in the budget balance.

Direct public debt – total public debt, except guaranteed public debt.

Disinflation – process of reducing inflation.

Economic classification – expenditure classification based on their economic nature and effect.

ESA 2010 methodology (*European System of National and Regional Accounts*) – The European System of National and Regional Accounts is an accounting reporting framework used internationally for a systematic and detailed description of an economy (of a region, a country or group of countries), or its components and its relations with other economies. The main difference between ESA 2010 methodology and the cash methodology is that revenues and expenditures are recorded in "accrual" system (based on commitments, not actual payments as in the cash system). ESA 2010 methodology replaces ESA 95 methodology, being adopted in 2013.

Euro Plus Pact – it is also known as the Competitiveness Pact and its objective is the stability of euro area, member states committed themselves to take measures to encourage competitiveness, employment and consolidation of public finances.

European Agricultural Guarantee Fund (EAGF) – European funds for implementation of support measures for farmers.

European Regional Development Fund (ERDF) – Structural Fund which supports the less developed regions by financing investment in the productive sector, infrastructure, education, health, local development and small and medium enterprises.

European semester – additional tool for preventive surveillance of economic and fiscal policies of the Member States; is an annual cycle of economic and budgetary policy coordination, which takes place in the first six months of the year, in order to identify any inconsistencies and emerging imbalances of economic and fiscal policies that would violate the rules set out in the Stability and Growth Pact.

European Social Fund (ESF) – Structural Fund for Social Policy of the European Union, which supports employment measures for labor and human resource development.

Eurosystem – the central banking system of the euro area. It comprises the European Central Bank and the national central banks of EU Member States from the euro area.

Excessive Deficit Procedure (EDP) – the corrective arm of the Stability and Growth Pact (SGP) that imposes penalties in cases of no prompt correction of excessively high deficits (having breached or being in risk of breaching the deficit threshold of 3% of GDP at market prices) or excessively high debt (having violated the debt rule by having a government debt level above 60% of GDP, which is not diminishing at a satisfactory pace. This means that the gap between a country's debt level and the 60% reference needs to be reduced by 1/20th annually on average over three years).

Exchange Rate Mechanism II (ERM II) – the exchange rate arrangement established on January 1, 1999 that provides a framework for exchange rate policy cooperation between the Eurosystem and EU Member States that are not in the euro area. Although membership in ERM II is voluntary, Member States with derogation are expected to join. This involves establishing both a central rate for their respective currency's exchange rate against the euro and a band for its fluctuation around that central rate. The standard fluctuation band is ±15%, but a narrower band may be agreed on request.

Excise – special consumption tax applied to domestic and imported products, borne by consumers and included in the sale price of some specific commodities.

Expansionary fiscal policy – is a fiscal policy behavior that has an accelerating effect in aggregate demand growth and may lead to an amplification of inflationary pressures.

Expansionary monetary policy – monetary policy that stimulates aggregate demand and a possible amplification of inflationary pressures.

Fee – the price one pays as remuneration for services provided by an economic agent or a public institution.

Final consumption – component of the aggregate demand which includes private consumption and government expenditures for public goods and services.

Financial account – flows of transactions associated with ownership change on assets or liabilities of a country and includes foreign direct investments, portfolio investments, financial derivatives, other capital investments and reserve assets.

Fiscal Compact – part of the Treaty on Stability, Coordination and Governance signed on March 2, 2012 by all EU member states, except for the United Kingdom and Czechia. The treaty is aimed at strengthening fiscal discipline by introducing an automatic correction mechanism and stricter surveillance. The fiscal compact establishes a requirement for national budgets to be in balance or in surplus. This criterion would be met if the annual structural government deficit does not exceed 0.5% of GDP at market prices. If public debt is significantly below 60% of GDP and risks addressing long-term public finance sustainability are low, the structural deficit may reach a maximum level of 1% of GDP.

Fiscal consolidation – policy aimed at reducing budget deficits and the accumulation of public debt.

Fiscal impulse – the impact of discretionary fiscal policy on aggregate demand. It is computed as the change of structural balance relative to the previous period; a positive value corresponds to an expansionary fiscal policy and a negative value to a restrictive fiscal policy.

Fiscal policy – policy that aims to influence the economy using the tax system as instrument.

Fiscal/Tax revenues – budget revenues collected through taxation. Fiscal revenues include: personal income taxes, corporate income taxes, capital gain taxes, property taxes and fees, goods and services taxes and fees, taxes on foreign trade and international transactions, other taxes and fees, social security contributions.

Fiscal rule – a long-term constraint on fiscal policy through numerical limits on budgetary aggregates. Fiscal rules are intended to avoid pressure from incentives and excessive spending, especially in the upward phase of the economic cycle so as to ensure accountability in the management of public finances and public debt sustainability.

Fiscal space – 1. the difference between current public debt and a threshold of public debt that does not involve increasing costs for financing the deficit and which takes into account the historical evolution of fiscal adjustment; 2. financial resources available for additional expenditures required to implement development projects.

Fiscal strategy – public policy document designed to set out fiscal objectives and priorities, revenue and expenditure targets of the General Consolidated Budget and its components and the evolution of the budget balance for a three-year period.

Fiscal sustainability – a set of policies is said to be sustainable if the state is able to meet its debt payments without any major additional correction in the budget balance.

Functional classification – expenditure classification based on their destination in order to assess public funds allocations.

GDP deflator – an indicator that reflects the change in prices of the goods and services composing GDP; it is computed as a ratio between GDP in current prices and GDP in prices of the base year.

Guaranteed public debt – loans guaranteed by the Ministry of Finance and local government authorities.

Harmonized Index of Consumer Prices – consumer price index whose methodology has been harmonized between EU countries; the inflation objective of the European Central Bank and the euro area inflation rate are expressed based on this index.

Implicit tax rate – the ratio between the actual collected revenue for a specific type of tax and the corresponding macroeconomic tax base.

Inflation – reflects the widespread and persistent increase in prices and it is typically measured by the consumer price index.

Inflation target – is set by central banks that have adopted the inflation targeting strategy. The target can be set as a fixed level of inflation and/or as a range. The National Bank of Romania sets the target as a midpoint within a target band of +/- 1 pp.

Informal economy – legal economic activity, but hidden from public authorities in order to avoid paying taxes, social security contributions or to avoid compliance with legal standards on labor and with other administrative procedures.

Medium Term Objective (MTO) – is the medium-term objective for the budgetary position and differs for each EU Member State. For states that have adopted the euro or are in the Exchange Rate Mechanism II, it is -1% of GDP or a budget surplus. Reassessment of medium-term objectives is done every four years or when a major structural reform is adopted.

Monetary policy interest rate – the interest rate used for the main operations of the NBR. At present, these are one-week repo operations, established by fixed interest rate auctions.

Nominal convergence criteria (Maastricht) – the four criteria set out in Article 140 (1) TFEU that must be fulfilled by each EU Member State before it can adopt the euro, namely: 1) the inflation rate must not exceed by more than 1.5 pp the average of the three best performing EU countries in this respect; 2) the long-term nominal interest rate must not exceed by more than 2 pp the average interest rate in the first three member states with the best performance in terms of price stability; 3) the public budget deficit must be less than 3% of GDP, the public debt to GDP ratio must be less than 60%; 4) exchange rate fluctuations must not exceed +/- 15% in the last two years preceding the examination.

Nominal variables – variables expressed in current prices.

Non-fiscal/tax revenues – other budget revenues that do not include taxation, such as royalties, payments from SOEs' profit, fines, charges.

One-off component of the budget balance – a component of revenues or expenditures that has a temporary nature.

Output gap – an indicator that measures the difference between the actual GDP of an economy and potential GDP. It is also acknowledged as GDP deviation.

Pillar 1 of the pension system – the name given to the state pension system; has a compulsory character and is based on the redistribution of money collected during a financial year, the "pay as you go" system (the present employees pay for the currently retired population).

Pillar 2 of the pension system – name given to the private pension system; has a compulsory character for employees below the age 35 at the time of its introduction (2007) and aims to provide a private pension that supplements the public pension. Contributions to private pension funds are nominal and immediately after they are paid into the employee's account, they become his property.

Potential GDP – real GDP that can be produced by the economy without generating inflationary pressures. Potential GDP is determined by long-term fundamental factors such as organization of the economy and the productive capacity of economy determined by technology and demographic factors that affect the labor, etc.

Primary balance of the General Consolidated Budget – the difference between budget revenues and expenditures, excluding the interest payments with regard to public debt.

Primary structural budget deficit – structural budget deficit net of the "non-discretionary" component of the budgetary policy - interest expenses related to public debt; it is used in the analysis of the sustainability of fiscal policy.

Pro-cyclical fiscal policy – fiscal policy behavior that does not fulfill its stabilizing role of the economic cycle but rather contributes to amplifying cyclical fluctuations and inflationary pressures from excess demand.

Proxy – a variable which estimates/approximates and replaces another variable, an unobservable one.

Quasi-fiscal deficit – takes into account public sector expenditures not recorded into the budget; particularly, it refers to the losses of state-owned enterprises which translate in the default of their financial obligations to the public budgets and public utilities.

Real convergence – reaching a high degree of similarity and cohesion of economic structures of the candidate countries; although the Maastricht treaty does not mention real convergence criteria, these can be summarized by a series of economic indicators like GDP per capita, the degree of openness, the share of the commerce with Member States, economic structure.

Real GDP – represents the value of final goods and services produced in an economy in a given period, adjusted with price increases. Real GDP dynamics is used to measure the economic growth of a country.

Real variables – variables expressed in constant prices (the prices of a base year).

Reference interest rate – starting with September 1, 2011, the NBR's reference interest rate is the monetary policy interest rate, established by decision of the NBR's Board of Directors.

Restrictive monetary policy –monetary policy behavior that constrains the aggregate demand in order to reduce inflation.

Royalty – payment to the holder of a patent, copyright or resource for the right to use their property.

S0 – an "early detection indicator" which was designed to highlight shorter term risks of fiscal stress (within a 1-year horizon) through the "signals approach".

S1 – indicator of the sustainability gap that shows the required increase in taxes or decrease in expenditures (as a percentage of GDP) subject to a debt level of 60% of GDP at the end of the period.

S2 – indicator of the sustainability gap that indicates the required fiscal effort (as a percentage of GDP) subject to the inter-temporal budget constraint on an infinite time horizon.

Seasonality – periodic pattern in the evolution of an economic variable that systematically appears at certain times of the year.

Stability and Growth Pact – consists of two EU Council Regulations, on "the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies" and on "speeding up and clarifying the implementation of the excessive deficit procedure", and of a European Council Resolution adopted at the Amsterdam summit on June 17, 1997. More specifically, budgetary positions close to balance or in surplus are required as the medium-term objective for Member States since this would allow them to deal with normal cyclical fluctuations while keeping their government deficit below the reference value of 3% of GDP. In accordance with the Stability and Growth Pact, countries participating in EMU will submit annual stability programs, while non-participating countries will provide annual convergence programs.

Stand-by Arrangement – an arrangement for an IMF member through which the country is assured that will be able to make purchases (drawings) from the General Resources Account (GRA) up to a specified amount and during a specified period of time, usually one to two years, provided that the member observes the terms set out in the supporting arrangement (see **Conditionalities**).

Stock-flow adjustment of public debt – process that ensures consistency between changes in the debt stock and net lending flows. It takes into account accumulation of financial assets, changes of foreign currency debt and statistical adjustments.

Structural budget balance – is determined by deducting from the cyclically adjusted budget balance the temporary elements (one-offs).

Structural budget deficit – the budget deficit that would be recorded if GDP was at its potential level; it’s the size of the deficit recorded in the absence of business cycle influences.

Swap – chain compensation scheme for outstanding obligations to the general consolidated budget; operation that implements the extinction of outstanding budgetary obligations, with equivalent impact on revenues and expenditures.

Taxation efficiency index – index through which it is measured the effectiveness of tax collection. It is computed as the ratio between the implicit tax rate and the statutory tax rate.

Taxes – compulsory and non-refundable levy charged by a government with the purpose of financing public goods and services.

Trade balance – section of the balance of payments that records the difference between exports and imports of goods and services made in a certain period of time.

Voluntary compliance – principle under which taxpayers will comply with the tax laws and, more importantly, will accurately report income and the deductions they benefit from, without direct compulsion by the authorities empowered to do so.