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Romania
Fiscal Council

2018
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List of abbreviations

CEE  Central and Eastern Europe
CEF  Connecting Europe Facility
CF   Cohesion Fund
CPI  Consumer price index
EAFRD European Agricultural Fund for Rural Development
EAGF European Agricultural Guarantee Fund
EC   European Commission
ECB  European Central Bank
EBRD European Bank for Reconstruction and Development
EDP  Excessive Deficit Procedure
EMFF European Maritime and Fisheries Fund
ERDF European Regional Development Fund
ESA 2010 European System of National and Regional Accounts 2010
ESA 95 European System of Accounts 1995
ESF  European Social Fund
EU   European Union
FRL  Fiscal Responsibility Law No 69/2010
FS   Fiscal Strategy
FSA  Financial Supervisory Authority
GCB  General consolidated budget
GCI  Global Competitiveness Index
GDP  Gross Domestic Product
GEO  Government Emergency Ordinance
IBRD International Bank for Reconstruction and Development
HICP Harmonized Index of Consumer Prices
IMF  International Monetary Fund
MEF  Ministry of European Funds
MPF  Ministry of Public 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 Member States from Central and Eastern Europe
NPISH Non-profit institutions serving households
NRDP National Rural Development Programme
NREF Non-reimbursable external funds
NRP National Reform Programme
OECD Organization for Economic Co-operation and Development
<table>
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<th>Description</th>
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<tr>
<td>OP</td>
<td>Operational Programme</td>
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<tr>
<td>OPFMA</td>
<td>Operational Programme for Fisheries and Maritime Affairs</td>
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<td>OPADP</td>
<td>Operational Program for Assistance to Disadvantaged People</td>
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<td>pp</td>
<td>Percentage points</td>
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<td>RAMP</td>
<td>Revenue Administration Modernization Project</td>
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<td>SGP</td>
<td>Stability and Growth Pact</td>
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<td>SME</td>
<td>Small and Medium Enterprises</td>
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<td>SSC</td>
<td>Social Security Contribution</td>
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<td>TSCG</td>
<td>Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (The Fiscal Compact)</td>
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<td>TUEF</td>
<td>Temporary Unavailability of European funds</td>
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I. Summary

The Fiscal Council is an independent authority established by the Fiscal Responsibility Law No. 69/2010 (FRL), which aims to support the Government and the Parliament in designing and implementing the fiscal policy and to promote the transparency and sustainability of public finances.

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

The Romanian economy continued its upward trend in 2018, but the growth rate slowed significantly compared to the previous year. The structure of economic growth remained unbalanced, being mainly based on consumption, but 2018 also recorded a large impact of changes in inventories. Economic growth was accompanied by important fluctuations in inflation and a significant deepening of the current account deficit. The labor market has maintained a favorable trajectory, with the unemployment rate reaching its lowest level since 1992, while wages continued to rise significantly.

In 2018, Romania's economy continued to evolve on an upward trend, but there was a significant slowdown in economic growth. Thus, gross domestic product (GDP) advanced by 4.1% in real terms compared to the 7% growth recorded in 2017. The main contribution to economic growth continued to be provided by the final consumption expenditure of the population (+3.3 percentage points - pp), a significant positive impact being also exerted by changes in inventories (+2.9 pp). On the other hand, net exports (-1.7 pp, due to the stronger growth of imports relative to exports) and gross fixed capital formation (-0.7 pp, amid a 3.2% drop in real terms compared to the previous year) had an unfavorable influence on economic growth. In terms of supply, it should be noted that GDP growth was supported by all sectors of the national economy, excluding constructions, the most important contributions belonging to industry and commerce.

The year 2018 started with a steep rise in inflation, reaching a peak of 5.4% in May, while the second half of the year saw it decline to 3.3% in December. At the same time, the price increase across the entire economy, as measured by the GDP deflator, stood at 5.9%. On the other hand, the current account deficit continued to deepen from 3.2% of GDP in 2017 to 4.5% of GDP in 2018, being partially financed by foreign direct investments. The non-governmental credit maintained an upward dynamics, recording an increase of 4.5% in real terms relative to 2017. The labor market continued the favorable evolution from the previous year, the average number of employees rising to 5.1 million (+3.3% compared to 2017), while the unemployment rate reached 3.3% which represents the minimum recorded since 1992. The net average wage across the entire economy was 2,685 lei, up by 14.8% compared to 2017, its dynamics being supported by increases in both public and
In 2018, the fiscal policy continued to deviate from the MTO, while the budget deficit according to the ESA 2010 methodology slightly exceeded the initial target but remained close to the 3% of GDP ceiling. In what concerns the targets expressed in nominal terms, they were exceeded both in cash terms and according to ESA 2010. Most national fiscal rules have been systemically circumvented since the adoption of FRL in 2010 and, starting from 2016, the structural deficit rule has also been violated. Despite the fact that Romania became the object of a significant deviation procedure from the MTO for the second time, in 2018 the structural deficit deteriorated to 2.98% of GDP from 2.94% in the previous year.

Since 2006, Romania has pursued a strong pro-cyclical fiscal policy, stimulating intensively but unnecessarily and counterproductively the economy during the expansion periods (2006-2008) and slowing down during the periods when it operated under potential (2010-2015), thus contributing to the amplification of the economic cycle fluctuations and to the deepening of the imbalances accumulated in the economy. The fiscal consolidation process that took place between 2010 and 2015 has been partially reversed by maintaining an expansionary fiscal stance.

The general consolidated budget (GCB) for 2018 was based on a deficit target of 2.97% of GDP in cash terms and of 2.98% of GDP according to the European System of National and Regional Accounts 2010 (ESA 2010), which represents an increase compared to the values recorded in 2017, as a result of the continued fiscal relaxation and the transfer of social contributions from the employer to the employee. Thus, there was again a deliberate deviation from the medium-term budgetary objective (MTO), which sets a structural budget deficit of maximum 1% of GDP, the structural deficit for 2018 being estimated, at that time, at 3.32% of GDP. The final budget execution was in line with the target deficit in cash terms (2.90% of GDP), but exceeded it according to the ESA 2010 methodology (3.02% of GDP), while the structural deficit deteriorated to 2.98% of GDP from 2.94% in 2017, according to the latest European Commission (EC) estimates. Moreover, although the EC has warned Romania for the second time in December 2017 of the significant deviation from the MTO, with the recommendation to initiate a structural adjustment of 0.8% of GDP in 2018, this recommendation was not followed when formulating the budget proposal for 2018. The first budget revision maintained the deficit close to the 3% of GDP ceiling, although in June 2018 the EC issued a new recommendation on the need for a structural adjustment of 0.8% of GDP in 2018, which leads to the

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1 MPF estimated the structural deficit at 2.8% of GDP in 2018 according to the Convergence Program 2019-2022.
vulnerability of public finances. Between 2016 and 2018 the cumulative fiscal impulse was strongly positive, amounting to 2.9 pp of GDP, which exceeded significantly the limits imposed by the MTO.

The collection efficiency index decreased in the case of direct taxes paid by the population, remained unchanged in the case of VAT, but recorded positive developments for direct taxes paid by firms and for SSC. The results are partly influenced by the effect of discretionary fiscal policy measures.

Following the tax cuts from recent years, tax revenues continued to decline as a percentage of GDP, ranking Romania as the second to last among EU countries.

The collection efficiency index for direct taxes paid by the population recorded a significant decrease (from 0.81 to 0.7, which represents the minimum of the 2009-2018 period), but this is partly due to the changes in the taxation of earnings through the transfer of contributions from employers to employees. By comparison, collection efficiency of direct taxes paid by firms has slightly improved (from 0.24 to 0.28), but this is not due to receipts from corporate income tax, being influenced by the evolution of other taxes included in this category, as well as tax payments made by firms to beneficiaries other than the Romanian state. On the other hand, the collection efficiency index remained at 0.7 for VAT receipts and in the case of social security contributions (SSC) it increased from 0.71 to 0.75, this increase being partially caused by discretionary measures of fiscal policy. As for excise duties revenues, although they recorded an increase of 1.9 billion lei relative to 2017, the collection efficiency deteriorated during 2018, especially in the case of energy and tobacco products, and the unfavorable evolution of this budgetary aggregate has materialized in the failure to achieve the initial programmed level.

Analyzing the impact of tax cuts in recent years, they have contributed to the erosion of tax revenues that reached 26.7% of GDP in 2018, including SSC (which had a strong positive evolution offsetting the sharp fall in fiscal revenues). Thus, from the perspective of this indicator, Romania continues to rank on the penultimate place among the EU countries, with a gap of 13.2 pp relative to the EU average of 39.9% of GDP. In 2018, the effects of the major changes brought by the new Tax Code resulted in the reduction of the weight of budget revenues in GDP by 3.4 pp (the indicator increased by 0.4 pp at EU28 level) and led to a fall of 1.2 pp in the weight of tax revenues in GDP (while they increased by 0.6 pp for the EU as a whole).
The need for increasing tax collection efficiency remains significant. Therefore, the cancellation of the tax administration modernization project developed in conjunction with the WB and the annulment of reform measures that were already implemented is likely to reverse the administrative reform process.

In 2013, an extensive process of reforming the Romanian tax administration was launched in collaboration with the World Bank (WB) and the Fiscal Council noted in its annual reports an improvement in the efficiency and simplification of the tax collection administrative apparatus. However, at the initiative of the Romanian authorities, the Revenue Administration Modernization Project (RAMP) was cancelled in March 2018, due to the lack of progress in the previous year, although its deadline was set for 2021. Furthermore, after the abandonment of RAMP, the Senate approved the amendment of GEO no. 74/2013 in November 2018, at the proposal of MPF, effectively cancelling a series of reform measures that were implemented since 2013. As a result, Romania descended 7 positions in the Paying taxes 2018 ranking compared to the previous edition.

Personnel and social assistance expenditures, expressed as a percentage of budget revenues, have returned to their pre-crisis levels as a result of rapid increases during the last three years. Moreover, similar to 2009, Romania recorded in 2018 the highest level of personnel and social assistance expenditures relative to budget revenues (70.1%) among CEE countries, while at the same time exceeding the EU28 average (67.4%).

Investment expenditures, expressed as a percentage of GDP, recorded a slight increase to 3.63% of GDP. After a rather stable evolution before 2007, personnel expenditures and pensions relative to budget revenues have advanced at a rapid pace in 2008-2009, reaching a peak of 75.9% in 2009. In that year Romania recorded the highest level of personnel and social assistance expenditures, as a percentage of total budget revenues, among Central and Eastern European (CEE) countries and surpassed the EU28 average. Following the implementation of the fiscal consolidation program, their share declined significantly over the 2013-2015 period, falling to a lower level than other CEE countries, except for Hungary. But Romania has started to reverse this trend in 2016 and, following the aggressive increase of pensions and wages in the public sector during 2018, it recorded again (similar to 2009) the highest level of personnel and social assistance expenditures (70.1% of total budget revenues) among CEE countries which is, as well, above the EU28 average (67.4%). Moreover, the developments from 2019 seem to strengthen the upward trend of ‘mandatory’ expenditures relative to total budget revenues, which will substantially complicate the coordinates of future fiscal policy.

Compared to the last 5 years, investment expenditures registered a slight recovery in 2018, after the minimum that was recorded in 2017, but remained well below the average of the 2013-2017 period (by 0.9 pp). Compared to the previous year, investment expenditures
(from 3.12% of GDP in 2017), but remain well below the average of the 2013-2017 period (by 0.9 pp of GDP).

The Fiscal Council advocates a firm enforcement of the legal framework for public investment management and appreciates that some progress has been made in this area.

Public debt, expressed as a percentage of GDP, recorded a minor reduction in 2018 due to the favorable effect of economic growth and of the negative real interest rate that have offset the adverse impact of the high budget deficit. According to EC forecasts, public debt is expected to exhibit an upward trend in the following years.

The absorption of European structural and cohesion funds remains modest, recording a rate of 20.5% in March 2019 which places Romania on the penultimate place among the NMS CEE. Compared to the EU average, Romania has an increased by 7.5 billion lei (+0.5 pp of GDP). Compared to the initial budget, investment expenditures were lower by 4.6 billion lei (0.49% of GDP respectively), the deviation being significantly smaller compared to the previous year. This development is attributable mainly to the underachievement of the expenditure forecast for projects financed by European funds under the 2014-2020 financial framework.

It appears that the reform process of public investment management has reached a deadlock in 2018, the ability to develop and prioritize major investment projects proving to be quite limited. The frequent changes in fiscal policy, the non-implementation of regulatory impact assessment tools, poor strategic planning, delays or even reversals of public sector reforms (mainly abolishing corporate governance measures in state-owned companies) are real impediments to the development of medium and long-term investments.

Public debt, measured according to ESA 2010 methodology and expressed as a percentage of GDP, recorded a small decrease from 35.2% in 2017 to 35% in 2018. This development was supported by real economic growth (-1.4 pp) and the real interest rate (-0.8 pp), which registered a negative value, while the primary deficit (+1.8 pp) and the stock-flow adjustment (+0.2 pp) contributed to the increase of the public debt to GDP ratio. Between 2019 and 2022, according to the baseline scenario, public debt is projected to gradually increase to 42.1% of GDP and, assuming unfavorable scenarios for economic growth and the evolution of the interest rate, it could reach 44.9% of GDP (in close proximity to the 45% threshold stipulated by the FRL). The forecast is based on EC projections for economic growth and budget deficits, which are significantly more adverse than the estimates from the 2019-2022 Convergence Program. If the latter projections are taken into account, public debt in the baseline scenario is forecasted to gradually decrease to 34.5% of GDP in 2022.

The 2014-2020 programming period was characterized by a slow start due to delays in finalizing the European regulatory framework and such delays are expected to have a greater impact on countries that lack experience and administrative capacity. Romania’s performance in terms of absorption of European funds allocated under the 2014-2020 multiannual financial framework, taking into account only structural and cohesion funds, is modest according to the data available in March 2019. Thus, despite an increase of 11.2 pp compared to April 2018, Romania is ranked together with Slovenia on the penultimate place.
unfavorable gap that increased gradually to 5.8 pp at the end of 2018. Improving the absorption of European funds requires the implementation of specific recommendations addressed to Romania by the EC and the reform of public administration.

The 2019 budget projections and the medium-term framework associated with it institute, similar to the previous year, a deliberate and sizeable deviation from the fiscal rules enshrined in both the national legislation and European Treaties ratified by Romania.

The balance of risks associated with the projected budget deficit is tilted on the negative side. The risk of re-entering the EDP appears to be significant if the current policies are maintained.

In its opinion on the draft budget, the Fiscal Council identified a high probability of a negative income gap generated by an optimistic estimate of the GDP growth rate and of the VAT revenues (by including \textit{ex-ante} the impact associated with the measures aimed at improving collection which resulted in the overestimation of VAT revenues by around 5 billion lei). The Fiscal Council has also identified an underestimation of at least 3 billion lei in the case of goods and services expenditures and interest expenditures considering their execution from the previous year. Taking into account the budget execution for the first four months of 2019, the Fiscal Council appreciates that there is a high risk of falling short from the projected VAT revenues, as well as overrunning significantly the projected social assistance, personnel and interest expenditures. Moreover, the Fiscal Council identified risks associated with the tempestuous adoption of fiscal measures under

\footnote{The EC 2019 Spring forecast estimates that the structural deficit will increase by 0.4 pp of GDP.}
GEO no. 114/2018 (such as the introduction of the bank asset tax and of additional taxes for the energy and communication sectors) which exerted a negative impact on economic activity. In the context of maintaining the current fiscal policy parameters, in 2019 the balance of risks appears to be significantly leaning towards exceeding the 3% threshold for the budget deficit, requiring corrective measures concerning either revenues or expenditures in order to avoid entering the excessive deficit procedure (EDP).
II. Macroeconomic Framework in 2018

In 2018, Romania’s economy continued to evolve on an upward trend, but there was a significant slowdown in economic growth with the GDP increasing by 4.1% in real terms compared to the 7% growth recorded in 2017. Thus, after a period of successive increases since 2011, the real GDP in 2018 is 22.7% higher than in 2008 when the peak value of the pre-crisis period was recorded. The trajectory of the Romanian economy is in line with EU-wide trends where 2018 marked a moderate advance in economic activity amid a slowdown in the second half of the year. This development was caused both by external factors, including the uncertainties surrounding international trade (especially in the context of tensions between China and the USA) and the global decline in production, as well as internal factors related to the disruption of car production, the emergence of social tensions and uncertainties about the fiscal policy of several EU member states\(^3\).

![Figure 1: The evolution of economic growth forecasts for 2018](image)

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

Analyzing Figure 1, it can be noticed that the initial forecasts of the EC, IMF and EBRD projected a moderate growth rate for the Romanian economy in 2018. Subsequently, taking into account the strong GDP growth in 2017, the forecasts were revised upwards but, as the results of the first quarters of 2018 exhibited a pronounced slowdown in economic growth, the forecasts were readjusted to a

\(^3\) According to the EC 2019 Winter Forecast.
lower level. Thus, the actual GDP growth rate was above the projections at the beginning of 2017, but failed to rise to the more optimistic estimates from the start of 2018. On the other hand, NCSP’s forecasts were significantly higher than those of the EC, IMF and EBRD, surpassing them on average by 1.5 pp. Consequently, in comparison to the 5.5% initial forecast of NCSP, which was taken into account when drafting the 2018 budget, the actual economic growth was lower by 1.4 pp, creating the premises for encountering difficulties in meeting the planned budget parameters. However, the significant underestimation of the GDP deflator (which had a value of 5.9% in comparison to the forecast of 2.1%) made it possible for the macroeconomic variables in nominal terms (relevant from the perspective of tax revenues with the exception of excise duties) to accommodate at least partially the overestimation of the real GDP growth rate.

In terms of expenditures (see Figure 2), the main contribution to the economic growth registered in 2018 continued to be provided by the household final consumption expenditure which accounted for 3.3 pp of the total growth of 4.1%. However, it should be noted that this contribution is much lower compared to the previous year (+6.3 pp) due to the significant deceleration of private consumption growth in real terms from 10% in 2017 to just 5.2% in 2018. Surprisingly, the second largest contribution to economic growth (+2.9 pp) was provided by the change in inventories. However, given the experience of previous years, there is a possibility that subsequent revisions may attribute some of this contribution to other components of aggregate demand. A positive but smaller impact came from government consumption, which contributed 0.3 pp to GDP growth, based on a 1.8% increase in real terms relative to the previous year. On the other hand, net exports had a significant negative contribution to economic growth (-1.7 pp) due to the more pronounced dynamics of imports (real growth of 9.1%) compared to exports (real growth of 5.4%). At the same time, it should be noted that both components suffered a significant slowdown compared to 2017 when double-digit growth rates were recorded. Last but not least, gross fixed capital formation had a negative impact on economic growth (-0.7 pp) caused by a 3.2% reduction in real terms compared to the previous year. Thus, the return of investments on an upward trend after the 2016 decline was short-lived, although investments were expected to improve by making progress in the implementation of projects financed through European funds.

In terms of supply, GDP growth was supported by almost all sectors of the national economy\(^4\), with the most important contribution being made by industry (+1 pp), this sector also having the largest share in GDP formation (23.6%) followed by wholesale and retail; repair of motor vehicles and motorcycles; transport and storage; hotels and restaurants (+0.7 pp) with a share of 18.3% in GDP formation, by professional, scientific and technical activities; activities of administrative services and support services (+0.4 pp) with a share of 7.3% in GDP formation, by the information and communication sector (+0.4 pp) with a share of 5.2% in GDP formation and by agriculture, forestry and fishing (+0.4 pp) with a share of 4.3% in GDP formation. The other economic sectors contributed less than 0.2 pp to GDP growth and the only sector that exerted a negative influence on economic growth was construction (-0.3 pp), with a weight of 5.4% in GDP formation. Overall, the gross value added by the entire

\(^4\) According to the National Institute of Statistics (NIS) press release from April 8, 2019.
economy contributed with 3.1 pp to economic growth, the remaining difference of 1 pp corresponding to net taxes on products. Compared to 2017, there is a very similar structure of the contribution of economic sectors to GDP growth, the top contributors and their weight in GDP formation suffering minor changes. At the same time, constructions remain the only sector with a negative contribution in 2018, but the unfavorable impact is more pronounced compared to the previous year.

Source: Eurostat, Fiscal Council’s calculations

After 2017 saw an almost uninterrupted rise in inflation, the level of 3.3% recorded in December being close to the upper limit of the 1.5%-3.5% variation interval, 2018 started with a steep rise in inflation that exceeded the 3.5% limit even since January. The upward trend of the indicator continued throughout the first half of the year, reaching a peak of 5.4% in May, but inflation slowed down in the second half of the year and declined markedly in the fourth quarter, down to 3.3% in December, this being the minimum level recorded in 2018. Thus, both the inflation rate recorded at the end of the year and the average annual inflation of 4.6% exceeded the 2.6% and 3.1% values taken into account when elaborating the 2018-2020 Fiscal Strategy (FS). In what concerns the CPI inflation, adjusted to remove the effects of tax changes, it had a similar trend increasing during the first two quarters, then declining in the second half of the year, with the decrease being accelerated in the fourth quarter at the end of which was recorded a rate of 3.2%. The price increase across the entire economy, as measured by the GDP deflator, reached 5.9% in 2018 and the difference between the deflator and the

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5 This value is not only an annual maximum but also the maximum level of the last five years.
6 According to the Inflation Reports from May 2018, August 2018, November 2018 and February 2019, published by the National Bank of Romania (NBR).
average inflation of 4.6% can be attributed to price increases affecting government consumption (14.7% stimulated by wage increases in the public sector) and gross capital formation (7.8%).

A quarterly analysis shows that 2018 started with a surge in inflation, so that at the end of March there was already an advance of 1.6 pp compared to December 2017 and the upper limit of the variation interval was exceeded by 1.5 pp. This evolution occurred as a result of the gradual elimination of the statistical effect associated with tax changes implemented during the first quarter of 2017. At the same time, a series of inflationary pressures were generated by increases in electricity and natural gas prices, in production costs and by the depreciation of the national currency against the euro. Thus, significant increases, as compared to December 2017, were recorded by both the core inflation (+0.6 pp) and the one calculated under the constant tax assumption (+0.6 pp). Inflation growth slowed markedly in the second quarter of 2018 and in June the upward trend ended at 5.4%, representing a 0.4 pp increase over the previous quarter. This development was generated exclusively by exogenous factors (mainly the increase in international oil prices and excise duties on cigarettes) and benefited from the easing of inflationary pressures on aggregate demand, as well as from the slight appreciation of the national currency against the euro. The third quarter saw inflation entering a moderate downward trend, reaching 5% in September, which corresponds to a decrease of 0.4 pp compared to the previous quarter, but this value remained outside the variation interval associated to the 2.5% target. The main reason for the deceleration of inflation is represented by the elimination of the statistical effect of inflationary shocks from the third quarter of 2017, while prices of vegetables and natural gas acted in the direction of increasing the annual inflation rate. In line with NBR's projections, the downward trend in inflation was stronger during the last quarter of 2018, so that in November it returned within the 1.5%-3.5% variation interval and in December continued to fall until 3.3% (representing a decrease of 1.7 pp relative to the previous quarter). The main contributor to this development was fuel, both by incorporating the 25% reduction in oil price and by eliminating the effect of the increase in excise duty on fuels implemented in October 2017. Additionally, the base effect of the electricity price increase during the fourth quarter of 2017 and the favorable developments in food prices, especially processed food (including the effects of the swine fever), also supported the reduction of inflation. It should be noted, however, that the upward trend in energy prices, coupled with the growth of labor costs (generated by successive increases in the minimum wage), with the persistence of a tense labor market and of a surplus in aggregate demand, there are conditions that can generate inflationary pressures in the following period.

In response to the sustained rise in inflation, the NBR Board of Directors operated two successive increases in the monetary policy interest rate in January (to 2%) and February (to 2.25%), followed by a further increase in May when it was set at 2.5%, this level being kept unchanged until the end of the year. In what concerns the minimum reserve requirements, they remained at 8% throughout the 2018 for both domestic and foreign currency liabilities.
With regard to the external position, the current account deficit continued to widen in 2018, reaching 4.5% of GDP versus 3.2% in 2017, amid an increase of almost EUR 3.2 billion (about 53%) over the previous year, while GDP advanced by only 8.2%. The significant deepening of the current account deficit raises questions about potential external and competitiveness imbalances, the European scoreboard setting a threshold at 4% of GDP for the average of deficits recorded over the last 3 years. In the case of Romania, this average reached 3.3% of GDP, creating the conditions for exceeding the 4% threshold in the absence of adequate recovery measures.

The increase in the current account deficit is largely due to a deterioration in the balance of goods and services from a deficit of EUR 4 billion in 2017 to a deficit of EUR 6.5 billion in 2018 (the situation was generated exclusively by the balance of goods, its deficit being EUR 2.7 billion higher). Smaller contributions came from the primary income balance, the deficit of which increased by EUR 0.4 billion, and from the secondary income balance, its deficit deteriorating by EUR 0.3 billion.

In nominal terms, exports of goods and services continued to grow by 8.5% over the previous year (EUR +6.6 billion), but this evolution is significantly lower than the 11% growth rate recorded in 2017. On the other hand, the growth rate of imports remained higher relative to exports (+11.2%, representing EUR +9.1 billion), but again there was a significant slowdown compared to 2017 when exports increased by 14.1%.

Analyzing the changes in the current account balance in terms of difference between the savings and the investment rate, it can be noted that the savings rate continued its downward trend from previous years, decreasing by almost 0.6 pp of GDP in 2016, while the investment rate grew by 0.8 pp compared to 2016. Thus, the evolution of both rates contributed to the increase of the current account deficit. Comparing these results with those of 2007, when the highest current account deficit of the 2005-2018 period was recorded (13.6% of GDP), the adjustment to the current level was mainly achieved through the reduction of the investment rate by around 7.2 pp, while the savings rate advanced by only 1.9 pp.

Direct investment of non-residents in Romania amounted to EUR 4,988 million in 2018, this figure representing a 4% increase as compared to 2017. Thus, it can be observed that direct investment of non-residents remained on a moderately ascendant trajectory, the levels recorded during the last three years being significantly above the 2010-2015 average. However, they are still much lower compared to the pre-crisis period, with the average annual value of foreign direct investment in 2007-

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7 According to BPM6 standards (the balance of payments manual developed by IMF), the terminology of the current account components changed. Thus, the primary income balance and the secondary income balance replaced the income and transfers balance.

8 The primary income balance shows the amounts payable and receivable in return for providing temporary employment, financial resources or non-financial assets to other non-resident entities. Thus, primary income represents the return of institutional units for their contribution to the production process or for supplying financial assets and renting natural resources to other institutional units.

9 The secondary income balance shows the redistribution of income, i.e. the situation in which the resources employed for current purposes are provided by a state without repayment. Personal transfers and current international aid can be mentioned as examples of such operations.
2008 being around EUR 8,373 million. In terms of net foreign direct investment\(^\text{10}\), it recorded a 6.1% increase over the previous year, reaching EUR 5 billion. Thus, in the context of a significant deepening of the current account deficit, net foreign direct investment financed only about 55% of it.

**Figure 3: The evolution of the real GDP, domestic demand and current account, 2005-2018**

![Graph showing the evolution of real GDP, domestic demand, and current account from 2005 to 2018.](image)

*Source: NBR, Eurostat, Fiscal Council's calculations*

Romania’s external debt increased by 2.1% in 2017, compared to the previous year, reaching EUR 99.4 billion at the end of December but, supported by the stronger GDP dynamics, the external debt to GDP ratio continued to decrease from 51.9% to 49%. Consequently, following the gradual reduction of the external debt to GDP ratio, the current level represents a significant improvement over the 2010-2012 period when the indicator stood at around 75%. However, the indicator is expected to increase in the future in order to reflect the current account balance deterioration.

Long-term debt accounted for 68.4% of the external debt, this category registering a decrease of EUR 0.6 billion (-0.8%) compared to the previous year. On the other hand, short-term external debt increased by 9.1% to EUR 31.5 billion and its weight in total foreign debt increased by 2 pp from 29.6% in 2017 to 31.6% in 2018. Thus, starting in 2014, there was a tendency of restructuring the external debt by maturity, reflected in the reduction of long-term debt (which stood at around 80% in 2013-2014), coupled with increases in the short-term debt and 2018 marks the only case over the last decade in which the share of long-term external debt fell below 70%. In this respect, it should be noted that prioritizing short-term debt may contribute to the vulnerability of Romania’s external position if financing difficulties should arise. The decline in long-term debt in 2018 was mainly the result of a

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\(^{10}\) Net foreign direct investment represents the total investment of non-residents in the domestic economy from which the residents’ investment abroad is deducted.
decrease in private debt (EUR -1.6 billion) and non-residents' deposits (-0.2 billion). On the other hand, direct external public debt increased by about EUR 1.3 billion, despite a EUR 1.7 billion reduction in financial loans, this dynamics being counterbalanced by bond issues on the international markets in February, June and October 2018 through which the Romanian government obtained a total financing of almost EUR 5 billion with maturities between 11 and 30 years\textsuperscript{11}.

The dynamics of non-governmental loans continued on an upward path, registering an advance of 4.5% in real terms in December 2018 compared to the same period of the previous year. Thus, domestic currency denominated loans increased by 9.8% in real terms, while foreign currency denominated loans continued to lose ground, decreasing by 1.4% in euro equivalent, but these developments occurred amid a downward trend in the level of financial intermediation that ranks Romania on the last place among EU countries\textsuperscript{12}. The dynamics of lending activity can be attributed to factors such as the growth of disposable income (due to wage increases in the public and private sectors) and the favorable evolution of the labor market (manifested through the reduction of the unemployment rate, coupled with an increase of average earnings and of the minimum guaranteed wage). On the other hand, the level of interest rates had an adverse evolution in the context of rising inflationary pressures, so that in 2018 ROBOR recorded increases ranging from 1 pp to 1.6 pp depending on maturity. At the same time, during 2018 credit institutions showed a tendency to tighten the access of non-financial corporations and households to loans (mainly consumer loans, the conditions for mortgage loans being mostly unchanged). Moreover, banks estimate a significant tightening of credit standards for households, starting with the first quarter of 2019, due to the enforcement of NBR’s prudential measures aimed at limiting leverage. The demand for loans from non-financial firms increased strongly in 2018, especially during the first three quarters, while demand from households had a bumpy trend marked by increases in the first two quarters followed by a significant decline in the second half of the year\textsuperscript{13}. The ratio of non-performing loans continued its downward trend from previous years, reaching 5% in December 2018, compared with 6.4% in December 2017. Also, from a macro-prudential point of view, there is a comfortable level of liquidity in the banking system, the loans/deposits ratio of the non-governmental sector consolidating its position close to 76% (76.2% in December 2018 compared to 76.9% in December 2017).

The moderate expansion of lending activity in 2018 was due both to the dynamics of household loans (+5.7% in real terms) and of the loans granted to non-financial corporations (+2.9% in real terms). In the case of households loans, the advance was caused exclusively by those granted in domestic currency (+15.6% in real terms), while loans in foreign currency declined by 10.5% in euro equivalent. In the case of corporate loans, the positive variation was driven by all loan categories, both in domestic (+3% in real terms) and in foreign currency (+6.1% in euro equivalent).

The labor market continued on an upward path in 2018 with the average number of employees rising

\textsuperscript{11} According to public debt data, available on the MPF website.


\textsuperscript{13} According to the quarterly Bank Lending Surveys published by the NBR.
to 5,109 thousand persons\textsuperscript{14}, representing an advance of 3.3\% compared to the previous year, supported by an increase in the number of employees in both the private (+3.5\%) and the public sector (+2.5\%)\textsuperscript{15}. Thus, the unemployment rate maintained its downward trend from previous years and reached the level of 3.3\% which represents the minimum recorded since 1992\textsuperscript{16}.

In 2018, the gross average monthly wage across the entire economy amounted to 4,502 lei\textsuperscript{17}, representing an increase of 39.7\% as compared to 2017, but the advance is partly due to the re-establishment of the tax structure by transferring the social contributions from the employer to the employee. Thus, the net average wage was 2,685 lei, up by 14.8\% over the previous year, and the real wage increased by only 9.7\% due to the average annual inflation of 4.6\%. The positive dynamics of the average wage was supported by the evolution of both public sector (+43.1\% for the gross average earnings, amid additional wage increase measures, especially for health and education personnel) and private sector earnings (+37.1\% for the gross average earnings, due to the persistence of a tight labor market). Last but not least, another factor that influenced the dynamics of the gross average wage across the economy was the increase of the guaranteed minimum wage from 1,450 lei in February 2017 to 1,900 lei\textsuperscript{18} as of January 2018.

\textsuperscript{14} According to the NCSP forecast from May 2019.
\textsuperscript{15} The public sector includes public administration, education, health and social assistance, excluding armed forces and assimilated personnel. The private sector is approximated by removing the public sector from the values recorded for the entire economy.
\textsuperscript{16} According to unemployment data available on the NIS website.
\textsuperscript{17} According to the NCSP forecast from May 2019.
\textsuperscript{18} It should be noted that this increase also includes the transfer of social contributions from the employer to the employee.
### Table 1: Macroeconomic indicators in 2018 (Fiscal Strategy forecast versus actual)

<table>
<thead>
<tr>
<th></th>
<th>Fiscal Strategy 2018-2020</th>
<th>Actual 2018</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>GDP</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>GDP (million lei)</td>
<td>907,852</td>
<td>944,220.2</td>
</tr>
<tr>
<td>Real GDP</td>
<td>5.5</td>
<td>4.1</td>
</tr>
<tr>
<td>GDP deflator</td>
<td>2.1</td>
<td>5.9</td>
</tr>
<tr>
<td><strong>GDP Components</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Final consumption</td>
<td>5.8</td>
<td>4.7</td>
</tr>
<tr>
<td>Private consumption expenditure</td>
<td>6.5</td>
<td>5.2</td>
</tr>
<tr>
<td>Government consumption expenditure</td>
<td>3.2</td>
<td>1.8</td>
</tr>
<tr>
<td>Gross fixed capital formation</td>
<td>7.9</td>
<td>-3.2</td>
</tr>
<tr>
<td>Exports (volume)</td>
<td>6.5</td>
<td>5.4</td>
</tr>
<tr>
<td>Imports (volume)</td>
<td>7.9</td>
<td>9.1</td>
</tr>
<tr>
<td><strong>Inflation</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>December 2018</td>
<td>2.6</td>
<td>3.3</td>
</tr>
<tr>
<td>Annual average</td>
<td>3.1</td>
<td>4.6</td>
</tr>
<tr>
<td><strong>Labor market</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Unemployment rate (end of period)</td>
<td>3.9</td>
<td>3.3</td>
</tr>
<tr>
<td>Average number of employees</td>
<td>4.2</td>
<td>3.3</td>
</tr>
<tr>
<td>Net average wage</td>
<td>11.0</td>
<td>14.8</td>
</tr>
</tbody>
</table>

Source: NCSP, Eurostat, MPF
III. Fiscal policy in 2018

III.1. The assessment of objectives, targets and budgetary indicators

According to article 61, para. (2) of the 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.

According to article 26, para. (1) of the FRL, until July 31 of each year, the MPF 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 for the period 2018-2020 was elaborated and approved in November 2017, at the same time with the draft budget proposal for 2018, which implies that both documents set out an identical fiscal framework for 2018. Under these circumstances, the requirement for the Fiscal Council 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 in this situation irrelevant. The Fiscal Council draws attention to the perpetuation of this situation over the past 5 years, with the Government issuing the Fiscal Strategy or an updated version of it together with the draft budget for the respective year, which is not likely to create an efficient budgetary planning based on ex-ante compliance with fiscal rules and undermining the role of guidance that a medium-term fiscal and budgetary strategy must have for the budget.

The GCB for 2018 was based on a macroeconomic forecast scenario that estimated an economic growth at 5.2% in real terms, while the headline deficit target was projected to 2.97% of GDP according to cash standards (from 2.84% of GDP in 2017\(^{19}\)), respectively to 2.96% of GDP according to

\(^{19}\) Updated data for 2017 in May 2019. At the time of drafting the budget for 2018, the cash budget deficit for 2017 was estimated at 2.96% of GDP.
ESA 2010 methodology. In the presence of an increasing positive output gap, maintaining the budget deficit close to the 3% ceiling involved a deterioration of the structural deficit which recorded a significant deviation from the MTO set at of 1% of GDP, respectively, a structural deficit projected at 3.17% of GDP, relative lower compared to 3.4% of GDP in 2017\(^{20}\), adjusting for the impact of the wage increases induced by the transfer of social contributions from the employer’s burden to that of the employee, the reduction of the personal income tax rate from 16% to 10%, as well as the increases in the social assistance expenses.

The final budget execution was in line with the deficit target, the budget deficit standing at 2.90% of GDP, or 27.34 billion lei (compared with a projection of 26.96 billion lei) according to the cash methodology, while the nominal GDP was 36.3 billion lei higher compared to that used for the initial budget forecast. According to ESA methodology, the budget deficit stood at 28.5 billion lei (3.02% of GDP) which is above than the target expressed as a percentage of GDP by 0.06 pp and very close to the limit set by the corrective arm of the Stability and Growth Pact of 3% of GDP.

The difference between the budget deficit computed according to the two methodologies can be explained by elements that act in both directions, namely those that are accounted for only in the national methodology while others are included only in the European methodology. Thus, the main elements that explain the gap of 1.16 billion lei between the ESA 2010 and the cash deficit are as follows:

- dividend distribution by state-owned companies from previously accumulated reserves that only affect public debt according to the European methodology (the gap between the ESA 2010 and the cash deficit is + 2.05 billion lei);
- payments in advance for the purchase of military equipment that will be recognized only at delivery according to the European methodology (the gap between the ESA 2010 and the cash deficit is - 4.45 billion lei);
- changes related to the payment of amounts in relation to the European funds granted (adjustments based on Law no. 260/2018, amounts reimbursed for agriculture), the gap between the ESA 2010 and the cash deficit being + 3.16 billion lei;
- differences between the decisions on the payment of the amounts of the pollution tax refund (3.2 billion lei) and the actually paid (1.6 billion lei), resulting in a gap between the ESA 2010 deficit - cash deficit of + 1.6 billion lei;
- payment of amounts in the account of Law no. 85/2016 already recorded in the execution of ESA 2010 in 2016 (a gap between ESA deficit - cash deficit of +0.8 billion lei);
- differences in the treatment of interest expense, the ESA 2010 being smaller (thus, the ESA deficit is lower by 1.25 billion lei compared to cash deficit);
- differences between social contributions and VAT receipts according to ESA and cash methodologies of - 2.3 billion lei for January 2019;

\(^{20}\) Updated data for 2017 (May 2019). At the time of drafting the budget (November 2017), the structural deficit for 2017 was estimated at 3.06% of GDP. The difference is mainly the effect of the different estimates of the output gap for 2017 in the two moments of time.
the compensation decisions set by the National Authority for Restitution of Properties in 2018 amounted 1.54 billion lei while 1.8 billion lei were actually paid, so that the gap between ESA deficit - cash deficit is equal to - 0.26 billion lei;

• the contribution of the state-owned companies in the public administration sector: the gap between ESA-deficit deficit-cash deficit + 0.3 billion lei (lower by 1.9 billion lei compared to the previous year).

In conclusion, although there were elements with a significant impact on the budget deficit according to just one of the methodologies, they cumulatively canceled each other. It must be highlighted that the decision to demand the state-owned companies to distribute additional dividends from the reserves accumulated in previous years has no influence on the ESA 2010 budget deficit which is relevant for the evaluation of fiscal rules at the European level.

In terms of fiscal policy rules for 2018, the nominal ceilings for the GCB balance, the primary balance, total expenses (excluding revenues from post-accession EU funds, pre-accession funds and financial assistance from other donors) and personnel expenditure were established by the Law no. 269/2017 (see Table 2 below). The budget execution revealed non-compliance with the ceilings for the GCB balance, total expenses (net of financial assistance from the EU and other donors) and personnel spending. In relation to the level expressed as a percentage of GDP, except for the ceiling set by Law 269/2017 for the GCB balance according to national methodology, the limits for total BGC expenditures (excluding post-accession European funds, pre-accession funds and other donor financial assistance) and personnel spending were violated, although the nominal GDP was 36.3 billion lei higher compared to that used for the initial budget forecast.

Thus, when drafting the budget for 2018, almost all the fiscal rules were violated ex-ante, as follows:

• the rule stipulated by art. 7 (c) on the presentation of an adjustment plan through which the annual structural deficit converges towards the MTO, agreed with the institutions of the European Union;

• the rule stipulated by art. 14 para. 1, according to which, in the event of a deviation from the MTO or of the timetable for the adjustment to it, the Government must approve/submit to Parliament for approval a set of correcting measures;

• the rule that the accompanying law on the approval of the limits specified in the fiscal-budgetary framework should include the adjustment path towards the MTO (art. 26, para. 3);

• the rules stipulated by art. 26 para. 1 on the deadline for elaboration of the fiscal-budgetary strategy (July 31) and art. 29 para. 4 on the presentation and signing of the declaration of responsibility by the Prime Minister and the Minister of Public Finance, certifying the conformity of the fiscal-budgetary strategy and the fiscal-budgetary framework associated

21 These are treated by Eurostat as a disinvestment of public companies and not as budget revenues.

with the FRL, regarding the targets or limits established by the fiscal rules, and with the principles of the fiscal responsibility;

- the rule on the obligation for the Government to submit to Parliament an annual budget that conforms with the principles of fiscal responsibility, fiscal rules and any other provisions of the FRL (art. 30 para. 4) and which provides that, in the absence of the above compliance, the requirement to mention the deviations, as well as the measures and deadlines until the Government will ensure compliance with them (art. 30 paragraph 5).

In relation to budget execution, the following fiscal rules have been violated *ex-post*:

- the rule stipulated in art. 12 regarding the compliance with the nominal ceilings stipulated by the Law no. 269/2017 for the GCB balance, total GCB expenditure (net of financial assistance from the EU and other donors) and personnel spending;

- the rule on the prohibition to increase total spending and personnel expenditure on the occasions of budgetary revisions (art. 17);

- the rule prohibiting the increase of the total GCB spending (net of financial assistance from the EU and other donors) in the context of budgetary adjustments only when it is made for the public debt service or for the payment of Romania's contribution to the EU budget (art. 24).

### Table 2: Nominal ceilings for GCB balance, total and personnel expenditure

<table>
<thead>
<tr>
<th></th>
<th>Law no. 269/2017</th>
<th>Execution 2018</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>GCB balance</td>
<td>Total expenditure*</td>
</tr>
<tr>
<td></td>
<td></td>
<td>of which:</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Personnel expenditure</td>
</tr>
<tr>
<td></td>
<td></td>
<td>GCB balance</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Total expenditure*</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Personnel expenditure</td>
</tr>
<tr>
<td><strong>million lei</strong></td>
<td>-26,959.6</td>
<td>286,077.3</td>
</tr>
<tr>
<td></td>
<td>-2.97%</td>
<td>31.5%</td>
</tr>
<tr>
<td><strong>% of GDP budget draft</strong></td>
<td>-2.86%</td>
<td>30.3%</td>
</tr>
<tr>
<td><strong>% of GDP provisional data for 2018</strong></td>
<td>-2.90%</td>
<td>31.7%</td>
</tr>
</tbody>
</table>

*Source: MPF, Eurostat

* Excluding financial assistance from the EU and other donors

The table above presents the limits specified in the initial fiscal-budgetary framework, as established by Law no. 269/2017 (in blue) and the budget execution (in black). The italic figures are the percentages of GDP of the initial budget indicators recalculated with updated data on nominal value of GDP (944.2 billion lei versus 907.9 billion lei in the initial budget). When taking into account the same provisional data for GDP value (third row in the table), it can be noticed that for all indicators the limits expressed as a share of GDP were exceeded. However, the increase in personnel costs was compensated by the non-realization of investment expenditures (compared to the initial program, the gap is about 5.2 billion lei, respectively 0.55% of GDP), the increase in total expenditures being due
to a massive under-estimation of the goods and services and social assistance spending in the initial budget.

Next are presented the evolution of the main budgetary aggregates and the assessment of the compliance with the fiscal rules during the year, respectively, from the perspective of the two budgetary amendments.

The first budget revision, approved at the beginning of August 2018, (GEO no. 78/2018) rectified upward both GCB revenues and expenditures by 9.2 billion lei, respectively, by 10.3 billion lei\(^{23}\) compared to the initial budget, leading to an increase of 1.1 billion lei in the projected headline deficit. Compared to the ceilings stipulated by Law no. 269/2017, the Fiscal Council noted that almost all of them were exceeded\(^{24}\), except for the one referring to the GCB balance as a percentage of GDP which was maintained at 2.97% of GDP as in the initial projections, only due to the increase in the forecast for nominal GDP\(^{25}\). Thus, the rule defined by article 12, letter a) of the FRL, which states that “the GCB balance and the personnel expenditure of the GCB, expressed as a percentage of GDP, cannot exceed the annual ceilings that were set out in the Fiscal Strategy for the first 2 years covered by it”, was partially respected. However, for all the other budgetary aggregates, the amendments made by the first budget revision are in contradiction with the fiscal rules established by the law no. 69/2010 republished. The level defined by the Law on Ceilings no. 269/2017 for the GCB primary balance was exceeded by 1.1 billion lei, and for the personnel expenses the provisions of art. 12 lit. a) for the level expressed as a percentage of GDP and lit. c) for the nominal level, as well as of art. 17 para. 2 prohibiting the increase in personnel expenditure on the occasion of budgetary revisions were violated. For the total GCB expenditures, excluding financial assistance from the EU and other donors, the non-compliance with the fiscal rules was observed in the case of article 12, letter c), as well as article 24 of the FRL, which allows for an increase in total GCB expenditure (excluding financial assistance from the EU and other donors) during budget revisions only when it is made for the service of public debt or for the payment of Romania’s contribution to the EU budget. The provisions of article 26, para. (5), which reaffirms the mandatory ceilings established by law for next year’s budget as well as the provisions of the correction mechanism stipulated in art. 14 of the LFRB by not applying the EC recommendation to initiate a structural adjustment of 0.8% of GDP in 2018, were also violated. Consequently, the first revision for amending the 2018 state budget law stipulated the necessary derogations from the aforementioned fiscal rules and redefined the ceilings set by Law no. 269/2017 in line with the revised levels of the budgetary aggregates.

\(^{23}\) At the time of drafting the first Fiscal Council’s Opinion (August 10, 2018), the data received from MPF showed an increase for the GCB revenues by 6.4 billion lei and for the GCB expenditures by 7.5 billion lei compared to the initial budget. Subsequently, on September 3, 2018, MPF submitted new data, which increased GCB revenues and expenditures by additional 2.8 billion lei compared to the first draft of the amendment, and thus the Fiscal Council updated its Opinion on September 5, 2018.

\(^{24}\) Overruns of the ceilings for: GCB deficit and primary deficit by 1.1 billion lei, personnel expenditure by 5.1 billion lei and for the total expenditure excluding financial assistance from the EU and other donors by 10.1 billion lei.

\(^{25}\) Based on the first 6 months evolution, NCSP increased its forecast by 37.1 billion lei (up to 945 billion lei).
**Budgetary revenues**, including swap scheme (amounting to 1,620 million lei, with a symmetrical effect on revenue and expenditure), were revised upward by about 9.2 billion lei, in the context of execution of the first 6 months of the year, and the changes in the level and structure of the swap scheme\(^{26}\).

Considering the GCB revenues aggregates net of swaps, were significantly revised upward:

- **social contributions**: + 6.2 billion lei, in line with the execution of the first semester\(^{27}\);
- **non-tax revenues**: + 3.2 billion lei, a performance over expectations of revenue in the first half of the year and the distribution of dividends of the state-owned companies in the second half of the year;
- **personal income tax**: + 1.8 billion lei, due to wage dynamics over the initial estimates.

Reductions in the revenue levels were operated at:

- **taxes on the use of goods, the authorization of the use of goods and conducting activities**: -1.5 billion lei, amid the postponement for the renting of frequency bands for mobile phone operators;
- **income from capital**: -0.96 billion lei, due to non-realization of the estimated income from the sale of heavy water.

The estimates of *amounts received from the EU for payments made and pre-financing*, have been maintained unchanged, even though the execution of the budget in the first half a degree of achievement compared to annual target of 24.4%, of which *the structural funds and cohesion funds*, accounted for 14% of the annual program.

**Budget expenditure**, excluding swap scheme was increased by 9.7 billion lei, mainly on the account of a significant increase of personnel expenses by 5.1 billion lei (amid both of initial under-budgeting, as well as of the impact of wage increase decided subsequently to the approval of the initial budget).

Other categories of expenditure which have been increased:

- **social assistance**: by 1.8 billion lei\(^{28}\);
- **goods and services**: by 1.5 billion lei;
- **other transfers**: by 1.1 billion lei, out of which, 0.765 billion lei for sums for the payment of Romania contribution to the EU budget, the exceed of the ceiling laid down by the Law no. 269/2017 being partly justified from the perspective of the fiscal rules within the limits of this amount;
- **reserve fund** by 1 billion lei\(^{29}\).

\(^{26}\) In the initial budget, the swap scheme was estimated at 1,020 million lei, at the first revision an increase of 600 million lei was made, the plus being entirely destined for the VAT revenues.

\(^{27}\) As a result of wage dynamics above the initial expectations and higher incomes than initially estimated from payments from legal entities for disabled people not engaged.

\(^{28}\) Validating the warning issued by the Fiscal Council in its Opinion on the Annual Budget Law, on a probable under estimation of at least 1.5 billion lei.

\(^{29}\) By derogation from the provisions of art. 30 para. (2) of the Law no. 500/2002 on public finances regulating the use of this fund.
Investment expenditures were reduced by 1.1 billion lei and subsidies by -0.5 billion lei.

The second budget revision, approved in November 2018 (GEO no. 101/2018), supplemented the GCB revenues by 246 million lei and total expenses by 382 million lei, the nominal headline deficit being higher by 136 million lei compared to the first budget revision, respectively, at a level of 28.2 billion lei (+1.24 billion lei above the ceiling of Law no 269/2017).

The proposed revision required a number of derogations from the provisions stipulated in art. 12, lit. a) - c), art. 17 para. (2), art. 24 and art. 26 para. (4) and (5), as well as of art. 2 para. (2) and art. 3 para. (5) and (6) of Law no. 269/2017 republished, thereby sanctioning the non-observance of the majority of the tax rules except for the BGC balance as a share of GDP.

Therefore, the modifications introduced by the draft of the second revision compared to the first amendment supplemented the overrun of the ceilings with:

- 0.1 billion lei for personnel spending, respectively by 5.2 billion lei above the nominal ceiling defined in Law no. 269/2017 (0.2 pp of GDP);
- 3.6 billion lei for total expenditures, excluding financial assistance from the EU and other donors, the gap towards the ceiling established by the Law no. 269/2017 being 13.7 billion lei.

In addition, it is noted the non-compliance with the ceiling defined by Law no. 269/2017 for the GCB primary balance (+0.2 billion lei), under the conditions of the interest spending increase (+1.1 billion lei). Thus, through the second budget revision for 2018 the provisions of art. 12, lit. (a), (b) and c), art. 17 par. (2), art. 24 and art. 26 par. (4) and (5) of the FRL, providing for appropriate exemptions from the aforementioned fiscal rules and redefining the ceilings of Law no. 269/2017.

It is worth mentioning that the deficit target as a share of GDP within the limit of 3% was only possible by including extraordinary revenues in the budget, represented by the payments from the reserves of state-owned companies (distribution of super-dividends) and the registration as budget revenues of a new categories of EU funds called "other EU funds" corresponding to the ex-post settlement of the European funds related to projects already carried out with non-EU funding.

Compared to the first budget revision, the GCB revenues excluding swap schemes, were revised upwards by 775 million lei, with a significant decrease in tax revenues (-3.33 billion lei) offset by increases of revenues related to non-tax income (+2.4 billion lei), social contributions (0.7 billion lei) and "other EU funds" (+4.2 billion lei).

The main categories of fiscal revenues that were revised downward were:

- VAT: -2.48 billion lei;

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30 In the context of the nominal GDP increase by 41.7 billion lei.
31 In the amount of 1090 million lei (from 1620 million lei, applied swap related to VAT revenues).
32 Confirming the reservations expressed by the Fiscal Council in the context of its opinions on the initial budget and the first budget revision.
• excise duties: -1.24 billion lei;
• taxes on the use of goods, the authorization of the use of goods and conducting activities: -0.34 billion lei;
• property taxes: -0.15 billion lei.

The estimate for corporate income tax was revised upwards: +0.41 billion lei.

It is to be noticed that the upward revision of non-tax revenues reflected mainly (+1.9 billion lei) the receipts from extraordinary payments from the reserves of state-owned companies having the nature of super-dividends, which are not treated as budget revenue in accordance with ESA 2010 rules33.

The amounts received from the EU for payments made and pre-financing for the 2014-2020 financial framework were reduced by 3.26 billion lei, by decreasing the estimates for the structural and cohesion funds whose final beneficiary is the public sector34 (-4.7 billion lei) and the European Agricultural Fund for Rural Development (-1.3 billion lei), concurrently with the increase by 2.7 billion lei of the amounts intended for the pre-financing of the projects of the non-governmental sector in the case of the temporary unavailability of European funds (article 10 of GEO no. 40/2015).

By eliminating the influence of the swap schemes, the budget expenditures were revised upwards by 912 million lei, as follows:

• goods and services - by 1.75 billion lei;
• interest spending - a plus of 1 billion lei, as in October was planned a peak payment;
• social assistance, by 0.8 billion lei.

The categories of spending downward revised are:

• subsidies, by -0.3 billion lei;
• investment expenditures, by -4.6 billion lei35, through dropping the expenditures related to the European-fund investment projects (-5.3 billion lei) and other transfers of the nature of the investments (-315 million lei) while increasing the capital expenditures (+1.1 billion lei).

Regarding the relevance of budgetary rules and the commitment to comply with fiscal discipline, it can be appreciated that, since the elaboration of the FRL in 2010, the national fiscal rules have exerted a weak constraint on the fiscal policy-makers, which resulted in:

- the lack of compliance with the annual ceilings set for the general government deficit, the primary deficit, the total expenditure and personnel expenditure, these being often violated ex-post;

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33 It reflects the reduction of the company's own funds, namely the reduction of the budget deficit financing needs and the explanation of the difference: budget deficit - the variation of the public debt stock.
34 It is the only category to be found in the ESA 2010 budget execution and in the aggregate of investment expenditure reported by the MPF, the remainder being amounts that pass through the GCB.
35 This reduction does not help to reduce the GCB deficit, as co-financing savings being offset by additional capital expenditure allocations.
- the frequent violation of the ban on increasing total expenditure and personnel expenditure during budget revisions;
- the Fiscal Strategy has not been developed on time (July 31);
- usually, the measures to reduce taxes are not accompanied by coherent compensation measures (such as increasing the tax base, rising other taxes or reducing expenditures);
- the structural deficit rule (MTO of -1% of GDP) has been violated since 2016 without explicitly foreseeing the adjustment path to MTO in the fiscal strategies for the period 2017-2018.

The Fiscal Council observes the breach of almost all fiscal rules in 2018, except for the one referring to the GCB deficit as a percentage of GDP. The inoperability of the fiscal rules is highlighted by the ease with which the government has assumed the exemptions from the fiscal rules set by the FRL when preparing the two State Budget Amendments for 2018\textsuperscript{36}, and ascertains their \textit{de facto} inoperability. Thus, when elaborating the two budget revisions for 2018, the Government stipulated in the corresponding GEOs the necessary derogations from the fiscal rules set by the FRL and readjusted the ceilings from Law no. 269/2017 in line with the revised levels of budgetary aggregates. The Fiscal Council notes the continued inoperability of the rule-based fiscal and budgetary framework stipulated by the republished FRL, as well as by the European Treaties signed by Romania.

Moreover, the concerns about the conduct of fiscal policy in Romania and the deliberate circumvention of European treaties are shared by the EC, \textbf{Romania being already the second time subject to a Significant Deviation Procedure from the MTO – a component of the preventive arm of Stability and Growth Pact} (the first was endorsed by the European Council on 16 June 2017, and the latter on 18 June 2018). Note that our country is the first member state for which this procedure was applied since its inauguration in 2011. Since the initial recommendation for a structural adjustment of 0.5% of GDP in 2017 was not met, on 5 December 2017 the recommendation of a structural adjustment of 0.8% of GDP in 2018 was reiterated. Failure to comply with this recommendation by approving a draft budget for 2018 which targeted a headline deficit as a percentage of GDP equal to the previous year\textsuperscript{37} led to the re-launch of the \textbf{significant deviation procedure from the MTO} on May 23, 2018\textsuperscript{38} with the recommendation of the structural adjustment at 0.8% of GDP to be made in 2018 and 2019. This recommendation was not met either (the two budget adjustments maintained the GCB headline deficit in the immediate approaching the 3% of GDP target), so the EC issued a new

\textsuperscript{36} In fact, the GEOs of the two revisions approved by the Government, redefined the ceilings stipulated in Law no. 269/2017, in line with the new levels of budget aggregates proposed for revision.

\textsuperscript{37} Respectively, a budget deficit of -2.97% of GDP. According to the EC's proposed adjustment, the actual deficit should have been much lower, at around 2% of GDP.

\textsuperscript{38} The recommendation aimed at an increase of net primary expenses in 2019 by no more than 4.5%. The procedure was also launched for Hungary (1% of GDP adjustment, + 3.3% increase in primary net expenses).
recommendation in December 2018 and required a structural adjustment of 1% of GDP\textsuperscript{39} starting 2019.

Framing the headline deficit in cash standards within the target was possible over the past three years, due to both a higher than initial estimated nominal value for GDP and the introduction of the extraordinary revenues. The Fiscal Council has repeatedly warned against the risk of targeting a budget deficit in the proximity of the 3% of GDP ceiling in the upward phase of the economic cycle, and thus promoting a pro-cyclical fiscal behavior, pushing on acceleration in the phase of economic expansion, that will lead, considering the (inevitable) reversal of the economic cycle, to the impossibility of stimulat

Moreover, the benefits in terms of additional short-term economic growth based on pro-cyclical fiscal relaxation are inferior to the costs of an inevitable fiscal consolidation in the downward phase of the economic cycle, as noted by recent economic literature\textsuperscript{40} that identified for the fiscal multipliers significantly higher levels in the recession period and low values during the expansion period. In addition, the Fiscal Council considers that maintaining or enrolling even on a moderate upward path of the public debt-to-GDP ratio during boom phase masks the accumulation of vulnerabilities that will materialize in an (inevitable) downward phase of the economic cycle. It should be noted that, in the case of Romania, there is an additional constraint concerning the relatively high size of public debt compared to that of the domestic financial sector, implying a limited capacity to absorb an additional stock of public debt, the exposure to the government sector versus the total assets of local banks (the main holder of public debt in the domestic market) being among the highest in the EU. In fact, in the 2018 Country Report\textsuperscript{41}, the EC warns Romania that it has high risks related to medium-term debt sustainability, being one of the few EU countries where debt is projected to increase rapidly, exceeding the 60% benchmark by 2028, if preserving current policies, and taking into account the increase in the age-related costs generated by population ageing. The recommendations made to Romania by the EC aim at a consistent fiscal and budgetary effort, starting in 2018, in line with the requirements of the preventing arm of the Stability and Growth Pact and ensure full implementation of the rule-based fiscal framework.

Below is the evolution of the main budgetary aggregates during 2018 in cash standards (\textit{Table 3}) and a summary analysis of the budget execution.

\textsuperscript{39} The EC estimate of the structural deficit in 2018 at that time was 4% of GDP, the level at which the launch of the excessive deficit procedure appears to be inevitable if the proposed adjustment is not applied.


Table 3: The evolution of the key budgetary aggregates during 2018 (billion lei)

<table>
<thead>
<tr>
<th></th>
<th>Initial budget</th>
<th>First revision</th>
<th>Second revision</th>
<th>Budget execution</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total revenues</strong></td>
<td>286.5</td>
<td>295.1</td>
<td>295.9</td>
<td>294.2</td>
</tr>
<tr>
<td><strong>Tax revenues</strong></td>
<td>256.3</td>
<td>265.6</td>
<td>265.4</td>
<td>266.8</td>
</tr>
<tr>
<td><strong>Social Contributions</strong></td>
<td>91.3</td>
<td>97.5</td>
<td>98.3</td>
<td>97.6</td>
</tr>
<tr>
<td>*<em>EU funds</em></td>
<td>28.4</td>
<td>28.6</td>
<td>29.5*</td>
<td>27.1*</td>
</tr>
<tr>
<td><strong>Total expenditure, of which:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current expenditure, of which:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Projects from EU funds</td>
<td>33.1</td>
<td>33.5</td>
<td>29.4</td>
<td>25.5</td>
</tr>
<tr>
<td>Capital expenditure</td>
<td>20.8</td>
<td>19.5</td>
<td>21.2</td>
<td>23.6</td>
</tr>
<tr>
<td><strong>Budget balance</strong></td>
<td>-27.0</td>
<td>-28.1</td>
<td>-28.2</td>
<td>-27.3</td>
</tr>
</tbody>
</table>

* Source: MPF

* Including "other EU funds", a new category introduced in the second budget revision in 2018.

**Note**: Amounts without the compensation schemes.

The results of the budgetary execution (including the swap scheme) in 2018 indicate a cash headline deficit by 0.38 billion lei (+0.04% of GDP) higher than in the initial program, the revenues being by 7.59 billion lei above the initial expectations, and expenditures by 7.97 billion lei.

**The budget revenue** excluding swap compensation schemes accounted for 7.72 billion lei above the initial budget forecast, mainly due to higher than expected receipts from:

- non-tax revenues (+6.8 billion lei), as a result of the extraordinary distribution of dividends by state-owned companies;
- social insurance contributions (+6.3 billion lei) on the background of accelerated wage dynamics and the under-estimate of payments from legal persons for disabled persons in the initial budget;
- other EU funds (+3.9 billion lei) a new category introduced on the occasion of the second budget revision, corresponding to the ex-post settlement on European funds for projects already carried out with non-EU funding;
- tax on profits, wages, income and capital gains (+3.1 billion lei) mainly on the basis of higher than expected revenues, favored by more alert wage dynamics in the public and private sectors.

The categories that recorded lower levels than expected in the initial budget\(^\text{13}\) were:

- amounts received from the EU in relation to payments made and pre-financing related to the 2014-2020 financial framework (-5.3 billion lei);

\(^{13}\) Within the structure of this revenue aggregate, the additional revenues came from: personal income tax (+1.94 billion lei), profit tax (+0.75 billion lei) and other taxes on income, profit and capital gains (+0.4 billion lei).

\(^{13}\) In line with the reservations expressed by the Fiscal Council in the Opinion on the initial budget.
- **taxes and duties on goods and services** (-4.9 billion lei), due to under execution of VAT receipts (-1.72 billion lei), excise duties (-1.71 billion lei) and the tax on the use of goods, authorization of use of goods or activities (-1.6 billion lei);
- **capital revenues** (-1 billion lei).

Regarding the execution of the **budget expenditures**, they exceeded the initial estimated values by almost 8 billion lei, with the following main categories that recorded higher than estimated values:
- **expenditure on goods and services** (+5.1 billion lei), as a result of initial sub-budgeting,
- **personnel expenses** (+5 billion lei) in line with the wage increases decided after approval of the initial budget;
- **capital expenditures** (+2.8 billion lei) for partial compensation of investment expenditures due to the non-realization of the **expenditures related to the projects with financing from non-reimbursable foreign funds for 2014-2020** (-7.9 billion lei);
- **social assistance expenditure** (+2.74 billion lei), due to insufficient initial budgeting;
- **interest spending** (+0.84 billion lei) related to the payment peak of October.

### Table 4: The development of budgetary revenue and expenditure according to cash methodology (% of GDP)

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total revenue</strong></td>
<td>30.8</td>
<td>32.6</td>
<td>29.4</td>
<td>29.3</td>
<td>30.2</td>
<td>31.2</td>
<td>1.1</td>
<td>1.9</td>
<td>0.4</td>
</tr>
<tr>
<td><strong>Tax revenue</strong></td>
<td>17.1</td>
<td>19.4</td>
<td>17.9</td>
<td>16.3</td>
<td>15.2</td>
<td>15.1</td>
<td>-1.0</td>
<td>-1.3</td>
<td>-2.0</td>
</tr>
<tr>
<td><strong>Personal income tax</strong></td>
<td>3.6</td>
<td>3.7</td>
<td>3.6</td>
<td>3.5</td>
<td>2.2</td>
<td>2.4</td>
<td>-1.3</td>
<td>-1.1</td>
<td>-1.2</td>
</tr>
<tr>
<td><strong>Corporate income tax</strong></td>
<td>2.1</td>
<td>1.9</td>
<td>2.0</td>
<td>1.7</td>
<td>1.6</td>
<td>1.7</td>
<td>-0.1</td>
<td>-0.1</td>
<td>-0.4</td>
</tr>
<tr>
<td><strong>Property tax</strong></td>
<td>0.7</td>
<td>0.8</td>
<td>0.8</td>
<td>0.6</td>
<td>0.6</td>
<td>0.6</td>
<td>0.0</td>
<td>0.0</td>
<td>-0.1</td>
</tr>
<tr>
<td><strong>VAT</strong></td>
<td>6.7</td>
<td>8.0</td>
<td>6.8</td>
<td>6.2</td>
<td>6.4</td>
<td>6.3</td>
<td>0.3</td>
<td>0.1</td>
<td>-0.4</td>
</tr>
<tr>
<td><strong>Excise duties</strong></td>
<td>3.1</td>
<td>3.6</td>
<td>3.6</td>
<td>3.1</td>
<td>3.2</td>
<td>3.0</td>
<td>0.1</td>
<td>-0.1</td>
<td>-0.1</td>
</tr>
<tr>
<td><strong>Social contributions</strong></td>
<td>9.4</td>
<td>8.0</td>
<td>8.0</td>
<td>8.3</td>
<td>9.6</td>
<td>10.3</td>
<td>1.4</td>
<td>2.0</td>
<td>0.9</td>
</tr>
<tr>
<td><strong>Non-fiscal revenue</strong></td>
<td>3.3</td>
<td>2.7</td>
<td>2.4</td>
<td>2.6</td>
<td>2.1</td>
<td>2.9</td>
<td>-0.4</td>
<td>0.3</td>
<td>-0.4</td>
</tr>
<tr>
<td><strong>Donations</strong></td>
<td>0.6</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>-0.6</td>
</tr>
<tr>
<td><strong>Amounts received from the EU for payments made</strong></td>
<td>0.4</td>
<td>2.4</td>
<td>0.9</td>
<td>2.0</td>
<td>3.0</td>
<td>2.9*</td>
<td>1.0</td>
<td>0.9*</td>
<td>2.5*</td>
</tr>
<tr>
<td><strong>Total expenditure</strong></td>
<td>38.0</td>
<td>34.1</td>
<td>31.8</td>
<td>32.1</td>
<td>33.0</td>
<td>34.1</td>
<td>1.1</td>
<td>2.0</td>
<td>-3.9</td>
</tr>
<tr>
<td><strong>Personnel expenditure</strong></td>
<td>9.2</td>
<td>7.3</td>
<td>7.5</td>
<td>8.1</td>
<td>8.5</td>
<td>9.1</td>
<td>0.5</td>
<td>1.0</td>
<td>-0.1</td>
</tr>
<tr>
<td><strong>Goods and services</strong></td>
<td>5.5</td>
<td>5.7</td>
<td>5.4</td>
<td>4.7</td>
<td>4.2</td>
<td>4.7</td>
<td>-0.6</td>
<td>0.0</td>
<td>-0.8</td>
</tr>
<tr>
<td><strong>Interest payments</strong></td>
<td>1.2</td>
<td>1.3</td>
<td>1.3</td>
<td>1.2</td>
<td>1.3</td>
<td>1.4</td>
<td>0.1</td>
<td>0.2</td>
<td>0.2</td>
</tr>
<tr>
<td><strong>Subsidies</strong></td>
<td>1.4</td>
<td>0.9</td>
<td>0.9</td>
<td>0.7</td>
<td>0.8</td>
<td>0.7</td>
<td>0.0</td>
<td>0.0</td>
<td>-0.7</td>
</tr>
</tbody>
</table>
Projects financed from post-accession grants

<table>
<thead>
<tr>
<th>Projects financed from post-accession grants</th>
<th>0.5</th>
<th>3.4</th>
<th>1.3</th>
<th>2.3</th>
<th>3.5</th>
<th>2.7</th>
<th>1.2</th>
<th>0.4</th>
<th>2.2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Social assistance</td>
<td>12.5</td>
<td>10.7</td>
<td>10.8</td>
<td>10.8</td>
<td>10.4</td>
<td>10.7</td>
<td>-0.4</td>
<td>-0.1</td>
<td>-1.8</td>
</tr>
<tr>
<td>Capital expenditure</td>
<td>4.3</td>
<td>2.5</td>
<td>2.5</td>
<td>2.3</td>
<td>2.2</td>
<td>2.5</td>
<td>-0.1</td>
<td>0.2</td>
<td>-1.8</td>
</tr>
<tr>
<td>Budget balance</td>
<td>-7.2</td>
<td>-1.5</td>
<td>-2.4</td>
<td>-2.84</td>
<td>-2.84</td>
<td>-2.9</td>
<td>0.0</td>
<td>-0.06</td>
<td>4.3</td>
</tr>
</tbody>
</table>

Source: MPF

Note: Amounts without the compensation schemes.

* Including "other EU funds" - a new category introduced in the second budget revision in 2018.

Table 4 shows the evolution of budget revenues and expenditures by national standards (cash), expressed as a percentage of GDP. The benchmarks for 2018 are the previous year and 2009, which marked the peak of the recession period.

From the perspective of the national methodology in 2018, compared to the previous year, a further deterioration of the budget deficit of 0.06 pp of GDP was registered, with the budgetary revenues increasing by 1.9 pp of GDP, while budget expenditures increased by 1.96 pp of GDP.

Tax revenues registered the most unfavorable evolution (-1.25 pp of GDP). Following the new fiscal relaxation measures introduced in 2018. In their structure the evolution is the following:

- **personal income tax** (-1.1 pp of GDP), as a result of reducing the legal rate by 6 pp from January, 1st, 2018;
- **excise duties** (-0.1 pp of GDP), due to the legislative change regarding the reduction of the excise level for the energy products in certain categories of activities;
- **profit tax** (-0.05 pp of GDP), as a result of changes to the tax regime for microenterprises;
- **property taxes** (-0.05 pp of GDP).

These unfavorable developments were partly offset at the aggregate level of the budget revenues by higher receipts from:

- **social contributions** (+2.04 pp of GDP) as a result of the impact of the change in the social contributions regime through their transfer from the employer's burden to that of the employee and higher than expected payments from legal persons for people with disabilities;
- **amounts received from the EU for payments made and pre-financing** (+0.88 pp of GDP) of which: **amounts related to the 2014-2020 financial framework** (+0.45 pp of GDP), **other EU funds** (+0.43 pp), the latter being a new revenue category introduced on the occasion of the second budget revision corresponding to the ex-post settlement on European funds of projects already carried out with non-EU funding;
- **non-tax revenues** (+0.32 pp of GDP) on account the distribution of super-dividends by the state-owned companies.

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\[44\] GEO no. 25/2018 has established, from 1 April 2018, a differentiated rate of excise duty for gas oil used as propellant for the carriage of goods by road for own use and for the carriage of passengers on a regular or occasional basis, excluding local public transport, decreasing by 183.62 lei /1000 l (by 217.31 lei / t) of the legal standard level.
On the expenditure side, compared to the previous year, there were significant increases in the following budgetary aggregates:

- **personnel spending** (+1.0 pp of GDP), to accommodate the change in the social contribution’s regime;
- **expenditure on projects financed by post-accession non-reimbursable EU funds** (+ 0.41 pp of GDP);
- **capital expenditures** (+0.22 pp of GDP);
- **interest spending** (+0.19 pp of GDP).

Budgetary cuts compared to the previous year were of lesser magnitude and were found at the level of **social assistance** (-0.07 pp of GDP), **goods and services** and **subsidies** (each with -0.02 pp of GDP).

Table 5 displays the evolution of budget revenues and expenditures by ESA 2010 standards, expressed as a percentage of GDP. The analysis for the year 2018 is conducted in relation to the previous year's developments and, respectively, to 2009 that was characterized by a historical maximum of the headline deficit in ESA standards.

The fiscal consolidation initiated in 2010, was characterized by a fast pace, in order to correct the existing major imbalances regarding the public finances position, Romania managing to reduce the budget deficit (according to ESA 2010 standards) in a relatively short period of time, from 9.2% of GDP in 2009 to 0.8% of GDP in 2015. However, the years 2016-2018 marked a reversal of this trend, with a significant increase in the budget deficit as compared to 2015, amid a massive decline in revenues (by 3.4 pp in 2018 compared to 2015), thus, partially canceling the results of the fiscal consolidation process. In 2018, the budget revenues were by 1.1 pp of GDP higher than in the previous year and by 1.7 pp of GDP compared to the 2009 level, as a result of the significant increase for the **social security contributions** that were by 2 pp of GDP higher compared to the previous year, and, respectively by 1.7 pp of GDP above the level of 2009. Tax revenues decreased by 1.1 pp of GDP on the background of the negative evolution of the direct tax revenues (-1.2 pp of GDP). Thus, **personal income tax** receipts were affected by the reduction of the legal rate from 16% to 10% and those from the **profit tax** by the modifications of the tax regime for microenterprises.

Indirect taxes grew slightly (+0.1 pp of GDP) on the basis of the VAT receipts, which increased by 0.2 pp of GDP, while the revenues from excise duties fell by 0.1 pp of GDP, both registering close levels to those recorded in 2009.

The significant adjustment compared to 2009 was achieved exclusively at the level of budget expenditures, which stood at 4.4 pp of GDP below the level of 2009, due to decreases in the following components: **gross fixed capital formation** (-3.2 pp of GDP), **social assistance** (-1.0 pp of GDP), **intermediate consumption** (-0.9 pp of GDP), **subsidies** (-0.7 pp of GDP) and **interest spending** (-0.2 pp of GDP). In contrast, the **remuneration of employees** increased by +0.7 pp of GDP. Compared to the previous year, budget expenditures increased by 1.4 pp of GDP, the main categories that contributed to this increase were the **remuneration of employees** (+1.1 pp of GDP) and **social assistance** (+0.1 of GDP).
In essence, the fiscal adjustment in 2009-2018 was mainly made on the level of investment, personnel and social assistance expenditure, although the decrease in these latter categories has largely been reversed over the past three years, notably the remuneration of employees, that in 2018 was 3.2 pp. higher than in 2015, both on the background of an alert wage dynamics and a change in the fiscal treatment of social contributions.
Further on, this chapter will include an analysis of the structural budget balance in Romania, given that the fiscal targets are defined primarily in terms of structural deficit, followed by a detailed examination on the developments of the main budgetary aggregates of revenues and expenditures. Finally, it will conclude with an assessment of the public debt dynamics and its determinants based on a medium-term projection.

III.2. The structural budget balance in Romania

In 2012, Romania signed and ratified the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG) which stipulates a rule-based fiscal framework, the target for the structural deficit of Romania being set at a maximum of 1% of GDP. 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 budget deficit. However, while in 2015 the structural deficit stood below the 1% of GDP target, since 2016 there has been a deliberate and sizeable deviation from this rule.

In theory, after reaching the MTO between 2013 and 2015, the fiscal consolidation process initiated in 2010 has been completed without the need for further tax adjustments. 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 of the budget balance will be positive).

Despite the fact that it conveys the fiscal stance of an economy much clearer, the structural budget balance presents a number of 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 Annual Report of the Fiscal Council, the output gap was revised significantly by the EC from -1.53% (2016), 1.2% (2017) and 1.39% (2018) in the 2018 Spring Forecast to -1.86% in 2016, 0.76% in 2017 and 0.94% in 2018 in the May 2019 Spring Forecast.

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45 The TSCG requires the signing parties to ensure convergence towards the country-specific MTO, imposing a structural deficit limit of 0.5% of GDP, respectively 1% for the Member States with a public debt significantly below 60% of GDP. In the case of Romania, the applicable limit for the structural deficit is 1% of GDP.

46 For example, complying with the OTM in 2018 would have implied an actual budget deficit of at most 2% of GDP.
The draft budget for 2018 targeted an overall deficit of 2.96% of GDP, according to the ESA 2010 methodology, corresponding to a structural deficit of 3.17% of GDP that was equivalent to a light improvement of about 0.23 pp of GDP compared to the 2017 structural deficit which was estimated at 3.4% of GDP at that time (January 2018).

The budget execution for 2018\textsuperscript{47} indicated an actual deficit of 3.02% of GDP, compared to 2.70% of GDP in 2017, while the structural deficit deteriorated further, reaching 2.98% of GDP compared to 2.94% of GDP in 2017, according to the latest EC estimates. Thus, the deterioration of the structural deficit was 0.4 pp of GDP contrasting with the estimated improvement anticipated by MPF, due to the EC revisions of the output gap, for 2017 being by 0.4 pp and for 2018 by 0.5 pp lower relative to the previous projections. This revision was equivalent to reducing the 2017 estimate of the structural deficit to 2.94% of GDP from 3.32% of GDP. For 2019-2020 EC estimates a further deterioration of the structural position (to 3.64 of GDP in 2019 and to 4.79% of GDP in 2020) in line with the evolution of the headline deficit.

Romania has pursued a strong pro-cyclical fiscal policy between 2006 and 2015, stimulating intensively but unnecessarily and counterproductively the economy during the expansion period (2006-2008) and slowing down when it operated below potential (2010-2015), thus, contributing to the amplification of the economic cycle fluctuations and to the deepening of the imbalances accumulated in the economy.

\textsuperscript{47}Published in April 2019 by Eurostat.
(see Figure 4). Basically, the pro-cyclicality of the fiscal policy during the pre-crisis economic boom has exhausted the required fiscal space to stimulate the economy during the recession that followed and the need to reduce the budget deficit during the crisis (primarily due to funding constraints) led, inevitably, to maintaining the pro-cyclicality of the fiscal policy. Consequently, the automatic, beneficial and stabilizing action of the cyclical deficit (the automatic stabilizers) was canceled by the pro-cyclical discretionary policy.

Over the period 2009-2015, the structural budget deficit declined sharply, from around 9% of GDP to 0.08%, and at a fast pace, the average rate of adjustment being around 1.7 pp per year until 2014. At the same time, it should also be considered that the starting level was high and required the rapid adoption of decisive measures in order to ensure the sustainability of fiscal policy. It is worth mentioning that this adjustment was made predominantly in 2010 and 2011 when the structural budget deficit decreased by an average of 2.7 pp per year, the fiscal consolidation being mainly carried out on the expenditure side through reforms concerning the wages in the public sector, the public pension system and budget programming. On the revenue side, the most important measure was to increase the standard VAT rate from 19% to 24%, starting in July 2010.

The fiscal consolidation conducted between 2010-2015 has been partially reversed and in a steep manner since 2016 as a result of the new Fiscal Code, which implies a broad loosening of the fiscal policy, while simultaneously regulating significant increases in spending, especially for wages and pension benefits. This development is in flagrant contradiction with the FRL's fiscal principles and rules, as well as with the European fiscal governance treaties signed by Romania. Thus, during 2016-2018 the fiscal policy stance became expansionary with a strong positive fiscal impulse, amounting to 2.9 pp of GDP, that exceeded significantly the limit imposed by the MTO, Romania being in the preventive arm\(^ {48} \) of the Stability and Growth Pact (SGP).

In the two next years, the fiscal policy will maintain its expansionary character, with the fiscal impulse forecasted at about 0.7% of GDP in 2019 and 1.2% in 2020, even if this implies exceeding the limit imposed by the MTO for the structural deficit by more than 3 pp of GDP. It should also be noted that the MPF projection included in the 2019-2022 Convergence Program differs significantly from that of the EC, anticipating structural deficits of 2.7% in 2018, 2.8% for the current year and 3.0% of GDP for 2020. These differences arise both as a result of different estimates of the actual budget deficit but also due to including one-off measures in the MPF projection for 2018-2019 that are not included in the EC estimates.

Continuing the expansionary fiscal stance that started in 2016 and carried on throughout 2017-2018, despite a positive output gap since 2017, leads to maintaining the pro-cyclicality of fiscal policy and

\(^ {48} \) In 2017, Romania became the first EU country subject to the Significant Deviation Procedure from OTM (SDP), and at the end of 2018 Romania was the second time the object of the SDP. SDP was launched for the first time in June 2017 and then renewed in June 2018. The failure to comply with the recommendations on structural adjustment during the year 2018 led the EC to issue a new warning in December 2018, recommending an annual adjustment of the structural balance of 1% of GDP since 2019.
weakens the position of public finances in the face of shocks which may require corrections during difficult economic times. Moreover, considering that the public debt at the end of 2018 stood at a significantly higher level than in 2008, respectively 35% of GDP compared to 12.4% of GDP (using ESA 2010 methodology), there is a clear lack of fiscal space to stimulate the economy during recession while there may even be risks to the sustainability of public debt. Besides, such a policy is in flagrant contradiction with the rules established by the TSCG and the FRL, effectively giving up the maintenance of the structural deficit target for the period 2016-2020. Additionally, the adjustment path to the MTO is not specified, a situation that has persisted for the last two years, and the automatic correction mechanism, stated by the law, is not currently de facto functional.

III.3. Budgetary revenues

GCB revenues, without the impact of the swap compensation schemes (amounting to 889.2 million lei), increased in 2018 by 17.4% (corresponding to an absolute increase of 43.6 billion lei) compared to the previous year. Consequently, budget revenues registered a value of 294.2 billion lei, representing 31.2% of GDP, marking a slight improvement compared to the 29.3% of GDP in 2017. This evolution was the result of a reduction in the share of tax revenues (-1.3 pp) continuing its downward trend, partially compensated with increases in the shares of social contributions (+2 pp), non-tax revenues (+0.3 pp) and the amounts received from the EU for payments made and pre-financing (+0.9 pp).

In the case of tax revenues, the most significant reductions in the share of GDP was registered by the personal income tax (-1.1 pp, due to the decrease of the standard rate from 16% to 10%), together with other categories which recorded under-executions, as: taxes on the use of goods, the authorization of the use of goods and conducting activities (-0.2 pp), excise duties (-0.1 pp), corporate income tax (-0.1 pp, due to changes in microenterprises tax regime in disfavor of taxation profits), and taxes on property (-0.1 pp). On the other hand, slight increases in the share of GDP in comparison with the previous year were recorded in the following categories of tax revenues: other taxes on corporate income, personal income and capital gains (+0.1 pp, within this category being included the receipts from tax on income of micro-enterprises), other taxes and duties on goods and services (+0.1 pp), respectively VAT (+0.1 pp). It should be noted that the downward trajectory of the personal income tax is counterbalanced by the advance of social contributions in the context of the effects

49 According to the national methodology, the share of GDP in public debt was 42.6% at the end of 2018.
50 An important influence on this revenue category was exercised by other amounts received from the EU accounting for 3.9 billion lei (representing +0.4 pp of GDP compared to the previous year), which correspond to the intention of the authorities to settle ex-post EU funded projects with non-EU funding. It should be noted that the recording of these revenues in the execution of ESA 2010 will be made according to the year in which the project for which EU funding request has been completed.
51 The Fiscal Council has carried out a detailed analysis of the impact of the successive increases of the ceilings applied to micro-enterprises incomes on budget revenues available on the institution’s website (http://www.fiscalcouncil.ro/31-iunie-2019.pdf).
produced by GEO no. 79/2017 for amending and completing the Law no. 227/2015 regarding the Fiscal Code, which emerged in the reorganization of the structure of taxation of the wage incomes, without having major effects on the overall budget receipts. In addition, the positive evolution of social contributions was stimulated by the wage increases in the public and private sector. In what concerns non-tax revenues, their advance reflects the continuation of the distribution of super-dividends in the form of extraordinary payments from accumulated reserves of the state-owned companies.

As in the previous years, the European funds absorption should be interpreted with caution, as apart from the impact of the ex-post settlement of projects with non-EU funding, these include agricultural funds\textsuperscript{52} and pre-financing to the non-government sector projects, not included in the public administration budget. Thus, although the amounts related to the 2014-2020 financial framework advanced by about 6 billion lei compared to 2017, the increase in the absorption of structural funds whose final beneficiary is the state was only by 0.6 billion lei.

Compared with the initial budgetary projection, the budget revenues in 2018 were higher by about 7.7 billion lei, representing an increase of 0.8 pp of GDP, as a result of higher than expected revenues for non-tax revenues (+0.7 pp of GDP, on the background of the distributing of super-dividends in the form of extraordinary payments from state-owned companies) and social contributions (+0.7 pp of GDP, favored by the gross wage increase well above the level projected by NCSP). These satisfactory developments were partially upturned by the non-fulfillment of the planned levels for tax revenues (-0.3 pp of GDP), amounts received from the EU\textsuperscript{53} (-0.2 pp of GDP) and capital incomes (-0.1 pp of GDP).

In the case of tax revenues, the execution under the initial projection is mainly due to VAT receipts (-0.2 pp of GDP), excise duties (-0.2 pp of GDP) and to the use of goods, authorization of the use of goods and conducting activities (-0.2 pp of GDP, due to the delay of the auction for the rental of frequency bands by mobile operators). On the other hand, the components that recorded a higher dynamic than the planned level are: personal income tax (+0.2 pp of GDP, in the context of a higher than expected growth of the wage envelope in the economy, both in the public and private sector) and corporate income tax (+0.1 pp of GDP). In what concerns the under-performance of the amounts received from the EU for the 2014-2020 multiannual financial framework (-5.3 billion lei compared to the initial projection), this is due almost exclusively to the downward revision of structural funds, the changes in the amounts allocated for agriculture and the pre-financing of the non-governmental sector being of opposite signs, thus, their overall impact even if positive, remains at a small size.

\textsuperscript{52}Amounts granted through the European Agricultural Guarantee Fund (EAGF), the European Agricultural Fund for Rural Development (EAFRD) and the European Fund for Fisheries and Maritime Affairs (FEPAM).

\textsuperscript{53}It should be noted that in the absence of ex-post settlement of projects carried out with non-EU funding of 3.87 billion lei, this revenue category would have recorded a under-execution of 5.3 billion lei (-0.6 pp of GDP) compared to the initial program estimates.
III.3.1. VAT and excises

**VAT revenues**, without the impact of the swap compensation schemes, registered a level of 59.4 billion lei in 2018, according to the cash methodology, less by about 1.7 billion lei than the level stipulated in the draft budget. The next table shows the evolution of VAT revenues and compensation schemes projected by the draft budget and amended by the budget revisions, compared to the actual figures of the budget execution. Thus, the two budget revisions diminished the initially projected VAT revenues, net of swap; the first revision, by around 0.6 billion lei, the second by another almost 2 billion lei, while the final execution recorded an increase of about 0.8 billion lei compared to the second revision. Regarding the compensation swap scheme, in the initial projection was estimated at a low level (0.2 billion lei), on the occasion of the first revision was significant increased up to 0.8 billion lei and, following the second revision, the scheme was amended to only 0.3 billion lei, while the final execution was close to the initial program.

It is worth to mention that this under-execution of the programmed VAT receipts occurred in the context of a growth rate of 8.7% for the relevant macroeconomic base (final consumption of households, excluding self-consumption and NPISH\(^{54}\)), slightly above the initial forecast (8.5%) considered in drafting the initial budget for 2018, creating the premises of even higher revenues than those actually recorded.

On the other hand, MPF estimated an advance of 4.9 billion lei for the VAT revenues based on the ex-ante inclusion of the effect of measures aiming at improving revenue collection, as well as the estimated impact of the introduction of the split VAT payment scheme, out of which about 4 billion lei were included in the initial budget\(^{55}\). Consequently, a preliminary assessment could indicate that although the initial target was missed by 1.7 billion lei, the measures aimed to improve the collection

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\(^{54}\) Non-profit institutions serving households.

\(^{55}\) Taking into account that the effect of such measures is difficult or even impossible to be ex-ante estimated, in the Fiscal Council’s opinion on the draft budget for 2018 it was estimated that VAT revenues were overvalued by about 3-4 billion lei.
would have resulted in an advance of over 2 billion lei. In this respect, the following clarifications are required:

- the initial budget projection was based on the data available in November 2017 (corresponding to the second budget amendment for 2017). The actual execution for 2017 recorded an increase of the VAT receipts by about 0.7 billion lei compared to the estimates of the second rectification for 2017, which leads to an increase by more than 0.8 billion lei of the revenue target for 2018, given the projected dynamics at that time for the final consumption of the population;
- the actual increase in the final consumption of the population in 2018 exceeded the projection envisaged for the initial budget by about 0.2 pp, stimulating for an advance of VAT receipts of over 0.1 billion lei compared to the programmed level;
- last but not least, the effect of the radical reduction of VAT reimbursements in the last two months of 2018 should be considered. Analyzing Figure 6, the monthly VAT receipts had a rather linear evolution, with no significant variations, the highest increase being recorded in May (18.4%), and the lowest in January and March (8%). By contrast stands the high volatility of VAT reimbursements which have fluctuated between months characterized by major increases (a maximum advance of 98.4% was recorded in March) and months marked by significant reductions (-28.5% in July, -30.5% in November, and -16.5% in December). Thus, comparing the VAT reimbursements made in November and December with the average of the first 10 months of 2018, there has been a considerable decrease in VAT refunds, this phenomenon having a positive impact on VAT receipts which, most likely exceeds 1 billion lei.

Consequently, cumulating the effects of these three factors mentioned above, we find that they explain almost entirely the positive evolution of the VAT receipts, which leads to the conclusion that the measures to improve the collection and introducing a system of split TVA payment evaluated by MPF at 4.9 billion lei, did not have a significant impact on the GCB revenues.

Compared to the previous year, the level of revenues corresponding to this budget aggregate, net of the impact of the swap schemes, advanced by 11.4% (+6.1 billion lei), mainly due to the increase in the final consumption of households. And in this case, it is possible to investigate the performance of the VAT receipts by making an ex-post projection of VAT revenues and comparing it with actual achievements. Thus, starting with the data for the 2017 budget execution, the 8.7% increase in the final consumption of households (excluding self-consumption and NPISH) was applied, resulting an ex-post projection of VAT receipts for 2018 of approximately 58 billion lei, while the actual execution recorded a level of 59.4 billion lei. The results show a positive difference of about 1.4 billion lei, which is attributable to the considerable reduction in VAT reimbursements in the last two months of 2018, with no significant revenue increases resulting from improved collection, despite the considerable impact estimated by MPF when drafting the initial program.

Therefore, it is important to highlight the lack of judiciousness when including ex-ante in the revenue projection the impact of measures aiming to improve collection that are difficult or impossible to
asses, requesting subsequently significant adjustments to be made with potential destabilizing effects from the economic or social point of view, thus conflicting with the principle of fiscal responsibility set out in Law no. 69/2010 republished. In this regard, the Fiscal Council has launched a series of warnings regarding the over-estimation of the VAT receipts in its opinions on the 2018 draft budget and on the two subsequent revisions, the negative impact being mitigated by the higher than expected developments in the relevant macroeconomic base as well as by the discretionary adjustment of the VAT reimbursements.

At the same time, it is particularly worrying maintaining this manner of forecasting the VAT revenues also when drafting the 2019 budget, that envisaged an increase of 6 billion lei based on the future implementation of measures aiming to increase the collection rate.

![Figure 6: VAT increasing rate (compared to the same period of the previous year)](image)

Source: MPF

In the following analysis, the effectiveness of VAT revenue collection will be assessed in relation to the ratio between the implicit tax rate\(^{56}\) and the weighted average tax rate. Regarding the latter, it should

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\(^{56}\) Defined as the ratio between the actual income collected for a given type of tax and the corresponding macroeconomic tax base.
be noted that, starting with the Annual Report for 2015, the weighted average VAT rate\textsuperscript{57} was determined, representing a change in the methodology used in the 2010-2014 Annual Reports of the Fiscal Council, so, the results presented here are not comparable to those from the above-mentioned editions. It should also be stressed that the weights used to determine the weighted average VAT rate are those of the harmonized index of consumer prices (HICP), which is the only available source when making international comparisons, although they represent only an approximation of the weighted average VAT rate for the entire economy. Thus, given that the goods and services subject to the reduced VAT rate have a higher weight in the consumer basket, it is expected that the weighted average VAT rate for the entire economy will be higher than the estimate of the Fiscal Council, the efficiency of taxation being overstated to a certain extent.

Figure 7 shows the evolution of the implicit tax rate and of the VAT taxation efficiency index for Romania, using as tax base both the final consumption of households and NPISH (right-hand scale, in blue) and the final consumption of households and NPISH excluding self-consumption (right-hand scale, in green). The decision to evaluate the effectiveness of VAT revenue collection by excluding self-consumption and the farmers’ market from the tax base is justified by the fact that these components have an important dimension in the case of Romania, the results for the taxation efficiency index being higher by 7% to 10% compared to the situation in which they were computed based on the total final consumption of households and NPISH.

Analyzing the evolution of the VAT taxation efficiency index it can be noticed that, after a period of relative stability between 2010 and 2014, 2015 marked a substantial improvement in the effectiveness of revenue collection, reaching the peak of the post-crisis period. The efficiency index shows minor decreases during 2016 and 2017 in the context of a 5 pp reduction in the standard VAT rate (from 24% in 2015 to 19% in 2017) while the applicability of the reduced VAT rates (9% and 5%) has been extended. The aforementioned measures have led to a drop in the weighted average VAT rate from 18.4% in 2015 to 14.1% in 2017. In this respect, it should be noted that the reduction in VAT rates during 2016 and 2017 (materialized by significant decreases of both standard and weighted average rates) has not led to an improvement in taxation efficiency and, implicitly, in voluntary compliance, while in 2018 a slight increase of 14.5% as a result of the change in the weights of HICP was noticed. In this respect, it should be noted that the reduction in VAT rates during 2016 and 2017 (materialized by significant decreases of both standard and weighted average rates) has not led to an improvement in taxation efficiency and, implicitly, in the voluntary compliance. At the same time, it can be noticed that the efficiency of VAT collection in Romania in 2018 remained at a level similar to the previous year, this result being in line with the analysis made on the basis of the comparison between the ex-post projection of this budgetary aggregate and the actual receipts has led to the conclusion that there have been no significant increases in revenue indicating an improvement in collection.

\textsuperscript{57}The standard VAT rate has been used previously but, beginning with 2015, it was replaced by the weighted average VAT rate which takes into account the effect of the reduced rates. It is determined based on the weights of various categories of goods and services in the consumer basket, while also taking into account the timing of the legislative changes that affect VAT rates.
Comparing the taxation efficiency for VAT in 2018 among the NMS CEE countries, the index of 0.758, recorded by Romania, is significantly lower than ones registered in Slovenia (1.02), Hungary (1.00), Estonia (0.98), Bulgaria (0.89), the Czech Republic (0.86) and Poland (0.82). Thus, Romania collected 6.4% of GDP in VAT revenues in 2018 (according to the ESA 2010 methodology), compared to 9.8% of GDP in Hungary, 9.3% of GDP in Bulgaria, 9.1% of GDP in Estonia, 8.2% of GDP in Slovenia, 8.1% of GDP in Poland and 7.7% of GDP in the Czech Republic. At the same time, the weighted average VAT rate was 19.9% in Hungary, 18.8% in the Czech Republic, 18.6% in Estonia, 17.1% in Poland, 16.9% in Bulgaria and 15.9% in Slovenia, while Romania registered a weighted average VAT rate of only 14.5%. In the taxation efficiency ranking, Romania occupied the penultimate position in 2018, down a position from 2017 as a result of the advance of Latvia, while Lithuania remained on last position of the ranking for the entire analyzed period.

![Figure 7: The evolution of the implicit tax rate and efficiency tax index for VAT in Romania](image)

The country classification of the taxation efficiency index should be interpreted taking also into account the structural differences between the analyzed economies, given that the higher percentage of rural population in Romania is reflected in a bigger size of self-consumption and farmers’ market (which are non-taxable), having an impact on the value of this index, as shown in Figure 7. Thus, the conclusion of a study developed by Aizenmann and Jinjarak (2005)59, that examined a panel of 44

58 For comparability, the index reported in Table 6 uses the same tax base for all countries, namely the final consumption of households and NPISH, including self-consumption.

countries between 1970 and 1999, was that the effectiveness of VAT collection is inversely proportional to the share of agriculture in GDP and directly proportional to the degree of urbanization and to the degree of openness of the economy – all three variables having an unfavorable influence in the case of Romania. It should also be noted that the current methodology for calculating the taxation efficiency index, although taking into account the impact of reduced VAT rates, does not include the impact of other GDP components that are subject to VAT (a part of intermediate consumption and of gross fixed capital formation in the case of VAT non-payers who do not have the right to deduct).

<table>
<thead>
<tr>
<th>Country</th>
<th>Weighted average VAT rate (%)</th>
<th>Implicit tax rate* (%)</th>
<th>Taxation efficiency index**</th>
<th>Rank</th>
</tr>
</thead>
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<td>15.1</td>
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</table>

Table 6: Taxation efficiency - VAT

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, the revenues for 2014, 2015 and 2016 include additional receipts due to implementing the compensation scheme for clearing arrears (+157 million lei in 2015, +287 million lei in 2016, +236 million lei in 2017 and 205.5 mil. lei in 2018).

** Computed as a ratio between the implicit and weighted average VAT rate.
Excise revenues amounted to 28.5 billion lei (3% of GDP) in 2018, lower than the estimate from the initial budget by 1.7 billion lei. Thus, the initial program estimate was 30.2 billion lei, considering the projected increase in the macroeconomic base (final consumption of the population in real terms) of 6.8% and the reintroduction of excise duty fuels in the autumn of 2017, accounting for 2.7 billion lei, while the actual dynamics of the macroeconomic base was only 4.6%. The first budget revision maintained the initial projected level, although the Fiscal Council warned in its opinion that, due to the achievement degree compared to the program at the end of the first semester (92.4%), it is possible an under execution at the level of the entire year of about 1.5-2 billion lei. Confirming the assessment of the Fiscal Council, the second revision diminished the expected level of excise tax revenues to 29 billion lei, the actual execution still reducing by 0.5 billion lei this budget aggregate.

Compared to the previous year, the level of revenues collected from excise duties increased by 1.9 billion lei (+7.2%), mainly due to the 4.6% advance of the final consumption of the population in real terms, together with the reintroduction of the extra excise on fuels.

Considering that only the aggregate amount of excise duties is presented in the budget, which does not allow to study the impact of changing a single category, it is of interest to carry out an analysis of the structure of excise revenues. Thus, in 2018, more than 60% of the revenues came from excise duties on fuel, compared to 57% in 2017, the increase in the share being attributable to the reintroduction of the extra excise on fuels. The excise duties on tobacco products represented the second important component, with a share of more than 36% of total, followed at a considerable distance by excise duties on alcohol, distillates and alcoholic beverages with a constant share of about 4% of total, while the rest of the categories were below 1% of total.

Analyzing the evolution for each category compared to 2017, it is noted that the excise revenues from energy products increased by almost 15% (+2.1 billion lei), significantly exceeding the dynamics of the relevant macroeconomic base, but their advance is far below the MPF assessment that, in addition to the effect of rising real consumption, estimated an increase in receipts by 2.7 billion lei due to the reintroduction of extra excise duty on fuels in September and October 2017. Problems with the under-execution of the estimated revenues are observed also for the excise duties on tobacco products, which have remained relatively constant in the last two years, although the excise duty increased from 439.94 lei/1.000 cigarettes in 2017 to 448.74 lei/1.000 cigarettes in 2018. The only category with positive results is the excise tax on alcohol, distillates and alcoholic beverages, which recorded an
advance of 9.5% (+0.1 billion lei), but due to their small share in total, their impact on the level of the entire budget aggregate is not significant. Therefore, it can be concluded that the performance of the excise revenues has deteriorated during 2018, the main non-performing categories being represented by the energy and tobacco products, the unfavorable evolution of this budget aggregate determined a gap of about -1.7 billion lei compared to the initial program. Taking into account the dynamics of the relevant macroeconomic base and the anticipated impact of measures regarding reintroducing the extra excise duty on fuel and increasing the excise duty on cigarettes in line with the annual calendar set out in the Fiscal Code, the loss in excise tax revenue can be estimated at about 1.5-2 billion lei.

### III.3.2. Direct taxes

The revenue from corporate income tax, according to cash standards and excluding the compensation schemes, amounted to 15.6 billion lei, which represents an increase of almost 1 billion lei over 2017 (+6.7%) and is also 0.75 billion lei higher than the initial budget estimates. The initial program forecasted revenues of 14.9 billion lei from corporate income tax and this level remained almost unchanged following the first budget revision. Taking into account that the dynamics of actual receipts exceeded the forecasts, the second revision operated an increase of the aggregate to 15.3 billion lei, which was in turn exceeded by the value of the budget execution by about 0.3 billion lei.

![Figure 9: Corporate income tax, 2018 (billion lei)](source: MPF)

The positive evolution of this aggregate was mainly determined by the corporate income tax paid by commercial banks which grew by almost 76% compared to the previous year (representing an advance of over 0.5 billion lei). On the other hand, corporate income tax paid by economic agents from the non-financial sector (representing the main component of corporate income tax amounting for more than 92% of total receipts) had a much slower evolution, registering an advance of just 2.9 % (+0.4 billion lei), although the relevant macroeconomic base (nominal GDP) recorded an increase of 10.2% in 2018. Thus, the aggregate results indicated that revenues from corporate income tax increased by 6.7% compared to the previous year, a rhythm that is significantly below the nominal GDP growth, indicating a revenue loss of about 0.5 billion lei and raising questions about the collection efficiency.

In this respect, it should be noted that the process of extending the scope of the microenterprise income tax to the detriment of the corporate income tax (which began in 2015) continued during 2018, generating a series of revenue losses that were highlighted by the Fiscal Council in a separate
Thus, the annual income ceiling until which a company is considered to be a microenterprise was raised in February 2018 from 500,000 euros to 1,000,000 euros (the equivalent expressed in lei) and companies that obtain more than 20% of their income from consultancy and management were no longer excluded from the microenterprise category. At the time of elaborating the draft budget, MPF appreciated that these measures will not have a budgetary impact, but according to the analysis made by the Fiscal Council, the loss of revenues from corporate income tax (due to the conversion of some corporations into microenterprises) was estimated at 0.9 billion lei which is partly compensated on the aggregate level by the revenue increase from microenterprise income tax. Given the results of the budget execution, the negative impact of the aforementioned measures was confirmed, the actual loss of revenues from corporate income tax being around 1 billion lei. On the other hand, this impact was mitigated by the considerable increase of the corporate income tax paid by commercial banks, which exceeded the effect of GDP growth by almost 0.5 billion lei, thus, explaining the loss of income observed at the aggregate level without identifying aspects that would indicate a deterioration in collection efficiency.

Source: EC, Eurostat, Fiscal Council’s calculations

In order to further analyze the matter, the collection efficiency index was calculated according to the ESA 2010 methodology. However, it should be noted that the results presented in this report are not

comparable to those of the previous editions for reasons related to data availability. As it can be seen in Figure 10, the corporate income tax collection efficiency index recorded the highest value of the post-crisis period in 2012 (amid the resumption of economic growth in 2011), followed by a significant decrease during the next two years. In 2015 there was an improvement in collection efficiency, the index coming close to the level recorded in 2012, but the increase was temporary because, due to the reduction of revenues from corporate income tax, the index decreased sharply during the next two years, 2017 marking its lowest value throughout the analyzed period. In this context, 2018 exhibited a slight recovery with the collection efficiency index rising from 0.24 in 2017 to 0.28. The increase was caused by the 17.6% advance in taxes paid by enterprises compared to the previous year. Given that revenues from corporate income tax, according to cash standards, increased by only 6.7% over the previous year, the evolution of the index is most likely caused by developments concerning other revenues included in this category (such as the microenterprise income tax), as well as by the evolution of tax payments made by enterprises to beneficiaries other than the Romanian state.

Table 7: Taxation efficiency – corporate income tax

<table>
<thead>
<tr>
<th>Country</th>
<th>Legal corporate income tax rate (%)</th>
<th>Implicit tax rate* (%)</th>
<th>Collection efficiency index**</th>
<th>Rank</th>
</tr>
</thead>
<tbody>
<tr>
<td>BG</td>
<td>10.0</td>
<td>10.0</td>
<td>10.0</td>
<td>4.6</td>
</tr>
<tr>
<td>CZ</td>
<td>19.0</td>
<td>19.0</td>
<td>19.0</td>
<td>7.0</td>
</tr>
<tr>
<td>EE</td>
<td>20.0</td>
<td>20.0</td>
<td>20.0</td>
<td>4.4</td>
</tr>
<tr>
<td>LV</td>
<td>15.0</td>
<td>15.0</td>
<td>20.0</td>
<td>4.5</td>
</tr>
<tr>
<td>LT</td>
<td>15.0</td>
<td>15.0</td>
<td>15.0</td>
<td>3.5</td>
</tr>
<tr>
<td>HU***</td>
<td>19.0</td>
<td>9.0</td>
<td>9.0</td>
<td>6.0</td>
</tr>
<tr>
<td>PL</td>
<td>19.0</td>
<td>19.0</td>
<td>19.0</td>
<td>4.4</td>
</tr>
<tr>
<td>RO</td>
<td>16.0</td>
<td>16.0</td>
<td>16.0</td>
<td>4.4</td>
</tr>
<tr>
<td>SI</td>
<td>17.0</td>
<td>19.0</td>
<td>19.0</td>
<td>4.3</td>
</tr>
<tr>
<td>SK</td>
<td>22.0</td>
<td>21.0</td>
<td>21.0</td>
<td>7.0</td>
</tr>
</tbody>
</table>

Source: EC, Eurostat, Fiscal Council’s calculations
* 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.
*** Compared to the previous report, local taxes were not taken into account when determining the legal corporate income tax rate.

61 The aggregate of “current taxes on income, wealth, etc. paid by corporations to government and rest of the world” was used for determining the implicit tax rate, while previous editions of the report employed the aggregate of “direct taxes paid by enterprises”.

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Compared to the other NMS CEE countries, Romania ranks fifth in 2018, slightly overpassing Slovenia (0.27), Poland (0.27) and Estonia (0.26). On the other hand, Bulgaria (0.51) and Hungary (0.42) continue to occupy the first two places, at a considerable distance from the other states included in the analysis. The results indicate a slight overall improvement in efficiency during 2018 with five of the ten countries registering increases of the index, while Bulgaria maintained the level recorded in the previous year. In what concerns the considerable decrease of the efficiency index for Hungary, this is due to the reduction of the corporate income tax rate from 19% to 9% (beginning with 2017), which caused a spectacular increase in the index during 2017 because the revenues included payments referring to the previous rate of 19% (as a result of a tax facility granted to companies that allowed them to postpone the payment of corporate income tax). As anticipated in the 2017 edition of the report, the increase in the collection efficiency index was temporary, and it was expected to be followed by a sizeable reduction.

The receipts from personal income tax, amounting to 22.6 billion lei in cash standards, followed a downward trend in 2018, registering a decrease of 24.6% (-7.4 billion lei) compared to 2017. The pronounced negative dynamics of this aggregate reflects the restructuring of income taxation by transferring the social contributions from the employer to the employee (see Box 1), while the tax rate was reduced from 16% to 10%. On the other hand, the relevant macroeconomic bases recorded positive evolutions as compared to the previous year: the average number of employees increased by 3.3% and the average net wage across the economy grew by 14.8%. Compared to the initial program, the first budget revision operated a 1.7 billion lei increase due to the fact that the average wage increase in the economy proved to be higher than the conservative estimates of the initial budget. The updated level was maintained at the second budget revision, while the final execution exhibited a further increase in revenues of approximately 0.2 billion lei.
The fiscal measures that came into force on January 1, 2018 established the transfer of social contributions from employers to employees and reduced their total amount from 39.35% to 37.25%, while also decreasing the tax rate for income from salaries, pensions, self-employment and copyright from 16% to 10%. In order to illustrate the effect of these measures on labor taxation, as well as on the main budgetary aggregates, the following table shows the contributions and taxes related to a net salary of 3,000 lei before and after the new tax regime was implemented.

<table>
<thead>
<tr>
<th></th>
<th>Year 2017</th>
<th>Amount</th>
<th>Year 2018</th>
<th>Amount</th>
<th>2018/2017</th>
</tr>
</thead>
<tbody>
<tr>
<td>SSC employer and employee (26.3%)</td>
<td>1,125</td>
<td></td>
<td>SSC employee (25%)</td>
<td>1,282</td>
<td>14.0%</td>
</tr>
<tr>
<td>Health contributions employer and employee (10.7%)</td>
<td>457</td>
<td></td>
<td>Health contributions employer and employee (10%)</td>
<td>513</td>
<td>12.3%</td>
</tr>
<tr>
<td>Personal income tax (16%)</td>
<td>571</td>
<td></td>
<td>Personal income tax (10%)</td>
<td>333</td>
<td>-41.7%</td>
</tr>
<tr>
<td>Other contributions*</td>
<td>95</td>
<td></td>
<td>Other contributions**</td>
<td>115</td>
<td>21.1%</td>
</tr>
<tr>
<td>TOTAL</td>
<td>2,248</td>
<td></td>
<td>TOTAL</td>
<td>2,243</td>
<td>-0.2%</td>
</tr>
<tr>
<td>Pillar II (5.1%)</td>
<td>218</td>
<td></td>
<td>Pillar II (3.75%)</td>
<td>192</td>
<td>-11.8%</td>
</tr>
</tbody>
</table>

*Contribution for holidays and allowances (0.85%), Unemployment contributions employer and employee (1%), Contribution for occupational injuries and diseases (0.15%), Guarantee fund for the payment of wage claims (0.25%)

** Labor insurance contribution (2.25%)

Based on the analysis from the previous table, it can be seen that the new tax regime has resulted in an effective increase in social contributions coupled with a reduction of personal income tax but, overall, the taxation of earnings has remained almost unchanged. Analyzing the evolution of each revenue category, the following observations can be made:

The growth of the taxation base exerted a positive influence on the revenues from social contributions which increased on average by 13.9%. Thus, while social contributions represented around 39.35% of the gross wage in 2017, this level being reduced to 37.25% at the beginning of 2018, gross wages have increased as a result of the new tax regime which makes the new quota equivalent to a total amount of social contributions representing 44.65% of the gross wages in 2017;

The reduction in the personal income tax rate from 16% to 10% had a significant negative impact on revenues which declined by 41.7%. It should be noted that this fall is larger than the impact of the quota reduction (-37.5%) since the transfer of contributions from the employer to the employee has also led to a decrease in the taxation base. Thus, the total effect is equivalent to a reduction in the income tax rate from 16% to 9.33%;

Last but not least, a decrease of about 11.8% can be noted in the amount transferred to pension pillar II as a result of a decline in the transfer quota from 5.1% to 3.75% which was only partially compensated by the increase in the gross wages.

However, following the evolution of the total revenues from taxes and contributions related to the present analysis, it can be observed that they remained almost unchanged (-0.2%), leading to the conclusion that the tax measures introduced from January 1, 2018 led to a rebalancing of the taxation structure, without having a significant impact on the aggregate level of labor taxation.
For a more detailed analysis of the collection efficiency in the case of personal income tax, an *ex-post* projection of this budgetary aggregate will be carried out and its starting point is the budget execution for 2017 which recorded a level of 30 billion lei, excluding the impact of the compensation schemes. The *ex-post* projection proceeds by applying two adjustments to the starting value:

1. Estimating the effect of fiscal measures that came into force on January 1, 2018, which changed the taxation regime\(^{62}\) of income from salaries, pensions, self-employment and copyright (these measures had a double negative impact by diminishing the tax base for personal income tax while, at the same time, reducing the legal tax rate, so, assuming a constant net income, the revenues from personal income tax diminish by 41.7%) and including this effect in the projection starting with February 2018 (the income tax owed for January 2018 is paid in the following month). Thus, the overall impact of the new taxation regime accounts for a 38.2% decline in revenues from personal income tax;

2. Projecting personal income tax revenues with the actual dynamics recorded for the relevant macroeconomic bases (+3.3% in the case of average number of employees, respectively +14.8% in the case of average net wage across the economy).

As a result of these two adjustments, the projected revenues from personal income tax amounts to around 22.1 billion lei. Taking into account the initial forecasts for the relevant macroeconomic bases from the draft budget, they would have indicated revenues of approximately 21.5 billion lei, suggesting a conservative approach in the estimation of this budgetary aggregate. Thus, the impact of the more favorable evolution of wages across the economy, compared to initial expectations, can be estimated at about 0.6 billion lei. The 0.5 billion lei surplus recorded by the actual receipts (which stood at 22.6 billion lei) compared to the *ex-post* projection (22.1 billion lei) indicates a potential improvement in collection efficiency of the personal income tax during 2018.

Similar to the analysis of collection efficiency for corporate income tax, for reasons related to data availability, the results presented in this report are not comparable to those found in previous editions\(^{63}\). According to the ESA 2010 methodology, revenues from income tax paid by households and NPISH decreased by about 9 billion lei (- 26.6% compared to the previous year), although income tax receipts in cash standards declined by only 7.4 billion lei (- 24.6%). These developments suggest an additional negative impact, most likely due to other revenues included in this aggregate or income tax payments made by households and NPISH to beneficiaries other than the Romanian state. As a consequence, the collection efficiency index recorded a significant decrease from 0.81 in 2017 to 0.7 in 2018, emphasizing the reversal of the improvement trend observed since 2013. At the same time, this value is the minimum recorded throughout the analyzed period. However, the interpretation of these

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\(^{62}\) The most important change refers to the transfer of social contributions from the employer to the employee.

\(^{63}\) The aggregate of “current taxes on income, wealth, etc. paid by households and NPISH to government and rest of the world” was used for determining the implicit tax rate, while previous editions of the report employed the aggregate of “direct taxes paid by households”.
results should take into account that a series of measures (see Box 1) have entered into force in 2018 and they exerted a negative impact on income tax revenues. Thus, the transfer of contributions from the employer to the employee has led to a decrease in the taxation base and the total effect exceeds the reduction in the legal quota from 16% to 10%, being equivalent to a reduction in the income tax rate to 9.33% which allows comparison with previous years. Therefore, assuming an equivalent tax rate of 9.33%, the tax efficiency index would have an improved value of 0.75. However, even under these circumstances, there is a noticeable worsening of collection efficiency in the case of taxes paid by households and NPISH.

The reduction of the collection efficiency index is also felt relative to the other NMS CEE countries. Thus, Romania descended one position compared to the 2017 rankings (from the fourth to the fifth place) and is currently positioned after Estonia (0.76) and Lithuania (0.79). The top two positions in the rankings are occupied by Hungary (1.01) and Bulgaria (0.93), which have remained there during the past three years, registering significantly higher collection efficiency indices than the other analyzed countries. A constant evolution is also noted at the bottom of the rankings, Slovenia (0.52) and Slovakia (0.58) occupying the last places throughout the entire analyzed period. Overall, the results display a significant heterogeneity of the collection efficiency index, the difference between the first and the last place being almost 50 pp.
For countries with progressive taxation systems (Poland and Slovenia), the figure reported is the average tax rate (for Poland – taxation system with two rates) or the second tax rate (for Slovenia – taxation system with four rates).

** 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 Czech Republic, 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.3.3. Social security contributions

The revenues from social security contributions, according to cash standards and excluding the compensation schemes, amounted to 97.6 billion lei at the end of 2018, by about 6.3 billion lei (+6.9%) higher than the initial estimates, given that the average number of employees increased by only 3.3% compared to the initial projection of 4.2%, but this evolution was offset by the dynamics of the average net earnings (+14.8%) which exceeded significantly the initial estimation of +11%. In the sense of generating higher revenues than those considered in the draft budget acted also the payments of legal entities for not employing disabled people (+1.1 billion lei compared to initial expectations), this impact being anticipated by the Fiscal Council in its opinion on the first budget revision. On the other hand, the enforcement titles paid during 2018, including Law no. 85/2016 which establishes the payment of salary differences for the teaching staff for the period October 2008 - May 13, 2011, should also be taken into account. Although the planned 2018 value of the enforcement titles was 512.5 million lei, the actual payments amounted to only 160.6 million lei, which led to a decrease of the SSC level by about 120 million lei.
Analyzing the projection of revenues from social security contributions during 2018, it can be observed that the evolution above expectations of the average wage across the economy was incorporated during the two budget revisions, the first one stipulating a major upward amendment (+6.2 billion lei). At that time, the Fiscal Council considered that the projected level of SSC was justified given the budget execution for the first half of the year. The second revision increased the level of receipts by another 0.8 billion lei, but the projection proved to be unfeasible, the actual level of the receipts being close to the one set at the first revision. Compared to 2017, SSC receipts, excluding the compensation schemes, increased by 26.5 billion lei, representing a 37.3% advance. The main reason for this large increase is the restructuring, starting January 1, 2018, of the tax regime of earnings from salaries, pensions, self-employment and copyright, by transferring contributions from employers to employees (see Box 1).

Thus, although the amount of total contributions decreased from 39.35% to 37.25%, the transfer of contributions from employers to employees triggered a significant advance of the gross salary, leading to an actual increase in SSC receipts by about 13.9%. Thus, the new 37.25% rate is equivalent to rate of 44.65% applied to the gross wages in 2017. Beyond the impact of this factor, SSC receipts were also influenced in 2018 by the wage growth across the economy, by the increase in the taxation base for disabled people contributions paid for not employing disabled people as of September 1, 2017 (effective impact of +1.5 billion lei) and by reducing transfers to Pension Pillar II starting January 1, 2018.

For a more detailed analysis of the collection efficiency in the case of SSC revenues, an ex-post projection of this budgetary aggregate will be carried out, similar to personal income tax analysis, and its starting point is the 2017 budget execution which recorded a level of 71.1 billion lei, excluding the compensation schemes. Considering the increase in taxation stemming from the transfer of contributions from employers to employees and an 11-month implementation period (January related taxes are effectively paid in the following month), it leads to an expected increase of 12.6% for this budgetary aggregate. After adjusting the starting point with the actual dynamics recorded by the relevant macroeconomic bases (+3.3% average number of employees, respectively +14.8% average net wage across the economy), a revenue level of about 95.4 billion lei appears to be feasible. However, taking into account the supplementary payments of legal entities for not employing disabled
people (+1.5 billion lei) and the decrease in transfers to Pension Pillar II (+0.8 billion lei), SSC revenues are projected at 97.7 billion lei, a level which is very close to the one recorded in the 2018 budget execution. Thus, adjusting for the aforementioned factors, the collection efficiency for this budgetary aggregate seems unaffected. The significant revenue surplus compared to the initial budget is therefore explained by a conservative estimate of this aggregate in the draft budget for 2018, the fast increase of wages across the economy and a surge in the payments of legal entities for not employing disabled people.

In order to reflect more accurately the dynamics of the SSC receipts between 2015 and 2018, in the table below are presented the adjusted series of this budgetary aggregate,

<table>
<thead>
<tr>
<th>Source: FSA, MPF, Fiscal Council’s calculations</th>
</tr>
</thead>
</table>

Thus, if the gross series is considered, SSC revenues in 2018 amounted to over 105 billion lei, exceeding the receipts from the previous year by 34.7% (+27.1 billion lei), this dynamic being slower than the one observed in the budget execution (approximately 37%) because the gross series includes the transfers to Pension Pillar II which advanced by only 8.1%. If the impact of enforcement titles is eliminated, SSC revenues increased in 2018 by 35.3% (+27.4 billion lei) compared to the previous year, taking into account the important reduction of enforcement titles.

Before analyzing the evolution of SSC revenues according to ESA 2010, it should be mentioned that since 2017, the statistical treatment of special pensions was modified, these being simultaneously incorporated into social security contributions on the income side and personnel expenses. Because this statistical treatment artificially alters the levels of the two budgetary aggregates, also affecting the comparability with previous years, the amounts related to special pensions were eliminated. Thus, SSC revenues were computed as total contributions paid by employers and employees. The same formula was applied to the other NMS CEE states in order to assess the collection efficiency of SSC on the basis of comparable data series.

<table>
<thead>
<tr>
<th>Table 9: Social security contributions (million lei)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
<tr>
<td>Adjusted series</td>
</tr>
<tr>
<td>Swap</td>
</tr>
<tr>
<td>Pension Pillar II</td>
</tr>
<tr>
<td>Gross series*</td>
</tr>
<tr>
<td>*out of which enforcement titles</td>
</tr>
</tbody>
</table>

Thus, if the gross series is considered, SSC revenues in 2018 amounted to over 105 billion lei, exceeding the receipts from the previous year by 34.7% (+27.1 billion lei), this dynamic being slower than the one observed in the budget execution (approximately 37%) because the gross series includes the transfers to Pension Pillar II which advanced by only 8.1%. If the impact of enforcement titles is eliminated, SSC revenues increased in 2018 by 35.3% (+27.4 billion lei) compared to the previous year, taking into account the important reduction of enforcement titles.

Before analyzing the evolution of SSC revenues according to ESA 2010, it should be mentioned that since 2017, the statistical treatment of special pensions was modified, these being simultaneously incorporated into social security contributions on the income side and personnel expenses. Because this statistical treatment artificially alters the levels of the two budgetary aggregates, also affecting the comparability with previous years, the amounts related to special pensions were eliminated. Thus, SSC revenues were computed as total contributions paid by employers and employees. The same formula was applied to the other NMS CEE states in order to assess the collection efficiency of SSC on the basis of comparable data series.

---

64 Taken from the budget execution of each year.
* For 2014, the legal SSC tax rate was computed as the weighted average of the applicable rates: 44.35% in the first 9 months of the year and 39.35% as of October 1st, 2014.

According to ESA 2010 methodology, SSC revenues had a similar dynamics as in cash standards, recording a 38% over the previous year. This development was a result of the above-mentioned factors regarding the growth of gross wages due to the transfer of contributions from employers to employees, the advance of the relevant macroeconomic bases, the increase of the payments of legal entities for not employing disabled people and the decrease of transfers towards Pension Pillar II. Thus, it can be observed (see Figure 14) that the SSC implicit tax rate remained almost unchanged compared to 2017, although the legal rate decreased by 2.1 pp, which led to the appreciation of the collection efficiency index from 0.71 to 0.75. Taking into account that payments related to disabled people and transfers towards Pension Pillar II generated additional receipts of about 2.3 billion lei, which are not due to improvements in collection efficiency, the implicit tax rate can be adjusted to 27.3% which corresponds to a collection efficiency index of 0.73. Even in this case, a slight improvement in the efficiency index can be observed compared to the 0.71 value recorded in 2017.

Relative to the other NMS CEE countries, Romania occupied the eighth place in the ranking of the SSC collection efficiency, climbing one position in comparison to 2017. In terms of the aggregate rate of social contributions, Romania is ranked seventh (after Slovakia, the Czech Republic, Poland, Lithuania, Slovenia and Hungary), descending one position due to the reduction of the total SSC rate from 39.4% to 37.3%. Out of the countries that have a lower SSC rate than Romania, it is noteworthy that Estonia has achieved higher implicit tax rates over the past three years. This result could also be explained by
different SSC tax regimes for certain categories of income (income from self-employment, copyright, rent, investment income, etc.).

### Table 10: Taxation efficiency – social security contributions

<table>
<thead>
<tr>
<th>Country</th>
<th>Legal SSC rate* (%)</th>
<th>Implicit tax rate** (%)</th>
<th>Collection efficiency index***</th>
<th>Rank</th>
</tr>
</thead>
<tbody>
<tr>
<td>BG</td>
<td>31.0</td>
<td>21.8</td>
<td>0.70</td>
<td>8</td>
</tr>
<tr>
<td>CZ</td>
<td>45.0</td>
<td>48.0</td>
<td>1.07</td>
<td>1</td>
</tr>
<tr>
<td>EE</td>
<td>35.4</td>
<td>31.3</td>
<td>0.88</td>
<td>5</td>
</tr>
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<td>LV</td>
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<td>LT</td>
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<td>9</td>
</tr>
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<td>SI</td>
<td>38.2</td>
<td>34.2</td>
<td>0.90</td>
<td>4</td>
</tr>
<tr>
<td>SK</td>
<td>48.6</td>
<td>46.8</td>
<td>0.96</td>
<td>3</td>
</tr>
</tbody>
</table>

Source: EC, Eurostat, Fiscal Council’s calculation

* Aggregate data for employer and employee contributions. If the rates were changed during the year, the weighted average was used.

** 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 (299.4 mil. lei in 2016, 632.6 million lei in 2017 and 490.9 million lei in 2018).

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

### III.4. Budgetary expenditures

The budgetary expenditures, without the impact of swap compensation schemes (in the amount of 0.9 billion lei), have recorded an advance of 17% compared to the previous year (+46.6 billion lei), reaching the level of 361.6 billion lei at the end of 2018. In the context of a significant growth of the nominal GDP (+10.2%), the share of budgetary expenses in GDP increased significantly by almost 2 pp, respectively from 32.09% to 34.06% of GDP. The main budgetary expenditures that registered a higher dynamic than the average were: expenditure funded from reimbursable funds (+39.8%), transfers for public entities (+36.8%), other expenditures (+34.4%), interest (+27.8%), personnel expenses (+23.7%), goods and services (+9.8%), social assistance (+9.5%), subsidies (+7.6%), while lower dynamics than the
average were registered by projects funded by external grants (-33.6%)\(^\text{65}\). The increase of the total expenditures’ share in GDP was achieved due to the substantial growth of personnel expenses (+1 pp) driven by the sustained wage increases in the public sector, capital expenditures (+0.23 pp), as well as other expenditures and others transfers (+0.13 pp). Compared to the budgetary execution from 2017, the share in GDP of social assistance expenses has changed marginally (-0.07 pp), as well as the share of projects funded by external grants (-0.04 pp)\(^\text{66}\).

Reported to the amounts established in the budget draft for 2018, the budgetary expenditures were at a superior net level, being higher by 8.1 billion lei (+2.6%), respectively by 0.86 pp of GDP, mainly due to positive contributions of personnel expenses and goods and services (+0.53 pp each), capital expenditures (+0.3 pp) and social assistance expenditures (+0.29 pp). The most significant reduction in expenditure compared to the initial budget was registered at the level of projects funded by post-accession external grants 2014-2020 (-0.83 pp of GDP). The pressures on personnel and social assistance expenditures were much higher than those initially anticipated as a result of their initial sub-budgeting, as well as salary increase subsequent to those decided in the initial budget draft. These were partially accommodated from higher revenues than expected at the level of income tax, social security contributions and dividends shared by state companies. In essence, the investment expenditures of the state were significantly reduced, partly as a result of decrease of the revenues from EU funds compared to the projected level, but also partly to accommodate the wage increases.

In 2018, the analysis of the quarterly execution of BGC’s expenditures\(^\text{67}\) shows a concentration degree of them in the last quarter, with a share in the 4\(^{th}\) quarter in total year increasing compared to 2017 (respectively 31.2%, against 28.3 % in the previous year). Thus, the total expenses amounted to 100.7 billion lei in the 4\(^{th}\) quarter of 2018 (compared to 71.4 billion lei in the 4\(^{th}\) quarter of 2017, respectively an increase of 41.1%), being higher by 34.9% than the level from the previous quarter (compared to an increase of 12.9% of the expenses realized in the 4\(^{th}\) quarter against the 3\(^{rd}\) quarter of 2017).

Analyzing the evolution of expenditures’ structure from the last quarter of 2018 compared to the previous quarter, it can be noted the acceleration of capital expenses (+194.8%, respectively a contribution of 31.9% from the total increase quarter IV/III), as well as those corresponding to the projects funded by external grants (+438.5%, respectively a contribution of 46.4% to total increase), causing a similar evolution to public investment expenditures (for which the share of the fourth

\(^{65}\) Throughout this chapter, the amounts for projects funded from EU grants are cumulated for the 2007-2013 and 2014-2020 financial years. Strictly for the financial year 2014-2020, the change is about 33% as compared to previous year. Thus, from the total of 28.9 billion lei of this budgetary revenue category, only 11.1 billion lei represents structural funds, the difference being made up of European funds allocated for agriculture (almost 17.8 billion lei) and of the amounts intended for the pre-financing of the projects from non-governmental sector in the event of temporary unavailability of European funds, based Art. 10 of GEO no. 40/2015 (0.3 billion lei).

\(^{66}\) The comparability with the previous year has to be done with caution, because the grants received from EU also contain the amounts for agriculture which only pass through the general consolidated budget. Exclusively for structural funds corresponding to financial year 2014-2020, the increase is 1.5 billion lei (+0.54 pp of GDP).

\(^{67}\) Including the swap compensation scheme.
quarter in total year was of 55.4%, respectively an advance against the previous quarter of almost 210%). The others categories of budgetary expenditures had a total contribution of 21.7% to the increase of total expenses of the fourth quarter compared to the previous quarter, respectively: goods and services expenses contributed with 13.7% (+32.8% compared to the previous quarter), personnel expenses had a contribution of 3.6% (+4.2% against the third quarter), social assistance expenditures had a contribution of -2.9% (-2.9% compared to the third quarter), other transfers had a contribution of 0.9% (respectively an increase of 6.8% compared to the previous quarter), and the subsidies had a contribution of 3% (+72.4%).

<table>
<thead>
<tr>
<th>Figure 15: Quarterly revenues of the GCB in 2018 (million lei)</th>
<th>Figure 16: Quarterly expenditures of the GCB in 2018 (million lei)</th>
</tr>
</thead>
<tbody>
<tr>
<td>![Graph of GCB revenues]</td>
<td>![Graph of GCB expenditures]</td>
</tr>
<tr>
<td>Trim. I</td>
<td>Trim. II</td>
</tr>
<tr>
<td>0.0</td>
<td>10.0</td>
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<tr>
<td>80.0</td>
<td>90.0</td>
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</table>

**Source:** MPF

The expenditure concentration in the last quarter of the year highlights serious weaknesses in the budgetary programming process, especially for public investment expenditure (funded from capital expenditure and European funds), although the principle of prudence might justify the postponement of some expenditure until the projection regarding the budgetary revenue has a lower degree of uncertainty. Otherwise, in 2018, the quarterly evolution of budgetary revenues, indicates that those were largely achieved in the last quarter of the year, but in a much higher proportion than in the previous year (with a share in total year of 30.6% compared to 28.3% in 2017, respectively an increase against the previous quarter of 23.7%, in contrast to only 13% in 2017).

The Fiscal Council reiterates its previous years’ recommendation for a lower volatility of inter-quarterly budgetary expenditures.
III.4.1. Personnel and social assistance expenditures

The personnel expenditures increased by 5.02 billion lei compared to the amount considered in the draft budget for 2018. Initially projected to a level of 81.11 billion lei, the final value of these expenditures was 86.14 billion lei, respectively 9.12% of GDP, being higher with 0.53 pp of GDP than the level established by draft budget.

The projected evolution of personnel expenditures during 2018 stood blatant in contradiction with the Law on ceilings no. 269/2017, being estimated overruns of the threshold both at first budget revision (by 5.1 billion lei and 0.2 pp of GDP) and at the second budget revision (by 0.11 billion lei additional to the first revision, reaching the total amount of 0.2 pp of GDP, in the context in which the GDP forecast was increased by 41.7 billion lei since the moment when the law on ceilings was established). The upward trend of personnel expenses starting with the first revision is explained by the insufficiency of initial allocations on which Fiscal Council drew the attention in its Opinion regarding the draft budget and which was reflected in the budgetary execution of the first months of the year. To this also contributed the impact of some wage increases decided after the draft budget approval, both situations generating pressures on this budgetary aggregate.

In the same time, the major upward revision highlights the lack of fiscal rules’ constraining character, and also the inability to control the personnel expenditure increases, exactly what the fiscal responsibility law should prevent.

Compared to the year 2017, the personnel expenses have raised significantly by 16.53 billion lei, respectively 23.7%. Actual, the increase of this budgetary aggregate was higher, being obscured by the smaller amounts paid for court decisions compared to previous year, which generated savings in salary tire.

It is noted that in 2018, the amounts paid for court decisions having as object granting salary rights to certain categories of employees from public sector (160.6 million lei) were lower than those planned (512.5 million lei) and than those paid in 2017 (1,181.8 million lei). Without the impact of these amounts, the personnel expenditures increased in 2018 by 17.55 billion lei, respectively 25.64%.
Table 11: Enforceable titles issued/paid on the account of the court decisions regarding the payment of salary differences for some categories of employees, million lei

<table>
<thead>
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</thead>
<tbody>
<tr>
<td>Central adm. (State budget)</td>
<td>3,240.0</td>
<td>8.5</td>
<td>3.8</td>
<td>82.3</td>
<td>1,599.4</td>
<td>67.4</td>
<td>997.4</td>
<td>5,998.8</td>
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<tr>
<td>Local adm.</td>
<td>3,060.0</td>
<td>867.6</td>
<td>1,614.4</td>
<td>1,064.1</td>
<td>2,094.3</td>
<td>20.3</td>
<td>20.3</td>
<td>8,741.0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Social security budget</td>
<td>116.0</td>
<td>28.6</td>
<td>5.5</td>
<td>12.2</td>
<td>7.6</td>
<td>1.2</td>
<td>0.0</td>
<td>171.1</td>
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<tr>
<td>Total</td>
<td>6,416.0</td>
<td>904.7</td>
<td>1,623.7</td>
<td>1,158.6</td>
<td>3,701.3</td>
<td>88.9</td>
<td>1,017.7</td>
<td>14,910.9</td>
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</tr>
</thead>
<tbody>
<tr>
<td>Central adm. (State budget)</td>
<td>162.0</td>
<td>311.0</td>
<td>1,531.7</td>
<td>1,234.6</td>
<td>363.1</td>
<td>476.2</td>
<td>80.8</td>
<td>1,006.0</td>
<td>5,165.4</td>
<td></td>
</tr>
<tr>
<td>Local adm.</td>
<td>153.0</td>
<td>306.0</td>
<td>2,447.2</td>
<td>2,806.1</td>
<td>544.6</td>
<td>705.0</td>
<td>79.2</td>
<td>0.0</td>
<td>7,041.1</td>
<td></td>
</tr>
<tr>
<td>Social security budget</td>
<td>6.0</td>
<td>24.2</td>
<td>72.6</td>
<td>59.3</td>
<td>0.0</td>
<td>0.6</td>
<td>0.6</td>
<td>0.0</td>
<td>163.3</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>321.0</td>
<td>641.2</td>
<td>4,051.5</td>
<td>4,100.0</td>
<td>907.7</td>
<td>1,181.8</td>
<td>160.6</td>
<td>1,006.0</td>
<td>12,369.8</td>
<td></td>
</tr>
</tbody>
</table>

Source: MPF

Beyond the increases decided during the year, the draft budget already included a series of state personnel expenses increases. These were determined by the entry into force of Law no. 153/2017 regarding the remuneration of staff paid out of public funds, starting 1st July 2017, on the basis of which salary increases were granted or allowed for some categories of budgetary employees. Thus, since 1st January 2018, the gross amount of basic wages, job balances, monthly balances, bonuses and allowance raised by 25% compared to December 2017. Moreover, since 1st March 2018 was foreseen the increase of basic wage for teaching staff by 20% against February 2018, and also the increase of basic wage for medical staff up to level established by law for the year 202268.

Other negative impact on this budgetary aggregate was led by the increase of the guaranteed minimum wage from 1,450 lei on month to 1,900 lei on month since January 1, 2018. The impact of this measure wasn’t specified in the explanatory note of the Government Decision no. 846/2017 for the established of the gross guaranteed minimum wage in payment on November 29, 2017. The evolution of personnel expenditures in 2018 was also influenced by the GEO no. 46/2017 which

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68 As a result of the tax measures for the reinstatement of the tax structure of income from salaries, pensions, self-employment and copyright by transferring contributions from employer to employee, applicable from 1 January 2018, the total personnel costs borne by the employer increased less compared to gross wages.
decided to grant holiday allowance, in the form of vouchers, in the amount of 1,450 lei (the equivalent of the gross guaranteed minimum wage in 2017) for an employee. According to explanatory note, the impact of this measure on personnel expenses was estimated to 1.73 billion lei during July 1, 2017 – November 30, 2018.

During the year were also decided others salary increases which applied starting with May 2018. Consequently, was decided to grant food allowance for higher education staff (the decision being an optional one for the universities, since the expenditures were going to be supported from its own budget), the payment of a 100% benefit of basic salary for the staff hired in sanitary, social assistance and medical-social assistance units for work during the legal holidays and on the other non-working days according to the regulations in force, the increase of the gross salaries of the school inspectors by 20% compared to February 2018, the increase of the personnel in the sanitary and social assistance units by paying a benefit between 15% and 20%, granted depending on the fulfillment of some criteria stipulated in the law. It has also been decided to pay compensatory amounts for employees who have earned lower net salary wages since March 2018 than those in February 2018 as a result of applying the provisions of the benefits Regulation. The implementation of these measures had a negative impact, leading to the increase of the state personnel expenses by 595 million lei in the last 7 months of 2018, as shown in the explanatory note of the GEO no. 41/2018.

As a result of these increases, the net average salary in the public system in 2018 reached the level of 3,330 lei, increasing by 20.25% compared with 2017, higher by 30.84% than the wage from the private sector which registered the level of 2,545 lei (increasing by 11.03% compared with the previous year). Considering quarterly averages, the salary in the public sector for the fourth quarter of 2018 registered a level of 3,470 lei, 21.14% more than in the same period of 2017, while the salary in the private system was 2,669 lei, up only 10.89% compared to the fourth quarter of 2017. The highest increase was recorded in the public health and social assistance sector, the net average salary reaching 3,050 lei in the fourth quarter of 2018, 30.66% higher than in the same period of the previous year. These dynamics has strongly contributed to raising the average wage in the budget sector.

In the public sector, the salaries of public administration and defense personnel have risen. Their level in the last quarter of 2018 was 4,300 lei, having a growth rate very close to that of private wages (it recorded an increase of 9.57% compared to the last quarter of 2017). The net average salary of the employees in education was 2,890 lei in the last 3 months of 2018, being 20.27% higher compared to the same period of the previous year.
After the increase of 165,600 people registered during 2005-2008, the total number of employees in the governmental sector decrease by 167,208 people during December 2008 – December 2018, up to the level of 1.23 million (Figure 19). Practically, most of the personnel reductions took place in the period 2009–2011, when the number of employees in the public sector declined by about 180,000, this being due mainly to the introduction of the rule of "one new employee to 7 departures from the system" (applied until 2012, inclusively), whereas in the period 2012–2014 the reduction was approximately of 9,540 persons. The adjustment recorded in the period 2009-2018 took place mainly at the level of local executive authorities (-44,296 positions filled), Ministry of Internal Affairs (-17,606 positions filled), other institutions fully financed from own revenues (-12,039 positions filled), Ministry of Public Finance (-7,819 positions filled), Ministry of Public Defense (-7,672 positions filled), Ministry of Agriculture and Rural Development (-4,815 positions filled). On the other hand, in the same period were registered increases to the level of Ministry of Justice (+3,238 positions filled), Ministry of European Funds (+1,222 positions filled), Public Ministry (+1,029 positions filled), Ministry of Labor and Social Justice (+991 positions filled).

On the other hand, it should be noted, however, that also in 2018 was a continuation of the slight reversal of the decrease of the number of staff, present in the previous years, the number of occupied positions increasing by 20,706 (+1.71%) as compared to 2017 (compared with 21,163 and + 0.26% in 2016 respectively), especially at the level of the local executive authorities (+8,080 positions filled), the Ministry of Internal Affairs (+4,758 positions filled), the healthcare system, including the Ministry of Health (+4,054 positions filled). Otherwise, decreases were registered in Ministry of Regional...
Development and Public Administration (-1,187 positions filled) and Ministry of Public Finance (-595 positions filled).

Starting with 2018, it was decided to pay the salaries of the pre-university education staff from the state budget through the budget of the Ministry of National Education. As a result of this shift in staff costs, there were major fluctuations in the number of employees. Thus, in December 2018 compared to December 2017, at the level of the Ministry of Education, the number of positions filled increased by 285,971, while at pre-university education it decreased by 285,245. Compared to December 2008, the number of jobs in the Ministry of Education increased by 282,697, while those in pre-university education decreased by 331,566.

**Figure 19: The evolution of the public sector employment in the period 2005-2018**

The adjustment made in the period 2009-2012 is mainly the result of applying the rule of "one new employee to 7 departures from the system" given that most of the exits from the system were achieved through voluntary dismissal or retirement. The abandonment of this rule starting from 2013 was intended to reduce the adverse selection and allowed some changes in the structure of the personnel. Thus, the reductions in the period 2009-2012 was achieved only to a small extent based on qualitative criteria, such as reducing personnel where it was identified a surplus of employees whereas hiring personnel in the sectors with personnel deficit on the basis of cost standards rigorously defined and thus establishing an optimum level of operation. The Fiscal Council considers this approach to be appropriate and recommends that the new appointments to be made in the identified sectors with personnel deficit, even by transfer of posts from the sectors with personnel surplus to the sectors with personnel deficit, also having in view the strict framing in the wage bill previously approved.
Compared to other European Union’s countries, Romania’s position in terms of the wage expenses in the public sector as a percentage of the total collected revenues has sharply deteriorated in 2018, following a good development starting 2011 due to the fiscal consolidation measures undertaken since mid-2010. If until 2010, the wage bill as a share of total budgetary revenues according to ESA 2010 data placed Romania in the first half of the ranking (on the 8th position in 2008 and on the 10th position in 2009), 2011 revealed a better ranking for our country, respectively 20th position out of 28 countries, following the 18th position in 2013, on the background of the recovery of wages and wage increases for some categories of state employees. In 2015, Romania was also on a good position namely the 20th position out of 28 countries, due to a slight increase of the revenues to the budget and to preserving the share of the wage bill in GDP. But then, in 2016 the situation has deteriorated and Romania ascended abruptly on 9th position, reaching in 2017 second position and in 2018 first position. This negative evolution is the is the result of the dynamics of personnel expenditures’ share in GDP which registered an increase of 1.2 pp in 2018 compared to 2017. On the other hand, compared to 2017, when the share of budgetary revenues in GDP decreased by 1.3 pp compared to 2016, in 2018 the budgetary revenues reported to GDP increased by 1.1 pp.

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Romania registered the highest growth from EU28, followed by Czech Republic by 0.7 pp and then by Croatia and Lithuania with 0.3 p increase over the previous year.
The Fiscal Council notes the manifestation of an accelerated growth trend in personnel expenses, Romania’s position compared with other EU countries deteriorating strongly over the past three years. The repeated wage increases in the public sector and the entry into force as of 1st of July 2017 of Law no. 153/2017 regarding the salaries of the staff paid from public funds have consistently contributed to the worsening of situation related to this category of expenditure.

Social assistance spending in 2018 was above the value projected in the draft budget, being revised upwards on the occasion of the two budget revisions. Estimated in the initial budget at 98.62 billion lei, it recorded a final value, net of the impact of compensation schemes, of 101.36 billion lei, by 2.78% (the equivalent of about 2.74 billion lei) more than in the initial program. Social assistance expenditure was much higher than planned, mainly as a result of registering a higher budgetary impact in the execution than initially estimated for the fiscal policy measures decided in 2016, but also due to the introduction of additional measures with the occasion of the two budget revisions for 2018. Compared with the year 2017, the social assistance expenditures were higher by almost 8.79 billion lei, respectively 9.5%.

The greatest impact on evolution of social assistance expenses was led by the following fiscal policy measures: the increase of pension point by 9% from July 1, 2017 reaching 1,000 lei (according to GEO no. 2/2017, with subsequent amendments and supplements), respectively by 10% from July 1, 2018, reaching 1,100 lei, the increase of social allowance for pensioners from 520 to 640 lei, as well as the increase and the change of way of setting the monthly allowance for child growth and insertion incentive (according to GEO no. 82/2017, with subsequent amendments and supplements).

On the occasion of first budget revision, the social assistance expenditures were revised upward by 1.8 billion lei, and at the second revision they were additional increased by 0.81 billion lei. These decisions validated the warning issued by Fiscal Council in the context of draft budget approval, on the fact that this aggregate is under budgeted, as could be seen from an extrapolation of apparent trend in quarterly execution of the year, as well as from the pension point dynamics.

Starting with 2009 the deficit of the social security budget, considering also the special pensions has widened significantly up to a value of 20.1 billion lei in 2017. In 2018, the deficit was significantly reduced to 11.6 billion lei, mainly as a result of the fiscal measures regarding the reinstatement of the tax structure of income from salaries, pensions self-employment and copyright by transferring contributions from employer to employee (see Box 1). Thus, although the total contribution rates
decreased from 39.25% to 37.25%, the transfer of contributions from employer to employee
determined a significantly increase of gross wage, leading practically to an increase in the level of
taxation through social security contributions with almost 13.9%. In addition to raising labor taxation
through SSC, the reduction in the deficit is also explained by the reduction in the contribution to
Pension Pillar II (from 5.1% in 2017 to 3.75% in 2018), the increase in the number of employees in the
economy, as well as the wage growth pace faster than the one of pension point.

According to the Fiscal Strategy for 2019-2022, the projections for the next years show that the social
security budget deficit will register a significant decrease of up to 4 billion lei in 2019, and will
draastically increase to 12.1 billion lei in 2020, reaching 11.2 billion lei in 2021 and 17.7 billion lei in
2022. In the Opinion regarding the draft budget for 2019 and Fiscal Strategy for 2019-2022, the Fiscal
Council noted that the increase of social assistance expenditures, according to the amounts estimated
for 2020-2021, are not consistent with the evolution foreseen by the new pension law approved by the
Parliament. Moreover, given the parliamentary elections scheduled for the end of 2020, the
intention of the authorities to increase the retirement point on September 1, 2020 violate the
provisions of art. 17, paragraph (1) of fiscal responsibility Law which prohibits the adoption of
normative acts leading to an increase in personnel or pension expenditures in budgetary sector less
than 180 days before the expiration of the Government mandate. The Fiscal Council recommends to
adopt a decision regarding the pension point modification after the moment of elections. Given that
spending would fully reflect the announced growth schedule of pension point, the social security
budget deficit would be much higher than that estimated in the current situation.

From the perspective of the deficit as a percentage in GDP, the execution indicates a decrease from
2.29% in 2011 to 1.92% in 2014, followed by a new increase up to 2.48% in 2015 and a slight decrease
in 2017, when it reached a level of 2.34% of GDP. The downward trend of the deficit as share in GDP
continued in 2018 reaching 1.23% of GDP. The projections for the next years indicate a decrease of the
deficit during 2019-2022 (0.39%, 1.1%, 0.95% and -1.4%). As stated above, the deficit-to-GDP ratio
would be higher if an aggregate of social assistance expenditure would fully include future increases in
the pension point.

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70 In Fiscal Council’s opinion the expected dynamics appear inferior to those that would prevail if the point of
pension would evolve according to the trajectory described in the normative act stipulating its values of 1,775
lei as of 1st September 2020 and 1,875 lei as of 1st September 2021. This trajectory would imply average
increases of 24.2% and 26% in 2020 and 2021, while the foreseen dynamics of social security assistance of state
social security budget is only 20.4% and 8.9% respectively. According to the above described path of the
retirement point, the expenditures should be higher than those projected by 2.65 billion lei (0.24% of GDP) in
2020 and by 17.7 billion lei (1.5% of GDP) in 2021.

71 According to the growth assumptions presented by the Ministry of Public Finance in fiscal strategy for 2019-
2022.
Source: MPF, cash standard data
Note: In addition to the spending of the state social insurance budget for the period 2016-2010 were included spending with military pensions. According to Law no. 223/2015 from 1 January 2016, the funds necessary to pay military pensions and other social insurance rights due to military pensioners are provided from the state budget, through the budgets of the institutions: Ministry of National Defense, Ministry of Internal Affairs, and Romanian Intelligence Service.

The deficit of the state social insurance budget has occurred on the account of excessive social security budget expenditure in the period 2007-2009 (+75.8%) and in the context of a favorable dynamics of the social contribution revenue during the period preceding the financial crisis, as a result of the economic boom and also anticipating to maintain this trend in the future. Unfortunately, a significant share of the social contribution revenues augmentation has proven to be of cyclical nature, the further developments invalidating the optimistic forecasts that led to the significant increase of the pension point. The self-financing of the system has fallen sharply from 2006 (from 118.81%) to 2011 (73.02%), reaching the historical minimum in 2016 (65.41%) and it maintained at a close value in 2017 (68.81%). In 2018, the self-financing registered a slight increase to 83.62%, and for the year 2019 is estimated a level of 94.71%.

Therefore, the decision to increase certain permanent expenditures such as those related to pensions should take into account the trend of receipts from contributions, as well as the forecasts concerning employees-retiree’s rate, especially in the context of population aging, on 1st of January 2018 the population aged 65 and over exceeded the young population 0-14 years old (3550 thousand compared to 3052 thousand persons) according to NIS data. At the same time, it became obvious the need to find...
an indexing rule that would ensure the long term sustainability of the social security budget rather than the discretionary approach in the past.

The ratio between the number of contributors and the number of beneficiaries fell sharply in the last 28 years, from 2.28 employees per pensioner in 1990 to only 0.94 employees per pensioner in 2017, the number of the state social insurance pensioners having an increasing trend, while the number of employees had a decreasing trend, especially until 1999-2000. However, in recent years, the ratio has improved from 0.77 employees per pensioner in 2010 to 0.84 employees per pensioner at the end of 2014, being placed in 2016 at 0.91, slightly above the level registered in 2008 (0.89). The projections of European Commission\textsuperscript{72} show that the ratio between population aged over 65 years old and population between 15-64 years old will increase from 26.3% in 2016 to 52.8% in 2070.

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\textbf{Figure 23: The evolution of the number of pensioners versus the number of employees (thousand persons)}

\begin{figure}
\centering
\includegraphics[width=\textwidth]{figure23}
\caption{The evolution of the number of pensioners versus the number of employees (thousand persons)}
\end{figure}

\textit{Source: NIS, less the number of employees for 2018 for which the source is NCSP, Winter Forecast 2019}

A measure aiming to improve the medium and long term financial situation of the social insurance budget was represented by the new pension law (Law no. 263/2010 of the unified public pension system, updated) through which it has been pursued a number of objectives designed to correct the imbalances recorded in the pension system. Nevertheless, returning to the special pension system eliminated in 2010, the occurrence of multiple exemptions and the new special pensions jeopardize the sustainability of the reforms initiated earlier and could generate new pressures on the social

security budget deficit. The recently adopted laws introduce new rules, ensuring better conditions for early retirement and generous computing formulas based on the salary earned before retirement. It should be noted, however, that the unitary pension system currently applied provides better conditions for some categories of workers, in order to compensate for particularly risky working conditions and shorter occupations. Starting with 2015, special pensions were reintroduced and it can be noted a reduction of the link between pension contributions and future accrued pension rights which has the potential to generate a negative impact on long-term sustainability of the pension system, especially since other professional groups will be also encouraged to push for the restoration/establishment of privileges. Moreover, the renunciation of the pension indexation formula since 2017 affects substantially the sustainability of the pension system, the discretionary approach and the abandonment of the rules having the potential to contribute to the widening of the state social insurance budget deficit and maintaining the self-financing of the state social security budget far below the level required.

Source: NIS

According to NIS data, in 2018, the average monthly pension was 1,172.25 lei, higher by 9.65% over the previous year, as a result of the pension point indexation by 10%, respectively 100 lei. Pensions paid out of the social security budget were at an average level of 1,126.25 lei, and those corresponding to pensioners that were farmers were on average 464 lei. At the same time, the pensions granted to the military personnel have reached an average monthly level equal to 3,712.33 lei, 29 lei (0.7%) less than in 2017. It is worth noting that the average monthly pension corresponding to beneficiaries from
defense system, public order and national security increased by approximately 89.33% during 2010-2018, as a result of the recalculation according to Law no. 119/2010 and GEO no. 1/2011 and the subsequent increases, even in the circumstances that the initial forecasts indicated a decline in the value of these pensions after applying the contribution principle. Article 121 of Law no. 223/2015 on state military pensions stipulates that that the differences between the amounts of pensions due for December 2010 and those established under Law no. 119/2010 and GEO no. 1/2011, approved by Law no. 165/2011, as subsequently amended and supplemented, shall be returned to the beneficiaries, at their request, in staggered manner, for a maximum period of 2 years from the date of entry into force of the Law, and until June 30 the beneficiaries can express their option with regard to the period of time envisaged for the recalculation of the pension. The Government Decision no. 146/2016 approved the Norms for the application of the provisions of this Article, specifying that in November 2016 the payments will be made for the differences for which applications were submitted until September 30, 2016, including differences corresponding to the years 2011 and 2012. The differences for the others requests and periods were due to be paid in November and December 2017, but these deadlines were postponed until June 30, 2018 by GEO no. 90/2017.

**Figure 25: Social security expenditure as a share of total revenues in EU28**

![Figure 25: Social security expenditure as a share of total revenues in EU28](image)

*Source: Eurostat*

*Note: Taking into account the change in the treatment of special pensions by Eurostat, for Romania collected revenues have been adjusted accordingly to avoid double counting (similar to Figure 20).*

In the year 2018, Romania has descended one place compared to 2017 regarding the share of social security expenditures in total revenues, placing in the second half of the EU member states. In 2018,

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73 Placed on 17th position out of 28 countries after being placed on 25th position in 2015.
the share of social assistance expenditures in total budgetary revenues decreased by 1.1 pp related to previous year. This decrease was led by the faster growth pace of revenues (+ 1.1 pp of GDP) compared with the growth pace of this expenditure aggregate (+ 0.1 pp of GDP). However this category of expenditure has a lower share in total budgetary revenues compared to the EU average, the increase of revenues share in GDP to 31.2%, contributes to the improvement of Romania’s position in the ranking.

The Fiscal Council notes the manifestation of a sustained trend of reversing the pension reforms designed to ensure long-term financial sustainability and pleads strongly in the favor of maintaining the progress made in recent years, both in terms of the principles introduced (exclusive use of the principle of contribution in determining the pension value) and in terms of a strict compliance with the pension’s indexation mechanism as introduced by the new pension law. At the same time, the Fiscal Council considers as major the risk of a substantial increase of social security budget deficit if the measures which foreseen significant increases in the pension public system during 2020-2021 would be implemented.

III.4.2. Goods and services expenditures

The execution of goods and services expenditures registered a much higher level, compared to the one envisaged in the draft budget (+5.06 billion lei), as well as to the values projected during the two budget amendments made in 2018. Initially estimated at 39.61 billion lei, the final execution of this aggregate reached the level of 44.68 billion lei, being by 3.55 billion lei above the amount estimated in the first budget revision and by 1.8 billion lei above the amount proposed in the second budget revision.

Expressed as share of GDP, the goods and services expenditures remained at the same level of 4.7% as in 2017, representing the minimum of period 2009-2018. Compared to the previous years, the share of GDP of this budget aggregate was significantly reduced, decreasing by 0.9 pp related to the average of the period 2009-2017.

Compared to the 2017 execution (40.69 billion lei), this category of expenditure (without the impact of swap compensation scheme) was projected through the initial budget at a lower level of approximately 1.07 billion lei. Moreover, the authorities have undertaken to reduce payments of goods and services related to the maintenance and operation of institutions by 10% compared to
payments made in the previous year\textsuperscript{74}. However, expenditure on goods and services increased by 9.8%, respectively 4 billion lei compared to 2017 with the budget allocation being increased steadily during the year 2018.

Given that the execution during the year of goods and services expenditure aggregate for the first 7 months indicated a increase of 8.5% compared to the same period from the previous year, at the first revision operated in August 2018, their amount registered an upward revision, but by only 0.9 billion lei corresponding to an advance of 2.26% compared to the draft budget. In the updated version of the first budget revision in September 2018, expenditures on goods and services were increased by 0.6 billion lei compared to the initial version and by 1.5 billion lei compared to the budget proposal, but it was registered a surprising decrease of about 2.5 billion lei to the budget of Unique National Health Fund, given that the dynamics of the expenditures of this institution was higher than in the previous year, as well as an increase of over 1 billion lei to the budget of administrative-territorial units.

In the Opinion on the first budget revision for 2018, the Fiscal Council noted that the amount by which the annual goods and services expenditures were revised was insufficient, as it implied a nominal decrease of 0.4% reported to the 2017 execution. With the updated budget revision proposal in September, the new level of spending on goods and services was higher by 1.1% than the execution of 2017, but analyzing data from operational execution, the growth pace was well below than that registered.

On the occasion of the second budget revision, the goods and services expenses have been again upward revised. Even under these circumstances, the Fiscal Council appreciated as high the risks of exceeding the updated coordinates of the goods and services expenditures aggregate. Thus, although increasing by almost 1.8 billion lei compared to the level from the first revision (amounting to 2.25 billion lei above the level assumed in the initial budget), the new level was superior by only 5.4% compared with that from the execution of the year 2017, given that the execution at the end of October revealed higher expenditure by 10.1% compared to the period January-October 2017.

As in the previous year, the motivation for the modifications made on the occasion of the budgetary revision projects was not clearly explained in the substantiation notes accompanying the budget revision proposals in order to ensure the transparency of the decisions taken by the Government. The explanation note attached to GEO concerning the second state budget revision for 2018 indicated as argument for necessity to allocate additional amounts, only the evolution of this budgetary aggregate which in the first 9 months of 2018 compared to the previous year registered an increase of 9.2%, due especially to the higher expenses of the local administration (+ 9.07%), Institutions fully or partial funded from own revenues (+ 16.97%) and Unique National Health Fund (+ 4.03%). The cumulative increases of allocations for this expenditure aggregate, in the context of budget revisions, as well as the final execution confirmed the objections of the Fiscal Council regarding the necessity of some additional allocations for this budgetary aggregate compared to the amounts advanced at that time.

\textsuperscript{74} GEO no. 90/2017 regarding some fiscal-budgetary measures, amending and completing some normative acts and extending some deadlines.
In previous years, the aggregate of goods and services expenditures proved to be difficult to control. Thus, during 2011-2013 and 2017-2018, the level of expenditure on goods and services (without the impact of compensation schemes) registered in budget executions was higher than the level initially budgeted or even those upward revised on the occasion of the budget amendments, while the period 2014-2016 was characterized by a different situation, with the final execution having a lower expenditure level 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 this area of expenditure or the motivation for the major revisions made during the year not being explained in the documents accompanying the successive iterations of the budget. These explanations are even more necessary as there are some substantial changes with the potential to influence the achievement of the deficit target or the compliance with the fiscal rules. The Fiscal Council calls for a budgetary programming taking into consideration all expenditures envisaged in this budget chapter within the draft budget along with a proper enunciation of the funds’ destination, as well as comprehensive explanations during budget revisions regarding the sources of potential increases in this category of expenses. Although as a percentage of GDP the level of expenditures on goods and services was in 2018 at the historical minimum of the last 10 years, insufficient allocations from the initial draft budget led to the need to identify significant additional resources of billion lei. Increased transparency could be a good starting point in streamlining the goods and services expenditure, this being necessary to be accompanied by a comprehensive reform of the public procurement system in general.

III.4.3. Public investment expenditures

Investment expenses include, according to the budget classification, capital expenditures (nonfinancial assets), projects funded by external post-accession grants, expenditure for reimbursable programs, capital transfers and other transfers related to investments.

Compared to the previous year, in 2018, the state investment spending, considering all budget items of this category, including swap compensation schemes, increased by 7.5 billion lei from 26.7 billion lei to 34.2 billion lei (in cash standards), respectively by 27.9% in nominal terms, and by 20.8% in real terms, the share of public investment spending in GDP increasing by 0.5 pp (from 3.12% of GDP in 2017 to 3.63% of GDP). Compared to the previous 5 years’ development, the execution of investment spending as percentage of GDP was in the year 2018 in the penultimate place (the lowest level being registered in 2017, minimum investment year during 2009-2018), by 0.9 pp below the average 2013-2017 (4.54% of GDP).

The analysis of this budgetary aggregate from the perspective of the comparison between the actual execution and planned investment expenditures from the initial budget or established through revised budgets during 2014-2018 persistently reveals significant deviations in the sense that the executions are invariably below the estimates of the initial and the revised budgets. Thus the negative gap

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75 Using the GDP deflator as price index.
expressed as percentage of GDP relative to the initial budget of the amounts actually spent reached in 2018 a level of 0.55%, being well below than in the previous year (1.48% of GDP), this result being based mainly on the increase of internal funding resources to compensate for non-realization of attracting European funds. Thus, the execution related to the initial program for internal financing funds represented 71.3% in 2017, but in 2018 the achievement degree of the program advanced to 96.8%. Compared with the advance of achievement degree of the program for European funds to finance investment expenditure was much lower (from 60.3% in 2017 to 71.2% in 2018).

**Figure 27: The evolution of public investment expenditure in the period 2009 – 2018**

(million lei, % of GDP)

![Image of Figure 27: The evolution of public investment expenditure in the period 2009 – 2018](Image)

Source: MPF

The 2018 budget was elaborated by returning to an upward path of the aggregate investment expenditures after the pronounced decline from 2017 (3.12% of GDP), on the basis of a possible revival of the absorption of European funds and respecting Romania’s commitment to NATO. In the initial budget construction the investment expenditures were envisaged to a level close to the program of 2017, but with a significant increase compared to the execution of this year (+12.6 billion lei), with increases located at the level of capital expenditures (+6.2 billion lei, out of which 5.5 billion lei were...

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76 The allocation of 2% of GDP for the endowment of the army in order to strengthen Romania’s strategic partner’s profile at NATO, EU, USA level according to Governance Program 2017-2020, as well for streamlining the endowment of the army according to measure from the Memorandum approved by decision of Supreme Council of National Defence no. 174/24.11.2016.
additionally allocated to the Ministry of National Defense) and at the level of the expenditures related to the projects financed by external EU funds (+4.5 billion lei), simultaneously with the reduction of the investments transfers (-0.8 billion lei). Thus, excepting the increase in the in the allocation for the army (based on the Romania’s commitment to NATO to allocate a budget for defense representing 2% of GDP), by the budget construction for 2018, similar to the years 2013-2017, it was foreseen a larger weight of the external source financing (an increase in the EU funds absorption coming from the new financial year 2014-2020) in total investment expenditures, respectively, reducing the share of internal sources (capital expenditure), a correct and welcomed approach in the opinion of Fiscal Council, thus freeing financing resources that could be used for fiscal consolidation.

Nonetheless, the plan to increase investment by substituting capital expenditures with non-reimbursable EU funds did not function also in 2018, revealing a major deviation from the estimation from the initial budget of the investment expenses (-4.6 billion lei, -0.49% of GDP respectively), however much lower in magnitude compared to the difference between the execution and the initial budget for 2017 (of -12.7 billion lei, -1.48% of GDP respectively). This deviation from the initial plan was due to the non-materialization of the expenditure forecast both for projects financed by external non-reimbursable funds related to the new financial year 2014-2020, where the difference between the execution value and the initial budgetary plan was -4.4 billion lei, respectively -0.47% of GDP, and for other transfers related to investments (-2 billion lei, respectively -0.25% of GDP). These unfulfilled were partial offset by the capital expenditures increase (+1.7 billion lei, respectively +0.18% of GDP compared with the initial budget). If we analyze the evolution of the ratio capital expenditure/projects funded by external non-reimbursable funds for the financing of investment expenditure, in 2018 it is noted its maintaining at almost double values compared to the period 2012-2015, even if reduced compared with the previous year (209% compared to 238%), proving the inability of the Romanian authorities to attract the amounts allocated by the EU for financing the public investment programs.

Also, in 2018, the quarterly evolution of the investment spending shows a concentration in the last quarter (more than half of the total year), which puts into question the effectiveness of the budgetary programming both in terms of the management of investment projects and of establishing the criteria for achieve investments according to their importance and usefulness. Practically, in the last quarter investment spending was 3.7 times more than the average of the three previous quarters, which highlights serious deficiencies in budgetary programming for this aggregate that systematically presents an extremely high volatility of the quarterly distribution of the programmed spending compared to the actual ones. From the perspective of the evolution of the share of the quarterly in total execution, this fluctuated between 14.3% in the first quarter, 12.4% in the second quarter and 17.9% in the third quarter, reaching 55.4% in the last quarter of 2018, being roughly in line with the quarterly evolution of flows related to projects funded by non-reimbursable external funds.

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77 115% on average with a minimum of 74% in 2015, given that this year was a maximum for EU funds absorption, being the deadline for attracting European funds for the 2007-2013 financial period.
In 2018, the capital expenditures for investment\textsuperscript{78} were projected in the initial budget at a higher level compared with the actual spending from the previous year (by 2.8 billion lei, of which 88% for Ministry of National Defence). The final execution registered a level by about 1.7 billion lei higher than the programmed level from the initial budget (+8.1%), respectively by 4.5 billion lei over than in 2017 (+24.5%). The supplementation of the investment expenses from internal funds was necessary to counterbalance the major failure to achieve the amounts attracted from the European Union.

\textbf{The projects financed by post-accession external funds (NREF) for public investment spending, were projected by the initial budget of 2018 in a large expansion compared to the previous year (+7.6 billion lei, basically, doubling them), given the possible revival of the European non-reimbursable funds from the new financial year 2014-2020. The execution of these was, again, much below initial expectations (-4.4 billion lei, respectively - 29%), significantly contributing to the underachievement of the initially programmed level for investment expenditures.}

This underachievement did not lead to an increase in the deficit, the failure to implement investment projects involving savings regarding the co-financing and non-eligible expenditures, but the failure in absorbing European funds at the level planned for this year would induce negative effects on the economic growth both from the perspective of the direct effects and those propagated\textsuperscript{79}, as well as from the perspective of lack of ability to absorb European funds allocated to our country, by preserving a lower degree of absorption.

\textsuperscript{78} Representing the main component of the capital expenditure (that also include capital transfers and stocks).

\textsuperscript{79} The contribution of investment to potential growth is crucial, ensuring a non-inflationary economic growth.
Missing the target for the projects funded through external post accession grants is correlated with the EU funds absorption rate from the financial year 2014-2020 for which the underachievement of the revenues in 2017 compared to the initial budget was at aggregate level (including amounts for agriculture and TUEF, but exclusively the newly introduced category other EU funds\(^{80}\)) of 5.17 billion lei, -0.55% of GDP respectively, due to the evolution under expectations of the structural funds of which final beneficiary is the state.

The expenditure regarding the projects funded by reimbursable programs that have a very small share in total investment spending were over both the level in the previous year (by about 115 million lei, +42% respectively) and of the initial budget projection (by 102.7 million lei, +36% respectively compared with the program).
An analysis of the investment expenditures efficiency also reveals from this perspective an unsatisfactory result for our country, especially reported to the evolution of the other EU member states. In the Country Report for 2018 elaborated by the EC\(^{81}\), it is reiterated that the high level of the public investment expenditures is accompanied by an insufficient infrastructure, with negative impact on the connection to the main transport corridors\(^{82}\), on labor mobility, but also on private external investors decisions to invest, thus accentuating regional disparities. Given that, Romania has had, over the last decade, one of the highest rates of public investment from the EU, the infrastructure is insufficient both in terms of quality and quantity, which suggest a poor efficiency of the public capital expenditures. Thus, the Report lists as the main factors that contributed to this state: the low degree of absorption of European funds; reduced administrative capacity and persistence of inefficiency in preparing, prioritizing and implementing investment projects.

The quality of infrastructure is one of the lowest, especially in the critical sectors, such as road, rail and energy infrastructure due to the very modest performances registered by the majority of state-owned enterprises and the lack of progress in the sense of restructuring those who record losses. It should be noted, that in 2017 the rate of new investments by the state owned companies\(^{83}\) marked a recovery after the drastic decrease from 2016 (0.45%), but much below average of period 2014-2015 (3% compared with 4.5%) and at a level considerably lower than the average recorded during the pre-crisis

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82 Romania is on the last place in EU on the density of highways (38 km/1000 inhabitants), but on a leading place regarding the risk of road accidents.

period (about 12%). Moreover, the empirical evidence in the literature suggests a correlation between the inefficiency of public expenditure and the overestimation of the effective social capital, and the poor results of the state-owned enterprises, which are the main infrastructure providers in these fields, are considered to be particularly worrying. Further, the poor condition of infrastructure is directly responsible for the low efficiency with which Romania can deliver its goods and connect the producers with consumers, compared to its main trading partners. This is supported by the statistical data published by Eurostat, if we consider the Romania’s ranking on the 5th position among the member states (after Estonia, Latvia, Poland and Sweden) in terms of the share of public investment of GDP, respectively on the first place concerning the average of the share of public investment in total budget revenues over the same time period, while the infrastructure quality places our country on the last position within the same group of countries.

Figure 31 shows for all EU member states, the correlation between the average of the last 10 years of the share of investment in GDP and the index of road transport infrastructure efficiency for 2018. Countries are grouped according to the median of the ratio between the share of investment expenditures of GDP over the period 2009-2018 and the road transport infrastructure efficiency index, reported for 2018. In countries where this ratio is above the median (characterized by a high efficiency of investment expenditures relative to the quality of the resulting infrastructure and represented in blue), respectively in countries with a rate equal or less than the median, characterized by a lower efficiency of investment expenditures relative to infrastructure quality (represented in red). It is worth mentioning Romania’s placement in this latter group of countries on a position suggesting that from this perspective, the investment expenditures related to the quality of infrastructure have the lowest efficiency in the EU.

According to the 2018 Global Competitiveness Report Romania is ranked on 58th position (out of 140 countries) in terms of transport infrastructure quality, respectively on 113th position regarding the quality of roads. Compared with the assessment in the previous year, Romania has registered a relative stagnation on the global competitiveness indicator (the same 52nd place, but out of a higher number of countries, being placed after Bulgaria). A major part of the indicators which compose the

85 Measured by Logistic Performance Index (LPI), which, according to 2018 LPI Report developed by WB is well below that of Germany, Italy and France. Thus, compared with the previous report (from 2016), since 2018 Romania has raised 7 positions in LPI ranking for infrastructure, placing on 51st position, but at a great distance from Germany occupying the 1st place, France-13th place and Italy-19th place in the ranking.
87 This sub-indicator is part of the composite transport infrastructure indicator that is part of the Infrastructure Pillar. The transport infrastructure sub-indicator is composed of the infrastructures: 1. roads (the score being calculated by aggregating the connectivity and quality sub-components); 2. the railway; 3. the airway and 4. the seaways. Starting with 2018, the score for the transport infrastructure of each country is calculated as a percentage against a maximum of 100%.
88 A slight progress compared to the assessment in the 2017 Global Competitiveness Report (120th place/137).
Infrastructure Pillar in the edition from this year of Global Competitiveness Report is new compared with the previous year’s edition (when this was assessed from less components, Romania being placed on 103rd position out of 137 states) and contains sub-indicators which places our country on a better position at aggregate level, respectively, on the 55th position out of 140 countries (a newly introduced indicator into Infrastructure Pillar is electrification ratio which places our country on the first position with a 100% ratio) or on others leading positions for sub-indicators regarding the quality of drinking water). Compared with EU member states we maintain on the last position in terms of overall quality infrastructure (especially that of road transport), which proves a very poor capacity to spending in an adequate manner the funds for public investments. Moreover, over the last two years, the share of public investments in GDP and in budgetary revenues significantly decreased compared with the average over the last 10 years: thus, compared to an average in the last 10 years of 4.5% of GDP, in 2017 and 2018 were allocated 2.6% of GDP, respectively compared to a 10 years average of 13.6% of GDP for the share of investments in budgetary revenues, in 2017 this represented 8.4%, and only 8.1% in 2018, which is likely to further contribute to deepening the gap between the quality of infrastructure in Romania and in most EU countries in the coming years.

Source: EUROSTAT, World Competitiveness Report 2017 – 2018

For comparability with the situation of other new member states, Estonia is placed in the Global Competitiveness Report for 2018 on 38th position in terms of roads quality, respectively on 21nd position in terms of transport infrastructure quality, Poland is placed on 64th position, 28th respectively, Hungary is placed on 74th position, 64th respectively, Czech Republic is placed on the 68th position, 20th respectively, Slovakia is placed on the 67th position, 38th respectively and Slovenia is placed on the 41st positions for roads quality, 44th respectively for transport infrastructure quality. Bulgaria is placed on
the 90th position for roads quality (27 places far from Romania), respectively 64th position for quality of transport infrastructure, although the investments allocation as share of GDP as average of the last 10 years are well below Romania (3.9% of GDP, respectively 10.9% of budget revenues).

In the case of Romania, there are high efficiency reserves regarding the use of public funds allocated to investments and the Government had initiated during 2013-March 2014 a reform of the public investment management. In this respect, it was signed a technical assistance contract with the World Bank for the project “Improvement of Public Investment Management”, aiming at improving the process of preparation, selection and strategic prioritization of the public investments projects, that ended in December 2015, and in 2016 the recommendations for improving the selection process of the investment projects and strengthening the role of the Public Investment Unit were implemented (GEO no. 88/2013 and GD no. 225/2014). Starting with 2017 are in force the provisions of the Decision no. 907/2016 regarding the elaboration phases and the framework content of the technical and economic documentation related to the objectives/projects financed by public funds in order to eliminate the deficiencies noted in the investment process, to optimize the financing and achievement of the investment objectives and to increase the efficiency of the use of public funds. The Decision no. 363/2018 for modification and completion of the methodological Norms regarding the prioritization of public investment projects, approved by Government Decision no. 225/2014, new clarifications have been added to the procedure for prioritizing new investments.

Also, in November was issued GEO no. 100/2018 regarding the general frame applicable to the sovereign development and investment funds, which clarifies the way of establishing them in accordance with the Law no. 31 of commercial societies.

Concerning transparency, we mention that until 2016 inclusive, on the website of MPF is a list of large infrastructure projects of over 100 million lei, monitored by a MPF profile unit. However, as in 2017 also in 2018 this list is no longer public, which suggests that the reform of public investment management has reached a deadlock, the ability to develop and prioritize major investment projects proving to be quite limited. Only infrastructure projects carried out in cooperation with the European Investment Bank are submitted to the EC for approval, but also their implementation is long delayed.

Moreover, as highlighted in the Country Report for 2018 (published in February 2019) it is considered that often changes of fiscal policy, the failure of systematically using the assessment tools for determining the legislative impact, poor strategic planning investments, delays in the recent reforms

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89 In accordance with the requirements of the new legal framework, prior to approving the budget, the MPF is obliged to present to the Government the list of prioritized significant public investment projects to be financed through the state budget, which are selected according to opportunity, economic and social justification, financial affordability, period remaining until the completion, Romania’s commitments to international financial institutions.

90 Modified in 2015 to align the process of prioritizing significant projects with the budget timetable.

91 The main policy recommendation concerning the ex-post revision of the PIM project with the WB is the introduction of a reporting system for the investment programs at local and central level.
and reversal of the reform\textsuperscript{92} regarding corporate governance in state-owned companies constitute real impediments to the investment growth. Among the reasons for not realizing investment projects are included: the inefficiencies in public administration and public acquisitions, the lack of predictability for legislation and the lack of timely and efficient consultation of stakeholders, by promoting, through emergency ordinances, measures of great impact on the private environment. Otherwise, EC noted that in terms of transparency is registered a regress in 2018, noting delays in publishing the Report of MPF regarding the state-owned companies. The EC’s report highlights also that the draft law on the establishment of the Sovereign Fund of Development and Investment does not clearly set the impact of including those 30 state-owned companies and seems to exclude this funds both from the application field of the Law no. 111/2016 regarding the Corporate Governance of the public enterprises and from the consolidated budget. And as regard the Master Plan of General Transport of Romania adopted in 2016, which represented an important step towards improving strategic investment in road and rail infrastructures, the performances are slow up to date.

The investment expenditure’s evolution from 2012-2018, illustrates that it was maintained the under-execution pattern of investment spending compared with the initial annual planning, which reflects not only an easy way to achieve fiscal consolidation, but also an administrative inability to perform the planned investment projects funded through non-reimbursable EU funds.

The Fiscal Council advocates for the effective application of the legal framework of the public investment management and notes that some progress has been made regarding the reform in this area, but decisive steps are needed further in order to increase the transparency of the prioritization process and the efficiency of the allocation and spending process of public money for the achievement of public investments.

\textbf{III.4.4. The contingency reserve fund and the intervention fund at Government’s disposal}

According to the Public Finance Law no. 500/2002, article 30 para. (2), the contingency reserve fund at the Government’s disposal is allocated to main authorizing officer 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.

\textsuperscript{92} Law no.111/2016 on Corporate Governance was de facto canceled in December 2017 by a Parliament amendment which provides for derogation for almost 100 companies, including the largest state-owned enterprises.
Also, we draw again attention to the emergency ordinances issued by the Government which established 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. Similar to the previous years, also in 2018 were issued derogations from art. 30, paragraph (2) of Law no. 500/2002 regarding public finances, repeatedly supplementing the expenditures of main authorizing officers from the reserved fund at Government’s disposal. Thus, the Law no. 2/2018 of the state budget for 2018 allowed allocations from the budgetary reserve fund at Government’s disposal towards the Ministry of Regional Development and Public Administration, Ministry of Internal Affairs and Ministry of Communications and Information Society. The GEO no. 101/2018 regarding the revision of the state budget for 2018 and the GEO no. 102/2018 regarding the revision of the state social security budget for 2018 allowed allocations from the budgetary reserve fund by derogation from the provisions of art. 30, paragraph (2) of the Law no. 500/2002 to the main authorizing officers of state budget for providing social assistance rights of amounts foreseen in enforceable titles having as object the granting of some personnel salary rights, as well as for supplementing the transfers from the state budget to the state social security budget.

In addition to these emergency ordinances, a large number of government decisions issued over the year have established the use of the budget reserve fund to the Government’s disposal by derogation from the provisions of art. 30, paragraph (2) of the Law no. 500/2002 for:

- Financing the National Program for Local Development, first and second stage;
- Supporting the system of child’s protection and the public centers for adult persons with disabilities;
- Granting rights of salary nature that have become enforceable;
- Investment expenditure (Maramureș International Airport, video monitoring system in Sibiu);
- Payment of current and capital expenditures for some administrative-territorial units;
- Supporting the activities of the cults, the Elie Wiesel National Institute for the Study of the Holocaust in Romania;
- Ensuring the continuity of the public service of thermal energy supply;
- Ensuring the amounts related to the public government debt;
- Purchase of vehicles, space rentals, establishment of institutions, financing expenditure regarding the representation and protocol activities, etc.

These above mentioned expenditures can not be considered unforeseen and should have been taken into account when substantiating the state budget.

93 To finance the National Program of Local Development, including the second stage.
94 For centralized purchase of special vehicles/ambulances for the Emergency Mobil Service, Resuscitation and Extrication.
95 For the enforcement of court’s decisions concerning the Contract for the supply of products no. 37/30th April 2013.
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 for the year 2017 published in March 2019, identified the following issues regarding the allocations from the reserve fund:

- The initial budgetary provisions of the Budget Reserve Fund (BRF) were increased by 6.25 times during the fiscal year, both on the basis of the budget revisions and on the basis of the renunciations of the main authorizing officers for some budgetary credits approved by the annual budgetary laws, as well as from the unused amounts allocated through GD;
- The under-evaluation of the necessary budgetary credits in the initial moment of drafting the budgets of the main authorizing officers which subsequently led to the need of using resources from the contingency reserve fund available to the Government;
- 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 96.3% of the total amount allocated), as well as the violation of art. 54, paragraph (10) of the Law no. 500/2002 by constituting the BRF from the amounts deriving from the renunciations of the main budgetary authorizing officers, especially in November and December.

At the local and central level, the allocations from the BRF mainly concerned foreseeable expenses (the provision of the public heating service, certain local or international events whose occurrences were certain) and spending generated by the underestimations of the budgetary credits needed at the moment of drafting main authorizing officers’ budget96 (ensuring the payment of the rights of insurance and social assistance from the pension public system, personnel expenditure).

As a result of its findings, the Court of Accounts has recommended to the Ministry of Public Finance:

- Carrying out an analysis at the level of each main authorizing officer which registers a deviation of more than 10% from the initial provisions, in order to identify the elements that determined this level of deviation and, to take, as appropriate, the necessary measures to correct the programming deficiencies, including the analysis of the prospect of implementing a sanctioning system;

96 For 24 main authorizing officers, representing 387% of the number of the state budget main authorizing officers, the percentual deviation between the initial estimations and the actual payments exceeded 10%, which indicates a rather low level of budget programming accuracy.
• The reduction or elimination of the derogations from the rules on the allocation of resources from the Reserve Fund at the disposal of the Government, stipulated in art. 30 par. (2) of the Public Finance Law no. 500/2002, with the subsequent modifications and completions, aiming at "providing funds only for expenditures that justify urgency or unforeseen character occurring during the budget year, for which immediate financing is required and for which the funds existing in the budgets of the main authorizing officers are insufficient in relation to their destination, for reasons beyond their will".

This report studies the use of the contingency reserve fund at the Government’s disposal during 2018, based on the Government decisions published in Romania’s Official Journal by which are allocated amounts to main authorizing officers and to specific destinations.

In 2018, were allocated from the contingency reserve fund 2636.1 million lei (0.8% of the total spending, 0.3% of GDP respectively), of which bot 1444.3 million lei to the central administration and 11192.8 million lei to the local authorities. Compared to the previous year, the reserve fund allocations increased by 1906.7 million lei, respectively by 261% of GDP, on the account of the increase in transfers to the central administration of 1283.5 million lei, while the amounts forwarded to the local authorities have increased by 623.2 million lei (basically, they doubled compared with the previous year). The year 2018, registered the second highest level of use of the reserve fund in the analyzed period, the allocated amounts being over than those registered during the period 2009-2017, representing 65.5% of the peak reached in 2008 and being higher by over 50% than the average of the period 2007-2017 (see Figure 32).

Figure 32: Total contingency reserve fund allocations (billion lei)

Source: Fiscal Council’s calculations based on Government decisions regarding the contingency reserve fund allocations
In 2018, in terms of the number of Government decisions adopted for the purpose of allocating amounts from the reserve fund, there can be noticed a significant increased from 22 Government decisions in 2017 to 36 in 2018, this level being much lower than the one recorded during 2007-2011 and close to the one during 2012-2013 (see Figure 33). Also, it is notable that the tendency of the preceding years to decide most spending from the contingency reserve fund in the last month of the years was maintained, 14 out of 36 Government decisions being approved in December 2018, amounting 1200.8 million lei, representing 45.6% of the allocations for 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 33: Number of Government decisions regarding contingency reserve fund allocations](image)

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

From the perspective of the destinations for the allocations from the contingency reserve Fund at the Government’s disposal, in 2018, they were directly in percentage of 54.8% of the total to the central authority, and 45.2% to the local authorities. At the level of central administration the main beneficiaries were: the Ministry of Regional Development and Public Administration that received 30.3% of the total amount allocated from the budgetary reserve fund at local and central level, the Ministry of Internal Affairs that received 6.2% of the total amount allocated from the reserved fund, the Ministry of Justice (5.6% of the total) and Ministry of Public Finance that received 4.3% of the total allocations from reserve fund.

97 Accordingly, in the amount of 800 million lei, representing over 55% of the amounts allocated to the central authority in 2018.
Comparing the destinations’ shares of the amounts allocated from the reserve fund in the last two years (see Figure 34) it can be observed that the main beneficiary in 2018 is represented by the central authority which received 1443.3 million lei (9 times more than in 2017), while the local authority benefited of 1191.8 million lei (+ 110% compared with the previous year). In contrast, in 2017 the reserve funds were mostly directed to the administrative-territorial units which received 568.6 million lei (779% of the total), the central authority benefiting from allocations from the reserve fund amounting 160.9 million lei (22.1% of the total).

Based on the analyses elaborated in previous years, regarding the manner of using the amounts from the contingency reserve fund, the Fiscal Council revealed 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 and formulated strong recommendations regarding amending the legislation that regulates the contingency reserve fund use. The Fiscal Council notes, however, in 2018, a decline compared with the previous year regarding the manner of using the amounts from the reserve fund.

Considering the international best practices in this field and the Court of Accounts conclusions, the Fiscal Council considers as absolutely necessary the implementation of urgent measures to amend the legislation that regulates the contingency reserve fund use, reiterating the recommendation on the explicit identification of expenditure that can be made from the contingency reserve fund and a higher

Source: Fiscal Council’s calculations based on Government decisions regarding the contingency reserve fund allocations
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 recommends 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 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 2018, the amounts allocated from the intervention reserve fund at Government’s disposal amounted 515.7 million lei (6 times more than in 2017), their destinations being in accordance with the Public Finance Law no. 500/2002.

### III.5. The public debt

The interest expenses, expressed in cash terms registered a significant growth in 2018 compared to the previous year (+2.8 billion lei, respectively, by almost +28%) and, in the conditions of a 10.2% nominal GDP advance, their share in GDP increased from 1.2% to 1.4%. This development arises in the context of an acceleration in the stock of debt, from 5.5% in 2017 to 9.6% in 2018. To be noted that the final value of this expenditure chapter was higher by 0.8 billion lei compared to the projection in the initial budget (by about +7%, the update of the estimated level being done at the second revision), suggesting an under-valuation of this budgetary aggregate at the moment of drafting the budget.

The public debt increased in 2018 by 9.6% (+28.9 billion lei), according to ESA 2010 methodology, but its share in GDP registered a slight decrease, from to 35.2% to 35.0% compared to previous year, as a result of the 10.2% economic growth, in nominal terms. On the other hand, according to national standards, the public debt increased with more than 32 billion lei (8.8%) while its share in GDP diminished from 43% of GDP at the end of 2017, to 42.6% in 2018.

The average interest rate paid on public debt stopped its downward trend manifested in the previous years, staying at 3.8%, similar to 2017. This development may look surprising, in the context of significant increase in the interest spending, in national standards. However, it should be noted that according to ESA 2010 methodology, interest spending increased by only 0.5 billion lei (+4.7%) as compared to the previous year. The considerable difference between the results of the two approaches can be explained by the differential treatment of issuance premiums related to the
renewal of previous government bond issuances that are fully included in the amount of the interest spending according to cash standards, while the ESA2010 methodology gradually amortize them over the life of the loan.

### Figure 35: The evolution of financing costs in national currency in the period 2014-2018

Source: NBR

The cost of attracting new resources in national currency registered a positive development in 2014 - 2016, due to the inclusion, starting with July 2014, of the bonds issued by the Romanian state in the calculation of the GBI-EM Global Diversified index series by JP Morgan, the extension of the average maturity of public debt, a loose monetary policy measures of the central bank, the obtainment of a BBB- rating from Standard & Poor's in May 201498, but also due to a liquidity surplus in the financial markets. On the other hand, the year 2017 marked a reversal of this trend by recording increases in the cost of attracting new resources in national currency, this trend even accelerated in 2018 due to the high inflation rate. The increase in the cost of attracting new resources, for all maturities, compared to 2017 (see Figure 35), was significant in the case of short-term maturities (the highest +2.4 pp for new loans of 6 months maturities) compared to long-term loans (the lowest increase of 0.6 pp being recorded for loans with a maturity between 7 and 10 years).

A similar development was noticed regarding the cost of attracting new resources in foreign currency from the external markets99, with government bond yields of 2.6% and 3% for maturities of 10 to 12

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98 Some investors have restrictions on investing in sovereign debt of countries that are not classified in the category of those recommended for investment.

99 During the year 2018, Romania attracted financing from the foreign markets through two Eurobond issues in February and October, with a total value of EUR 3.75 billion (maturities of 11, 12, 20 and 21) respectively through a 1.2 billion dollars issuance of 30-year maturity in June 2018.
years (compared with 2.1%, respectively 2.4% in 2017), of 3.5% and 4.2% for maturities of 20-21 years (compared with 3.6% in 2017) and 5.2% for maturity of 30 years.

Regarding the structure of the public debt, in 2018 the share of the central administration debt (96% of the total) and of the local public debt (4% of the total) remained at a level close to that recorded in the previous year. Government bonds strengthened their position as the main public debt instrument, accounting for 41.1% of the total public debt financing (compared with 37.2% in 2017), followed by euro-bonds by 28.9% (compared with 27.1% in 2017), while the other categories of instruments registered declining shares as follows: state loans (14.9% from 18.4% in 2017), state loans from the General Treasury account (14% from 14.9% in 2017) and treasury bills (1% from 2.4% in 2017).

The currency structure of the public debt shows a slight increase in the share of national currency loans from 54.4% in 2017 to 55.8% in 2018 (taking into account the 42.9 billion lei to be attracted through issuances in the domestic market), and for the dollar-denominated loans from 6.7% in 2017 to 7.3% in 2018 (backed by a 1.2 billion dollar bond issuance in June 2018). On the other hand, although new euro-denominated loans were attracted due to issuances both on the domestic market (0.6 billion euro) and on the external one (3.75 billion euro), their share in the total government debt registering a slight decrease from 38.3% in 2017 to 36.4% in 2018.

Relating to the maturity structure of government securities newly issued in 2018, the trend of attracting longer-terms resources initiated in the last years continued even more accentuated. Therefore, the treasury bills with maturities lower than 1-year totaled 10.7% din of new loans in 2018, a significant decrease compared to the share of 27.3% recorded in 2017. Therefore, the share of funding over longer periods has advanced compared to the period 2009-2012 (the share of treasury bills with maturities lower than 1 year totaled 65% of new loans in 2009). The bonds with maturities of 1 to 5 years have a share of 54.6% in total issued securities in 2018 (a significant increase compared to 44% in 2017), those with a maturity of 5 to 10 years have a share of 25% in 2018 (compared with 23.9% in 2017), while those over 10 years have a share of 9.7% in 2018 (a significant advance from 4.8% in 2017).

However, it should be noted that, due to the trend of attracting resources for longer periods, the residual average maturity of government securities issued on the domestic market increased from 3.7 years in 2017 to 4.6 years in 2018. It may be noted that the preference for borrowing on a longer-term allows a reduction in the public debt vulnerability against the short-term interest rate developments as well as to any difficulties encountered in the process of refinancing the outstanding debt.

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

\[
\frac{d_t}{y_t} = (1 + \lambda_t) \times \frac{d_{t-1}}{y_{t-1}} + \frac{pb_t}{y_t} + sf a_t
\]

100 According to the national methodology.
Where \( d_t \) is public debt stock at time \( t \), \( y_t \) represents nominal GDP at time \( t \), \( pb_t \) – is primary deficit at time \( t \), \( sfa_t \)- stock-flow adjustments at time \( t \), and

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

where \( y_t \)- real GDP growth rate during time \( t \), \( i_t \) – interest rate at time \( t \) and \( \pi_t \)- inflation rate at time \( t \).

The above relationship shows that public debt as share of GDP at time \( t \) depends on its weight in the previous period adjusted by the difference between the real interest rate and the economic growth rate, plus the consolidated general budget primary deficit expressed as percentage of GDP. In case of a real economic growth rate higher than the real interest rate for the public debt, the latter, expressed as a percentage of GDP, will have a downward trend even when the primary deficit equals to 0. It is therefore possible to reduce public debt as share of GDP even when the primary balance registers a primary surplus lower than the interest expenditure provided that the real economic growth is higher than the real interest rate of public debt. The coefficient \( \lambda_t \) can be seen as a real interest rate adjusted by the economic growth.

The year 2018 marked a small decrease in the share of public debt as a percentage of GDP, respectively, by -0.2 pp. Using the dynamic equation presented above, a number of contributions can be identified. In the sense of reducing the government debt ratio in GDP we mention the contribution of the real economic growth (-1.4 pp) and of the real interest rate (-0.8 pp), while the primary deficit (+1.8 pp) and stock-flow adjustments (+0.2 pp) contributed to the increase of the share of public debt in GDP. As for the stock-flow adjustments, although of a small size, it is the result of several significant factors that have acted in opposite ways. Thus, the ex-post disbursement of EU-funded projects with non-EU funding (as ESA methodology recognize only the projects related to the fiscal year 2018), the continuation of paying super-dividends by the state-owned companies from the accumulated reserves (which is assimilated to a disinvestment according to ESA methodology), the postponement of the pollution tax refund until June 30, 2019, as well as the late payment of the final court decisions regarding wage differences in education, have acted in the sense of diminishing the public debt ratio to GDP. On the other hand, the purchase of military equipment with prepayment (which will be recognized according to ESA methodology at the delivery of equipment), higher interest spending due to the resumption of older government bonds (the issuance premiums are gradually amortized according to ESA methodology), together with the next month’s registering of VAT and CAS revenues related to the current month have contributed to the increase of the government debt ratio in GDP.

It should be noted that similar to last year, the economic advance registered in 2018 (4.1%) have overlapped with a negative real interest rate (-2.4 % due to high inflation rate), which led to a negative value for the coefficient \( \lambda_t \) and implicitly to a favorable impact to the dynamics of the government debt expressed as a percentage of GDP. Concluding, the negative impact of the higher budget deficit (3% from 2.7% in 2017) and the stock -flow adjustments on the public debt path was overshadowed by the real economic growth rate coupled with a negative real interest rate.
For the estimation of the determinant factors’ contributions to the changes in the public debt ratio to GDP in the period 2019-2022, the official EC forecasts for real GDP growth, the budget deficit as a share in GDP and the GDP deflator were used\textsuperscript{101}. As the EC does not make projections of the interest spending for the government debt, the estimates for this indicator have been taken from the Convergence Program 2019-2022, while the stock-flow adjustments were assumed to be zero. Thus, on the basis of the EC forecasts, a gradual advance of the public debt ratio is projected during the period 2018-2021, from 35% of GDP in 2018 to 42.1% of GDP in 2022. It should be noted that this evolution is based on the economic growth rates projected by the EC which are significantly lower than those predicted by the Government (an average spread over 2 pp), while the budget deficits assessed by the EC are at a higher level than those laid down in the Convergence Program (an average difference of almost 2 pp for 2020). Thus, the estimates for 2019 in the Convergence Program provide an economic advance of 5.5% and a budget deficit of 2.8% of GDP, while the EC forecast is anticipating an economic growth of just 3.3%, accompanied by a budget deficit of 3.5% of GDP that would exceed the 3% benchmark set in the corrective arm of the SGP. Although the Convergence Program foresees a moderate fiscal consolidation in 2019-2022 (totaling 1 pp of GDP), it is not accompanied by concrete measures to support it. In the absence of such measures, the budget deficits for the period 2021-2022 not covered by the EC forecast were assumed at the level of 2020. On the other hand, the EC forecast foresees much higher levels of GDP deflator compared to the government estimates, leading to a negative real interest rates that partially mitigate the public debt advance. In conclusion, the

\textsuperscript{101} Spring forecast of May 2019. As the forecast horizon for EC is for only 2 years, for 2021 and 2022, the projected values for 2020 were maintained.
projections for the evolution of the government debt ratio in GDP for the 2019-2022 horizon, based on the 2019 EC Spring Forecast, show a gradual increase of this indicator, especially starting 2020 (see Figure 36). In terms of the contribution of the determinant factors, the upward trajectory is driven by high budget deficits, while real economic growth rate and negative real interest rates have a favorable impact.

The above results depend to a large extent on the forecasts used for the real interest rate and for the real GDP growth rate. A higher-than-expected real interest rate would involve additional costs for public debt financing and may lead to an increased public debt as share of GDP. Furthermore, a lower economic growth rate may cause an increase in the public debt ratio to GDP compared to the initial forecasts. Considering the uncertainty associated to the forecasts, a sensitivity analysis is appropriate in order to assess the impact of changes in the variables used for assessing the development of the public debt.

For the construction of the scenarios we used the MPF projections from the Convergence Program 2019-2022 and the 2019 EC Spring Forecast. Thus, there are two baseline scenarios: one based on EC forecast, as described in the previous paragraphs, in which the EC’s projections for the budget deficit, economic growth and GDP deflator were used (for the years 2021-2022, not covered by the EC forecast, the same values were assumed as in 2020), and the other, the MPF scenario based exclusively on the forecasts made under the Convergence Program 2019-2022. Thus, if the EC scenario foresees a gradual increase of the government debt to GDP ratio up to 42.1%, the MPF scenario estimates a gradual decrease of the indicator to 34.5% of GDP. The difference of more than 7 pp between the two underlying scenarios has as main sources the higher budget deficits projected by the EC compared to those anticipated by MPF, as well as the lower economic growth predicted by the EC compared to MPF. On the other hand, as mentioned above, the EC forecast provides higher levels of GDP deflator compared to MPF estimates, which is likely to further mitigate the gap between the two projections. These differences clearly show both the sensitivity of the public debt path to the assumptions used and the increasing risks to the evolution of the public indebtedness.

Starting from the baseline scenario built with EC data - also taking into account the Fiscal Council’s budget deficits estimates for the following period, which are closer to the EC’s ones - several scenarios were built (see Figure 37):

- two optimistic scenarios, characterized by an economic growth higher than the initially projected by 1 pp, adding to the second scenario a lower real interest rate by 1 pp. It is interesting to note that although these assumptions are optimistic, both scenarios anticipate an increasing trajectory of the indicator, at the end of the forecast horizon reaching 40.9% of GDP for the first scenario, respectively of 39.5% of GDP for the second scenario
- two pessimistic scenarios. For the first one the real GDP growth rate is lower by 1 pp, and for the other scenario was added a real interest rate higher by 1 pp. Both scenarios show an increasing trend starting 2019, at the end of the forecast horizon, the public debt reaching 43.4% for the first scenario, respectively, 44.9% of GDP for the second one.
It should be noted that compared to the baseline EC scenario and the four alternative scenarios elaborated, only the MPF forecast provides a downward trajectory of public debt. Moreover, even in the most optimistic scenario, the projected public debt for 2022 is by 5 pp higher than the MPF estimates. On the other hand, additional risks to the scenarios under consideration arise from potential negative exchange rate shocks, given the relatively high share of public debt denominated in foreign currencies. However, even all scenarios shows that the 45% threshold of the public debt in GDP, defined by the FRL, is not exceeded, it is worrying that in the case of the pessimistic scenario with an unfavorable evolution for the economic growth and real interest rate, the projected debt level for 2022 is closed to the threshold (44.9% in GDP).

![Figure 37: Scenarios for the evolution of public debt (% of GDP)](image)

Source: EC, MPF, Fiscal Council’s calculations

FRL was amended by the end of 2013, one of the changes being the introduction of some thresholds for public debt triggering government action. Thus, if the public debt exceeds 45% of GDP, MPF draws up a report on the justification of the debt increase and presents proposals for maintaining this indicator at a sustainable level; if the debt ratio exceeds 50% of GDP, the Government is freezing public sector wages and possibly adopts additional debt relief measures; if the indicator is higher than 55%, the social assistance costs in the public system also automatically freeze. All these new provisions are aimed at preventing a situation where public debt would exceed the 60% of GDP threshold stipulated in the Maastricht Treaty.

Furthermore, an additional constraint is related to the relatively high size of public debt as compared to the domestic financial sector and its most likely limited absorption capacity of an additional public
debt stock at the current financial intermediation level. Thus, at the end of 2018, the share of Romania’s public debt in total banking assets was about 68% (from 65% in 2017), while the exposures to the government sector compared to total assets for local banks (the main holder of public debt on the domestic market) reached 20% (from 19% in 2017), both indicators being among the highest in the EU.

The outcome of such situation is most likely an increased dependence on non-resident investors, which is associated with an increasing vulnerability to interest shocks and changes in risk appetite in the global financial markets as well as a possible sovereign rating alteration.

The Fiscal Council considers that the current trajectory of the government debt ratio in GDP may lead to the accumulation of excessive vulnerabilities that would become fully visible in a future downward phase of the economic cycle. In this respect, a prudent behavior is recommended by using of the current favorable economic climate to reduce indebtedness. Even if the growth in public debt as a percentage of GDP is largely concealed by the high GDP growth, as well as by negative real interest rates (in the context of high inflation rates), the vulnerabilities associated with public debt have the potential to be quickly unveiled in the context of adverse cyclical developments. In addition, the continuing growth of public debt above 40% of GDP may become problematic at the current level of development of the economy and its limited absorption capacity by the local financial markets.
IV. The absorption of EU funds

In the 2014-2020 financial framework, as highlighted by the data provided by the Ministry of European Funds (MEF)\textsuperscript{102}, Romania has been allocated European structural and investment funds (ESIF) of about 31 billion euro. A key component 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\textsuperscript{103} 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 to six operational programs: 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), but in October 2018 the Regional OP was expanded by including the SME Initiative. At the same time, in order to better adapt to the economic and social circumstances, 72.5 million euro, granted within the Regional OP, were reallocated for the acquisition of ambulances and medical equipment\textsuperscript{104}.

In addition to the funds related to EU cohesion policy, 19.4 billion euro were allocated for the Common Agricultural Policy\textsuperscript{105}, 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). Including the funds granted for Cross-border Co-operation, as well as those from the Connecting Europe Facility (CEF) instrument, Romania has more than 43 billion euro available under the Multi-Annual Financial Framework 2014-2020. Since the analyzes carried out by MEF and EC include the funding provided through NRDP and OPFMA, \textit{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 ensuring consistency and an improved coordination that simplifies access to ESIF\textsuperscript{106}. The total budget for the 2014-202 cohesion policy is set at approximately 355 billion euro and more than half of this budget (about 53%) is allocated to the group of new EU Member States from Central and Eastern Europe: Bulgaria, the Czech Republic, Croatia, Estonia, Latvia, Lithuania, Poland, Romania, Slovakia, Slovenia

\textsuperscript{102} According to the absorption report for ESIF funded programs on February 1, 2019.
\textsuperscript{103} The Cohesion Fund (CF), the European Regional Development Fund (ERDF) and the European Social Fund (ESF).
\textsuperscript{104} \url{https://ec.europa.eu/romania/news/20181017_modificare_program_operational_regional_utilizare_fonduri_ue_romania_ro}.
\textsuperscript{105} Representing the amount of funding provided through the National Rural Development Program (NRDP) and the European Agricultural Guarantee Fund (EAGF).
\textsuperscript{106} ESIF 2014-2020: official texts and comments.
and Hungary. 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 18.78 billion euro, and Table 12 shows the allotment of funds for each operational program during the two programming periods. It may be noted that, except for the Competitiveness OP, all the other operational programs benefited from increases in the allocated funds, the most important ones being targeted at programs that recorded high absorption rates over the 2007-2013 financial framework.

<table>
<thead>
<tr>
<th>Total allocations 2014-2020</th>
<th>Total allocations 2007-2013</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Regional</strong></td>
<td>6.9</td>
</tr>
<tr>
<td><strong>Infrastructure</strong></td>
<td>9.2</td>
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<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td><strong>Competitiveness</strong></td>
<td>1.3</td>
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<td></td>
<td></td>
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<tr>
<td><strong>Human Capital</strong></td>
<td>4.4</td>
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<td></td>
<td></td>
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<tr>
<td><strong>Administrative Capacity</strong></td>
<td>0.6</td>
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<tr>
<td></td>
<td></td>
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<tr>
<td><strong>Technical Assistance</strong></td>
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<tr>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>22.6</td>
</tr>
<tr>
<td></td>
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</tr>
</tbody>
</table>

Source: EC, MEF

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) which transposes the EU’s overall objectives into national targets, taking into account its specific economic circumstances. The NRP is transmitted together with the Stability and Convergence Program, both documents being integrated into the national budgetary plans for the next three years. The NRP contains the policies and measures proposed to promote sustainable and inclusive growth, high levels of employment and the achievement of the Europe 2020 objectives.

In the 2018 NRP, submitted by Romania to EC in April 2018, reforms and development priorities were defined taking into account the conclusions of the 2018 Annual Growth Survey, of the 2017 Country Specific Recommendations and of the 2018 Country Report for Romania. Thus, the 2018 NRP defines a set of policies to respond to economic challenges from the fiscal-budgetary sphere (focusing on measures to improve public investment management, to streamline budgetary spending, to improve tax collection and to ensure financial stability), from the public administration sphere (with emphasis on measures to continue the decentralization process, to strengthen transparency and participatory

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107 A detailed presentation of the funds allocated to each country, together with their respective absorption rates, can be found in Table 14.
governance, to improve staff skills and professionalism, to increase the absorption of European funds, to reduce and prevent corruption at all administrative levels) and from the business environment (focusing on measures to stimulate investments, to support sectors with growth potential and to improve the performance of state-owned enterprises). In what concerns the achievement of national targets established under the Europe 2020 strategy, the 2018 NRP sets out the main reform directions, such as: modernizing labor market institutions, adapting to labor market changes and socio-economic integration of young people (the employment objective); stimulating private investment in research, development and innovation and providing a high-quality scientific base (the research, development and innovation objective); supporting sustainable development and environmental quality, mitigating the effects of climate change and reducing greenhouse gas emissions (the environment and climate change objective); financing investments aimed at the use of renewable energy sources (the renewable energy objective); the increase of energy efficiency and modernization of urban heating systems (the energy efficiency objective); increasing the quality of pre-university education, upgrading school curricula, expanding prevention and intervention measures concerning pupils with risk of early school leaving and improving educational infrastructure (the early school leaving objective); increasing the quality of higher education and its correlation with the labor market and promoting entrepreneurship education (the tertiary education objective); increasing the quality of life for the rural population, reducing poverty among the most deprived people and reforming the health system (the social inclusion and poverty alleviation objective). It is important to note that many priorities and development directions of the 2018 NRP are fully or partially financed by European funds, so that the absorption of these funds is a relevant indicator of the capacity to meet the proposed objectives.

Analyzing the data provided by the EC at the beginning of March 2019 (see Table 13), there is a significant improvement in the absorption capacity of European funds compared to April 2018. Thus, in less than one year, the absorption rate (including pre-financing) increased from 9.3% to 20.5% of the total funds allocated for the 2014-2020 programming period. The results recorded at the level of operational programs show that Technical Assistance OP (39.7% versus 22.6% in April 2018), Infrastructure OP (22.4% versus 13.2%) and Competitiveness OP (21.7% versus 10.5%) retained their top positions in absorption rates rankings, registering significant increases between April 2018 and March 2019. A slower evolution was recorded in the case of Administrative Capacity OP, its absorption rate advancing from 10.8% to 18%. On the other hand, it should be noted a significant reduction of the gap for operational programs that had very low absorption rates: Human Capital OP (19.7% versus 6.3%) and Regional OP (17.8% versus 4.2%, the result being also improved by the decision to include here the SME Initiative which had the highest absorption rate of 83.8%).


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 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.
According to the reports provided by MEF, 3.6 billion euro had been requested from the EC by February 1, 2019 for the following operational programs: Infrastructure OP (1,638.6 million euro), Regional OP (876.6 million euro), Human Capital OP (649.9 million euro), Competitiveness OP (226.2 million euro), Technical Assistance OP (94.3 million euro) and Administrative Capacity OP (71.7 million euro). Following the submission of payment applications, the EC made reimbursements of around 3.2 billion euro until the beginning of March 2019 and their breakdown by operational programs is also available in Table 13. Thus, it can be noted that the actual absorption rates (calculated by eliminating pre-financing) are approximately 6 pp lower on average compared to the ones that include pre-financing.

Table 14 presents an analysis of the situation in Romania compared to the other new EU Member States from Central and Eastern Europe, based on the data available at the beginning of March 2019. The majority of these states (including Romania) received a larger amount of structural and cohesion funds allocations for the 2014-2020 programming period in comparison to the previous financial framework, with the exception of the Czech Republic (21.5 billion euro compared to 26.5 billion euro), Hungary (21.5 billion euro compared to 24.9 billion euro), Latvia (4.4 billion euro compared to 4.5 billion euro) and Slovenia (3.1 billion euro compared to 4.1 billion euro). However, when computing
the allocations per inhabitant, Romania is positioned on the penultimate place with around 1,132 euro/inhabitant, just ahead of Bulgaria (1,024 euro/inhabitant). On the opposite side, seven of the eleven analyzed countries received allocations of over 2,000 euro per inhabitant, the highest values being recorded by Estonia (2,659 euro/inhabitant), Slovakia (2,526 euro/inhabitant), Lithuania (2,279 euro/inhabitant) and Latvia (2,208 euro/inhabitant). Compared with the 2007-2013 period, the Baltic States remained among the highest allocations per capita, Poland and Slovakia registered significant increases, while the Czech Republic, Slovenia and Hungary have suffered important reductions of this indicator.

Table 14: Absorption of structural funds for the 2014-2020 programing period – comparison with other EU member states

<table>
<thead>
<tr>
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</thead>
<tbody>
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<td>7.4</td>
<td>2.0</td>
<td>27.4</td>
<td>1,024.2</td>
<td>280.9</td>
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<td>18.4</td>
<td>1,989.4</td>
<td>366.7</td>
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<td>31.9</td>
<td>2,659.3</td>
<td>847.9</td>
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<td>1.1</td>
<td>23.8</td>
<td>2,207.5</td>
<td>525.7</td>
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<td>30.0</td>
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<td>683.2</td>
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<td>Poland</td>
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<td>28.9</td>
<td>2,022.3</td>
<td>583.7</td>
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<td>5.0</td>
<td>23.1</td>
<td>2,047.9</td>
<td>473.9</td>
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<tr>
<td>Romania</td>
<td>22.6</td>
<td>4.6</td>
<td>20.5</td>
<td>1,132.3</td>
<td>232.3</td>
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<tr>
<td>Slovakia</td>
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<td>21.5</td>
<td>7.0</td>
<td>32.5</td>
<td>2,181.2</td>
<td>708.8</td>
</tr>
</tbody>
</table>

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 recorded at the beginning of March 2019, Romania remains at the bottom of the ranking, occupying the penultimate position together with Slovenia, while Croatia, the newest member of the EU, continues to rank last with an absorption rate of 18.4%. All the other countries included in the analysis have absorption rates of more than 22.5%, the highest levels being recorded by Hungary (32.5%), Estonia (31.9%) and Lithuania (30%). Thus, although the absorption rate in Romania increased by 11.2 pp compared to April 2018, there is still an important gap in comparison with the majority of the states included in the analysis and stronger efforts are needed to recover it.

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110 Population on January 1, 2014 (the start of the 2014-2020 multi-annual financial framework), according to the data provided by Eurostat.
Analyzing the dynamics of the structural and cohesion fund absorption rates (see Figure 38), it can be noticed that the 2014-2020 financial framework had a difficult start, not only in Romania, but also across the EU member states. The legal framework for this period was finalized late by the EC, European Parliament and Member States, mainly affecting those countries which lack the experience and administrative capacity to recover delays. As in the case of the 2007-2013 financial framework, very low absorption rates were recorded in the early years, Romania being in the vicinity of the EU average. However, since 2016 Romania started to lag behind the EU average and the gap gradually increased until 2018. The data available at the beginning of March 2019 exhibits a slight narrowing of this gap, but its size continues to exceed 5 pp. Although data series are too short to allow for a robust extrapolation of future absorption rates, the evolution noted so far raises questions about the possibility of encountering difficulties in absorbing European funds, similar to the 2007-2013 financial framework.

In the 2019 Country Report, the EC appreciates that Romania is one of the main beneficiaries of European funds and accessing them can play an important role in implementing the recommendations addressed to the Romanian government. However, the operationalization of projects continues to be delayed in several sectors, so the implementation of specific key recommendations and related reforms is postponed significantly. Public administration reform is one of the main prerequisites for EU financial support and, aiming towards a more effective implementation of the cohesion policy, the EC has made a number of recommendations, including:

- the elimination of excessive bureaucratic requirements and an increased use of simplified cost options;

Source: EC, Fiscal Council’s calculations
- strengthening the capacity of managing authorities, intermediate bodies, final beneficiaries and other bodies working with EU funds in order to prepare and implement projects;
- the development and implementation of a roadmap for strengthening the administrative capacity needed to manage and effectively implement EU funds;
- improved measures to prevent and address conflicts of interest, fraud and corruption;
- improved performance in the area of public procurement, in particular by reducing the rate of "single bids" and the number of direct attributions.

The absorption of EU funds is a national interest objective and a solution for stimulating the economy which also generates positive social effects such as: reducing disparities between regions, poverty and social exclusion, improving the quality and relevance of the education system, developing a sustainable transport network and stimulating investments in infrastructure, improving water and waste management systems, promoting the competitiveness of firms as well as their research and innovation capacities etc. Given the slow start of the implementation of the 2014-2020 financial framework, coupled with a gradual deepening of the gap towards the EU average, further efforts are needed to increase the absorption rate of European funds. In this respect, the existence of a medium-term strategic planning that leads to a stable hierarchy of priorities and an increase in the administrative capacity to manage European funds is key to reviving the absorption rate. At the same time, increasing the transparency and efficiency of the public procurement system, coupled with a standardization of project selection mechanisms, are essential to the development of public investment.
V. The sustainability of public finances

V.1. Arrears of the general consolidated budget

The arrears of GCB\textsuperscript{111} to the private sector 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 2018, the amount of arrears stood at 192.6 million lei, decreasing by 115.8 million lei compared to the same period of the previous year, respectively a reduction of 38%.

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 have reached a level of 842 million lei at the end of 2018, representing an increase of 240.3 million lei (+40%) over the previous year. Compared to 2017, the increase in arrears was mainly located at the level of the social security budget (+250 million lei, relative to 0.95 million lei in December 2017), registered mainly in the last two months of 2018. The state budget recorded an increase of 38.6 million lei (+75%) in overdue payments with a delay of less than 90 days, offset by a 47.5 million lei reduction (-9%) at the level of local budgets, compared to December 2017.

The total outstanding payments of the GCB to private sector companies reached a level of 1017.7 million lei at the end of 2018, being higher by 207.4 million lei compared to the same period of the previous year. This development was mainly caused by the increase of overdue payments with a delay of less than 90 days (+238.5 million lei) which was partially offset by the reduction of arrears between 90 and 120 days (-17.6 million lei) and those over 360 days (-16.5 million lei).

Compared to the end of 2017, a significant reduction of 83.4 million lei can be observed for arrears of more than 360 days to other entities (from 87.5 million lei in December 2017 to 4.1 million lei in December 2018), located at the level of the social security budget (excluding hospitals), possibly as a result of implementing Order no. 3809/19.12.2018 for the approval of the methodological norms regarding the conclusion of the 2018 budget execution which overturned the negative effects generated by the application of Order no. 3315 / 22.12.2017\textsuperscript{113}.

\textsuperscript{111} 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.

\textsuperscript{112} The difference relative to total outstanding payments (1034.6 million lei, see Table 15) is represented by overdue payments to employees and other entities, as well as for interest and loans.

\textsuperscript{113} Order no. 3315/2017 for the approval of the methodological norms regarding the conclusion of the 2017 budget execution led to the impossibility of making payments in the Treasury after December 27, 2017. On the other hand, Order no. 3809/2018 extended the deadline until December 31, 2018 for payments by bank transfer to accounts opened at the Treasury, respectively until December 28 for cash payments, which could be paid on January 3, 2019 as payments recorded on December 31, 2019.
The sizeable reduction of GCB’s outstanding payments during the last 6 years (from 3.8 billion lei in 2012 to 0.2 billion lei in 2018) 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).

V.2. Tax collection in Romania – international comparisons

The ratio of budgetary revenues to GDP in Romania (tax and non-tax revenues) was 32% in 2018, according to ESA 2010 methodology, a level that is 13 pp lower than the EU average (45% of GDP) and among the lowest across EU Member States, second only to Ireland. The ratio of tax revenues to GDP (taxes and SSC) reached 26.7% in 2018, ranking Romania again on the penultimate place, with a gap of 13.2 pp towards the EU average of 39.9%. Analyzing these results in comparison to the previous year,
the gap towards the EU average shrank by 0.9 pp in the case of budgetary revenues (from 13.9 pp in 2017) and by 0.8 pp in the case of tax revenues (from 14 pp in 2017).

The share of tax revenues in GDP is significantly lower than in countries with similar economies such as Hungary (37.4%), Slovenia (36.7%), the Czech Republic and Poland (36%). Compared with Bulgaria, the share of budgetary revenues in GDP is lower by 4.8 pp, respectively by 2.8 pp in the case of tax revenues. In 2018, compared to 2015, the effect of the major changes brought by the new Tax Code, which caused an ample fiscal relaxation, led to a 3.4 pp reduction in the ratio of budgetary revenues to GDP (while the indicator increased by 0.4 pp across EU28), respectively to a 1.2 pp decrease in the ratio of tax revenues to GDP (while the indicator advanced by 0.5 pp across EU28).

![Figure 39: Budgetary and tax revenues in 2018 (% of GDP, ESA 2010)](image)

*Source: Eurostat*

*Note: Tax revenues include SSC.*

The structure of tax revenues in Romania in 2018 has changed significantly compared to previous years, 2018 being the first year in which the share of indirect taxes in total tax revenues is outpaced by that of SSC revenues (mainly due to the modification of the SSC regime through their transfer from employers to employees, as well as additional receipts from legal entities paid on the account of disabled persons which determined a significant increase of the SSC revenues). Although the share of indirect taxes in total tax revenues has decreased compared to the previous year\(^\text{114}\), it is still significantly higher than the European average (a 5.4 pp positive gap) with a level of 39% compared to 33.6% in the EU28. The share of SSC revenues in total tax revenues reached a level of 42.7% in 2018 (6.3 pp higher than in the previous year, respectively 9.4 pp above the EU28 average, Romania ranking on the fourth place across EU countries). On the other hand, the share of direct taxes in total tax

\(^{114}\) The share of indirect taxes in total tax revenues decreased by almost 1 pp; in 2017 their share in total tax revenues was 39.9% compared to the EU28 average of 33.7%.
revenues decreased to only 18.4% (compared to 23.7% in 2017, which brought the indicator 14.7 pp below the EU28 average) this revenue category being strongly affected by the reduction of personal income tax from 16% to 10%. Indirect taxes continue to be an important component of tax revenues in Romania, a characteristic which is typical to developing countries, their share in total tax revenues remaining significantly above the EU average (+ 5.4 pp), even if in 2018 it decreased compared to the previous year. The fiscal relaxation measures of the past four years, which led to the reduction of the standard VAT rate from 24% in 2015 to 19% in 2017, coupled with the extension of the reduced VAT rates, contributed to the significant reduction of the positive gap between Romania and the EU average, compared to the 2010-2015 period. The fiscal consolidation initiated in 2010, which aimed at raising indirect taxes, led to increasing their share in total tax revenues (from 43.9% in 2010 to 47.3% in 2015), while at EU level this indicator ranged from 33.6% to 33.9% during the same period. It can be assessed that indirect taxation is favorable to long-term economic growth while direct taxation has a more discouraging effect on engaging the production factors. In the 2016-2018 period, Romania witnessed a rapid tendency of reversing the share of indirect taxes in total tax revenues (from 42.6% in 2016, to 39.9% in 2017 and 39% in 2018), following the reduction of the VAT rate by 5 pp and the extension of the reduced VAT rates, but they still occupy an important place among budgetary revenues. The structure of budgetary revenues in Romania is mainly oriented towards indirect taxes and SSC revenues (together they amount to 81.6% of tax revenues), while, at European level, there is a tendency to balance the share of direct taxes, indirect taxes and SSC revenues. Many EU countries that recorded high weights of budgetary revenues in GDP also benefit from relatively high weights of direct taxes in total revenues.

In 2013 an ample reform process of the Romanian tax administration was launched, on May 8, 2013 being signed the Loan Agreement between Romania and the International Bank for Reconstruction and Development (IBRD) which amounted to 70 million euro that were intended to be used for the Revenue Administration Modernization Project (RAMP). Bulgaria has implemented a similar program for restructuring the tax administration between 2002 and 2008 and achieved very good results in increasing collection efficiency, reducing administrative costs and combating the gray economy. According to the RAMP program, the tax administration reform aimed at redesigning and increasing the capacity of the IT system in order to manage a centralized database that includes data on all taxpayers in Romania. The main targets that had to be achieved by the end of the implementation period were: increasing collection efficiency for taxes and social contributions and improving tax compliance, as well as by reducing the fiscal burden of taxpayers.

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115 The reduction in the weighted average VAT rate was around 7 pp in 2018 compared to 2013, when the measure of reducing the legal VAT rate for bread and bakery products from 24% to 9% was initiated (in September).

116 Law no. 212/2013 on the ratification of the Loan Agreement between Romania and IBRD. RAMP was structured on four components: institutional development; increasing efficiency and operational effectiveness; modernizing services for taxpayers; coordination and project management.

The implementation period of the project was initially estimated at 5 years (starting with the fourth quarter of 2013), but given the delays in carrying out the program, at the solicitation of the National Agency for Fiscal Administration (NAFA), in 2016 Romanian authorities requested an extension of 2 years for the contract, which was established through GO no. 1017/29.12.2016 (the execution of the project was extended until September 30, 2020 and the deadline for withdrawing payments until March 31, 2021).

Between November 2013 and 2017, the WB conducted periodic analyzes of the implementation and results of this program which, starting with 2015, showed a deterioration of the progress towards achieving the objectives, as well as of the general progress from "satisfactory" in 2014 to "moderately satisfactory" in 2015, respectively "moderately unsatisfactory" in 2016 and "unsatisfactory" in 2017, and of the general risk rating which deteriorated from "high" in 2014 to "substantial" in the 2015-2017 period, while the pace of implementation slowed down significantly in the second part of 2017. On the occasion of the analysis for 2017\(^{118}\), carried out in July 2018, the WB warned the Romanian government that no progress has been made in the last 6 months of 201 (since the evaluation from June 2017) and that the NAFA modernization process stopped immediately after the first stage of the acquisition of the budgetary revenue management system, which was completed in October 2017. In addition, at the Spring Meeting of the WB and IMF Group (Washington, April 20-21, 2018), the Romanian Minister of Finance called for a new restructuring of the project and on November 19, 2018 submitted, on behalf of NAFA, the request for the cancellation of the RAMP project. Subsequently, the WB was notified that the termination date of the program was set by the Romanian government on March 31, 2019, the implementation of RAMP being cancelled\(^{119}\). Out of the total funds made available by the IBRD since August 2013, up to February 6, 2018, 24.65%\(^{120}\) were drawn (17.3 million euros out of the 70 million euros that were allocated).

According to the provisions of the program, the following specific targets should have been achieved by the end of 2018:

- increasing voluntary tax compliance at declaration and payment for VAT to 83.5%, for personal income tax to 86.0% and for SSC to 82.5%;
- a collection cost of 0.9% (from 1.1% at the end of 2012);
- improving the satisfaction of taxpayers concerning the integrity and quality of services by 15%.

The main indicators of the fiscal administration activity did not show any improvement in 2018\(^{121}\) compared to 2017. The cost of collection, remained, similar to the previous years, at the starting value recorded on December 31, 2012, respectively 1.1%. The degree of voluntary compliance with the

\(^{118}\) July 10, 2018, Romania Revenue Administration Modernization Project Audit FY 2017.


\(^{120}\) [https://static.anaf.ro/static/10/Anaf/Relatii_R/Raport_auditFY_2017_RO_21062018.pdf](https://static.anaf.ro/static/10/Anaf/Relatii_R/Raport_auditFY_2017_RO_21062018.pdf).

\(^{121}\) Considering the first three quarters of 2018 (in comparison to the same period of 2017) [https://static.anaf.ro/static/10/Anaf/Informatii_R/Buletin_statistic_fiscal3_2018.pdf](https://static.anaf.ro/static/10/Anaf/Informatii_R/Buletin_statistic_fiscal3_2018.pdf).
payment of fiscal obligations, including partial payments, increased slightly to 86.87% (from 86.07% in 2017), but the personnel expenses for 1 million lei of net budgetary revenues increased from 9605.2 lei to 9915.7 lei (+ 2.6%).

The positive effects registered in NAFA’s activity during the implementation of the RAMP project are minor in comparison to the initial objective of the reform (which aimed to implement a computer system that allows NAFA to centralize financial data from the entire country\(^\text{122}\)) and refer to:

- the improvement of NAFA procedures;
- the participation of over 500 employees in training courses;
- the improvement of NAFA’s capacity to analyze and forecast revenues;
- the development of the voluntary compliance strategy;
- the consolidation of management integrity, internal controls, audit techniques and the improvement of anti-fraud measures.

It can be appreciated that, due to the implementation of the reform process that aimed at simplifying and making the administrative apparatus for collecting taxes more efficient, the number of fiscal administration at central level has been considerably reduced, although more efforts are required at the local level, Romania being still placed above the average of the new EU member states regarding the number of financial administrations compared to the number of inhabitants\(^\text{123}\). However, given the cancellation of the RAMP program, in November 2018 the Senate approved the MPF proposal for the modification of GEO no. 74/2013, though which a series of reform measures initiated in 2013 and already implemented were practically annulled, the legislative proposal aiming to reorganize the 8 regional directions of NAFA into 41 county directions and an additional one for the municipality of Bucharest. In February 2019, the Chamber of Deputies endorsed these measures and, moreover, established that the National Customs Authority (NCA) should move from the jurisdiction of NAFA to that of the MPF. However, on March 6, 2019, at the proposal of 104 deputies, the Constitutional Court of Romania (CCR) was notified for the unconstitutionality of this law, given that the budgetary impact of NAFA reorganization was not estimated, the legislative misspecification of the reorganization process, as well as the MPF’s lack of competence in overtaking the NCA without the approval of the Court of Accounts.

The broad and complex process of simplifying the tax system and reducing bureaucracy has taken place gradually, the recognition of this progress being highlighted by the annual *Paying taxes* reports issued by PricewaterhouseCoopers (PwC) and the WB’s *Doing Business* reports. Thus, the latest available report, *Paying taxes 2019* (for the reference year 2017\(^\text{124}\)), ranks Romania, from the

\(^{122}\) This objective was practically canceled by GEO no. 77/30.10.2017 which established the National Center for Financial Information, within the MPF.

\(^{123}\) According to the *Tax administration 2017* report, elaborated by the OECD, in 2015 Romania ranked second after Poland (similarly for the number of employees in the tax collection administration), while for the indicator “fiscal revenue/GDP per 1,000 employees”, Romania was placed on the penultimate position among NMS countries.

\(^{124}\) The 2019 report is based on the latest data available on July 1, 2018 and refers to the fiscal year 2017 (data on company taxation is available after the consolidation of financial statements).
perspective of ease of paying taxes, on the 49th place among the 190 countries that were analyzed, a weaker position compared to the previous year (42th place). Compared to the previous year, in 2017 the annual number of hours required to pay taxes remained the same (163 hours), as did the number of annual payments that a company must make in order to pay tax duties (14 payments), while the share of taxes in total profits increased to 40% compared to 38.4% (despite reducing the VAT rate by 1 pp, from 20% to 19%). Thus, a medium-sized company in Romania made 2 more payments per year compared to the European average (12 annual payments), well below the global average (24 annual payments), and consumed for calculating, filling and filing tax returns 2 hours above the European average (161 hours), well below the global average (237 hours). From the perspective of the total tax rate (the share of taxes and social security contributions in the profit of a medium-sized company), in 2017 Romania recorded a level of 40%, above the European average of 39.3%, respectively below the global average of 40.4%.

From the perspective of the new sub-index of ex-post compliance introduced since 2015, respectively of the ease with which a company can start the processes related to VAT refund and to the audit that is required in the case of correcting errors found in the tax returns concerning corporate income tax, Romania is among the countries whose procedures are considered to be carried out with great difficulty and, compared to other CEE states, it is better positioned only relative to Bulgaria and Hungary. Thus, the ex-post compliance index registered a level of 76.8%, below the European average - 82.4%, but above the global average - 59.6% (where 100% represent processes with maximum efficiency and 0% totally inefficient processes). For comparison with NMS CEE countries: Estonia recorded a level of 99.4% for this sub-index, Latvia - 98.1%, Lithuania - 97.5%, Slovakia - 87.2%, Slovenia - 80%, Poland - 77.4%, Bulgaria - 71.0% and Hungary - 63.9%.

Overall, in 2017 Romania registered a setback in the process of improving the efficiency of paying taxes compared to the previous year, being placed in the second half of the ranking of CEE countries, ahead of Poland (69th place in the global ranking), Hungary (86) and Bulgaria (92), but well behind Latvia (13), Estonia (14) and Lithuania (18). The evolution of Romania compared to other CEE countries, is presented in Table 16. Since the calculation methodology has changed125, starting with the Paying taxes 2017 report, two rankings have been included for 2015, according to the two methodologies (the previous one, which does not take into account the new sub-index of ex-post compliance is placed in parentheses). Therefore, only the years 2015-2017 are comparable from the perspective of the aggregate ranking, but for most sub-indices the results are comparable for the entire analyzed period. It can be noticed that Romania’s position has worsened in 2017 compared to the previous year (down by 7 places).

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125 The methodology used in the Paying taxes 2017 report took into account for the first time the sub-index of ex-post compliance (which includes two specific processes related to VAT reimbursement and company audits in the case of correcting errors found in the tax returns concerning corporate income tax). The reports from previous years do not include this sub-index. For methodological details, see the 2016 Annual Report, Box 2 (http://www.fiscalcouncil.ro/RA2016%20engl%20iulie2017.pdf).
The indicator reflects the total number of taxes and contributions, the method of payment, the frequency of payments, the frequency of filing tax returns and the number of agencies involved in the tax collection process for companies (starting with the second year of activity). In the case of payments that are made electronically, regardless of the frequency of payments, only one payment is recorded.

** The indicator reflects the time needed for the preparation, filing and payment of the main tax obligations: corporate income tax, social security contributions, labor taxes, other taxes.

*** The indicator reflects the share of compulsory taxes and contributions that are paid by a company (starting with the second year of activity) in its commercial profit.

<table>
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<tr>
<th>Year</th>
<th>Estonia</th>
<th>Latvia</th>
<th>Slovenia</th>
<th>Lithuania</th>
<th>Bulgaria</th>
<th>Slovakia</th>
<th>Poland</th>
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<td>73</td>
<td>58</td>
<td>122</td>
<td>95</td>
<td>55</td>
</tr>
<tr>
<td>2015</td>
<td>21(32)</td>
<td>15(26)</td>
<td>39(67)</td>
<td>27(50)</td>
<td>83(99)</td>
<td>56(72)</td>
<td>47(62)</td>
<td>53(80)</td>
<td>77(89)</td>
<td>50(43)</td>
</tr>
<tr>
<td>2016</td>
<td>14</td>
<td>13</td>
<td>58</td>
<td>18</td>
<td>90</td>
<td>48</td>
<td>51</td>
<td>53</td>
<td>93</td>
<td>42</td>
</tr>
<tr>
<td>2017</td>
<td>14</td>
<td>13</td>
<td>41</td>
<td>18</td>
<td>92</td>
<td>48</td>
<td>69</td>
<td>45</td>
<td>86</td>
<td>49</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Year</th>
<th>Number of payments per year required in order to pay tax duties*</th>
</tr>
</thead>
<tbody>
<tr>
<td>2012</td>
<td>7 7 11 11 13 20 18 8 12 39</td>
</tr>
<tr>
<td>2013</td>
<td>7 7 11 11 13 20 18 8 11 14</td>
</tr>
<tr>
<td>2014</td>
<td>8 7 10 11 14 10 7 8 11 14</td>
</tr>
<tr>
<td>2015</td>
<td>8 7 10 11 14 8 7 8 11 14</td>
</tr>
<tr>
<td>2016</td>
<td>8 7 10 11 14 8 7 8 11 14</td>
</tr>
<tr>
<td>2017</td>
<td>8 7 10 10 14 8 7 8 11 14</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Year</th>
<th>Number of hours per year required in order to pay tax duties**</th>
</tr>
</thead>
<tbody>
<tr>
<td>2012</td>
<td>81 264 286 175 454 207 286 413 277 200</td>
</tr>
<tr>
<td>2013</td>
<td>81 193 260 175 454 207 286 413 277 159</td>
</tr>
<tr>
<td>2014</td>
<td>81 193 245 171 423 188 271 405 277 159</td>
</tr>
<tr>
<td>2015</td>
<td>84 161 245 171 453 192 271 234 277 161</td>
</tr>
<tr>
<td>2016</td>
<td>50 169 245 109 453 192 260 248 277 163</td>
</tr>
<tr>
<td>2017</td>
<td>50 169 233 99 453 192 334 230 277 163</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Year</th>
<th>Total tax rate***</th>
</tr>
</thead>
<tbody>
<tr>
<td>2012</td>
<td>49.4 35.9 32.5 43.1 27.7 47.2 41.6 48.1 49.7 42.9</td>
</tr>
<tr>
<td>2013</td>
<td>49.3 35.0 32.0 42.6 27.0 48.6 38.7 48.5 48.0 43.2</td>
</tr>
<tr>
<td>2014</td>
<td>49.4 35.9 31.0 42.6 27.0 51.2 40.3 50.4 48.4 42.0</td>
</tr>
<tr>
<td>2015</td>
<td>48.7 35.9 31.0 42.7 27.0 51.6 40.4 50.0 46.5 38.4</td>
</tr>
<tr>
<td>2016</td>
<td>48.7 35.9 31.0 42.7 27.1 51.6 40.5 50.0 46.5 38.4</td>
</tr>
<tr>
<td>2017</td>
<td>48.7 32.6 31.0 42.6 27.7 49.7 40.7 46.1 40.3 40.0</td>
</tr>
</tbody>
</table>

Source: PwC and WB

* The indicator reflects the total number of taxes and contributions, the method of payment, the frequency of payments, the frequency of filing tax returns and the number of agencies involved in the tax collection process for companies (starting with the second year of activity). In the case of payments that are made electronically, regardless of the frequency of payments, only one payment is recorded.

** The indicator reflects the time needed for the preparation, filing and payment of the main tax obligations: corporate income tax, social security contributions, labor taxes, other taxes.

*** The indicator reflects the share of compulsory taxes and contributions that are paid by a company (starting with the second year of activity) in its commercial profit.
Another report prepared by PwC in September 2018, namely the *Study on the implementation of Digital Governance in Romania*, shows that from the perspective of the efficiency of electronic governance in the delivery of public services (measured by the Electronic Governance Development Index), Romania is the last in the EU, respectively placed on the 67th out of 193 countries analyzed, the main cause being the weak integration of the IT systems in the public administration.

Thus, the study shows that, although Romania has registered an increase in the number of online services compared to the previous year, it is ranked in the last position because of: the deficient legislative framework in the field of digitalization, the non-unified technological infrastructure within the public institutions, as well as the lack of concern regarding developing the digital skills needed in the administrative apparatus.

Compared to similar economies, Romania enjoys an average tax collection rate from VAT receipts (see *Figure 40*), despite registering the lowest VAT weighted average rate. For example, in the year 2018 in terms of the VAT weighted average rate (based on HICP weights and characterized by the limitations described in subchapter III.3.1) and of VAT receipts, Romania was ranked on the last position of the new EU Member States. With a weighted average rate of 14.5%, Romania collected 6.4%\(^{126}\) of GDP from VAT, being the last in the ranking less by 0.6 pp than Slovakia which collected 7.0% of GDP from VAT, despite a higher average weighted rate (17.3%).

*Figure 40: VAT revenues in 2018 compared with the previous year (% of GDP)*

<table>
<thead>
<tr>
<th>Country</th>
<th>2017</th>
<th>2018</th>
<th>VAT weighted average rate (right scale)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bulgaria</td>
<td>16.9</td>
<td>18.8</td>
<td>9.0</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>7.7</td>
<td>7.7</td>
<td>7.7</td>
</tr>
<tr>
<td>Estonia</td>
<td>9.1</td>
<td>9.1</td>
<td>9.1</td>
</tr>
<tr>
<td>Latvia</td>
<td>8.0</td>
<td>8.3</td>
<td>8.0</td>
</tr>
<tr>
<td>Lithuania</td>
<td>19.3</td>
<td>19.2</td>
<td>19.3</td>
</tr>
<tr>
<td>Hungary</td>
<td>19.9</td>
<td>19.9</td>
<td>19.9</td>
</tr>
<tr>
<td>Poland</td>
<td>17.1</td>
<td>17.1</td>
<td>17.1</td>
</tr>
<tr>
<td>Romania</td>
<td>6.2</td>
<td>6.4</td>
<td>6.2</td>
</tr>
<tr>
<td>Slovenia</td>
<td>15.9</td>
<td>15.9</td>
<td>15.9</td>
</tr>
<tr>
<td>Slovakia</td>
<td>17.3</td>
<td>17.3</td>
<td>17.3</td>
</tr>
</tbody>
</table>

*Source: EC, Eurostat*

\(^{126}\) The level of this indicator increased by 0.2 pp compared to 2017, when 6.2% of GDP was collected from VAT.
It is worth mentioning Bulgaria, having a structure of the economy similar to that of Romania and a 16.9% VAT-weighted rate collected 9.3% of GDP for VAT receipts in 2018, behind Hungary (having a VAT-weighted rate of 19.9%) and well above the level of countries with higher weighted average rates, such as Estonia (18.6%), Slovakia or Poland (17.1%.)

According to a recent EC study on VAT collection\textsuperscript{127}, in 2016, Romania ranked last by the level of VAT collection among all EU Member States with a VAT collection deficit (VAT Gap) estimated at 6.13 billion euro, respectively 35.88%, the highest value in the EU\textsuperscript{128}, but also in the CEE, and higher than in the previous year. Comparatively, Estonia recorded 7%, Hungary 13.33%, the Czech Republic 14.19%, Poland 20.80%, and Slovakia 25.68%. Note the evolution of Bulgaria, which decreased by more than 7 pp compared to the previous year (from 21% to 14%).

Regarding the share in GDP of \textbf{social security contributions} paid by employees and employers relative to the statutory rate, Romania is highlighted as showing the lowest level of collection for this category of revenues (see \textit{Figure 41}).

Thus, the revenues from the contributions collected by Romania in 2018 even if significantly increased compared to the previous year (+2.1 pp of GDP), recording a value of 10.6% of GDP, but corresponding to the statutory rate of 44.7\textsuperscript{129} (corresponding to the legal rate of 37.25% adjusted with the base broadening, to make it comparable with other countries) - ranking the third among the analyzed member states - represents one of the lowest values in this sample, superior only to Latvia (with 9% of GDP, but in the context of a statutory rate of 35.1%) and Bulgaria (8.6% of GDP, but with a statutory rate of only 32.4%).

Estonia (collecting from social contributions 11.2% of GDP), Hungary (12.8% of GDP) and Slovenia (14.5% of GDP) surpassed Romania, even if the social contributions statutory rates are significantly smaller. Compared to Poland, which collected from social contributions 12.9% of GDP, the statutory rate in Romania is by 3.2 pp higher, while compared to the Czech Republic (social contributions of 15.6% of GDP), the statutory rate in Romania is by 3.3 pp lower.

A more detailed analysis of the tax efficiency indicators is presented in sub-chapters \textit{III.3.1. VAT and excise duties}, respectively, \textit{III.3.3. Social security contributions}.


\textsuperscript{128} EU average was 12.3%, lower compared with 2015 (13.2%).

\textsuperscript{129} This level was calculated as equivalent to the increase in gross wages due to the shift of social contributions from the employer to the employee.
Concluding, after a relative improvement in terms of efficiency and simplifying the administrative apparatus of tax collection, from both the perspective of decreasing the number of financial administrations (even if it can be noticed an increase in the number of employees in these structures), but also in terms of ease of paying taxes, at the level of 2018 the reform initiated in Romania in this field seems to be stagnating, and due to the cancelling the RAMP project, but also of the legislative proposal to amend the GEO no. 74/2013 through the reorganization of NAFA, can even be reversed.

Romania’s position in 2017 among the first third in the global ranking of *Paying Taxes 2019* is a positive result, but maintaining a leading position implies further efforts to continue investments in fiscal infrastructure and technology, since the digitalization of the financial reporting has the potential to make more efficient the internal processes of the tax authorities, including the control and monitoring mechanisms, also in the benefit of the taxpayers.

**V.3. Public expenditure – structure and sustainability**

In Romania, the structure of the budgetary expenditures is characterized by the dominance of personnel and social assistance expenditure (pensions, social aids, and so on). Although their relative importance has declined significantly in 2011 – 2015 period as a result of the fiscal consolidation, 2015 representing the minimum of the analyzed period, starting with the year 2016 recorded the reversal of this evolution (*Figure 42*), the personnel and social assistance expenditure strongly increased by 9 pp, and in the year 2017 they increased by another 5 pp compared to the previous year. In 2018, the
increasing trend continued, but with a smaller pace, reaching 70.1% (from 68.6% in 2017) and higher than the average of 69.7% for the period 2008-2010.

**Figure 42: The evolution of social assistance and personnel expenditures as share of total budget revenues (%)**

![Chart showing the evolution of social assistance and personnel expenditures as share of total budget revenues.](chart.jpg)

**Source:** Eurostat

**Note:** Taking into account the change in the treatment of special pensions by Eurostat, for Romania the personnel spending and the budget revenues have been adjusted accordingly to avoid double counting.

This development can be attributable to the nominal increase of these expenditure categories compared to the previous year, respectively by 25% for the expenses related to the compensation of the employees (due to the wage increases in the public sector) and 10.7% for the social assistance expenditures, that surpassed the increase of 14.4% for the budget revenues compared to the previous year. It is worth noting that the share of personnel expenditure in the total budget revenues in 2018 (32.6%) is superior to the average of the period 2008-2010 (29.9%), while the share of social assistance expenditure (37.5%), although at a far distance (2.3 pp) compared to 2017 (0.6 pp) from the average for the period 2008-2010 (39.8%), is still higher compared to the average of 2011-2015 (35.3%), the expansionary fiscal policy of the last three years cancelling the effect of adjustments in personnel and social assistance spending made in the period 2011-2015. Compared to the previous year, the share of social assistance expenditure in the total budgetary revenue decreased by 1.2 pp, while personnel expenditure’s share in the total revenues increased by 2.8 pp.

The precarious state of the public pension system is an important vulnerability of the public finances position and the share of this expenditure category in total revenues is still too high compared with other EU member states and, applying the pension law no. 263/2010 should have supported the aim of reducing the share of this expenditure category in total budgetary revenues in the medium-term. This objective, however, is currently jeopardized by the manifestation of some reversing pressures on the
pension system reform, which were implemented in the period 2015-2016, being extensively commented on in the section on personnel and social assistance expenditure.

Also, in terms of medium and long-term sustainability, it is important that any increases of wages in the public sector in the following years to be done only in line with the evolution of economic activity and, especially, with productivity gains, given that during 2016-2018 there was a trend of massively increasing the personnel expenses of the state by significantly higher rates than that of the nominal GDP and public revenue growth rate over this period of time.

After a relatively stable evolution in items of the expenditure share in the budgetary revenues, before 2007, the personnel and pension expenditure strongly increased during 2008-2009, with a maximum of 75.3% in 2009, when Romania recorded the largest share of personnel and social assistance expenditures in total budget revenues at the level of CEE countries, and also a level much higher than the EU28 average. Following the implementation of the fiscal consolidation program, the share decreased significantly, falling below the level recorded in the CEE countries, with the exception of Hungary, in the period 2013-2015. However, starting with 2016 Romania reversed this trend, and due to the aggressive increases in the public-sector wages and pension benefits, in 2018 was recorded, similar to 2009, the highest level of the personnel and social assistance spending related to the budget expenditures.

Source: Eurostat

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

Respectively, on average, their share in total budget revenues was 69%.
revenues in the region (70.1%), above the EU28 average (67.4%), being by 4 pp above the next ranked country, respectively Poland and by 2.7 pp above the EU28 average (67.4%). The evolution of this indicator for the CEE countries and the EU28 average in the period 2005-2017 is presented in Figure 43.

Regarding the development of the social security budget (pensions, unemployment and health) it is noticed that, if in the period 2000–2007 were characterized by a relatively equilibrated or even positive balance, after 2008 their deficits have represented an important component of the general consolidated budget deficit, respectively between 64% and 81% in the period 2010-2017.

In 2018, the deficit of social insurance systems has been reduced considerably, reaching 10% of the total budget deficit. This decrease represents the result of the fiscal measures for repositioning the assessment of the tax base, materialized in the increase of taxation through social contributions. Basically, in the period 2013-2018, Romania would have had a significant budgetary surplus if the social security budget had been in equilibrium. In particular, the deficit recorded in the public pension system (1.86% of GDP in 2018), practically the most important part of this budget, significantly affects the public finance position, representing a major risk to the sustainability of fiscal policy in the medium and long-term.

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 2018 edition, Romania ranks 55th out of 140 countries with a score for the Infrastructure pillar of 71.2%\textsuperscript{131}, and is placed the 58th in the ranking for the overall quality of the infrastructure, the quality of the roads being the weakest component, which only places us on the 113th position out of 140 countries, with a score equal to 3 (out of maximum of 7).

The score regarding infrastructure is only a part of the global competitiveness index (GCI) for which Romania recorded a score of 63%, maintaining the 52th position like in the previous year, but out of more countries (140 compared to 135 in 2017). United States is the leader (with a score of 86%), followed by Singapore (83.5%) and Germany (82.8%).

The efficiency reserves for the budgetary expenditures are still very high. For example, Romania was ranked the 5th from the perspective of the allocation for investment expenses in the period 2009-2018 as a percentage of the GDP of all EU countries (and as the first for their share in budget revenues over the last 10 years), but with all these budgetary efforts, the results were very modest, with Romania having at the level of 2018 one of the weakest transport infrastructures in the EU\textsuperscript{132} (Figure 45), being followed only by Bulgaria and Malta (placed in this ranking on 12th and, respectively, 24th positions). However, the investment expenditures have been significantly reduced in the last two years, in 2018 their share in GDP being smaller than in 2017, respectively only 45% of the 2009 level and half of the 2015 level. In 2018 Romania ranked the 12th in the EU28 in terms of allocations to this destination as a percentage of GDP (lower by 4 positions compared to 2017) and second to last position in the CEE countries, before Bulgaria.

\begin{figure}
\centering
\includegraphics[width=\textwidth]{figure45}
\caption{Infrastructure quality}
\label{fig:infrastructure_quality}
\end{figure}

\textsuperscript{131} Starting with 2018, the score is calculated as a percentage against a maximum of 100%. Also, as novelty elements compared to the previous year, are the introduction of some new sub-indicators, the aggregate score being defined on a much wider sample of indices compared to the previous year.

\textsuperscript{132} According to the Global Competitiveness Report, the 2018 edition. Compared to the 2017 edition, a series of new sub-indicators were introduced for this pillar, which places Romania in a much more favorable position compared to last year’s evaluation (for example, it was introduced a sub-indicator on electrification for which we have 100%, ranking on the first place in the analyzed countries).
It should be noted that, after 2015, that represented the first year after 2008 in which spending on public investments as a percentage of GDP increased compared to the previous year, given that 2015 was the last year for the absorption of EU funds for the financial framework 2007-2013, starting 2016 it return to the evolution observed during the period 2009-2014, namely the continuous decrease of this category of expenditures. In 2018 the investment spending decreases relative to 2015 by 2.6 pp of GDP.

Compared to budget revenues, public investments spending fell by 0.3 pp compared to the previous year and by 6.6 pp compared to 2015, staying well below the pre-crisis level. Under these circumstances, increasing the efficiency of public spending is more necessary, given that it is unlikely that high levels of the past allocations for this destination can be sustained in the near future.

**Figure 46: The share of investment expenditures in GDP and in total budgetary revenues (average 2008-2018)**
VI. 2019 – Macroeconomic and fiscal perspectives

VI.1. Macroeconomic framework

2018 marked a moderation of the growth trend\textsuperscript{133} which is projected to continue in 2019 amid a slowdown in the euro area and Japan (as a result of natural disasters in 2018), the economic crises in Argentina, Brazil, Venezuela and Turkey, the effect of tensions in US-China trade relationships and the uncertainty about Brexit.

According to the IMF spring forecast\textsuperscript{134}, it is estimated that in 2019 global economic growth will decelerate slightly, from 3.6% in 2018 to 3.3%, with positive developments being projected for Asian emerging economies, which are expected to continue to display high growth rates (6.3% versus 6.4% in 2018), while advanced economies are estimated to have a less impressive performance (1.8% versus 2.2% in 2018), the US being forecasted to remain the top performer (2.3% compared to 2.9% in 2018). At European level, the IMF estimates that 2019 will record the lowest economic growth since 2013, respectively 1.2%, particularly as a result of the poor performance of emerging and developing countries, with an estimated GDP growth of just 0.8% (compared to 3.6% in 2018). For the euro area countries it is forecasted an advance of 1.3% (versus 1.8% in 2018) while the projection for the EU economy is 1.6% (compared to 2.1% in 2018). For the year 2020, the IMF forecast estimates a slight increase in economic growth at 3.6% globally, 1.5% in the euro area and 1.7% in the EU, coupled with a comeback of emerging and developing countries in Europe at 2.8%. pronounced

The EC spring forecast\textsuperscript{135} estimates a 1.4% real GDP growth in 2019 for EU27\textsuperscript{136} (compared to 2.1% in 2018) and 1.2% for the euro area\textsuperscript{137} (compared to 1.9% in the previous year), while for 2020 it projects a slight comeback for both the EU27 (1.7%) and the euro area (1.5%). These forecasts are based on the evolution recorded during the second half of 2018, characterized by a sharp slowdown in economic growth and international trade (affected by the US-China trade dispute), but also by the uncertainty surrounding the Brexit process\textsuperscript{138}. In spite of the financial problems in Italy, the deceleration of the German economy, the accumulation of public debt in the PIIGS countries, the EC estimates that the

\textsuperscript{133} In comparison to the IMF winter forecast, the estimates concerning global and, especially, European growth are more pessimistic as a result of the marked slowdown during the second half of 2018.


\textsuperscript{136} Excluding the United Kingdom.

\textsuperscript{137} Excluding the United Kingdom.

\textsuperscript{138} The Brexit agreement should have been finalized by March 27, 2019 under Article 50 of the Treaty of Lisbon but was postponed until October 31, 2019 at the European Council’s emergency meeting on April 6-7, 2019, provided that the UK participated in the European parliamentary elections of 23-26 May, otherwise leaving the EU was set for June 1, 2019 with or without an agreement.
fundamentals of the euro area countries are sound, being supported by the improvement of the labor market, the low financing costs and the preservation of a slightly expansionary fiscal policy, and anticipates a higher pace of growth for the European economy in 2020.

In what concerns the balance of risks associated with the economic growth forecasts, the EC appreciates that the projections are exposed to significant risks for negative developments due to US-China trade tensions\(^1\), the long-term decline in global exports, a significant deceleration of the Chinese economy and the high dependence of financial markets in emerging countries on sudden changes in risk perception and investors’ expectations concerning economic growth. Besides the aforementioned dangers, other risk factors identified by the EC include: the resumption of the negative loop between bank exposure and sovereign debt in certain euro area countries, the EU’s high dependence on global demand (which increases the vulnerability to external developments), the continuation of temporary factors that disturb economic growth and the major risk that the Brexit negotiations will not be completed under the new timetable agreed in April 2019, with a negative impact not only on the UK economy but also on European trade, well above initial estimates. These risks can be partly mitigated by an increase in aggregate demand based on a better absorption of EU funds with a favorable effect on investments and labor market conditions, but require a firm commitment from governments to drive fiscal policy towards reducing public debt, as well as in formulating policies that consistently support economic growth.

In its forecasts for EU27 Member States, EC estimates only positive growth rates for the year 2019, the highest being for Malta (5.5%), Poland (4.2%), Ireland and Slovakia (3.8%), Hungary (3.7%), Romania\(^2\) and Bulgaria (3.3%). On the opposite side, it is estimated that Italy will register the lowest growth rate among EU27 countries (0.1%), followed by Germany (0.5%), Belgium (1.2%), France (1.3%), Sweden (1.4%) and Austria (1.5%). United Kingdom is expected to grow by 1.3% and for EU28 is estimated the same growth as for EU27 (1.4%). In what concerns the global economy, excluding EU28, EC estimates a 3.6% advance in 2019 (versus 3.9% in 2018) and 3.8%, respectively, in 2020.

From the perspective of the real GDP gap compared to the pre-crisis levels, it is noteworthy that in 2018, due to the real GDP growth in all Member States (albeit at a slower pace than in 2017), the number of EU countries that still exhibit a real GDP under the level recorded in 2008 was reduced to 3 (Greece, Italy and Croatia) compared to 5 countries in the previous year (Greece, Italy, Croatia, Portugal and Finland). Among them, Greece continues to show the biggest gap compared to the pre-crisis period, its real GDP accounting for about 76% of the level achieved in 2008, while Italy is close to 97% and Croatia at 99%. On the other hand, the top positions in the list of countries registering significantly higher levels of real GDP relative to 2008 remained unchanged from the previous year: Ireland (+66.7%), Malta (+58.6%), Poland (+40.4%), Slovakia (+25%), Luxembourg and Romania

\(^1\) Since the second half of 2018, the two countries are in a so-called “trade war”. An initial 25% hike in tariffs on USD 50 billion worth of imports was implemented in July 2018 and it was followed in September by another 10% rise in tariffs on USD 200 billion worth of imports. Another 25% increase on import tariffs was postponed by the US government from January 1, 2019 to April 1, 2019.

\(^2\) A sharp decline compared to the EC Winter Forecast which estimated a 3.8% increase in 2019.
(+22.8%). It is worth mentioning that during the post-crisis period there was a positive but uneven evolution of economic activity in EU Member States, 2018 being the second consecutive year of economic expansion across all EU economies (including the UK). This is encouraging from the point of view of convergence within the EU but, based on the developments of the last decade, the EC draws attention to the fact that most of the countries that have managed to exceed the level of pre-crisis economic activity are those with high GDP per capita values\textsuperscript{141}, which raises questions about real convergence in the coming period.

From the perspective of inflation in the EU27, measured with the aid of HICP, a slight reduction is expected in 2019 (to 1.5% compared to 1.8% in the previous year) due to the base effect generated by the reduction in food in fuel prices, followed by a minor increase to 1.6% in 2020. For the euro area, HICP is estimated at 1.4% in 2019 and it is expected to remain constant in 2020. It should be noted that the aggregate HICP values dissimulate important differences between EU Member States amid different monetary policies and divergences in the evolution of the exchange rate, with the largest gap in 2019 forecasts being recorded between Greece (0.8%) and Romania (3.6%). As in the previous year, the EC Spring Forecast estimates that Romania will have the highest average annual HICP inflation rate among EU Member States for the considered period of time: 3.6% for 2019 and 3.0% for 2020.

From the perspective of Romania’s economic growth, the EC anticipates a slowdown from 4.1% in 2018 to 3.3% in 2019, but this level remains well above the EU27 average (1.4%), being the sixth highest growth rate in the EU (together with Bulgaria) after Malta (5.5%), Poland (4.2%), Ireland and Slovakia (3.8%) and Hungary (3.7%).

The slight deceleration of GDP growth in 2019 is based on the projections that private consumption will continue to advance at a high pace (+5.2% amid robust wage increases), a similar evolution being expected for public consumption (3.8% compared to 1.8% in 2018), while taking into account a negative contribution of net exports, due to a stronger dynamics of imports (+6.9%) relative to exports (+4.4%). On the other hand, it is estimated that investments will have a comeback in 2019 (+1.4% for gross capital formation from -3.4% in 2018), in the context of increased investments in equipment and constructions, fueled by making progress in the implementation of projects financed by European funds. The unfavorable evolution of net exports will contribute to the worsening of the current account deficit, which is projected to increase from 4.5% in 2018 to 5.2% in 2019.

For 2020, the EC expects that economic growth will continue its downward trend to 3.1%, but it remains one of the highest values across EU Member States, well above the projected EU27 average (1.7%).

\textsuperscript{141} These include Luxembourg, Ireland, Denmark, Sweden, the Netherlands, Austria and Finland (with a GDP per capita relative to the EU27 average between 322% - Luxembourg and 137% - Finland). The countries situated at the opposite end in 2018 are: Bulgaria with 25.3%, Romania with 33.6%, Poland with 41.8% and Hungary with 43.7% of the EU27 average.
Analyzing the dynamics of the 2019 economic growth forecasts for Romania, it can be observed that between January 2018 and May 2019 they were revised downwards by all three international financial institutions, the most extensive correction being operated by the EC (-0.7 pp), followed by EBRD (-0.6 pp) and IMF (-0.4 pp). Thus, from the winter 2018 growth forecast for the Romanian economy’s which stood at 4.2% (EBRD), 4.0% (EC) and 3.5% (IMF), the projections were updated in the spring of 2019 to 3.6% (EBRD), 3.3% (EC) and 3.1% (IMF). These corrections occurred amid the economic growth deceleration during 2018, but also in the context of a difficult economic climate at both European and global level, as well as domestically due to the fiscal measures approved in December 2018 through GEO no. 114. It should be noted that, similar to the previous year, the growth rates projected by NCSP (from 5.7% in the winter of 2018 to 5.5% in May 2019) are significantly more optimistic in comparison to those estimated by the three international financial institutions, resulting in a spread of 2.2 pp as compared to their average\textsuperscript{142}. Moreover, the downward revision of NCSP’s prognosis for 2019 had a very small size of just -0.2 pp.

According to the Inflation Report published by NBR in May 2019, the annual CPI inflation rate\textsuperscript{143} will reach 4.2% at the end of 2019, above the upper limit of the variation range (1.5% - 3.5%) associated to

\textsuperscript{142} From a gap of 2.4 pp relative to IMF estimates to a difference of 1.9 pp compared to EBRD forecasts.

\textsuperscript{143} Computed according to national methodology. It is different from the HICP inflation rate which is computed according to the European methodology.
the 2.5% target. The rising projection of inflation is the result of supply shocks (a series of unanticipated shocks in the exogenous components of the consumer basket let to an upward revision of CPI inflation by 1.2 pp compared to the February 2019 report) and of the medium-term influence exercised by fundamental factors. After the first quarter of 2019 has already boosted inflation to 4%, NBR forecasts a slight reduction by the end of the third quarter, amid the mitigation of inflationary pressures from the exogenous components of the consumer basket, but inflation is set to rise again towards the end of 2019 due to the dissipation of favorable effects recorded in the same period of the previous year. At the same time, inflationary pressures from the internal environment, mainly due to the excess demand, as well as the tariffs increase in the telecommunications field, have to be taken into account. NBR appreciates that the risks associated with the forecast are tilted towards positive deviations, the main sources of risk being the following: the uncertainties associated with fiscal and revenue policies, especially in the context of the 2019-2020 electoral calendar; the tightness of the labor market which is affected, among other factors, by migration and a lack of correlation between workforce training and employers’ requirements; uncertainties about the evolution of domestic prices for gas, electricity and food; the global economic slowdown amid the US-China “trade war” and the uncertainties surrounding the Brexit process, as well as the future evolution of international commodity prices.

The “signal” estimates for GDP dynamics in the first quarter of 2019 indicate a relative stagnation in economic growth, with a 1.3% increase over the previous quarter and a 5.0% advance relative to the same period of 2018. Most likely, the deceleration of the wage growth rate, coupled with the rising inflation rate, is likely to moderate the increase in real disposable income and, implicitly, in private consumption. In this context, even though the first quarter has the smallest contribution to GDP growth, it is likely that international financial institutions will maintain their projections for the 2019 economic growth, the most recent values falling within the 3.1%-3.6% range, well below the level estimated by NCSP (5.5%).

In the opinion of the Fiscal Council, the balance of risks associated with real GDP growth in 2019 is tilted towards the negative side, especially in relation to the May 2019 NCSP estimate of 5.5% and also in relation to the economic growth projection of 5.7% on which the initial budget is built. Potential additional risks can be generated internally by a slowdown in private investments as a result of the gradual strengthening of monetary policy, by a further reduction in public investments in order to achieve fiscal targets or by an increase in uncertainty about government policies, as well as externally through uncertainties about global demand and the evolution of European economies, with a negative effect on Romanian exports. Additionally, a possible deepening of the budget deficit above the 3% reference level\textsuperscript{144}, could potentially cause foreign investors to reassess the degree of risk associated with the Romanian economy which would further increase the cost of government borrowing and put pressure on the exchange rate.

\textsuperscript{144} The EC 2019 Spring Forecast estimates for Romania a budget deficit of 3.5% of GDP in 2019 (compared to 3.1% in 2018) due to the increase in personnel and social assistance (pensions) expenditures.
VI.2. Fiscal framework

The draft budget for 2019 was submitted to the Fiscal Council for approval on January 31, 2019, but after parliamentary debates, the consolidated budget that was approved by the Government in mid-March recorded an increase of total expenditures and, implicitly, of the deficit by 2.13 billion lei\textsuperscript{145}, the updated GCB deficit targets being 2.76\% of GDP according to the cash methodology\textsuperscript{146} and 2.78\% of GDP according to ESA 2010 methodology. In its opinion on the draft budget\textsuperscript{147}, the Fiscal Council appreciated that the construction of the 2019 budget and of the associated medium-term framework denoted, similar to the previous year, a significant and widening slippage from the requirements of the SGP’s preventive arm, imposed by the national legislation through the FRL. Moreover, the convergence towards the MTO (1\% of GDP structural deficit) was expected to start only in 2021, but with a net structural effort that is below the minimum 1 pp of GDP that should have been applied beginning with 2019, in line with the latest EC Recommendations from May 2018 as part of the re-opening of the Significant Deviation Procedure for Romania\textsuperscript{148}. In fact, the 2019 budget was adopted with multiple exceptions from the FRL, Law no. 50/2019 on the state budget for 2019 stipulating that the Prime Minister and the Minister of Finance guarantee only that the 2019-2021 Fiscal Strategy, in what concerns the correctness of the data, but not the principles stipulated in the FRL.

With regard to the fiscal position expressed in structural terms, following the accelerated fiscal consolidation between 2010-2015 (the structural budget balance decreased from 5.36\% of GDP to 0.2\% of GDP in 2015), amid a widening of the output gap while maintaining the budget deficit close to the 3\% target, in 2018 the structural deficit deteriorated to 2.98\% of GDP\textsuperscript{149} (from 2.94\% of GDP in 2017). Although Romania is subject to a Significant Deviation Procedure (triggered in May 2018) for the second time, according to the 2019-2022 Convergence Program, the 2019 structural deficit is estimated at 2.97\% of GDP and is projected to increase to 3.03\% of GDP in 2020, ignoring the EC’s recommendation to begin the adjustment path in 2019 with an annual step of 1 pp of GDP.

\textsuperscript{145} In its Opinion on the updated version of Fiscal Strategy for 2019-2021 and the draft Government Ordinance for approving the ceilings of certain indicators in the fiscal framework for the year 2019 (March 11, 2019), the Fiscal Council noted that, for the first time since its establishment, the budget deficit target was increased after the submission of the draft budget to Parliament, in direct contradiction with the provisions of art. 15 of the Public Finance Law.

\textsuperscript{146} In the initial version of the draft budget (January 31, 2019), the GCB deficit target was set at 2.55\% according to the cash methodology, respectively to 2.57\% according to ESA 2010 methodology.


\textsuperscript{148} The updated version of the 2019-2021 Fiscal Strategy (March 2019) stipulates that the adjustment efforts are delayed until 2021 and will start at just 0.25 pp of GDP.

\textsuperscript{149} In its 2019 Spring Forecast, the EC estimates the further deterioration of the structural balance, from 3.64\% of GDP in 2019 to 4.79\% of GDP in 2020.
It is worth noting that the 2019-2022 Convergence Program, published in the second half of May 2019, does not clearly indicate the convergence path towards the MTO, indicating a 0.25 pp of GDP adjustment in 2021 and a further 0.4 pp of GDP in 2022, but without specifying the measures that will lead to this result, contrary to the FRL’s rules and to the EC recommendations, implying that the automatic correction mechanism is not working. Moreover, the EC projections from the Spring Forecast (released in May 2018) indicate levels of the 2019 budget deficit that are significantly higher than Government’s estimates, respectively 3.5% of GDP for the actual deficit (according to ESA 2010 methodology) and 3.6% of GDP in structural terms, this projections being consistent with the Fiscal Council’s assessments. Thus, Romania is among the few countries that reversed the fiscal consolidation trend, being the only EU Member State that is expected to record budget deficits for 2019 and 2020 that will exceed 3% of GDP\textsuperscript{150}.

In its opinion on the draft budget (March 11, 2019), the Fiscal Council identified a high probability of a negative income gap caused, on one hand, by the optimistic estimates of the GDP growth rate and of the labor market developments, based on a macroeconomic scenario that is rather inappropriate from the perspective of a prudent fiscal approach and, on the other hand, by including \textit{ex-ante} in the VAT and excise duties revenue projection the impact of measures taken by NAFA to improve collection efficiency and reduce tax evasion, which was estimated at over 5 billion lei. Moreover, the Fiscal Council identified an underestimation of social assistance and personnel expenditures, as well as the contribution towards the EU budget, taking into account the newly adopted legislative measures and the execution of the previous year. Based on its findings, the Fiscal Council assessed the 2019 budget deficit at around 3.5% of GDP, assuming a no policy change scenario, and warned that there is a significant likelihood that corrective measures will be needed during 2019 in order to avoid exceeding the 3% of GDP deficit ceiling stipulated by the corrective arm of the SGP.

At the end of March 2019, both revenues and expenditures were below the levels from the quarterly program of the initial budget by approximately 2.9 billion lei (representing 0.28% of GDP and 96.3% of the programmed levels), respectively 4.9 billion lei (representing 0.48% of GDP and 94.2% of the programmed levels). Consequently, relative to the program, the impact is favorable in the sense of achieving a budget deficit that is below the quarterly target by 2.1 billion lei (-5.48 billion lei compared to the quarterly target of -7.55 billion lei).

With regard to budgetary revenues, the execution below quarterly targets was due mainly to \textit{amounts received from the EU for the 2014-2020 financial framework} (1.1 billion lei below target representing 77.4% of the programmed level) and \textit{tax revenues} (1 billion lei below target representing 97.6% of the programmed level). This budgetary aggregate recorded slight surpluses in the case of \textit{excise duties} (+49.5 million lei, 100.7% compared to the quarterly program), \textit{corporate income tax} (+92 million lei, 102.2% compared to program), \textit{other taxes on income, profit and capital gains} (+28.8 million lei, 103.3% compared to program), \textit{other taxes on goods and services} (+61.4 million lei, 105.3% compared to program) and \textit{other tax revenues} (+21.8 million lei, 108.9% compared to program). On the other hand, significant negative gaps were recorded by VAT (-924.9 million lei, 94.3% compared to program).

\textsuperscript{150}EC estimates the budget deficit in 2020 at 4.5% of GDP.
property tax (-122.1 million lei, 96.4% compared to program), taxes on the use of goods, the authorization of the use of goods and carrying activities (-77.9 million lei, 94.4% compared to program), personal income tax (-90.2 million lei, 98.4% compared to program) etc. Similarly, negative gaps were recorded in the case of non-tax revenues (-179.5 million lei, 96.4% compared to program) and social security contributions (-505.5 million lei, 98.1% compared to program).

On the expenditure side, the execution for most expenditure categories was lower than the program at the end of the first quarter, except for those related to goods and services (+66.2 million lei, 100.6% compared to program). The negative gap of 4.9 billion lei between total expenditures and the quarterly program was mainly caused by projects financed by non-reimbursable funds from the 2014-2020 financial framework (-1.3 billion lei, 76.2% compared to program), followed by capital expenditures (-1 billion lei, 76.6% compared to the program), subsidies (-0.98 billion lei, 62.8% compared to the program), interest expenditures (-0.38 billion lei, 89.3% compared to program), personnel expenditures (-0.33 billion lei, 98.6% compared to program) and transfers between public administration entities (-0.23 billion lei, 58.3% compared to program).

Essentially, the budget execution for the first quarter of 2019 shows a significant underperformance of amounts received from the EU for the 2014-2020 financial framework and of tax revenues while, on the expenditure side, the negative gap was mostly caused by projects financed by non-reimbursable funds, capital expenditures and subsidies.

Analyzing the execution for the first 4 months of 2019, compared to the same period from the previous year, significant under-achievements can be identified in the case of amounts received from the EU for the 2014-2020 financial framework (they reached only 15% of the annual plan\textsuperscript{151}) and tax revenues (31% of the annual plan, compared to 34% in the previous year, due to lower receipts from VAT and excise duties). In what concerns the expenditures, the ratio of the 4-month execution to the annual plan is set on an upward trend for personnel (32.3% compared to 30.5% in 2018), interest (43.3% compared to 39.1% in 2018) and social assistance expenditures (34.7% compared to 32% in 2018), confirming the warnings issued by the Fiscal Council in its opinions on the budget draft.

Taking into account the budget execution in the first months of 2019, the Fiscal Council appreciates that there are significant risks concerning the realization of programmed revenues (especially those related to VAT), as well as exceeding the amounts estimated for budget expenditures (especially social assistance, personnel and interest). In the context of maintaining the current fiscal-budgetary policy parameters, the 2019 risk balance appears to be significantly tilted towards exceeding the 3% deficit ceiling, requiring corrective measures directed at revenues or expenditures in order to avoid entering the EDP. Keeping the deficit below the ceiling may be supported, similar to the previous year, by the underachievement of investment spending as a result of a low absorption of EU funds granted through the 2014-2020 financial framework. Under these circumstances, the Fiscal Council recommends that the Government should accelerate structural reform measures with an impact on the efficiency of revenue collection and of public money spending. Moreover, the Fiscal Council

\textsuperscript{151} The EU funds received during the first 4 months of 2018 amounted to 22% of the annual plan.
reiterates its recommendation on the rapid operationalization of the public investment prioritization process and a real reform of the public administration expected to streamline the functioning of various state levels on the basis of performance management, which could generate significant gains in the efficiency of budget expenditures.

The Fiscal Council has constantly drawn attention to the risk associated with the repetitive conduct of targeting a budget deficit very close to 3% of GDP as being likely to lead to a weakening of public finances and to a complication in their management in the event of some adverse shocks, thus, keeping fiscal policy in the trap of pro-cyclical behavior. This slippage, whose subsequent correction through fiscal consolidation in the downward phase of the economic cycle is likely to generate economic and social costs that will cancel the positive short-term effects of fiscal relaxation, as shown by economic theory, international empirical studies and even by Romania’s experience in the last 10 years. Moreover, the deepening of the budget deficit led to a widening of the deviation from the MTO and was coupled with the deterioration of the quality of public spending, in the sense of increasing the share of personnel and social assistance expenditure, to the detriment of those generating long-term economic growth, such as investments, education or health.
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http://projects.worldbank.org/P130202/romania-tax-modernization-project?lang=en&tab=overview
Appendix – Glossary of terms

**Adjustment program** - a detailed economic program, usually supported by use of 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, external, and structural areas, as necessary to achieve economic stabilization and set the basis for self-sustained 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 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 without direct intervention by policymakers. 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 budget expenditures.

**Budgetary policy** - financial policy of the state regarding the public expenditures; public resource allocation policy.
Budget revision – operation through which the budget is amended during a budgetary year.

Buffer – a reserve established by the Ministry of Public 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 - account which reflects the evolution of capital transfers and acquisitions/sale of non-financial assets.

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

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

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

Conditionality - 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.

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 revenues component dependent to the demand excess/deficit (economic expansion/contraction), eliminating trend deviations; the level of budgetary revenues cyclically adjusted 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 structuring based on their economic nature and effect.

Economic growth - annual growth rate of the real GDP

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 an 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 differences between ESA 2010 methodology and cash methodology are revenues and expenditures recording in "accrual" system (based on commitments, not actual payments like in 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; the European Semester is a six-months period every year during which the Governments of the member states have the opportunity to collaborate and discover the experiences and opinion of their EU homologues in order to detect any inconsistencies and emerging imbalances of economic and fiscal policies that could violate the rules of 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 ECB and the national central banks of those EU Member States whose currency is the euro.
**Excessive Deficit Procedure (EDP)** – the corrective arm of the Stability and Growth Pact (SGP) that impose 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 1 January 1999 that provides a framework for exchange rate policy cooperation between the Euro system and EU Member States whose currency is not the euro. 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 possible amplification of inflationary pressures.

**Expansionary monetary policy** - the monetary policy behavior has effect in stimulating 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 good and services.

**Financial account** - account which presents the 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, excepting the United Kingdom and Czech Republic. 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** - the policy aimed to reduce budgetary deficits and the accumulation of public debt.
**Fiscal impulse** - the impact of discretionary fiscal policy on aggregate demand. It is computed as change of structural balance from the previous period; a positive value corresponds to an expansionary fiscal policy and a negative value - to a restrictive fiscal policy.

**Fiscal policy** - a policy that wants to influence the economy using the system of taxes as instrument.

**Fiscal revenues** - budget revenues collected through taxation. Fiscal revenues include: personal income taxes, corporate income taxes, capital gain taxes, property taxes and fees, good and services taxes and fees, taxes on foreign trade and international transactions, other taxes and fiscal fees, social 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, a threshold level that does not involve increasing costs for financing the deficit and which takes into account historical evolution of fiscal adjustment; 2. Financial resources available for additional expenditure 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 structuring 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 of 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 European Union 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 revenue collected for a particular type of tax and its associated tax basis.
Inflation - reflects the widespread and persistent increase in prices and it is typically measured by the consumer price index. Inflation erodes the purchasing power of money: the same amount is used to buy fewer goods.

Inflation target - inflation target set by central banks that have adopted inflation targeting strategy. The target can be set as a fix-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 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 major structural reform is adopted.

Monetary policy interest rate – the monetary policy interest rate represents the interest rate used for the main open market operations of the NBR. At present, these are one-week repo operations, developed by auction at fixed interest rate.

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, public debt to GDP ratio must be less than 60%; 4) exchange rate fluctuations must not exceed +/- 15 percent in the last two years preceding the examination.

Nominal variables – variables expressed in current prices.

Non-fiscal revenues - other budget revenues that do not include taxation, such as royalties, payments from SOE’ profit, fines, charges.

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

Output gap - an indicator that measures the difference between actual GDP of an economy and potential GDP; the term “excess demand” is also used.

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 now 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 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 budget expenditure, excluding the interest payments with regard to public debt.

**Pro-cyclical fiscal policy** - the fiscal policy behavior does not fulfill its stabilizing role of economic cycle but rather contribute to amplify 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 expenditure not recorded into the budget; particularly, it refers to the losses of state owned enterprises which translate in the defaults of their financial obligations to the public budgets and public utilities.

**Real convergence** - in the process of adhesion to a single currency area, it is necessary to achieve also a real convergence, respectively 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** - represent 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 1st, 2011, the NBR’s reference interest rate is the monetary policy interest rate, established by decision by the NBR’s Board of Directors.

**Restrictive monetary policy** - the monetary policy behavior constrains the aggregate demand in order to reduce inflation.

**Royalty** - payment to the holder of a patent or 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 increasing taxes or reducing expenditure (as a percentage of GDP) required subject to a debt level of 60% of GDP at the end of the period.

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

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

Stability and Growth Pact - The 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 on the Stability and Growth Pact adopted at the Amsterdam summit on 17 June 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 - A decision of the IMF by which a member is assured that it 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.

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

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.

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

Swap – chain compensation scheme for outstanding obligations to BGC; operation through which the extinction of outstanding budgetary obligations, with equivalent impact on revenues and expenses.

Taxation efficiency index – index through which it is measured the effectiveness of tax collection. It is computed as the ratio of 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.
**The contingency reserve fund** – amount of money available to the Government, which is allocated to main authorising officers from state government and local governments, based on Government’s decisions to finance urgent or unforeseen expenditures incurred during the year.

**The implicit tax rate** – the ratio between the actually collected revenue for a specific type of tax and the corresponding macroeconomic tax base

**Trade balance** - section of the balance of trade which presents the difference between exports and imports of goods and services recorded in a specified 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.